



House of Commons  
Environmental Audit  
Committee

---

# Water: The Periodic Review 2004 and the Environmental Programme

---

**Fourth Report of Session 2003–04**

*Report, together with formal minutes, oral and  
written evidence*

*Ordered by The House of Commons  
to be printed Wednesday 28 April 2004*

**HC 416**

Published on Thursday 6 May 2004  
by authority of the House of Commons  
London: The Stationery Office Limited  
£20.00

## The Environmental Audit Committee

The Environmental Audit Committee is appointed by the House of Commons to consider to what extent the policies and programmes of government departments and non-departmental public bodies contribute to environmental protection and sustainable development; to audit their performance against such targets as may be set for them by Her Majesty's Ministers; and to report thereon to the House.

### Current membership

Mr Peter Ainsworth MP (*Conservative, East Surrey*) (Chairman)  
Mr Gregory Barker MP (*Conservative, Bexhill and Battle*)  
Mr Harold Best MP (*Labour, Leeds North West*)  
Mr Colin Challen MP (*Labour, Morley and Rothwell*)  
Mr David Chaytor MP (*Labour, Bury North*)  
Mrs Helen Clark MP (*Labour, Peterborough*)  
Sue Doughty MP (*Liberal Democrat, Guildford*)  
Mr Paul Flynn MP (*Labour, Newport West*)  
Mr Mark Francois MP (*Conservative, Rayleigh*)  
Mr John Horam MP (*Conservative, Orpington*)  
Mr Jon Owen Jones MP (*Labour, Cardiff Central*)  
Mr Elliot Morley MP (*Labour, Scunthorpe*)  
Mr Malcolm Savidge MP (*Labour, Aberdeen North*)  
Mr Simon Thomas MP (*Plaid Cymru, Ceredigion*)  
Joan Walley MP (*Labour, Stoke-on-Trent North*)  
David Wright MP (*Labour, Telford*)

### Powers

The constitution and powers are set out in House of Commons Standing Orders, principally Standing Order No. 152A. These are available on the Internet via [www.parliament.uk](http://www.parliament.uk).

### Publication

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at: [www.parliament.uk/parliamentary\\_committees/environmental\\_audit\\_committee.cfm](http://www.parliament.uk/parliamentary_committees/environmental_audit_committee.cfm).

A list of Reports of the Committee in the present Parliament is at the back of this volume.

### Committee staff

The current staff of the Committee are: Mike Hennessy (Clerk); Eric Lewis (Committee Specialist); Elena Ares (Committee Specialist); Anna O'Rourke (Committee Assistant); Caroline McElwee (Secretary); and Robert Long (Senior Office Clerk).

### Contacts

All correspondence should be addressed to The Clerk, Environmental Audit Committee, Committee Office, 7 Millbank, London SW1P 3JA. The telephone number for general inquiries is: 020 7219 6150; the Committee's e-mail address is: [eacom@parliament.uk](mailto:eacom@parliament.uk)

### References

In the footnotes of this Report, references to oral evidence are indicated by 'Q' followed by the question number. References to written evidence are indicated by page number as in 'Ev12'.

# Contents

---

<b>Report</b>	<i>Page</i>
<b>Conclusions and recommendations</b>	<b>1</b>
<b>Introduction</b>	<b>5</b>
Changes since PR99	6
<b>PR04: The Environmental Programme</b>	<b>7</b>
The Current Programme	8
Ministerial Guidance	9
Timing of investigations	13
Customer Awareness	13
<b>The Review Process</b>	<b>14</b>
Role of the Regulator	14
Sustainable Development and Environmental Roles	14
Review Structure and Timing	16
Timing of the Reviews	16
Customer Survey	17
Use of National Averages	17
<b>Affordability</b>	<b>18</b>
Affordability and Debt	19
<b>Diffuse Pollution</b>	<b>20</b>
Water Framework Directive	21
<b>Looking Forward</b>	<b>22</b>
<b>Past reports from the Environmental Audit Committee since 1997</b>	<b>26</b>



## Conclusions and recommendations

---

1. We welcome the improvements to the Review process following our predecessor Committee's report, in particular the joint customer survey, the improved cost-benefit analysis of the environmental programme and the new sustainable development duty of the Regulator. However there has been little progress in other areas, in particular that of diffuse pollution, for which the Government has yet to put any significant measures in place. (Paragraph 9)
2. We accept that there may be difficulties with estimating the costs and benefits of the proposed environmental programme. However we are not clear as to why the concerns expressed by the Regulator and water companies were not raised earlier in the process when they might have had greater effect. We are driven to conclude that timing of their raising these concerns was related to their wish to influence the debate on the size of the programme. (Paragraph 15)
3. Future reviews would benefit from a formal timetable for carrying out the cost-benefit analysis which should include clear opportunities for those involved in developing the methodology to raise any concerns they may have. Greater sharing of information between the Agency, who have expertise in determining benefits, and water companies, who have the expertise in determining costs of projects, would be beneficial. This would help prevent the unsatisfactory situation where the estimated cost of implementing the environmental programme in preferred plans differed by £1 billion between the Agency and water companies. (Paragraph 16)
4. We are satisfied that the Environment Agency has only put forward proposals which require water companies to address areas where they are having a significant environmental impact. (Paragraph 19)
5. We are concerned that proposals put forward by Ofwat to curtail the environmental programme did not rest upon those principals of sustainable development which the Regulator insists that he upholds. (Paragraph 21)
6. We seek assurance that the Regulator will examine all the costings put forward by water companies to ensure that the environmental programme is carried out for maximum benefit at minimum cost. We are seriously concerned that the first option examined by Ofwat for cutting back on environmental spending was the reduction of schemes rather than a rigorous examination of the water companies' estimated costs. (Paragraph 22)
7. We note that the water quality and environmental programmes are the only part of the Review over which the Government had any direct control and we are troubled that the guidance has become the focus of departmental wrangling, simply because it is the only way the Government can exert any direct influence over water prices. (Paragraph 23)
8. We are concerned that some Government Departments and Ofwat may still see environmental spending as the first option for cutting costs for water companies and

that other parts of the capital expenditure programme may not be subject to equal scrutiny. (Paragraph 25)

9. It is important that when the final guidance is issued in September 2004 we do not see the environmental programme again under renewed threat. We seek reassurance from Ministers in their response to this report that this will not be the case. (Paragraph 26)
10. We are concerned that the delay regarding publication of the ministerial guidance together with the extensive debate between Departments will have added to the concerns the finance sector have when investing in the water industry, particularly at a time when there is a reduced level of equity finance available to water companies. (Paragraph 29)
11. We would like DEFRA and Ofwat to ensure that in future any investigations included in the environmental programme for the current and future reviews are set out clearly and a definite timetable established for them to be completed. This will ensure that the results can be fed into the next review period. We would expect DEFRA, in their response to this report, to set out how this will be achieved. (Paragraph 30)
12. We are not convinced that enough is being done by all water companies to make customers directly aware of the benefits of the environmental programme to them. We would urge Ofwat and Water Companies to do more, particularly by direct communication with customers, including sending out information on the environmental programme with their water bills. (Paragraph 31)
13. We are very disappointed that the opportunity for placing sustainable development at the heart of the Authority's duties, through the Water Act 2003, was missed. We are also concerned that the duty of the new Authority to consider sustainable development will always be in danger of losing out to the Authority's primary economic duties, despite the Regulator's assurance that this will not be the case. (Paragraph 35)
14. In the light of recent events, which have highlighted the conflicting duties of the Regulator, we believe it is vital that the new Authority should have a specific duty to report on how sustainable development is incorporated into its other regulatory duties. The Government should use its powers to require this. (Paragraph 36)
15. We do not believe it is the role of the Regulator to decide what should or should not be included in the environmental programme. (Paragraph 37)
16. We do not think that the current five year review period is appropriate. It should be extended to a six-year period, or a twelve-year period with a mid term review, so as to fall into step with the Water Framework Directive. Extending the review in this way would result in greater certainty for water companies, investors and customers. However this would be with the proviso that a satisfactory system for interim determinations can be developed, which would be particularly important in view of increasing understanding of the effects of climate change and how these will impact on water companies' activities in the future. (Paragraph 40)

17. It would be much more useful in our view, for the section of the customer survey dealing with reactions to the proposed price rises to be carried out using information from water companies' final business plans. These figures are likely to be much closer to those of the final determinations and therefore more closely reflect customers' actual reactions to likely price movements. We appreciate that time constraints may make this difficult, nevertheless we would like to see the feasibility of this option being explored. (Paragraph 42)
18. The emphasis of the Review and the Regulator's analysis should be on what the proposed new price limits will mean to customers in individual water company regions not on a national average price rise, which gives little indication to customers of the likely changes to their water bills. (Paragraph 44)
19. The Regulator, as part of his duty to protect customer's interests, must ensure that more substantive information, where it exists such as is the case with levels of customer debt, is made available to customers in an accessible manner which makes clear the costs incurred in their own water region. Where this information does not already exist, as in the case of diffuse pollution, more effort should be made to obtain it and make it publicly available. (Paragraph 46)
20. Water prices are going to continue to rise for the foreseeable future. As result there will be an increasingly large proportion of the population on lower incomes that will find it difficult to pay water bills. If the Regulator is to continue to price water realistically, as is his duty, the Government is going to have to address this issue seriously. We strongly support the EFRA's Committee recommendation that people suffering from serious difficulty in paying their bills should be helped through the benefits and tax credit system. (Paragraph 50)
21. It is unacceptable that paying customers subsidise bad debt by an average of £10 per year, an amount which is likely to increase as water prices rise unless the issue of affordability is addressed. This also results in less money being available for other areas, including the environmental programme. Water companies must improve the efficiency of their billing and debt management systems to ensure prompt payment by customers. (Paragraph 53)
22. We are very concerned at the slow progress by the Government in reaching a decision on how diffuse pollution from agriculture will be tackled. In view of this, we would expect DEFRA's response to this report to include details of the timetable for the implementation of measures to which they are working. (Paragraph 58)
23. We are concerned that once the requirements of the Water Framework Directive become clearer there may be a large amount of work needed within a limited amount of time that may not only have a very significant impact on customers' water bills in 2010, but also on the UK's ability to meet statutory obligations. (Paragraph 60)
24. Overall we were disappointed to find that despite the concerns expressed by Government, Ofwat and water companies about the unpalatability of increasing water prices more is not being done by all of them to reduce costs to customers, particularly those less able to pay. The issues of diffuse pollution, customer debt and

affordability need to be seriously addressed as they all add significantly to water customers' bills. Dealing with these will have a greater impact on the cost of water to customers than attempting to cut spending on the environmental programme, which would reduce the majority of water customers' bills by a few pounds at most. (Paragraph 62)

25. Overall we were disappointed to find that despite the concerns expressed by Government, Ofwat and water companies about the unpalatability of increasing water prices more is not being done by all of them to reduce costs to customers, particularly those less able to pay. The issues of diffuse pollution, customer debt and affordability need to be seriously addressed as they all add significantly to water customers' bills. Dealing with these will have a greater impact on the cost of water to customers than attempting to cut spending on the environmental programme, which would reduce the majority of water customers' bills by a few pounds at most. (Paragraph 62)

## Introduction

---

1. The Director of the Office of Water Services (Ofwat) or Regulator sets price limits on water companies every five years at the conclusion of a process known as the Periodic Review. The most recent Review (PR04) started in October 2002. Ofwat will be announcing price limits in November 2004, which will come into effect in April 2005.

2. The period from privatisation to the 1999 Periodic Review (PR99) saw a large increase in the profits for water companies due to unexpected efficiency gains within the industry, despite substantial spending on capital investment and environmental improvements. Water prices rose significantly in the same period. This changed with the 1999 Periodic Review. The then Director, Sir Ian Byatt, determined that efficiency gains within the industry would result in £60 per customer per year savings in the period 2000-05, £30 of which were to be passed onto customers as lower bills and £30 of which were to finance improvements in drinking water and environmental quality.

3. Following the conclusion of PR99 our predecessor Committee carried out an inquiry into the extent to which the process and outcome of the Review contributed to environmental protection and sustainable development, resulting in the publication of the report *Water Prices and the Environment*.<sup>1</sup> This Report concluded that “the 1999 Periodic Review provides a satisfactory outcome for the environment but there is no room for complacency as we face new, future quality obligations and uncertain water resource constraints”. The Report also made a series of recommendations as to how the Review process could be improved. In addition, more recently, the Environment, Food and Rural Affairs Committee published a report on the current Periodic Review (PR04) in December 2003.<sup>2</sup>

4. The present inquiry was launched as a follow-up to our predecessor Committee’s inquiry, on 5 February 2004. This was following the delay in the publication of the principal guidance, setting out the Secretary of State’s main decisions on environmental and drinking water quality policy requirements, which was due to be published by DEFRA at the end of January 2004 and in the light of reports that this delay was due to pressures on the Department to reduce spending on the environmental programme.<sup>3</sup> The Committee decided to examine what should be the extent of the environmental programme allowed for in Ofwat’s price limits; the adequacy of Environment Agency and DEFRA guidance given to date on the size and scope of the environmental programme; and the pressures and various options faced by Ofwat in the setting of price levels against the background of the environmental achievements delivered as a result of the 1999 Periodic Review.

5. In the course of the inquiry we received 19 memoranda, for which we are grateful. We also took evidence on three occasions. We heard evidence from Elliot Morley MP, Minister for Environment and Agri-Environment, Department for Environment, Food and Rural

---

1 Seventh Report of Session 1999-2000 HC 597.

2 EFRA Committee First Report of Session 2003-04 HC121.

3 Independent on Sunday, ‘Blair to cut water clean-up plan’, 25 January 2004, p2.

Affairs; from Ofwat; from the Environment Agency; and from other environmental bodies and representatives from the water companies.

## Changes since PR99

6. In *Water Prices and the Environment* our predecessor Committee made a number of recommendations on the how the review process might be improved, some of which have been taken up and implemented in the current Review. The Committee concluded that the large number of contradictory customer surveys were not constructive and recommended that in future a comprehensive and independent customer survey should be commissioned following agreement about its contents amongst all the parties involved in the process. This recommendation was implemented. From the evidence submitted to the Committee this appears to have greatly improved the Review process.

7. Our predecessor Committee also found there was a need for better cost-benefit analysis by the Environment Agency of the schemes put forward by them for inclusion in the environmental programme. We heard evidence from the Agency as to how the methodology used to carry out the cost-benefit analysis for schemes put forward for inclusion in PR04 was subject to extensive peer review and was agreed following consultation with DEFRA, Ofwat and the water companies. The rigorous analysis resulted in a halving in the number of proposed schemes put forward by the Agency compared to those originally considered.<sup>4</sup> We welcome this rigorous approach.

8. A further recommendation of our predecessor Committee was that “the Regulator should be directly accountable for ensuring that Ofwat makes a positive contribution to the Government’s sustainability agenda”. We therefore welcome the requirement under the Water Act 2003 that the new Authority, which will replace the Director in 2005, will have to exercise powers and perform duties in “a manner which they consider is best calculated to contribute to the achievement of sustainable development”. We also welcome the Regulator’s assertion that he is already taking into account sustainable development in carrying out his duties.<sup>5</sup> However we are concerned about the compatibility of this new duty with the other duties of the Regulator as they currently stand and will be examining the issue further in this report.

**9. We welcome the improvements to the Review process following our predecessor Committee’s report, in particular the joint customer survey, the improved cost-benefit analysis of the environmental programme and the new sustainable development duty of the Regulator. However there has been little progress in other areas, in particular that of diffuse pollution, for which the Government has yet to put any significant measures in place.**

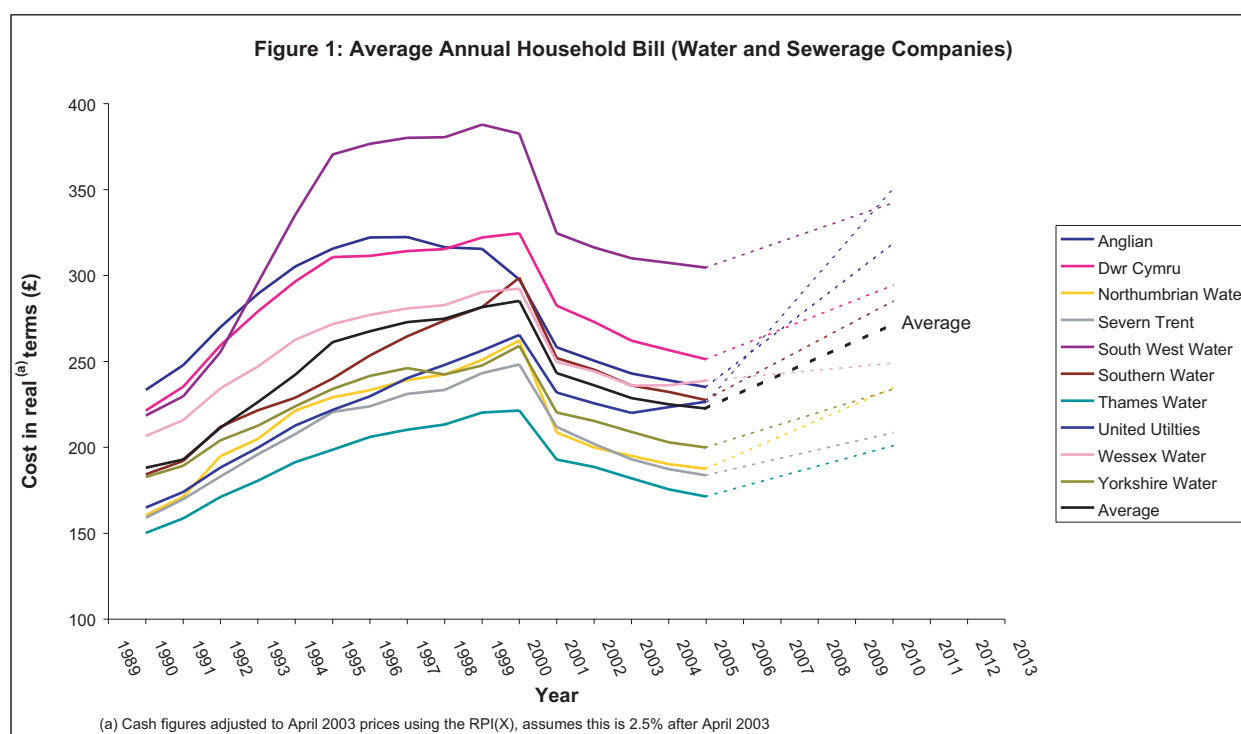
---

4 Q12.

5 Q141.

## PR04: The Environmental Programme

10. Previous reviews have included substantial environmental programmes. These were mainly focused on dealing with gross pollution from sewage works to ensure compliance with the Urban Waste Water Treatment and the Bathing Water Directives. The current programme has an increased focus on schemes that deal with water availability and abstraction, and smaller sources of pollution.<sup>6</sup> The environmental programme of PR99 resulted in £5.3 billion of investment on 7,000 projects. This was generally welcome and seen as a positive outcome of the Review. However this was achieved at the same time as a significant cut in customers bills of an average of £30 a year. As Baroness Young told us this "reduction really meant that the public were living on borrowed time [...] and that the price (of water) would have to go up in the next price round".<sup>7</sup> This is indeed the case. The Regulator stated in his evidence to us that in his opinion "we are going to see significant price rises for customers overall".<sup>8</sup> This is supported by the information contained in Figure 1, which shows average water and sewerage companies' household bills in real terms, from privatisation to date. The graph also shows the proposed price rises set out in the companies' preferred strategies.<sup>9</sup>



6 Q18.

7 Q3.

8 Q156.

9 House of Commons Library Research Paper 98/117 Water Industry Bill; Ofwat, Final Determinations; *Future water and sewerage charges 2000-05*, November 1999; Ofwat, Setting water and sewerage price limits for 2005-10; Overview of companies' draft business plans, October 2003.

## The Current Programme

11. Water companies published draft business plans setting out their preferred strategy in August 2003, which were costed together with two other plans, A and B, which were determined by the Regulator. Plan A included a defined package of quality and environmental improvements (mainly statutory obligations) together with a set reference level of cost assumptions. Plan B had a larger defined package of environmental improvements. A summary of the preferred strategies of all water companies, highlighting key issues, was published by Ofwat in October 2003.<sup>10</sup> These preferred strategies were in most cases fairly similar to plan A, though some companies allocated less funding to environmental spending in their preferred strategies than in plan A.

12. The environmental programme proposed by the Environment Agency and English Nature requires action at 4000 sites, with over two-thirds of the programme comprising statutory obligations that must be delivered by 2010.<sup>11</sup> The environmental programme in the companies' preferred strategies (some of which do not include all of the Agency's proposed actions or all statutory obligations) would cost £4.72 billion out of a total of £19.9 billion of proposed capital expenditure. Proposed spending on environmental improvements totalled £4.8 in plan A billion and £10 billion in plan B. These figures are all likely to change when the companies publish their final business plans in May 2004 and again when the Regulator publishes his determinations in August 2004.

13. The ten main environmental drivers behind the proposed actions in the programme were set out by the Environment Agency in their memorandum to us. The most significant of these were the Bathing Water Directive, Shellfish Directive and the need to deal with intermittent discharges.<sup>12</sup> These drivers were used to identify sites where there was a need for work to ensure that statutory and non-statutory obligations are met. The Agency then identified the sites where environmental damage is being caused by water companies and where remedial action would be possible. For actions proposed to comply with non-statutory targets, such as the UK Biodiversity Action Plan, a detailed cost-benefit analysis was carried out.

14. The methodology used for determining whether a scheme should be included in the environmental programme has been significantly developed since the previous Review. The benefits of all schemes, including those put forward to comply with statutory obligations, were assessed at a general level, including qualitative and quantitative benefits and monetary values where appropriate and possible.<sup>13</sup> For the small number of schemes, 438 in total, that were initially proposed and that did not fall under statutory drivers a cost-

---

10 Ofwat, Setting water and sewerage price limits for 2005-10: Overview of companies' draft business plans., October 2003.

11 Ev1, Environment Agency Memorandum Summary.

12 Ev4, Environment Agency Memorandum, Annex A Table A.

13 Q12.

benefit analysis was carried out on an individual basis which resulted in 270 ‘choices’ schemes being put forward by the Agency for inclusion in PR04.<sup>14</sup>

15. Calculating environmental costs and benefits is notoriously difficult. However the Environment Agency described their approach to us as “state of the art” and told us that, if anything, the economic benefits to the environment from the proposed work had been underestimated.<sup>15</sup> However, they told us that despite being involved in the development of the methodology Ofwat had begun to express concerns and would like to see it reviewed in future rounds.<sup>16</sup> In particular, the Regulator expressed concerns to us about whether it was valid to transfer information from one scheme to another as a way of estimating costs.<sup>17</sup> Doubts were also expressed to us by the water companies despite their direct involvement in developing the methodology used.<sup>18</sup> **We accept that there may be difficulties with estimating the costs and benefits of the proposed environmental programme. However we are not clear as to why the concerns expressed by the Regulator and water companies were not raised earlier in the process when they might have had greater effect. We are driven to conclude that timing of their raising these concerns was related to their wish to influence the debate on the size of the programme.**

16. **Future reviews would benefit from a formal timetable for carrying out the cost-benefit analysis which should include clear opportunities for those involved in developing the methodology to raise any concerns they may have. Greater sharing of information between the Agency, who have expertise in determining benefits, and water companies, who have the expertise in determining costs of projects, would be beneficial. This would help prevent the unsatisfactory situation where the estimated cost of implementing the environmental programme in preferred plans differed by £1 billion between the Agency and water companies.**<sup>19</sup>

## Ministerial Guidance

17. The role of Government is to set the policy framework within which the Review is carried out. It also has a major role in determining the requirements and interpretations set for companies by the Regulators. DEFRA set out the range of relevant policies and legal requirements that applied to the Review in initial guidance published in January 2003. In her statement the Secretary of State said:

“Many of these policies will arise from European or other statutory obligations, but there are still many policy choices to be made. In the light of further advice from the regulators in the second half of 2003 on the benefits of policies and their potential

---

14 Ev9, Environment Agency Memorandum, Annex C.

15 Q13.

16 Q14.

17 Q140.

18 Q79; Ev131 Appendix 12.

19 Q15.

impacts on customers' water bills, I will take decisions on what policies should proceed. I will then issue my principal guidance on this early in 2004."<sup>20</sup>

18. This guidance from Government set the parameters within which the water companies produced their draft business plans. It listed all the potential drivers, such as Directives, for environmental and water quality improvements, setting out which should be prioritised. The areas highlighted under each driver were categorised by DEFRA as: "essential and clear"; "essential when clear"; and "choices will be made".

19. While the guidance emphasised the need to meet all statutory obligations it also raised the question of whether the timing of this could be delayed:

"The Government will require the water industry to meet domestic and European statutory requirements. However, there is still room to explore how best and on what timetable to meet even those. Except where measures are specifically ruled out in the guidance, all potential improvements listed need to be further explored, and in particular their costs and benefits established, before decisions may be taken on whether, how and when they should proceed."<sup>21</sup>

This strong hint that there might be leniency in the need and timing for achieving some targets had, in our opinion, a significant influence in many of the water companies' decision not to include all statutory obligations in their draft business plans. According to English Nature only two water companies, Northumbrian Water and United Utilities, included all statutory obligations in their preferred strategies.<sup>22</sup> In their memorandum to Water UK said that "the industry's environmental duties are not an optional extra, they are a statutory requirement"; but when giving evidence put forward the argument that they were being asked to meet statutory obligations that would be better met by others,<sup>23</sup> such as farmers. We do not think that this argument is a valid one but it was given undue weight as a result of the phrasing of the Initial Government Guidance. **We are satisfied that the Environment Agency has only put forward proposals which require water companies to address areas where they are having a significant environmental impact.**

20. The Regulator wrote to the Secretary of State in December 2003 to give advice on the scale and timing of further water quality enhancements to be included in the environmental programme. It has become clear from the companies' draft business plans that there will be a need for significant price rises during the next five years, and the Regulator pointed out in the advice to Ministers that there would be hard choices to be made. The advice highlighted the possibility that there could be choices, as indicated by the Initial Guidance, in deciding "to what timetable even statutory requirements are to be met".<sup>24</sup>

---

20 DEFRA, Initial guidance from the Secretary of State to the Director-General of Water Services: 2004 Periodic Review of Water Price Limits, January 2003.

21 *ibid.*

22 Ev36, English Nature Supplementary Memorandum.

23 Ev45, Water UK Memorandum, para 35; Q89.

24 Ev70, Ofwat Memorandum, Annex .

21. Following the delay of the publication of the principal guidance, concerns were raised by various bodies including the Environment Agency and English Nature, that it was possible that the guidance when eventually published would not include all statutory objectives or many of the “choices” schemes put forward by them. They were also concerned about a constrained programme put forward by Ofwat, which according to the Agency would reduce the funding of the environment programme to a level significantly below that required for the minimum statutory environmental obligations that must be delivered between 2005-2010.<sup>25</sup> The indication given to us by the Regulator was a cut in the quality and environmental programme from £7 billion to £4 billion.<sup>26</sup> **We are concerned that proposals put forward by Ofwat to curtail the environmental programme did not rest upon those principals of sustainable development which the Regulator insists that he upholds.**

22. In its evidence to us the Agency highlighted the various ways in which they considered the costs for the environmental programme had been overstated by water companies. Their estimate was that the £4.9 billion environmental programme could be cut back by £1 billion without cutting back on any of the proposed schemes.<sup>27</sup> **We seek assurance that the Regulator will examine all the costings put forward by water companies to ensure that the environmental programme is carried out for maximum benefit at minimum cost. We are seriously concerned that the first option examined by Ofwat for cutting back on environmental spending was the reduction of schemes rather than a rigorous examination of the water companies’ estimated costs.**

23. The principal Guidance was due to be issued by the Secretary of State by the end of January 2004. The guidance was delayed until 11 March 2003, the date of the final evidence session of our enquiry, when Elliot Morley MP, Minister for Environment and Agri-Environment, gave evidence. Press reports at the end of January stated that there had been pressure from other departments on DEFRA, including Ofwat, the Treasury and No 10, regarding water pricing and the environment programme. In its memorandum to us, Water UK said “we believe that decisions on what is included in the guidance are made by Government collectively and not by DEFRA alone, so that the effectiveness of the debate between what are normally seen as key players is in reality constrained”.<sup>28</sup> The guidance issued by DEFRA is the only direct way that Government has of influencing water prices and the Regulator’s decisions. **We note that the water quality and environmental programmes are the only part of the Review over which the Government had any direct control and we are troubled that the guidance has become the focus of departmental wrangling, simply because it is the only way the Government can exert any direct influence over water prices.**

24. We welcome the fact that the principal guidance included, contrary to expectation, the majority of the elements within the programme put forward by the Environment Agency,

---

25 Ev4, Environment Agency Memorandum, para 25.

26 Q164.

27 Q15.

28 Ev45, Water UK Memorandum, para 41.

including the Agency's minimum package in full. The Minister emphasised to us the level of scrutiny and challenge to which the guidance was subject to prior to publication:

“there has been intense discussion within the Department, with the Department and the Treasury, in relation to, first of all, our responsibilities for the environmental programme and quality programme which relate to English Nature, the Environment Agency and the Drinking Water Inspectorate, which, of course, are all part of DEFRA. Is it justified, are there other ways it can be achieved, is the timescale realistic, is the pricing realistic?”<sup>29</sup>

25. The Minister also told us that the water quality and environment programme has been “put through the wringer”.<sup>30</sup> **We are concerned that some Government Departments and Ofwat may still see environmental spending as the first option for cutting costs for water companies and that other parts of the capital expenditure programme may not be subject to equal scrutiny.**

26. Given the above we are glad that the Minister was able to assure us that the debate over what should or should not be included in the programme, particularly with regard to meeting statutory obligations and nature conservation projects, has been completed and that future focus will be on how the schemes are costed.<sup>31</sup> **It is important that when the final guidance is issued in September 2004 we do not see the environmental programme again under renewed threat. We seek reassurance from Ministers in their response to this report that this will not be the case.**

### **Financeability**

27. The delay in publication of ministerial guidance not only affects the timetable for the periodic review, with the Regulator announcing the delay in submission of final business plans by water companies and the publications of the Ofwat's determinations, it also impacts on how the industry is perceived as a whole. There has been some debate as to the extent to which nature of the regulatory regime has resulted in the market value of the water industry being below its asset value and whether the depressed equity value of the industry has led to an increase in debt finance.<sup>32</sup> In addition there has been criticism that the cost of capital has been set too low in the past by the Regulator, which has again lead to an increase in debt financing.<sup>33</sup>

28. Water UK published its investor survey at the beginning of March 2004.<sup>34</sup> This found that investors believed that water is a relatively low risk sector compared to other areas of the market. However, of all the risks affecting the sector, political risk was regarded as by far the greatest, by 76% of all respondents. Market risk, which is the risk that the cost of

---

29 Q179.

30 Q184.

31 Q180.

32 Keith Palmer, *Financing the Water Industry* in Water, Sustainability and Regulation, Oxera, May 2003.

33 EFRA Committee First Report of Session 2003-04 HC121, Memorandum from Dr Dieter Helm.

34 Water UK investor Survey 2004, [http://admin.evolvingmedia.co.uk/users/files/0Full\\_Final\\_Survey.pdf](http://admin.evolvingmedia.co.uk/users/files/0Full_Final_Survey.pdf).

capital required by the market exceeds that allowed by the Regulator, was second, with 55% of respondents seeing this as a high or very high risk. This supports the view that, to increase the level of equity financing in the industry, either return on equity must be increased, by increasing the allowed cost of capital, or the regulatory regime must be changed to reduce the perceived risk. Concerns have been expressed that the flight from equity will result in a reduced ability of companies to raise capital. In addition debt financing is seen by some as resulting in a reduced incentive to invest and less focus on the long term.<sup>35</sup> A further risk from debt financing is the impact of rising interest rates, which would have a direct effect on the cost of water to customers.<sup>36</sup>

29. The Committee is very much aware that one of the concerns of financial institutions is the level of regulatory uncertainty in the water industry. **We are concerned that the delay regarding publication of the ministerial guidance together with the extensive debate between Departments will have added to the concerns the finance sector have when investing in the water industry, particularly at a time when there is a reduced level of equity finance available to water companies.**

### Timing of investigations

30. One of the issues highlighted during the course of the inquiry related to the timing of investigations included in previous environmental programmes.<sup>37</sup> These investigations are included in the environmental programme with the aim of determining whether further work by water companies to address a problem is required. Both English Nature and the Environment Agency have highlighted their concerns that many investigations that were due to be carried out in the 2000-05 period have not progressed far enough to inform the decisions of the 2004 Periodic Review.<sup>38</sup> This means that the results of some of the investigations cannot be used to implement schemes until 2010 at the earliest, a ten year delay from when the investigations were first agreed, which is clearly unsatisfactory. According to Water UK one of the reasons the problem exists is because effective arrangements for the timely completion of investigations have not been put in place by Ofwat.<sup>39</sup> **We would like DEFRA and Ofwat to ensure that in future any investigations included in the environmental programme for the current and future reviews are set out clearly and a definite timetable established for them to be completed. This will ensure that the results can be fed into the next review period. We would expect DEFRA, in their response to this report, to set out how this will be achieved.**

### Customer Awareness

31. The joint customer survey found that most customers were willing to pay for some environmental improvements, though few were happy to pay more than £5 per year

---

35 *ibid.*

36 Ev115, Memorandum from Dr Neil Summerton CB, Annex para 30.

37 Q58.

38 Ev22, Environment Agency Supplementary Memorandum; Ev36, English Nature Supplementary Memorandum.

39 Ev62, Water UK Supplementary Memorandum.

towards this.<sup>40</sup> The Committee is concerned that there is a lack of awareness amongst customers as to what the environment programme actually involves. We were pleased to hear from Water UK that some efforts are being made to ensure that customers are aware of the benefits to them of the water quality and environmental programme. Examples were given to us of how this is being done by working with wildlife organisations and funding programmes to increase environmental awareness.<sup>41</sup> Whilst this is positive we do not feel that it is enough. South West Water told us they contact customers directly to tell them of their work programme, which in the Committee's view is the most sensible and straightforward approach.<sup>42</sup> **We are not convinced that enough is being done by all water companies to make customers directly aware of the benefits of the environmental programme to them. We would urge Ofwat and Water Companies to do more, particularly by direct communication with customers, including sending out information on the environmental programme with their water bills.**

## The Review Process

---

### Role of the Regulator

32. The Director of Water Services has a range of duties. The primary statutory duties require the Regulator to ensure that water companies carry out their duties in accordance with the Water Industry Act 1991 and that companies are able to finance their functions and obtain a reasonable return on capital. The Regulator also has a secondary duty to protect customers' interests by ensuring that they are charged fairly and only pay for the costs they themselves impose on the water and sewerage systems.

### *Sustainable Development and Environmental Roles*

33. The Water Act 2003 resulted in extra duties being placed on the Regulator from April 2005, when the position of the Director will be replaced by a Water Services Regulation Authority, to consist of at least three members appointed by the Secretary of State. One of our predecessor Committee's recommendations was that the Regulator should be directly accountable for ensuring that Ofwat makes a positive contribution to the Government's sustainability agenda. We therefore welcome the requirement that the Authority will have to exercise powers and perform duties in "a manner which they consider is best calculated to contribute to the achievement of sustainable development". The Authority will also have a duty to have particular regard to the interests of vulnerable customers, including the disabled or chronically sick people, pensioners, those on low incomes and those residing in rural areas.

---

40 MVA, *Customer Research 2003: Periodic Review - National Report*, December 2003, <http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/pr04phase2>.

41 Q94; Q95.

42 Q95.

34. During the passage of the Water Act 2003 through Parliament there were amendments introduced that would have resulted in a requirement for the Authority's activities to be subject to an environmental audit for, among other things, contributions towards water conservation and sustainable development.<sup>43</sup> At the time, Elliot Morley MP, the Minister responsible, maintained that this was not necessary as the Authority would have a duty to include in its annual report a general survey of developments in matters falling within the scope of its functions. The Minister also rejected amendments that would have made the Authority's sustainability duty a primary rather than a secondary one.<sup>44</sup> We have concerns that the new duty of the Regulator, however welcome, may not be compatible as it stands with the Regulator's primary economic duties. The Regulator assured us that this was not the case and that he already seeks to take a balanced approach to his duties.<sup>45</sup> However the Minister did make it clear to us that it "is going to be a tough balancing act".<sup>46</sup>

**35. We are very disappointed that the opportunity for placing sustainable development at the heart of the Authority's duties, through the Water Act 2003, was missed. We are also concerned that the duty of the new Authority to consider sustainable development will always be in danger of losing out to the Authority's primary economic duties, despite the Regulator's assurance that this will not be the case.**

**36. In the light of recent events, which have highlighted the conflicting duties of the Regulator, we believe it is vital that the new Authority should have a specific duty to report on how sustainable development is incorporated into its other regulatory duties. The Government should use its powers to require this.**

37. The Economic Regulator's role has begun to impinge on the Environmental Regulator's role. This has been highlighted to us in memoranda received by the Committee and has become obvious to us over the last few months.<sup>47</sup> We are not convinced that the Ofwat has sufficient expertise in determining what should or should not be included in the environmental programme, yet in advice to ministers and evidence to us it would appear that this is part of what the Regulator now sees as his duties. It is our view that, with regard to the water quality and environmental improvement programmes, Ofwat's role should be limited to ensuring that what the Environment Agency has put forward is consistent with Government guidance and that water companies have costed the schemes correctly. **We do not believe it is the role of the Regulator to decide what should or should not be included in the environmental programme.**

---

43 HC Standing Committee D , 14 October 2003, c212.

44 ibid c213.

45 Q142.

46 Q188.

47 Ev109, Appendix 3, para 4.

## Review Structure and Timing

### *Timing of the Reviews*

38. Since the privatisation of the industry there have been three reviews of water prices, in 1989, 1994 and 1999, before that currently underway. The original intention was to carry out price reviews every ten years, after the Secretary of State set prices in 1989 and the Director reviewed prices in 1994. However Ofwat had decided by the 1994 Review that all the factors influencing prices and company performance made a five yearly review period more appropriate. The adequacy of this shorter review period is now being called into question. The Water Framework Directive which is one of the main future drivers for the industry will have a six yearly cycle, and there have been calls for the Periodic Review to fall into step with this.<sup>48</sup>

39. There is also a feeling amongst investors that a longer Review period would be beneficial. According to Water UK's Investors Survey the majority of investors would prefer a longer review period of between 7 and 10 years rather than the current 5 years.<sup>49</sup> Water UK made clear its view that it was never envisaged that there would be an ongoing need for high levels of environmental spending and as a result the Periodic Review is no longer fit for purpose.<sup>50</sup> This was not supported by the Environment Agency who took the view that if water customers are going to be paying for environmental improvements the costs of doing this should be included in the Periodic Review. However it recognised that, from an environmental point of view, a five year timescale often may not be long enough.<sup>51</sup>

40. We understand from the Government Response to the Environment Food and Rural Affairs Committee report that the Regulator is already committed to a further price Review in 2009, but that beyond that he plans to consult on the options for extending the Review period. **We do not think that the current five year review period is appropriate. It should be extended to a six-year period, or a twelve-year period with a mid term review, so as to fall into step with the Water Framework Directive. Extending the review in this way would result in greater certainty for water companies, investors and customers. However this would be with the proviso that a satisfactory system for interim determinations can be developed, which would be particularly important in view of increasing understanding of the effects of climate change and how these will impact on water companies' activities in the future.** This would ensure that regulators and water companies are able to respond to any unexpected changes, and that any new environmental improvements not included in the agreed programme can be insisted upon without need to wait for the next review.

---

48 EFRA Committee First Report of Session 2003-04 HC121.

49 Water UK investor Survey 2004, [http://admin.evolvingmedia.co.uk/users/files/0Full\\_Final\\_Survey.pdf](http://admin.evolvingmedia.co.uk/users/files/0Full_Final_Survey.pdf).

50 Ev44, Water UK Memorandum, para 32.

51 Q47.

## Customer Survey

41. During the last periodic review DETR, the Environment Agency, Water UK, the Drinking Water Inspectorate and Ofwat's National Consumer Council all carried out surveys independently. The confusion generated by the different surveys led to our predecessor Committee's recommendation that a joint customer survey should be carried out to better inform the review process. This has been done and all parties involved have expressed their satisfaction with the process. The survey was published in December 2003 and found that, for most companies, around two-thirds of customers wanted to see improvements in "managing the amount of water taken from the environment to supply customers and managing the effect of water company activities on the water quality of rivers, wetlands and coastal water".<sup>52</sup> However when it came to willingness or probable willingness to pay for the proposed plans (A, B or preferred) this fell to 60%, 53% and 60% respectively.

42. Whilst we welcome the joint customer survey and recognise the positive contribution the survey has made to the current review we are concerned that carrying out a survey of customer opinion of the *draft* business plans may not be the best use of resources. **It would be much more useful in our view, for the section of the customer survey dealing with reactions to the proposed price rises to be carried out using information from water companies' final business plans. These figures are likely to be much closer to those of the final determinations and therefore more closely reflect customers' actual reactions to likely price movements. We appreciate that time constraints may make this difficult, nevertheless we would like to see the feasibility of this option being explored.**

## Use of National Averages

43. Under the water companies' draft proposals the average household bill would increase from £234 in 2004-05 to £306 by 2009-10. The proposed final bill for 2009-10 varies between £239 for Thames Water to £407 for South West Water and £416 for United Utilities. The average proposed increase in bills as a result of the cost of environmental improvements in water companies' preferred plans was £26, but this varied from £3 for Thames Water to £90 for United Utilities. For all water-only companies, which do not carry out any sewage treatment, this was on average in the region of £1.

44. Given the large variation in the proposals put forward by water companies, the very different circumstances in which they operate, and the difference that already exists across the country in the level of bills to household customers it is questionable whether the production of a table of "average" proposed increases by water companies in England and Wales, as included in Ofwat's summary of companies' draft business plans, actually adds anything constructive to the debate, particularly when there are such enormous differences between the figures put forward by different companies.<sup>53</sup> These regional figures are

---

52 MVA, *Customer Research 2003: Periodic Review - National Report*, December 2003, <http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/pr04phase2>.

53 Ofwat, *Setting water and sewerage price limits for 2005-10: Overview of companies' draft business plans*, October 2003.

already produced by Ofwat and, given that there are only 10 water and sewerage companies and 12 water-only companies, the information is not unduly complex. **The emphasis of the Review and the Regulator’s analysis should be on what the proposed new price limits will mean to customers in individual water company regions not on a national average price rise, which gives little indication to customers of the likely changes to their water bills.**

45. There are several areas that have come to the attention of the Committee where very limited information is made generally available. For example, the yearly figures produced by Ofwat on the levels of customer debt includes general information in which companies are not specifically identified, so customers have no way of knowing how much debt they are subsidising in their area, even though these figures are made available to Ofwat by water companies. Another example is the cost of diffuse pollution to customers, which is given as £7 per customer per year by Ofwat, however other than this there appears to be little information available on how this varies from one region to another and the costs to customers in individual regions.

46. This use of average figures for reporting on many water companies’ activities is unhelpful when trying to determine the regional variations in impacts on customer’s bills. Whilst we understand the reason for this is often commercial confidentiality, or even a lack of basic information, it is our view that this conflicts directly with the right of customers to understand what they are paying for in their bills. **The Regulator, as part of his duty to protect customer’s interests, must ensure that more substantive information, where it exists such as is the case with levels of customer debt, is made available to customers in an accessible manner which makes clear the costs incurred in their own water region. Where this information does not already exist, as in the case of diffuse pollution, more effort should be made to obtain it and make it publicly available.**

## Affordability

---

47. The expectation of large increases in water prices over the next five years and beyond has brought the issue of affordability into the forefront of discussions over the current price review. It is an issue that has been raised by all those involved in the review process including the Regulator. In his letter to the Secretary of State in December 2003 the Regulator voiced his concerns that “bill increases will place real pressures on low-income customers”.<sup>54</sup> These concerns have also been raised by WaterVoice and the National Consumer Council in their memoranda to us. The EFRA Committee in its report on water pricing published last December concluded that “people suffering from serious difficulty in paying their bills should be helped through the benefits and tax credit system” and that the Government should review this issue.

---

54 Ev70, Ofwat Memorandum.

48. Increasing water prices has meant that water bills are becoming a significant proportion of expenditure for poorer households. In the South West Water region, which currently has the highest water and sewerage charges, average bills have more than doubled from £147 in 1989-90 to £342 in 2003-04 and according to WaterVoice are currently on a par with standard gas bills from British Gas and 50% more than standard domestic electricity bills.<sup>55</sup> The National Consumer Council highlighted in its memorandum to us that a pensioner receiving the Minimum Income Guarantee in the South West Water area will be paying 6% of their income in water bills and a single person on Jobseeker's Allowance would be paying 12% of their income.<sup>56</sup> Furthermore, the forecast increases in prices over the next five years will significantly affect those on lower incomes unless benefits are increased to take these into account.

49. We are concerned about the impact water bills have on water customers on lower incomes, and we are aware of the shadow that the issue of affordability has cast over spending proposals, in particular environmental spending. We were therefore glad to hear the Government's announcement, when it published its principal guidance, that it intends to review this issue:

“ I am concerned about the effects of water bills, especially on those least able to pay. I will be reviewing the way in which lower income households are helped with their water and sewerage charges”<sup>57</sup>

In evidence to us the Minister gave the impression that the aim was to look at best practice amongst water companies as to how they helped those less able to pay.<sup>58</sup> This does not go far enough. The review must look beyond company best practice and examine options for the Government directly to help those less able to pay, including by changes to the benefits system.

50. If those who use water are going to pay for the costs they impose on the environment, in accordance with the polluter pays principle, **water prices are going to continue to rise for the foreseeable future. As result there will be an increasingly large proportion of the population on lower incomes that will find it difficult to pay water bills. If the Regulator is to continue to price water realistically, as is his duty, the Government is going to have to address this issue seriously. We strongly support the EFRA's Committee recommendation that people suffering from serious difficulty in paying their bills should be helped through the benefits and tax credit system.**

### ***Affordability and Debt***

51. Ofwat's figures show that for 2002-03 customer debt stood at £781 million. In addition £93 million was written off during 2002-03. According to calculations submitted to us by

---

55 Ev127, WaterVoice Memorandum, para 34 (Appendix 10).

56 Ev114, National Consumer Council Memorandum., para 6 (Appendix 6).

57 Statement from the Secretary of State on the Principal Guidance to Ofwat, 11 march 2004, <http://www.defra.gov.uk/environment/water/industry/review/mar04.htm>.

58 Q 255.

Water UK the cost per customer of debt is currently just under £10 a year.<sup>59</sup> This is more than many companies are planning to spend on environmental improvements and equal to efficiency gains that are expected over the next five years: and it is a great deal more than the £2-3 per customer per year by which the Regulator was proposing to cut the environmental programme.<sup>60</sup>

52. Water companies and the Regulator claim that the main reasons for an increase in debts is the banning of disconnections of household customers. This claim is not supported by joint research commissioned by WaterVoice and Ofwat, which found that the ban on the disconnection of domestic water supplies does not influence payment of the water bill and that most customers are still convinced that they can be disconnected for non-payment of their bill.<sup>61</sup> The research also found that customers tend to pay whoever is more persistent in contacting them for payment and that customers and money advisors see frequent billing as a means by which to raise the profile of the water bill in the household budget. This would suggest that there are many ways in which water companies could improve their approach to dealing with customer debt. However this alone will not be enough unless measures are introduced by Government to help those less able to pay.

53. We are very concerned at the increasing level of debt to water companies, particularly as it is higher than the amount most water companies are planning to spend on environmental improvements over the next five years. **It is unacceptable that paying customers subsidise bad debt by an average of £10 per year, an amount which is likely to increase as water prices rise unless the issue of affordability is addressed. This also results in less money being available for other areas, including the environmental programme. Water companies must improve the efficiency of their billing and debt management systems to ensure prompt payment by customers.**

## Diffuse Pollution

---

54. The issue of diffuse pollution was raised several times during our inquiry. This is pollution arising from land-use activities (urban and rural) that do not discharge into water through a point source. This includes, for example, run-off from roads and agricultural land, both of which can be heavily polluted.

55. Diffuse pollution was an issue raised by our predecessor Committee in its report on the Periodic Review. It concluded that the Government was not tackling the problem with sufficient energy. It is therefore disheartening to find that despite the issue being much higher on the Government's agenda, mainly as a result of the Water Framework Directive (WFD), measures to deal with it have yet to be put in place.

---

59 Ev63, Water UK, Supplementary Memorandum.

60 Q26.

61 Paying for Water: Customer Research, Accent Marketing and Research, September 2003.

56. The Government has recognised that the existing controls on diffuse pollution are not comprehensive in their scope and so are inadequate on their own to discharge its obligations under the Water Framework Directive. As a result it announced in its third consultation on the WFD, published in October 2003, that it proposed to create new powers to control sources of diffuse pollution, to ensure that the necessary powers are available to implement the Directive and that it would consult separately on the details.<sup>62</sup> The Government also announced in 2003 that it would publish a draft action plan for consultation in early 2004 that would set out options to tackle agricultural diffuse pollution, which is one of the main concerns, including a consideration of the pros and cons of using economic instruments. The Minister told us this document was expected in April 2004.<sup>63</sup>

57. According to Ofwat figures dealing with diffuse water pollution currently costs water companies £7 per customer per year, a figure which Water UK says will rise as a result of tighter drinking water standards. According to them “one medium sized company has estimated that the costs for dealing with nitrates and pesticides during AMP4 will be £16.50 per customer”.<sup>64</sup> This is again a significant amount that will have as much of an impact on many water customers’ bills as the environmental or water quality programmes put forward in the current Review. We accept that water companies are understandably unhappy that they are being made to pay for dealing with pollution they do not cause when treating water for drinking purposes and the fact that no parallel measures have yet been put in place to address diffuse pollution, which is the cause of these increased costs. However this is in no way related, as Water UK and water companies tried to argue, to the requirement for water companies to meet their own statutory obligations. Other sectors, particularly agriculture, may now be more significant polluters of watercourses, but this does not exempt water companies from meeting their own obligations.

58. The Government has published various reports and strategies since June 2002 but has yet to come to any decision about what measures are to be used to deal with agricultural pollution. **We are very concerned at the slow progress by the Government in reaching a decision on how diffuse pollution from agriculture will be tackled. In view of this, we would expect DEFRA’s response to this report to include details of the timetable for the implementation of measures to which they are working.**

## Water Framework Directive

59. The Environmental Industries Commission have indicated that it is likely, once the definition of “good” status for water bodies is agreed upon within the Water Framework Directive, that a significant proportion of water courses will have to be improved by 2015 to meet EU obligations. The Government and Ofwat have expressed the view that measures cannot be put in place until it becomes clearer what the requirements of the Directive are. The Government in particular does not believe that any measures need to be

62 DEFRA, Third consultation paper on the implementation of the EC Water Framework Directive (2000/60/EC), August 2003.

63 Q197.

64 Ev65, Water UK Supplementary Memorandum.

put in place until 2012, which would only allow 3 years to achieve compliance. The Regulator did acknowledge to us that the Directive could have an impact on the price limits to be set in 2009 for the period 2010-15.<sup>65</sup>

60. We are glad that the Minister agreed with us that a gradual increase in water bills would be more desirable than a sudden larger rise at the beginning of the next Review period in order to meet the requirements of the WFD.<sup>66</sup> We do acknowledge that there are still a number of unknowns in relation to its implementation. However, **we are concerned that once the requirements of the Water Framework Directive become clearer there may be a large amount of work needed within a limited amount of time that may not only have a very significant impact on customers' water bills in 2010, but also on the UK's ability to meet statutory obligations.**

## Looking Forward

---

61. The review process has improved greatly since the last Periodic Review. We were particularly happy to see the degree of transparency and communication between all the different bodies involved. However we do feel that there may be further opportunities for information and expertise to be shared, particularly in the area of cost-benefit analysis of the environmental programme, given the expertise within water companies regarding the costing of projects. The Agency has done some good work in this area but given the critical comments from Ofwat and water companies we think more could be done by water companies to ensure greater information is available to the Agency to assist them with their work. We do understand that there may be commercial confidentiality issues involved which might restrict the options available, but it is an area that should be explored.

62. Through the course of this enquiry it has become clear to us that there are several areas affecting water prices that will need to be addressed in the very near future. For example, the information provided to us by the Industry and Ofwat shows that the "average" customer currently pays around £17 a year towards dealing with customer debt and diffuse pollution. Both of these issues are likely to result in considerable increases in costs to customers over the next five years if not properly addressed. **Overall we were disappointed to find that despite the concerns expressed by Government, Ofwat and water companies about the unpalatability of increasing water prices more is not being done by all of them to reduce costs to customers, particularly those less able to pay. The issues of diffuse pollution, customer debt and affordability need to be seriously addressed as they all add significantly to water customers' bills. Dealing with these will have a greater impact on the cost of water to customers than attempting to cut spending on the environmental programme, which would reduce the majority of water customers' bills by a few pounds at most.**

---

65 Ev86, Ofwat, Supplementary Memorandum, para 12.

66 Q224.

# Formal minutes

---

**Wednesday 28 April 2004**

Members present:

Mr Peter Ainsworth, in the Chair

Mr Gregory Barker  
Mr Colin Challen  
Mr David Chaytor  
Sue Doughty  
Mr Mark Francois

Mr Simon Thomas  
Joan Walley  
Mr David Wright

The Committee deliberated.

Draft Report (Water: the Periodic Review 2004 and the Environmental Programme), proposed by the Chairman, brought up and read.

*Ordered*, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 62 read and agreed to.

*Resolved*, That the Report be the Fourth Report of the Committee to the House.

*Ordered*, That the Chairman do make the Report to the House.

Several papers were ordered to be appended to the Minutes of Evidence.

*Ordered*, That the provisions of Standing Order No. 134 (Select Committees (reports)) be applied to the Report.

*Ordered*, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House.

[Adjourned till Wednesday 5 May at 3.00pm.]

## Witnesses

---

### Tuesday 2 March 2004

Page

**Baroness Young of Old Scone**, Chief Executive, and **Dr Andrew Skinner**, Acting Director, Environmental Protection, the Environment Agency Ev. 10

**Dr Alistair Burn**, Head of Water and Wetlands and **Sue Collins**, Director of Policy, English Nature; **Ruth Davis**, Head of Water Policy and **Mr Phil Burston**, Senior Water Policy Officer, Royal Society for the Protection of Birds Ev. 31

### Wednesday 3 March 2004

**Pamela Taylor**, Chief Executive, Water UK; **Mr Bob Baty**, Chief Executive, South West Water Ltd; and **Mr Ceri Jones**, Regulation Director, Northumbrian Water. Ev. 52

**Mr Philip Fletcher**, Director General, **Fiona Pethick**, Periodic Review Project Manager and **Mr Bill Emery**, Director of Costs and Performance Division and Chief Engineer, Ofwat Ev. 78

### Thursday 11 March 2004

**Mr Elliot Morley MP**, Minister of State for Environment and Agri-Environment, and **Mr Daniel Instone**, Head, Water Quality Division, Department for Environment, Food and Rural Affairs Ev. 89

---

## List of written evidence

---

Environment Agency	Ev. 1; Ev.21; Ev. 131
English Nature	Ev. 23; Ev. 36
Royal Society for the Protection of Birds	Ev. 27
Water UK	Ev. 41; Ev. 62
Northumbrian Water	Ev. 49
Ofwat	Ev. 65; Ev. 84.
Department for Environment, Food and Rural Affairs	Ev. 87; Ev. 99
Campaign Against Monopoly Abuse (CAMA)	Ev. 102
Chartered Institution of Water and Environmental Management (CIWEM)	Ev. 108
Dieter Helm	Ev. 109
Drinking Water Inspectorate	Ev. 110
Environmental Industries Commission	Ev. 112
National Consumer Council	Ev. 113
Neil Summerton	Ev. 115
Public Utilities Access Forum	Ev. 118
Sean Creighton	Ev. 120
Water Voice	Ev. 123
Yorkshire water	Ev. 128

# Past reports from the Environmental Audit Committee since 1997

---

## 2003-04 Session

First	Annual Report 2003, HC 214
Second	GM Foods – Evaluating the Farm Scale Trials, HC 90
Third	Pre-Budget Report 2003: Aviation follow-up, HC 233

## 2002-03 Session

First	Pesticides: The Voluntary Initiative, HC100 ( <i>Reply, HC 443</i> )
Second	Johannesburg and Back: The World Summit on Sustainable Development–Committee delegation report on proceedings, HC 169
Third	Annual Report, HC 262
Fourth	Pre-Budget 2002, HC 167 ( <i>Reply, HC 688</i> )
Fifth	Waste – An Audit, HC 99 ( <i>Reply, HC 1081</i> )
Sixth	Buying Time for Forests: Timber Trade and Public Procurement - The Government Response, HC 909
Seventh	Export Credits Guarantee Department and Sustainable Development, HC 689 ( <i>Reply, HC 1238</i> )
Eighth	Energy White Paper – Empowering Change?, HC 618
Ninth	Budget 2003 and Aviation, HC 672 ( <i>Reply, Cm 6063</i> )
Tenth	Learning the Sustainability Lesson, HC 472 ( <i>Reply, HC 1221</i> )
Eleventh	Sustainable Development Headline Indicators, HC 1080 ( <i>Reply, HC 320</i> )
Twelfth	World Summit for Sustainable Development – From rhetoric to reality, HC 98 ( <i>Reply, HC 232</i> )
Thirteenth	Greening Government 2003, HC 961

## 2001-02 Session

First	Departmental Responsibilities for Sustainable Development, HC 326 ( <i>Reply, Cm 5519</i> )
Second	Pre-Budget Report 2001: <i>A New Agenda?</i> , HC 363 ( <i>HC 1000</i> )
Third	UK Preparations for the World Summit on Sustainable Development, HC 616 ( <i>Reply, Cm 5558</i> )
Fourth	Measuring the Quality of Life: The Sustainable Development Headline Indicators, HC 824 ( <i>Reply, Cm 5650</i> )
Fifth	A Sustainable Energy Strategy? Renewables and the PIU Review, HC 582 ( <i>Reply, HC 471</i> )
Sixth	Buying Time for Forests: <i>Timber Trade and Public Procurement</i> , HC 792-I, ( <i>Reply, HC 909, Session 2002-03</i> )

## 2000-01 Session

First	Environmental Audit: <i>the first Parliament</i> , HC 67 ( <i>Reply, Cm 5098</i> )
Second	The Pre-Budget Report 2000: <i>fuelling the debate</i> , HC 71 ( <i>Reply HC 216, Session 2001-02</i> )

### 1999-2000 Session

First	EU Policy and the Environment: An Agenda for the Helsinki Summit, HC 44 ( <i>Reply, HC 68</i> )
Second	World Trade and Sustainable Development: An Agenda for the Seattle Summit, HC 45 (Including the Government response to the First Report 1998-99: Multilateral Agreement on Investment, HC 58) ( <i>Reply, HC 69</i> )
Third	Comprehensive Spending Review: Government response and follow-up, HC 233 ( <i>Reply, HC 70, Session 2000-01</i> )
Fourth	The Pre-Budget Report 1999: pesticides, aggregates and the Climate Change Levy, HC 76
Fifth	The Greening Government Initiative: first annual report from the Green Ministers Committee 1998/99, HC 341
Sixth	Budget 2000 and the Environment etc., HC 404
Seventh	Water Prices and the Environment, HC 597 ( <i>Reply, HC 290, Session 2000-01</i> )

### 1998-99 Session

First	The Multilateral Agreement on Investment, HC 58 ( <i>Reply, HC 45, Session 1999-2000</i> )
Second	Climate Change: Government response and follow-up, HC 88
Third	The Comprehensive Spending Review and Public Service Agreements, HC 92 ( <i>Reply, HC 233, Session 1999-2000</i> )
Fourth	The Pre-Budget Report 1998, HC 93
Fifth	GMOs and the Environment: Coordination of Government Policy, HC 384 ( <i>Reply Cm 4528</i> )
Sixth	The Greening Government Initiative 1999, HC 426
Seventh	Energy Efficiency, HC 159 ( <i>Reply, HC 571, Session 2000-01</i> )
Eighth	The Budget 1999: Environmental Implications, HC 326

### 1997-98 Session

First	The Pre-Budget Report, HC 547 ( <i>Reply, HC 985</i> )
Second	The Greening Government Initiative, HC 517 ( <i>Reply, HC 426, Session 1998-99</i> )
Third	The Pre-Budget Report: Government response and follow-up, HC 985
Fourth	Climate Change: UK Emission Reduction Targets and Audit Arrangements, HC 899 ( <i>Reply, HC 88, Session 1998-99</i> )

---



# Oral evidence

---

## Taken before the Environmental Audit Committee

on Tuesday 2 March 2004

Members present

Mr Peter Ainsworth, in the Chair

Mr Colin Challen

Mrs Helen Clark

Sue Doughty

Paul Flynn

Mr Malcolm Savidge

Joan Walley

David Wright

---

### Memorandum from the Environment Agency

#### SUMMARY

- Periodic reviews of the water industry have enabled England and Wales to meet EU and domestic legal obligations whilst the clean up of rivers and bathing waters has provided benefits for recreation, tourism, nature conservation, regeneration and has improved the ability of the industry to compete in international markets. But water companies need to do more to ensure they meet existing and new laws and standards and to ensure that it is a sustainable industry for future generations.
- For the present review we have recommended to Defra's Ministers an environment programme that will require action at 4,000 sites. Over two-thirds of the programme comprises statutory obligations that must be delivered by 2010. The rest contains improvements that have been justified by an analysis of costs and benefits, and which represent good value for money. In total the improvements will benefit 5,000 kilometres of river and over 2,200 square kilometres of wetlands, still waters and coastal waters. This is equivalent to a monetary benefit in the range of £3.5 to £7 billion.
- The water industry is not the only sector that impacts on the water environment. The Government has recognised the need to tackle diffuse pollution. Our programme covers action by the water industry to address only those environmental problems that it causes.
- The significant upward pressure on bills does not stem entirely or even mostly from environmental needs. If there were no environment programme, the preferred strategies of companies show that the average bill per household would still have to rise from £234 per annum in 2005 to £280 in 2010.
- Ofwat has proposed a constrained capital programme of £15 billion. We estimate that this option would allow less than two thirds of the cost of the environment programme in the last review. We are particularly concerned that this cut to the programme has been proposed before proper scrutiny of water companies' costs, and would result in a failure to deliver the minimum statutory obligations and loss of environmental benefits, and a high level of risk of infraction proceedings by the European Commission.
- The information placed in the public domain by Ofwat in December 2003 over-states the costs of the environment programme. It does not take account of the reductions to the environment programme that resulted from the Agency's assessment of costs and benefits and cost-effectiveness. Nor does it include challenge of the companies' estimates of costs arising from environmental schemes that are not required, or that go beyond the Agency's requirements, or where expensive solutions have been selected. We look to Ofwat to address these issues with companies.

#### INTRODUCTION

1. Limits on prices are determined in reviews by the Office of Water Services (Ofwat). In November 2004, Ofwat sets limits for the 2004 Periodic Review (PR04). It covers prices from 2005 to 2010.

2. Our role in the periodic reviews is to advise the Secretary of State on environmental aspects and the balance between water supplies and the demand for water. For nature conservation we do this in conjunction with English Nature.

3. Our proposal for the present review is described later in this memorandum. Once prices have been set, we monitor progress by the companies in delivering what has been agreed, issuing discharge consents and abstraction licences.

#### WHAT PREVIOUS REVIEWS HAVE ACHIEVED

4. Every day, water companies supply 15 billion litres of water. This is taken from rivers and underground. The used water from consumers after suitable treatment by water companies is discharged mostly into rivers or the sea. In providing these services, companies must protect the environment, promote the efficient use of water, and meet legal requirements.

5. Previous periodic reviews have delivered big improvements. They have reversed the environmental impact of under-investment. They have helped England and Wales to meet environmental obligations and they have provided significant social and economic benefits by improving recreation, tourism, nature conservation, and regeneration. They have improved the ability of the British water industry to compete in international markets.

6. The environment programme for the AMP2 period (1995 to 2000) delivered improvements like providing minimum levels of treatment to major sewage discharges and improvements to a proportion of the polluting intermittent discharges of storm sewage. This was done under the Directive on Urban Waste Water Treatment. There were improvements to meet the minimum standards of the Bathing Water Directive, and a small number of schemes for the Freshwater Fish Directive and to improve river water quality. There were 9 actions to deal with unsustainable abstractions.

7. The environment programme for the AMP3 period (2000 to 2005) will provide minimum standards of treatment to smaller sewage discharges, and improvements to a further proportion of polluting intermittent discharges of storm sewage. It also includes work to provide nutrient removal for some sewage discharges. The programme will improve compliance with the stricter 'Guideline' standards of the Bathing Waters Directive, improve river water quality, the microbiological quality of shellfish, and provide protection for some nature conservation sites. A programme of investigations and schemes for over 100 nature conservation sites affected by unsustainable abstractions was also included, which will lead to schemes to improve the ecology of some damaged sites and identify where further action is needed in the PR04 period.

8. Since 1990 there has been a substantial improvement in water quality in England and Wales, due in large part to improvements to water industry assets. By the end of 2005 continuous discharges of crude sewage from coastal discharges will have virtually ceased. Pollution of rivers and beaches by sewage debris has been reduced as a result of improvements to some 4,000 storm discharges so far. Between 1990 and 2003 compliance with minimum standards of the Bathing Waters Directive has risen since by over 20 percentage points to 99%. Seventy five per cent of bathing waters now meet the stricter guideline standards compared with only 25% in 1990, and 44% in 2000. River water quality has improved. In 2000, 94% of rivers were of good or fair chemical quality, compared with 87% in 1990.

9. But more needs doing to meet existing and new legislation and standards, and to ensure that the water industry is sustainable. A quarter of bathing waters fail to meet the guideline standards. Rivers have improved since 1990, but one in 19 are still "poor" or "bad". This is one in eight for urban rivers. Fifty four per cent of rivers have high levels of phosphorus.<sup>1</sup> Water companies are responsible for one in six of serious pollution incidents to water. One hundred and sixty protected freshwater and wetland sites (fens, bogs and grazing marsh) are at risk from licensed abstractions by water companies.

10. By the end of AMP3, some 1,800 intermittent (storm) discharges (around 10% of the total in England and Wales) will still be unsatisfactory, including those to the Thames Tideway. They will still be causing pollution by sewage debris. Companies are continuing to find more.

11. Sewer flooding is a further indication of inadequacies in the sewer network. While we welcome Ofwat's proposals to fund schemes to address problems of sewer flooding, we are concerned that without full drainage plans, water companies are treating the symptoms, rather than taking a holistic view to managing the sewer network. We have advised ministers of the importance of developing strategic drainage plans that will allow an integrated view of the sewer network, and its role in managing urban drainage.

12. The water industry is not the only sector to impact on the water environment and the Government has recognised the need to tackle diffuse pollution. The environment programme we propose for PR04 is the minimum needed by the water industry to deliver statutory obligations and some additional environment benefits that are good value for money. The programme will bring about benefits for future generations, and will contribute to a more sustainable water industry.

13. The Water Framework Directive expects waters to achieve "good status". Plans must be ready by 2009 and operational by 2012. This directive will influence future periodic reviews. So we need to continue to remedy the environmental deficiencies we know about now if we are to meet the requirements of this Directive. It is not sensible to wait for that period to begin to remedy environmental deficiencies that we know will need to be tackled if the requirements of the Framework Directive are to be met.

---

<sup>1</sup> Phosphorus is an essential nutrient for plants but in excess it leads to an imbalance. Eventually freshwater habitats can be dominated by algae, with loss of higher plants and their associated animals.

---

ENVIRONMENTAL PRIORITIES FOR THE 2004 PERIODIC REVIEW

14. The Agency, English Nature and Countryside Council for Wales have set out in advice to ministers<sup>2</sup> a programme that will require over 4,700 actions at around 4,000 sites from 2005 to 2010. The summary of the advice is included in Annex A. The drivers for improvements stem from European and domestic legal obligations, and Government policies. They are listed in Annex B to this memorandum.

15. Over two-thirds of the environment programme comprises “must do” statutory obligations. This part of the programme includes work required by the Habitats Directive and the Countryside and Rights of Way Act, the Freshwater Fish Directive, and the Directives for Urban Waste Water Treatment, Bathing Waters and Groundwater.

16. We also recommend schemes where there is more choice about what should be done, where these are justified by the assessment of costs and benefits. This part of the programme covers further work for Blue Flag beaches, the UK Biodiversity Action Plan, river quality, and some shellfish waters. It also includes precautionary work to investigate how endocrine disrupting substances can be removed from sewage effluent.

17. We have put forward a robust programme, supported by a cost benefit assessment. (Annex C). All actions have been assessed to help seek the most cost-effective option for companies to costs. Where the action is less clear we have recommended investigations. We have been rigorous in our assessment of what needs to be done and in doing so have cut our original proposals by some 30% although all of this is not yet reflected in Ofwat’s published costs.

18. The improvements we propose will benefit 5,000 kilometres of river and over 2,200 square kilometres of wetlands, still waters and coastal waters. This is equivalent to a monetary benefit in the range of £3.5 to £7 billion. These benefits include the value to current and future generations of improvements to recreation, fishing, and nature conservation. They include reductions in illness (for example, stomach upsets) from improvements to bathing waters. The biggest benefits are for reductions in the risks to ecosystems and natural habitats.

19. We estimate that the value of environmental damage from all discharges and abstractions is £1.2 to £1.9 billion per annum. The water industry is responsible for half. Our programme will halve the damage costs caused by water companies, and be a big step towards resolving issues under the Water Framework Directive.

20. Our benefits under-estimate the total because we have not included the monetary value of local economic development and regeneration associated with better water quality. The developments we have in mind are housing or commercial development in urban areas, once waterways are cleaner and more attractive.

## COSTS OF THE ENVIRONMENT PROGRAMME AND THE IMPACT BILLS

21. Water companies submitted their plans in August 2003. Ofwat published its overview of draft business plans in October<sup>3</sup> and their advice to ministers in December 2003.<sup>4</sup> We reviewed water companies draft business plans and provided advice to ministers in November 2003 (Annex A).

22. The companies’ preferred strategies show that even if there were no environment programme, overall bills would still need to rise substantially. With no environment programme, the average household bill would rise from £234 to £280 (£306 with the environment programme). Other pressures on bills include asset maintenance, operating costs, taxation changes, drinking water improvements and maintaining the financial attractiveness to investors.

23. In its advice to the Secretary of State (December 2003), Ofwat provide information on the costs of delivering environmental, drinking water and other related drivers, based on information in companies’ draft business plans.

24. Based on our own scrutiny of water companies’ draft business plans, the Agency believes that this information significantly over-states the costs of environmental improvements, and therefore its potential impact on bills. The reasons for this are as follows.

- Inclusion of schemes, which are no longer included in the environment programme as a result of completion of the Agency’s assessment of costs and benefits, or for which our additional scrutiny suggested a less costly solution than that costed by companies in their draft business plans;
- Inclusion of schemes put forward by companies, which are unnecessary or go significantly beyond the Agency’s requirements;

---

<sup>2</sup> Periodic Review of Water Industry Prices—2004. Environmental Priorities for the Water Industry An update of advice to ministers from the Environment Agency, English Nature and the Countryside Council for Wales on priorities for England and Wales, November 2003.

<sup>3</sup> Setting water and sewerage price limits for 2005–10: Overview of companies’ draft business plans, Ofwat, October 2003.

<sup>4</sup> Advice to inform the Principal Guidance on Scale and Timing of Further Quality Enhancements. Open letter to The Secretary of State for Environment, Food and Rural Affairs. Ofwat, 19 December 2003.

- Costs proposed by companies to deliver improvement are significantly higher than the industry benchmark for such schemes;
- Possible double counting of costs for schemes funded at the last Periodic Review for delivery by 2005, but which will not now be delivered until 2005 to 2010.

25. In its advice to ministers, Ofwat proposes a constrained capital programme of £15 billion. We estimate that this option would allow less than two thirds of the money allowed for in the last review for the environment programme. We understand that this proposal would reduce funding of the environment programme to a level significantly below that required for the minimum statutory environmental obligations that must be delivered between 2005 and 2010. Such a programme would result in the following:

- Failure to meet minimum obligations of the Freshwater Fish and Habitats Directives, with associated risk of further damage to internationally important wildlife sites, and fisheries;
- Failure to meet the requirement to provide adequate sewerage systems under the Directive on Urban Waste Water Treatment, with continued pollution of rivers by sewage debris until 2020;
- Compromised delivery of the Government's target (Public Service Agreement) for bringing into good conservation status Sites of Special Scientific Interest, with associated damage to nationally important wildlife sites;
- Some 20 Bathing Waters would not meet water quality standards necessary for Blue Flags.

#### REGIONAL VARIATIONS

26. There are significant differences between companies in the extent that the environment programme impacts on bills. The reasons for this include differences in the current level of bills, the size of the environment programme, and financial structures of the companies. Information published by Ofwat<sup>5</sup> on how bills might have to change by 2009–10 to deliver environmental improvements shows that for 8 of the 10 water and sewerage companies, the increase will be modest over the five-year period. For two companies, United Utilities and Southern Water, the level of increase is much higher. However, while these companies have larger environment programmes, the Agency has significant concerns about the costs put forward by companies to deliver these improvements.

27. In this price review, some companies with small capital programmes are proposing large price rises for 2005 to 2010. Although South West Water has a modest environment programme (it would add £4 to bills in 5 years for the company preferred strategy), it says prices for its customers need to rise by £73 by 2010 (company preferred strategy). This is due to a range of other pressures on bills. It is important these other pressures on bills are given the same level of scrutiny as the environment programme has received.

#### BEYOND THE 2004 PERIODIC REVIEW

28. At the last review, investment continued, but with a cut in prices. We believe this sent the wrong signal about the need for long-term investment by the water industry. Issues like the Water Framework Directive, climate change and the provision of resources for new development like the Thames Gateway means there is a need for continued investment. Delaying environmental improvements in this price review might offer a small saving on bills in the short-term. But these improvements will have to be delivered in the next review to meet Water Framework Directive requirements. Such delays, taken together with the additional requirements of the Water Framework Directive could mean much greater pressure on bills in the long-term.

*February 2004*

**Annex A**

### SUMMARY OF THE JOINT ADVICE OF THE ENVIRONMENT AGENCY, ENGLISH NATURE AND COUNTRYSIDE COUNCIL FOR WALES TO MINISTERS. NOVEMBER 2003

#### PERIODIC REVIEW 2004

##### *Summary and Recommendations*

1. In November 2002, the Environment Agency, English Nature and the Countryside Council for Wales published advice to Ministers on the environmental priorities for the water industry. This was done as part of the role of these three organisations in the review by the Office of Water Services, of price limits for water companies for the period from 2005 to 2010.

---

<sup>5</sup> Setting water and sewerage price limits for 2005–10: Overview of companies' draft business plans, October 2003.

---

2. Ministers have since given initial guidance for the price review<sup>6,7</sup> and the Environment Agency, English Nature and the Countryside Council for Wales have published a document called *A Good Deal for Water*—a joint view of the priorities for the environment that require action by the water companies. This report is an expanded and technical version of *A Good Deal for Water*. It draws on the draft plans of the water companies. These plans were published by the companies at the end of August, but details were not available in time to be included in *A Good Deal for Water* due to the constraints of the timetable.

3. Bringing together thousands of potential actions for the price review requires good co-operation between government, the water industry, the regulators and the conservation agencies. It involves exchanging large amounts of information, agreeing the form of every scheme, assessing benefits, and setting up ways to check the programme delivers the required benefits for the environment whilst aiming for the lowest cost options. We have aimed to run our part in the periodic review with clarity, openness and rigour. This document is part of that process.

4. In this document we **provide advice to Ministers on the environment programme to inform their guidance on the price review. We advise a programme of action by water companies to deliver the requirements laid down in legislation for the European Union and England and Wales. We also ask Ministers to support our recommendations for additional improvements that are justified by the assessment of costs and benefits.**

5. **We strongly urge that government take steps to promote parallel action on diffuse pollution.** There is a need to reduce the pollution washed from land and seeping through soil and groundwater from agricultural and urban land into rivers, lakes, wetlands, estuaries and coastal waters. Such pollution is associated with how land is used for agriculture or as developed areas and roads.

6. As a result of the mismatch in timetables for PR04 with, for example, the review of consents under Habitats Regulations and investigations funded under the last review (AMP3), the delivery of environmental improvements in line with national and international requirements will depend on further funding being made available between price reviews. **We advise Ministers to recommend that a mechanism is in place for allowing schemes to progress that will be required by legislation, but where the requirements are not clear enough at present to define exactly what needs to be done. Such a mechanism will give companies confidence about securing funding between periodic reviews.** This mechanism will be important for a number of obligations, in particular to ensure the requirements of the Habitats Directive are met during this period, and not delayed beyond 2010.

7. The Environment Agency is the statutory body with a duty for water resources planning in England and Wales. Our aim for water resources is that there should be sufficient water to meet people's needs while providing proper protection for the water environment. We advise that in their draft water resources plans, water companies may have placed too much emphasis on developing new resources, rather than managing demand. **We ask Ministers to provide guidance that confirms the need to consider measures to reduce demand and not just increase supply, to meet the needs of the environment programme, and to take into account all the risks and uncertainties associated with different options.**

8. **We advise Ministers to ask Ofwat to challenge the costs put forward by companies for environmental improvements and to require companies to adopt a consistent format for presenting the pressures on prices of these improvements.** We are concerned about the lack of transparency, and comparability, of the information in draft business plans, and that some companies have overstated the costs of environmental improvements. In some cases companies have omitted from their draft business plans, environmental schemes which are required by legislation. Costs should be challenged and the impact of financing assumptions on the costs of the environment programme should be scrutinised before final choices are made on the scale of the environment programme.

9. As we said in 2002, the outcomes of previous reviews of water company prices have transformed water quality and the protection of the water environment in England and Wales, and reversed many of the environmental impacts of under-investment. For the present price review, called Periodic Review 2004, or PR04, there are new environmental obligations, and the continuing challenge of securing what we have all achieved so far.

---

<sup>6</sup> Initial guidance from the Secretary of State to the Director-General of Water Services. 2004 Periodic Review of Water Price Limits. Department for Environment, Food and Rural Affairs. January, 2003.

<sup>7</sup> Initial Guidance from the Welsh Assembly Government to the Director General of Water Services on the 2004 Periodic Review of Water Price Limits ("PR04"). March 2003.

*Our programme and its benefits*

10. The Environment Agency, English Nature and the Countryside Council for Wales have a duty to advise the Secretary of State for the Environment, Food and Rural Affairs in England, and the Welsh Assembly Government's Minister for Environment, Planning and Countryside, on the environmental priorities for PR04. Our five-year programme of water quality and water resources improvements includes 4,700 actions. The programme will benefit 5,000 kilometres of river and over 2,200 square kilometres of wetlands, still waters and coastal waters. Table A shows the numbers of schemes.

11. Table A shows the schemes we believe should be progressed now that the assessment of costs and benefits, and further assessment of our programme has been completed.

12. Over two-thirds of the environment programme comprises "must do" statutory obligations. This part of the programme includes work required by the Habitats Directive and the Countryside and Rights of Way Act, the Freshwater Fish Directive, and the Directives for Urban Waste Water Treatment, Bathing Waters and Groundwater.

13. There are also the schemes where there is more choice about what should be done and where we recommend action where justified by the assessment of costs and benefits. These are also in Table A. This part of the programme covers further work for Blue Flag beaches, the UK Biodiversity Action Plan, river quality, and some shellfish waters.

14. The draft business plans of the water companies show that the environment programme is one of several pressures on prices. It is not the biggest, and varies significantly by company.

15. **The Agency estimates the value of the benefits of the environment programme for the schemes for which we propose action, are in a range from £3.5 to £7 billion.** The benefits of the programme will be wide ranging, not only directly improving and conserving the environment, but also generating opportunities for better public health, business, recreation and tourism. (There are a number of factors that would increase the benefits beyond those we have calculated. For example, we have been unable to include the monetary value of local economic development and regeneration associated with improved water quality). Based on our analysis of the costs of the schemes in the last review, the Agency believes that the water companies will be able to deliver the programme, and maintain security of supply, at a cost that is less than these benefits.

16. We believe the proposed environment programme is what people want, and that it will contribute to a sustainable water environment by delivering environmental benefits that are cost effective and worthwhile.

17. The programme is designed to help ensure that:

- treatment works, pipelines and sewers perform well and so underpin the improvements to the environment made in the last 10 years;
- companies have sound plans to provide enough water, consistent with the needs of all water users and the environment;
- the environmental impact of abstractions and discharges is reduced;
- legal requirements are met; and,
- the actions proposed are good value for money and promote sustainable development.

**Table A**

IMPROVEMENTS FOR WATER RESOURCES

<i>Reason for action</i>	<i>Numbers of sites</i>
Habitats and Bird Directives	43
Sites of Special Scientific Interest (CROW Act)	14
Biodiversity Action Plan	31
Local	37
Total for water resources	125

Table A (continued)

## IMPROVEMENTS FOR WATER QUALITY

<i>Reason for action</i>	<i>Numbers of sites</i>
Urban Waste Water Treatment Directive	280
Sewage sludge treatment	0
IPPC Directive	—
Groundwater	276
Dangerous Substances	3
Chemicals	—
Intermittent discharges	1,863
Freshwater Fish Directive	107
River Quality Objectives	369
Bathing Waters	733
Shellfisheries	543
Habitats and Bird Directives	206
Sites of Special Scientific Interest (CROW Act)	117
Biodiversity Action Plan	14
Local schemes (not covered by above)	71
Water Framework Directive	20
Totals for water quality, say	4,600

18. The Water Framework Directive will update current legislation and provide the means for greater integration in the way that all the activities that affect the water environment and our use of water are dealt with—not just those associated with the water industry. It will help ensure that the uses of water are sustainable in the long term. It focuses on environmental objectives and the full range of actions by which these can be met.

19. **We advise that our programme forms a positive and appropriate preparation for the water industry for this Directive, and will contribute to the “programmes of measures” by which the Directive’s purposes are to be achieved.** The Agency estimates that the programme will increase by more than 2,400 kilometres, the length of river that meets the requirements of the Water Framework Directive.

20. We also set out the risks associated with uncertainties about action that may be necessary to comply with European laws, but where we do not yet know what form this action should take. Companies will face substantial costs between this price review and the next. Measures should be taken to give companies confidence about this funding. And we recommend approaches that avoid encouraging short-term solutions that may be wasteful in the longer term.

21. Completion of investigations is essential if the water resources part of the environment programme is to be delivered. Where work led by the Agency proceeds to a point where the likely effects of water company abstractions on the environment can be identified, water companies will be expected to undertake their own investigations. These investigations should establish the degree to which abstractions are having an impact, where this is not already known, and assess options the company can take to mitigate this.

22. We are concerned that some companies have taken the view that certain schemes will be subject to claims of over-riding public interest and excluded them from plans on this basis. **We ask Ministers to give guidance on the scope for water companies to delay or cancel some statutory schemes on the grounds of over-riding public interest.** We believe that such a decision could only be taken by Ministers following a clear assessment of the options, and that companies should carry out all the necessary work to allow such decisions to be taken.

## Annex B

## DEVELOPMENT OF THE ENVIRONMENT PROGRAMME

We examined the risk of breaches of statutory requirements and the risk of environmental impacts. We looked at causes, and at the options for tackling the issues. This resulted in environmental requirements for each scheme, for example, limits on discharge quality. Where we were uncertain about the measures, we proposed investigations.

All schemes have been assigned “drivers”.<sup>8</sup> These define the obligations the scheme would deliver. The requirements for each scheme have been identified according to national guidance developed by the Agency, with English Nature for nature conservation, and have been subject to rigorous quality assurance. The guidance has been provided to water companies and other regulators.

<sup>8</sup> Environmental Drivers for PR04, version 3, April 2003.

The drivers for environmental improvements are summarised below

#### Waste Water Treatment and Storm Discharges

The Directive on **Urban Waste Water Treatment** imposes minimum treatment requirements on sewage effluents. The level of treatment depends on the size of the discharge and on the type of water to which it is discharged. The outcome is better water quality, particularly for rivers and coastal waters thought to be at risk from eutrophication. It also covers improvements to intermittent (storm) discharges of sewage, so reducing sewage litter in rivers and on beaches. The deadline for Intermittent Discharges under the Directive on Urban Waste Water Treatment is 31 December 2005.

#### Wildlife and Habitats

The **Habitats and Birds Directives** safeguard sites and threatened species that are important at the European level. The sites, Special Protection Areas and Special Areas of Conservation, form a network known as Natura 2000. Sites designated under the Convention on Wetlands of International Importance, especially as Waterfowl Habitat (Ramsar sites), are afforded the same protection as sites designated under these Directives.

The Regulations for the Habitats and Birds Directives require the Agency to demonstrate that permissions do not adversely affect the site. If this cannot be demonstrated the permission must be amended or revoked. The United Kingdom has already used all the time available to implement these Directives. The timetable negotiated with the Commission is for completion of the review of permissions between 2006 and 2010. The Regulations require a precautionary approach in which proven risks are dealt with.

English Nature notifies Sites of Special Scientific Interest (SSSIs). These form the network of protected sites of national importance for conservation. Although water companies have always had a duty to conserve SSSIs, the **Countryside and Rights of Way Act 2000** puts additional duties on public bodies, including Ofwat, the Agency and water companies, to further the conservation and enhancement of SSSIs. The Government has set a target for 95% of SSSIs achieving favourable status by 2010.

The **Biodiversity Action Plan** is a commitment through the Government's signing of the Convention on Biological Diversity. The Government has stated that it will meet its duties to conserve biological diversity under the Countryside and Rights of Way Act through the England Biodiversity Strategy. This sets out work for the next five years.

#### Fish and Rivers

The Directive on Freshwater Fish protects and improves the quality of waters for fish. It covers 34,000 kilometres of river and 14,000 hectares of still waters covering more than 14,000 hectares. The recent designation of 14,000 km was the subject of a Regulatory Impact Assessment by Defra.

A total of 40,000 kilometres of river also have River Quality Objectives. These define the water quality needed to protect fish, the use of the river for recreation and to ensure water quality for abstractions for water supplies, industry and agriculture.

Although the Freshwater Fish Directive is due to be withdrawn in 2013, the standards will carry forward into the Water Framework Directive.

#### Directive on Bathing Waters

Sets water quality standards to protect public health and the environment.

#### Directive for Shellfish Waters

Lays down standards for waters designated as shellfisheries and so protects shellfish and improves the marine environment. The Shellfish Hygiene Directive, sets conditions for the production and marketing of shellfish intended for human consumption. The Government is considering further designations under the Shellfish Waters Directive.

#### Groundwater

The **Groundwater Regulations** control the entry of certain substances into underground water and so protects these waters and the water supplies and rivers that depend on them. There are also cases where the abstraction of underground water may have too much impact on water quality and companies may need to develop an alternative source for drinking water. There are also cases where companies act to control the spread of historic pollution caused by others.

### Sewage Sludge Regulations

In most cases the best option for sludge is recycling to agricultural land. This is regulated through the Sludge Regulations. Further sewage treatment could increase sludge volumes. Restrictions could be placed on sludge disposal on agricultural land as a consequence of the Nitrate Directive, the Landfill Directive and the Groundwater Regulations.

The Directive on **Integrated Pollution Prevention and Control** controls activities at sewage works receiving certain discharges from industry via sewers, or where sludge is incinerated. This is a statutory obligation with implementation by 2007. The agency has given guidance and companies will need to act.

### Chemicals

Schemes for the Directives on **Dangerous Substances** cover extra treatment needed to deal with diffuse inputs of pollution to sewers and so reduce the amounts of chemicals entering the water environment. The Agency has also presented research on the feminisation of fish by chemicals in effluent. We recommend a programme with the water industry to establish the basis for any future changes needed in sewage treatment.

### Local Actions

This covers improvements that are not required under other headings, but have local support and will bring environmental improvements that will not be achieved in any other way.

### Water Framework Directive

Action taken through the work proposed by the Agency on PR04 will form a cost effective and adequate preparation for this Directive. This heading covers additional action, specific to the Directive, where this would be more efficient in the long run, for example stopping a discharge to groundwater that will be banned rather than spending money on treating it.

## Annex C

### ASSESSMENT OF BENEFITS

We made a systematic assessment of the benefits, in accordance with ministerial guidance. The aim was to:

- provide an assessment of the overall benefits of the environment programme so that customers and stakeholders can see what our proposals will deliver; and,
- inform decisions by ministers for schemes where there are choices about what should be done.

The assessment of benefits is based on a review of the available studies and inputs from the leading experts. The underlying methodology has been peer reviewed by academics, and agreed by Defra, Welsh Assembly Government and Ofwat.

Our estimates of benefits include the value for current and future generations of improvements to recreation, fishing, ecosystems and natural habitats. They include reductions in illness (for example, stomach upsets) from improvements to bathing waters. The biggest benefits are for reductions in the risks to ecosystems and natural habitats.

Overall, we believe the benefits we calculated are an under-estimate. We have been unable to include the monetary value of some benefits for improvements to migratory fish in upstream stretches, reductions in local aesthetic impact from discharges in coastal waters, and economic development and regeneration associated with better water quality. For example, housing or commercial development in urban areas, once waterways are cleaner and more attractive.

### Overall assessment of benefits

We assessed the environmental benefits of the whole environment programme for each company. This includes qualitative and quantitative benefits and monetary values where appropriate and possible. We estimated the effects of each company's programme on the environment by calculating information like the length of river, the area of lakes and wetlands and numbers of bathing waters that would be improved. We then derived monetary valuations for these improvements from an in-depth review of the available studies. We reported the results of the overall benefits assessment in our joint advice to ministers.

We have also published on our web site reports on the scope of the programme, the environmental outcomes, and action required by other sectors for each operational Area of the Agency.<sup>9</sup>

<sup>9</sup> [http://www.environment-agency.gov.uk/business/444304/444643/425378/547592/?version=1&lang=\\_\\_e](http://www.environment-agency.gov.uk/business/444304/444643/425378/547592/?version=1&lang=__e)

### Benefits of “choices” schemes

The Agency has assessed the environmental benefits of schemes for which Ministers have choices about what should be done. For this, we have used a peer reviewed Benefits Assessment Guidance<sup>10</sup> that was approved by a steering group including representatives of Defra and Ofwat. This appraisal system is considered by the leading experts to make the best use of the available information on the valuation of benefits. It is based on a comprehensive review of the available studies, and extensive inputs from the leading experts. It has been reviewed by the leading economists and stakeholders in the PR04 process including WaterVoice and Water UK.

We provided training for staff carrying out the assessments and ran surgeries to resolve problems. We have quality assured the findings with respect to the technical assessment of the outcomes, and the need for the scheme and its cost-effectiveness. We also ensured consistent and careful application of the benefits valuations.

The results of the benefits assessments were combined with scheme costs (both capital and operating costs) from water companies’ draft business plans, and were shared with water companies. We also consulted our statutory advisory committees on the findings of our assessments of the schemes.

We then grouped the schemes<sup>11</sup> under “choices will be made” or “subject to policy decisions” according to the ratio of benefits to costs. We recommended schemes should proceed whose monetary benefits were more than 1.2 times the cost, or where the scheme was considered to be of significant local priority.

We recommended that schemes for which the benefits were less than 1.2 times the costs should be deferred beyond 2010, unless they were considered to be significant local priority.

We assessed the benefits of 438 individual schemes comprising action at some 800 assets where there is choice about what should be done. Of these we recommend that some 270 schemes should be implemented under PR04, which would yield a monetary benefit of over £1 billion. We recommend deferral of the remaining schemes, which would have cost more than £1 billion. The net result is that our proposals for “choices” schemes would deliver 80% of the possible total environmental benefits for these schemes for 38% of the cost.

<sup>10</sup> Benefits Assessment Guidance. [http://www.environment-agency.gov.uk/business/444304/444643/425378/425401/425411/507669/?lang=\\_\\_e](http://www.environment-agency.gov.uk/business/444304/444643/425378/425401/425411/507669/?lang=__e)

<sup>11</sup> For the purpose of this analysis a scheme is defined as one or more actions that together deliver the desired environmental outcome.

*Witnesses:* **Baroness Young of Old Scone**, a Member of the House of Lords, Chief Executive, and **Dr Andrew Skinner**, Acting Director, Environmental Protection, the Environment Agency, examined.

**Chairman:** Welcome and good afternoon. You are joining us at an interesting time. We are looking forward to what the Government has to say about the Periodic Review; it is a topic of considerable interest to the industry, to consumers and to environmentalists alike, and we are grateful to you for sharing your time with us to discuss it.

**Q1 Mrs Clark:** The reason we are here is obviously totally self-evident, particularly to anyone who has a postbag as an MP or listens to concerns in the constituencies; it is actually about the possible water price rises that people are expecting as a result of the Periodic Review that is going on at the moment. Obviously this is raising the debate on proposed spending on environmental improvements by the various water companies. Bearing in mind the principle that the “polluter pays”, and the fact obviously that water is becoming increasingly scarce, do you think we actually pay the true cost for our water in this country?

**Baroness Young of Old Scone:** I am pretty certain that we do not. The price round exercise is one of the most heavily pored over and scrutinised pricing exercises in the environment these days, and looking at the impact of water abstraction and discharge of sewage on the water environment and costing that,

as we have had to do as part of the justification of the Environment Programme which is done in a very rigorous way, it is clear that the price of water will need to increase. However, we should say that the totality of the increase in bills is far from being made up of the Environment Programme solely, but there are a number of drivers of the cost increase, of which the environment is only part. Things like taxation, the cost of pensions, the cost of maintaining the assets which have been installed and the costs of financing the companies are also big drivers on the total bill that comes to the consumer, so we are very anxious about the kind of focus that there is and the assault that there is on the costs as represented by the Environment Programme only. We believe that there needs to be a scrutiny across the totality of the costs that the companies are quoting in order to make sure that there is real value for money right across all of the increases that they are seeking.

**Q2 Mrs Clark:** Any comments from Dr Skinner?  
**Dr Skinner:** No, I agree.

**Q3 Chairman:** Is there really an assault going on on the environmental elements of this or is it simply that there is pressure being applied by government to the

---

2 March 2004 Baroness Young of Old Scone and Dr Andrew Skinner

---

totality of the pricing regime and that you and others who obviously are concerned about the environment are shouting the loudest?

**Baroness Young of Old Scone:** I think it is absolutely right that government scrutinises the reasons for the bill increases across the whole spectrum because there is no denying that there is a substantial increase in bills over the period. It is exacerbated by the fact that in the last price round we saw substantial reductions in bills, which we objected to at the time, and that, I think, gave people a sort of false sense of belief that the price of water could continue to go down and stay very low. We always made the point that that reduction really meant that the public were living on borrowed time, as it were, and that the price would have to go up in the next price round. I think it is appropriate for there to be scrutiny right across all of those drivers to the costs, not just the Environment Programme and I am not sure that total rigour has been applied right across the board as yet. There is a process throughout the price round when the costs of various capital programmes can be reduced and we know from experience of two previous price rounds that during the preparation of the water determination, we will see a reduction in costs of something like 25% in overall terms. We are not yet at the end of the programme, so we believe there is considerable scope, during the remainder of the period when the water regulator will be making decisions, for him to really bear down on those costs and produce a further reduction as happened in previous price rounds. Even with that reduction, we have seen that as the companies implement these schemes, they always manage to outperform and do them cheaper. That is part of the incentive for the companies during the period, to try and do a better job, but as a result, we feel there has been undue prominence given to driving down the costs of the Environment Programme or at least not driving down the costs, but reducing the size of the Environment Programme without sufficient attention to driving down the costs. We believe that you can get the same size of programme, but for a cheaper price.

**Q4 Mrs Clark:** We are going on to discuss the nuts and bolts of the Environment Programme, but before we do that I would be very interested in assessing your views as to how the different bodies involved in the process have got on, how they have co-operated and how they have communicated over the last two years. Has it been positive and have we had some improvements since the rather tricky period of the last Review?

**Baroness Young of Old Scone:** I think we have probably all done a better job of being collaborative than we have ever done before. There has certainly been very good joint work between various regulators in the early stages of the Review, particularly between English Nature, CCW and ourselves. We have also worked very closely with Defra, I think we have developed extremely good relationships with the water companies for the most part and we have even, I think, had a pretty productive relationship with WaterVoice. For

example, all of the market research has been truly joint between us. We have, I think, also had a much more productive relationship with the economic regulator, with Ofwat, until really the last stages of this process, and we have always recognised that with this size of price increase, there would be tense moments towards the end because inevitably we are heavily driven by the needs of European directives and by a basic requirement to see improvement in the water environment so that we can prepare the way for the Water Framework Directive. The economic regulator has as his primary objective the promotion of competition and a fair deal for customers, and in a difficult settlement like this, the inevitability is that we will not see eye to eye completely at the end of the process. That is why government is there; government is there to decide at a political level what the size of the Environment Programme is that the country wants to afford or needs to afford and that is why we are waiting anxiously for government guidance at the moment.

**Q5 Mrs Clark:** I think we are as well, but as we are actually here to talk about the Environment Programme, perhaps you could outline at this point briefly exactly what does come within this umbrella within the scope of the Periodic Review. You talk about actions, but what kind of work are you discussing?

**Dr Skinner:** The Environment Programme is developed in stages and we start from environmental need. That environmental need might be, and in fact in most cases is, defined by statutory drivers stemming from European directives, but the programme also takes into account our views about other things which can be beneficially done and be, in our judgment, good value over and above that and that makes the total programme. The nature of the actions, as we call them, is very varied. They can be, and in most cases are, capital investment in new and improved works to operate to new and higher standards, and that might be at sewage treatment works, it might be in the sewerage system which is linked to it, or it might be in respect of new or different or in different locations the abstractions so that the raw supply needs can be met with less environmental disbenefits.

**Q6 Mrs Clark:** So a huge scale?

**Dr Skinner:** A big scale, yes, and that is what we have done in previous rounds with the same process. A lot of the programme and also in fact the numbers come from quite a lot of smaller actions, some of which are investigations where, in doing our exercises and applying our environmental tests, we have not felt confident that we know the answer and we, therefore, do not feel confident that we can specify a detailed new driver and, therefore, we put into the programme for costing by the companies investigations or we provide the data to ensure that next time round there is better ability to do that. We did that in the last Periodic Review and some of the schemes in the current programme are a result of data which is obtained. There are also other investigations and the most important one, in my

---

2 March 2004 Baroness Young of Old Scone and Dr Andrew Skinner

---

judgment, is the investigation that we want to see commissioned to assess the scale and the economic treatment of the problem of endocrine disruption, the impact upon fisheries from effluent discharges, so it is a very wide range. We have 4,700 actions in the programme, but not all of those are big capital schemes, but they are also the investigations I have described.

**Q7 Mrs Clark:** I was going to come on to that and I was going to ask you about the price range. Are we talking just about the really, really expensive range that you are listing under your 4,700, or are you actually talking about something which could even be a couple of hundred pounds?

**Dr Skinner:** No, not that small, but we are talking about schemes—

**Q8 Mrs Clark:** What is the lowest level then and what is the highest level, just to give us an idea of the scale?

**Dr Skinner:** Well, you have to remember that we are still quite early in the process and the costs at that level I have not personally seen. We are talking about some schemes which will be hundreds of thousands of pounds at the lower level, sometimes perhaps a bit smaller than that, but not in the hundreds.

**Q9 Mr Savidge:** You have gone in for fairly thorough cost/benefit analysis and we understand you have adopted different standards of analysis for those things which are required by statutory obligation and those which one might regard as being non-statutory or matters of choice. How far do you feel it is desirable in fact to have fairly rigorous standards even when one is dealing with matters which are statutory?

**Dr Skinner:** I think the standards are rigorous throughout, but I will explain why I say that. We took the decision, which was, among other things, stimulated by the advice of this Committee previously, to do the planning work for the whole of this round with a substantial programme of analysis of benefits and we set out a programme from the outset, one which we agreed with the other players in the exercise, the other members of the so-called regulators' group, and one which we evaluated in terms of the methodology by peer-group analysis from experts in this field, so what we have done is, by a substantial margin, the biggest of this kind applied to the water environment. We have applied it, as you indicated in your question, at two levels. We have done analysis of the whole programme at a high level against the total benefits to the country to make sure that the whole programme is seen to be a good deal for water, as we said in our publication, but we have taken the distinction, and we did this in collaboration with all the parties, including government, that the issue in terms of the statutory obligation is about cost-effectiveness. We have something we have to do, but we want to make sure, with the help of Ofwat and others, that it is done in the most cost-effective way because the judgment is about doing the works to the standards necessary by

the statute at the least cost to the customer. The other parts of the programme, the so-called "choices to be made" in Defra parlance, is where we have put our main effort of cost/benefit analysis. We did that because we think it is the right distinction to make because those are the right tests we ought to apply. Also it is a sensible way of using one of our pretty specialist and scarce resources because we are posing questions to government which are beyond their minimum statutory needs and government told us, and we agreed, that they wanted to have the most rigorous answers possible, so we did it as a way of balancing the expectations of government, our perceptions of need and, as I say, all of it under scrutiny and discussion with expert advice on how to do this because it has not been done in this way and to this scale before.

**Baroness Young of Old Scone:** We also believe that the benefits in the cost/benefit equation are probably an underestimate because although we have looked at the benefits to things like improvements for fishing, recreation, ecosystems and wildlife habitats, reduction in illness and improvements to bathing water, we have not actually taken on what I think is quite a valid set of benefits in terms of the quality of local environment's attraction to inward investment. We have seen, for example, in some of the inner cities the benefits of cleaning up the rivers, resulting in economic benefits and social benefits for inner-city populations and inner-city regeneration and we have not taken those benefits into account, yet I do believe they are real.

**Q10 Chairman:** These are the benefits which are collectively grouped in the £3½–7 billion worth of economic benefits?

**Dr Skinner:** Yes.

**Q11 Chairman:** You have given yourself quite a wide margin there, have you not, and yet you are telling us that you have left some of them out?

**Dr Skinner:** That is right because the techniques are not available to come up with hard costs, so what we are saying is that we have a set of figures which are based upon standard economic evaluation procedures and there are other benefits which are not zero or negative, but which we do not have the ability to quantify above that.

**Q12 Mr Savidge:** Could you conceive of a situation where even with a statutory obligation you might find the cost to be so excessively expensive that you might raise questions about it?

**Dr Skinner:** The challenge there is to bear down on the technology and to meet the obligations in the most cost-effective way and that is not a new challenge; it is something we have done in the Agency and its predecessors for all these rounds. When the Director General makes his decision and the companies get their financial allocations, there is then quite a detailed process which goes on between the Agency and the companies. They have got incentive of course with the way the system works, and we have no wish to support or encourage schemes which are other than the cheapest way of

---

2 March 2004 Baroness Young of Old Scone and Dr Andrew Skinner

---

doing the job, so there is quite a lot which goes on in terms of bearing down on costs and effectiveness after the key decision and that has happened in previous rounds and, as we have said, there is this record of the early numbers not being anything like the scale of final numbers for schemes commissioned and implemented in periodic reviews.

**Baroness Young of Old Scone:** I think it is also true to say that we have been pretty rigorous in chucking out schemes which did not stack up. We have been rigorous in taking schemes out of the programme which did not absolutely squarely address a real issue caused by a water company. Where the contribution to the Environment Programme was not a substantial one, where it was only a minor contribution to solving the problem, we have flung it out. Where it did not really look value for money, we have flung it out and often introduced an investigation or some further work rather than the scheme itself, so there is quite a lot of work being done by us. Andrew will be able to help me better with the figures, but my memory is that of the total number of schemes that we started with, we have reduced that by 50%, so we have gone down from 8,000 schemes to 4,000 schemes and we have reduced that in money terms so far by, we estimate, about a third. There were occasions during the work of this programme when I began to panic a bit and say to my team, "Are we being over-zealous in throwing things out which don't stack up?", and quite frankly I was worried that we might have gone too far.

**Q13 Mr Savidge:** Given the notorious difficulties of costing environmental benefits, how satisfied are you with the standards you have reached? You mentioned earlier of course that you have had a sort of collective effort with Defra and Ofwat and with peer-group analysis by academics, but how far do you feel that it has resulted in an optimum methodology or has it involved in some ways compromises in order to get everybody's agreement?

**Dr Skinner:** We think we are at the state of the art for this kind of activity. We recognise that the Water Framework Directive, which is going to require cost/benefit across multi-sectors, balancing impacts against water industry impacts, is a challenge for the future, so that is recognised and already work is starting, but for this exercise we believe we are at state of the art. We believe that the numbers are robust and we have also used them with considerable caution. Barbara mentioned that we have thrown schemes out and sometimes we have thrown schemes out which have had marginal qualitative benefit against cost, but we have set a threshold which is closer to two to one rather than one to one on the basis that it is not an exact science and we do want to be absolutely sure that what we are recommending to ministers is sound, so all the way through we have built these precautions in which is why I say that we are very confident in what we have said at the current level of knowledge and delivery of this kind of exercise.

**Q14 Mr Savidge:** What feedback have you had from Defra and Ofwat? Are they generally happy about the process or have there been issues where there have been disagreements?

**Dr Skinner:** Well, I differentiate between the two organisations. We have done the work and one of the scrutineers has been Defra's own economic arm, so nothing that we have done has not been done with their support. Ofwat have begun to tell us recently, as though they were part of the process discussing it, that they are questioning the methodology and certainly have given us signals that they want to see it revisited in future rounds. As I have said, we are very confident about where we are, but we have had that debate and that is the nature of this cyclical process. As I say, it gains extra complexity because of the multi-sector dimension which the Water Framework Directive will bring.

**Q15 Mr Savidge:** Are there any further tasks which might arise in the next five years which have not been included in the present programme?

**Dr Skinner:** There are uncertainties in the programme and this is one of the things which is a concern to us and also to colleagues in English Nature and that is because there are statutory obligations which will fall to be delivered during this period about which we do not yet have the sufficient investigative information to make prescriptions in the programme for ministers to consider, so there is the situation where investigations being done now will lead to decisions to be taken within the period. Now, there is a process for that which has been used in previous rounds, but I think it is going to be tested because of the scale of the issue which we face, but they are all set out in our advice to the Secretary of State in some detail.

**Baroness Young of Old Scone:** But there are also a number of areas where we believe there could be a reverse effect which is price reductions as the economic regulator goes through the programme before his final determination and bears down on prices. We believe that there could be somewhere around £1 billion in price reductions that could be achieved through good downward pressure on prices.

**Q16 Chairman:** Where would those come from?

**Baroness Young of Old Scone:** Looking at ways of being more efficient. We are not the expert in pricing schemes and I hesitate to take that on our own shoulders, but just looking at some of the schemes that we are aware of and previous similar schemes that have produced the same outcomes, we question where some of the costs being put forward for individual schemes are rather high.

**Q17 Chairman:** Does the regulator agree with you that there is £1 billion to come out?

**Baroness Young of Old Scone:** No, he has still got that job to do and we are rather worried that we are running out of road before the time for the final determination. It has been unfortunate that we have taken such a long time to get clear ministerial guidance to get through this part of the programme

---

2 March 2004 Baroness Young of Old Scone and Dr Andrew Skinner

---

because I think that truncates the rear end of the programme which is when the water companies really have to do a good job of producing the best possible schemes and when the economic regulator needs to really bear down on costs that the companies are suggesting. That was a part of the programme that I believe was skipped last time because of time pressures and I think that we, in negotiating the original programme, wanted to see plenty of time for that and it is being squeezed a bit at the moment by not being able to reach a view on ministerial guidance.

**Dr Skinner:** There are also related issues because the programmes which the companies have costed and which are the basis of the Director General's advice to ministers do not always measure up exactly with what we ask for, so there is quite a schedule of issues, all of which have been drawn to the attention of Ofwat, in what we call, "cost challenges" to look at and to see to what extent they can actually be turned into savings in the programme.

**Q18 Mr Savidge:** In what way do the current projects differ from the projects carried out in previous reviews and do you have any feel at all for how similar cost/benefit analysis might have affected those reviews?

**Baroness Young of Old Scone:** The nature of the programme in each of the two previous price rounds was quite different and in AMP2 we were dealing with very, very big pollution issues. As we have moved through successive price rounds, we have begun to deal with less gross issues where there are a large number of smaller impacts which need to be tackled and where we are actually seeking higher-quality standards as time has passed. We are also looking now at substantial programmes to deal with water availability and abstraction as opposed to pollution impacts, so they have been three very different price rounds. In terms of the last price round, AMP3, the benefits assessment was very different from the one we have done this time. It was not done at all on statutory schemes, but it was very much about an assumption that if a scheme required to be done in order to meet a directive standard, it would have to be done, although there were some schemes that were rejected on the basis of them being simply too expensive and extensively so. On the non-statutory drivers within the last price round, PR03, there was a high-level benefits assessment done, so I think we have really made huge progress this time round in having a much more rigorous process and I believe, therefore, that we can really stand up and say that the programme we are proposing is the basic minimum that ought to be put forward.

**Q19 Mr Challen:** Given that these reviews are a bit like Christmas, entirely predictable, I want to pick up this point about why ministers' guidance seems to be held up or late. Do you have any views on why they take their time?

**Baroness Young of Old Scone:** I think the issue is very much one of affordability. The political decision about how big an environment programme should be able to be afforded lies with ministers quite rightly

so as it should not be an issue that the economic regulator determines and affordability is an issue. The bills are going to have to be increased substantially as a result of a range of other drivers, taxation, pensions, asset maintenance, the costs of financing the company, et cetera, and I suppose, alas, the one area that everyone can focus on is the Environment Programme because that is the one that is subject to ministerial guidance and, therefore, comes under very close scrutiny, so at the moment that is being scrutinised intensely in preparation for ministers reaching a view.

**Q20 Mr Challen:** I am just wondering if that is really a problem that arises out of this whole process. You have this five-year review and things can change drastically perhaps after two or three years, changes in the health of the economy, for example. Is it not all a bit rigid?

**Baroness Young of Old Scone:** I think the economic regulator, when put on the same spot about the process, says it is not perfect and not necessarily highly desirable, but it is better than any of the other options that have been looked at so far. One of the things that certainly we want to do very swiftly after the end of this price round is to think about the points that we have learnt as a result of it in order to make sure that we improve the next round. The Water Framework Directive particularly is going to require us to take longer time horizons if we are looking at issues that can only be resolved over substantial periods of time, and I think the water companies very much welcome an opportunity to have a look at how we could have a longer period when they would have that degree of certainty in order to earn on their investments, so they very much appreciate that the Water Framework Directive takes much longer time horizons, but we need to find with the economic regulator a process for being able to do that.

**Q21 Mr Challen:** That leads on to my next question really which is that we seem to have accumulated this deficit, if you like, in spending on environmental projects. There is a climate of a need to clamp down and keep prices down which obviously will have an impact on the environmental work, but from the environmental point of view, are there choices available which might mean that money could be perhaps spent on some of the extra things, Plan B, I think it is called, rather than on the statutory requirements? For example, if you were a water company and you had perhaps achieved 95% of the target, but to get those last few percentage points would cost an awful amount of money, would it not be better to go and do something else that might produce a 20 or 30% improvement?

**Baroness Young of Old Scone:** I am sure Andrew will want to comment in more detail, but I think part of this really depends on where we are with regard to commitments we have made as a country to meet statutory targets. In some cases we are hard up against infraction proceedings because we have made a previous commitment, usually quite late on in the implementation process, to meet a target by a

---

2 March 2004 Baroness Young of Old Scone and Dr Andrew Skinner

---

certain date and, to be honest, we have run out of capital, we have run out of goodwill in Europe because we are so late. Some of the directives were required to be implemented in the 1980s and we have still not implemented them and we have run out of road quite frankly, so I think on those ones we do not have a lot of elbow room, and there may well be more room on some of the other statutory drivers.

**Dr Skinner:** I agree. The situation of a company saying, "Well, we've gone 95% of the way and we don't fancy going the other way", does not really bear up. We are not talking about their compliance with their own standards, but we are talking about achieving the standards in the environment and managing the discharges or the abstraction, depending on what it is, which have that impact.

**Q22 Mr Challen:** What I am saying is they might have to do something else with that amount of money which would produce a greater environmental good. Would that not be worth encouraging when they have done already a great deal to achieve the targets and sometimes when you get to that point, trying to achieve a target is just a tick-box approach, is it not?

**Dr Skinner:** No, because the way which in this country we implement the directives is done in a way which avoids that kind of mechanistic approach. We set the standards based upon a sensible interpretation of the directives to come up with outcomes which are good for the environment, so when we say we think that the statutory scheme is being delivered in full, we say it in the context that that is going to deliver good returns. Of course when you go into the non-statutory area, the cost/benefit approaches do allow you to make judgments about, and this is the way it has been presented to ministers, what they wish to do further and you can use the techniques, and that is the power of them, to make those decisions. We will stand by the position that the core is the core, it has been well conceived, it has been well analysed in terms of the companies' impacts and our advice to the Secretary of State is that it should be done.

**Q23 Chairman:** You do not ever think that reaching the final target on a whole range of things becomes an end in itself? Are you not suffering from "targetitis" because we have seen it in other sectors of the economy?

**Dr Skinner:** No.

**Baroness Young of Old Scone:** I think that we have just got to cast back during the preparation period to the fact that we have already taken a pretty hard-nosed look at what we think works and does not work in terms of meeting directive targets, so things that are high-cost and marginal will not be in the programme anyway. Therefore, having got to this stage where we have really clamped it down to things that matter and things that can be done in a cost-effective way, to lose any of those is actually losing the heart of the programme, so to trade those off for the non-statutory stuff still means we are hitting at stuff where we actually believe those schemes have been screwed down so far that they really are going

to knock the legs out from under the achievement of the directives or they would not be in the programme at this stage, having reduced it by 30% in cost terms and by half in terms of the numbers of schemes already.

**Q24 Mr Challen:** Are other European Union countries as keen on reaching these targets as we are, do you think?

**Baroness Young of Old Scone:** It varies from country to country, to be honest. We are behind some countries and we are in front of others. We are almost always behind in time. We are now adopting a kind of just-in-time approach to the implementation of directives, which is why for some of them we know that Europe is sitting on the sidelines like vultures, just waiting for us not to deliver commitments that we have already now given because we are very late in the day. We do not want to go back to the days when we were seen as the dirty man of Europe; we are the late man of Europe at the moment.

**Q25 Mr Challen:** What sort of dialogue have you had with Ofwat on their proposal to cut back on the Environment Programme? How specific is it?

**Baroness Young of Old Scone:** We meet very regularly with Ofwat and we have had a very close relationship at all levels both with the top of the house and at staff working levels and they have given us access to information in a useful way which has allowed us to assess, for example, the companies' preferred strategies. I think in the last few weeks it has been a much less easy relationship because of the fact that we are now really, we believe, at a point where we have pruned the programme and rigorously justified it, but Ofwat now continues to have concerns about affordability. It is clear that they are rather on the horns of a dilemma, I suppose, because there is not a lot they can do unless they can persuade the Chancellor about taxation, and it would be pretty unwise of them to squeeze down the asset-maintenance programmes of the companies because there is no point in us having as a nation invested in those assets only to let them decay again, and things like pensions are inexorable and they are not going to go away. Therefore, there is not much elbow room for Ofwat, except in the Environment Programme and inevitably, having focused on that and having done the rigorous work we have done so far, we really are not able to agree with them that there should be a further substantial reduction.

**Q26 Mr Challen:** They suggested that the price rise was to cover environmental spending, which I think is £26. Are they actually suggesting themselves what that ought to be, if not £26?

**Baroness Young of Old Scone:** I think the interesting thing about the price rises is that they vary quite considerably across the companies. The £26 average for the Environment Programme ranges from £3 at the bottom to £90 at the top which is the United Utilities' programme. Only two out of the nine major water companies are proposing price increases that are more than £10/11, so we are

---

2 March 2004 Baroness Young of Old Scone and Dr Andrew Skinner

---

anxious that that average figure of £26 is not seen as the kind of benchmark for the whole of the country. A considerable number of water customers will be paying far less than £26 for their environmental programme over the five-year period. We have always said that even the £26 was not a huge sum bearing in mind, and I know the economic regulator hates this analogy, that it is less than the price of a fizzy drink per week per household. What we are, I think, quite keen to press is that we should not set levels of price increase at the level that is necessary to make it affordable in two companies and we should look at other ways of tackling that problem because, otherwise, we will have to reduce quite considerably the programme. The other issue of course is that if you look at the impact of reducing the Environment Programme costs, say, you slashed them in half, you actually only produce a very, very modest reduction in the overall rise in bills because all the other elements stay constant and drive those bills up, so we think it would be really bad news for the environment and bad news for the future water prices because when the Water Framework Directive comes in and we approach 2012 and have got to have these schemes in, we could see huge increases in the next price round. We think it would be bad news for the environment if there was a big reduction in the Environment Programme for something like a £2 or £3 reduction in bills that water customers would hardly notice because it had been masked by a substantial increase in bills from other drivers.

**Q27 Chairman:** But surely if that were the mathematics and how it worked out, no sensible government would do it, would they? It is just not worth the candle, so I do not see what the row is about. If the benefit to the consumer is as small as you are suggesting, there should not be an issue here.

**Baroness Young of Old Scone:** I would agree.

**Q28 Mr Challen:** In the light of that answer and indeed the answer to the previous question, I am getting the opinion that Ofwat are not really approaching this process in a very neutral sort of fashion. Equally, they are actually targeting the environmental costs and saying, "There's a soft target. That's what we are going to drive down". Would you agree with that sentiment?

**Baroness Young of Old Scone:** I think it depends on solidarity between regulators. I think they are in a dreadful dilemma because there is no doubt about it that some of those other drivers are inexorable, almost unavoidable, so for us the thing that we ought to be supporting Ofwat in doing is really driving down individual prices of schemes, not chopping schemes out, but looking at where individual schemes can be reduced in price and can be more cost-effective so that we get a reasonable size of Environment Programme for the most economic cost that is possible, but bearing in mind that they are still going to be in a position where, even with substantial cost-effectiveness and that squeeze on this programme, it is still not going to

produce big reductions in the overall rise in bills. Andrew, perhaps I am being hard on Ofwat and perhaps you know more than I do.

**Dr Skinner:** I think the point I would add is that the situation is a creature of the process because the Periodic Review is not uniform, but it is composed of the Environment Programme and the other costs. The Environment Programme is reached by direction from the Secretary of State based on advice from the regulator, whereas the Director General has much more discretion to make a judgment about all the other costs that there are on the companies, so it is inevitable that it is the Environment Programme which is in the profile because that is the issue on which ministers have to make the biggest decisions and on which of course we and others are charged with making our judgments based upon the statutory obligations, as we perceive them, on the country. That is the issue. That is the reason why there is a perceived imbalance. As it happens, it is actually having most of the talk about the least of the costs and it is delaying, because of the delay in the recent decision, the really key part of the process which is to come yet, which is to come up with the final costs followed by detailed scrutiny which we and Ofwat want Ofwat to do for they are all straining at the leash now, waiting for the decision to be made.

**Q29 Mr Challen:** Should it not be a duty on everyone concerned with water, Ofwat included, to actually promote the idea that we need to spend this money, to actually convince people, that they have had a bit of a free ride over the last five years and this rise would not be £26 now if we had done the work when it was necessary and it might have been half that, so why are the regulators not all getting together and agreeing a line which then could be a very powerful argument to persuade everybody that that is what is necessary?

**Baroness Young of Old Scone:** I think there is a lot of unanimity, as we have discovered, between ourselves and English Nature and others. The reality is we have one set of objectives which is to make sure that we do a decent job by the environment, and the economic regulator has got the needs of customers to meet. I think the thing that we must not lose sight of is that it would be unfortunate if we were to pitch the cost of water in this country at the level that can be afforded by the very poorest households and that was the determinant. We are clear that there are other ways in which you can mitigate the impact of high water bills on customers. There are schemes by which if you are not able to pay, you can get a rebate. There are a number of voluntary schemes that the companies use for customers who are not able to pay and if we were to press, which we are very keen on for environmental reasons, for more effective universal metering, we could in fact not only reduce water loss through leakage more effectively, but we could also see the water companies introducing tariffs which would give a slug of free or very cheap water to everyone and then ramp up the costs of luxury use on a measured, metered basis. We believe that there needs to be a really hard look at all of these

---

2 March 2004 Baroness Young of Old Scone and Dr Andrew Skinner

---

mechanisms for abating the effect of higher water bills on poorer households and higher water households.

**Q30 Mr Challen:** How, if at all, do you respond to these reports that Number 10 and the Treasury and other powerful people have indicated that they want to keep these prices down? Has that influenced people's thinking at all, to your knowledge?

**Baroness Young of Old Scone:** I think we all recognise that there are a number of issues around in terms of prices of not just water, but electricity, energy generally, and community charge, which are pretty hot on the political agenda at the moment. Our concern is that, having got this programme down to the very minimum and really chucked everything out that is not totally justifiable and being hard up against infraction in a number of places, we took that on board ages ago and we were very conscious right from the start that affordability was going to be a key issue in this round and we wanted to make sure that our programme could be scrutinised externally and was very robust and we did that.

**Q31 Mr Challen:** Are Ofwat's proposed cuts focused on water resources and nature conservation or do they also include cutting back on water quality work?

**Dr Skinner:** Well, we have not seen the full detail of the cost constraint programme of Ofwat, but what we have seen bears heavily on the water quality programme as well as on water resources and habitats and takes us into very high risk of infraction territory. We have not had a chance to analyse it in detail, but we have written briefing notes for both Ofwat and Defra giving that advice.

**Q32 Chairman:** Which particular directives are in danger of hitting infraction?

**Dr Skinner:** The Freshwater Fish Directive, where we are already under infraction risk as we stand now, would be one of them. The Urban Waste Water Treatment Directive is another. There are other directives, but those are the main two.

**Baroness Young of Old Scone:** The sort of thing we are talking about is the continued pollution of rivers with sewage debris possibly well into 2010 if we do not hit now some of these unsatisfactory discharges, for example, which would be an implication of the constraint programme that Ofwat is proposing as well as fisheries damage, wildlife sites and loss of bathing beach quality at times when we are in many places desperately trying to promote the tourism industry.

**Q33 Sue Doughty:** In terms of your regional work and the contacts that you have through the Agency around the country, how much has there been an issue about what this would mean if this work could not go ahead on the biodiversity issues which are there? Is this something which in the regional plans which are produced has been presented as something which really needs to be safeguarded in terms of this expenditure?

**Baroness Young of Old Scone:** I should imagine that in some of the exercises that we have been doing both with the water companies and as part of our work in reporting on the environment on a regional basis, issues like this do get presented as important, but they will become even more so as we work through the stakeholder process around the Water Framework Directive where we will be getting stakeholders on a river basin basis together to talk about all of the impacts on the water environment, both quality and quantity, and what, therefore, are the highest priority things to hit. All of the stakeholders are going to be engaged in looking at all of the impacts, including the needs of the individual directives, so that is going to become a very public and transparent process in the very near future under the Water Framework Directive.

**Q34 Sue Doughty:** I think there is a bit of a difference between what is academic in terms of what the general impact of cutting back would be through the Review and whether or not there has been sufficient work done at a local level, so we are not talking about the academic impact of cutting back on the investment, but what that would mean in real terms and in terms of what needs to be done either on public health grounds or on biodiversity grounds and what the effect of that would be. I just wonder how much there is that link really in public awareness about what this disproportionate cut-back would be.

**Baroness Young of Old Scone:** I do not really think we have really yet had a chance to talk to WaterVoice on a regional basis about the impacts of this proposed reduction. Obviously we have talked to WaterVoice regionally about what the deliverables are and what the avoided infractions are in detail. We do try to pitch it in a very personal way so that it is not just seen as the achievement of directive targets, but what is it going to mean for your beach, for your river, might you get storm sewer outflows and whether the fishery is going to be okay and what it is doing for biodiversity, but I do not know what the most recent discussions in regions are.

**Dr Skinner:** The point I would make is that the whole of this process is underpinned by a huge amount of detail. All these thousands of schemes have got a lot of detail and that has been talked about at the local level and in many cases that has involved local stakeholders, and that is part of the process which has led to us recommending our programme. Now, if, as a result of ministerial decision, the programme is a smaller programme, we are well placed to have the dialogue to get the best value out of that for the community, so all that is in place, but we have not had a discussion because at the moment we are standing by the full programme that we recommended, but the detail is there.

**Baroness Young of Old Scone:** Just to give you an example, if we lose some of the sewage treatment and nutrient-stripping in the Lake District, the already very worrying pollution of places like Windermere and Coniston Water where we are getting nutrient run-off into the water for a variety of reasons, partly

from sewage works, that is already a very hot local topic and people are desperately worried about what this does not only to the biodiversity of the Lake District lakes, but also to the whole tourism industry if we end up with lakes which are choked with weed, are eutrophic and have got algal blooms in them and it is going to be very bad news.

**Q35 Chairman:** You are suggesting that if the cuts which have been mooted go ahead, we could end up with results like that?

**Dr Skinner:** Absolutely, and the other issue is that the programme is disproportionately weighted towards urban problems and the whole question of the regeneration of urban sites because of improved water quality will be prejudiced because a lot of the programme is in urban areas.

**Q36 Mr Challen:** It does sound like this is all going to come up right against the regulator's duty to "conserve and enhance" SSSIs under the Countryside and Rights of Way Act. Does it not really completely contravene that approach?

**Baroness Young of Old Scone:** I think that is why the decisions that ministers make is a crucial point because all of these targets have either been agreed by ministers in Europe or have been agreed by government. For example, the public service agreement target on the condition of SSSIs, which was also flagged up in the Countryside and Rights of Way Act, having made that commitment, it is now important that ministers put in place the mechanisms to be able to achieve it and that is why this ministerial guidance is really important.

**Q37 Chairman:** Just a minute or two ago when you were talking about the dilemma facing Ofwat, and you were generous enough to recognise that they have dilemmas too, you suggested that one way out for them might be to talk to the Treasury about taxation. What do you mean by that?

**Baroness Young of Old Scone:** I have learnt from bitter experience that I never talk about taxation in the absence of the Treasury because they do not much like that. The reality is that I think it would probably be pretty impractical because there is a corporation tax hit on the water industry in the next price round, but, on the other hand, it is a corporation tax hit on quite a few sectors and, therefore, I am sure the Treasury are not going to stand for any exemption for that sector, but it is one of the factors which drives up water bill prices.

**Q38 Sue Doughty:** We were talking earlier about the programme and the costing of the programme and what is very clear is that there does seem to me to be a certain amount of discrepancy between your proposed costs and the water companies' proposal of costs. You have been critical about this. What I would like to know is how we have got to a stage where your version of what you think it costs based on your experience of what has been happening previously is coming up differently to what they are

proposing to spend. How come they are putting forward one set of proposals to achieve their objectives whereas your experience says this does not seem to be the right set of figures?

**Dr Skinner:** What we are looking at now is a snapshot half-way through a process designed to take nearly three years. If you go back and look at the figures from the previous price rounds you will find that the numbers that companies put into their draft business plans, which is the equivalent of what we are looking at now, were significantly reduced in the final determination by Ofwat. The issue which is causing us concern now is that ministers are trying to take some difficult decisions based upon costs which everyone knows will not be the final costs. The question is how much will those costs be reduced by the process of scrutiny which is in train given all the other issues, not environmental, which are pushing in the other direction. All we are saying is that we think the same thing will happen this time as happened last time, which is that company plans after scrutiny will be smaller. We are asking that the Secretary of State making the decision is not unduly influenced by the size of the present numbers. We do not know yet what the right numbers are, nor do Ofwat. All we are saying is that, from the experience of the previous rounds and the kind of benchmarks that we can derive, we think there are areas, in some companies more than others, where we would like to see Ofwat do additional scrutiny, but unfortunately that is not possible until later in the process, after which time some pretty key decisions will be made.

**Q39 Chairman:** It seems to me that there is a potential problem here which is deeply embedded in the whole arrangement. You are not engineers; you are not quantity surveyors. You have said it is difficult for you to establish the detailed costings, but in a sense that is industry's job, they have an opinion but of course they also have a major commercial axe to grind. Ofwat has not yet made up its mind about the costings, but in what way are Ofwat qualified? They are not engineers either.

**Dr Skinner:** They have a system of reporters drawn from engineering specialists whose job it is to do that scrutiny on their behalf.

**Q40 Chairman:** So everybody relies on them?

**Dr Skinner:** Yes, that is right.

**Q41 Chairman:** Is that sensible?

**Dr Skinner:** It has worked in the past, although processes tend to stretch in time and so the concern is there is not sufficient time to do the job as rigorously as might be done. I would not wish to question that part of the process on the basis of experience from previous years.

**Q42 Sue Doughty:** We have got this problem—and it has been highlighted both in this session and in a memorandum—of double counting and projects being costed too highly. I appreciate what you are saying about the fact that this is a matter of gradually arriving at the likely truth in this. Do you

<sup>1</sup> Sites of Special Scientific Interest.

---

2 March 2004 Baroness Young of Old Scone and Dr Andrew Skinner

---

think there is a certain element of a strategic approach by companies, in other words is there a little bit of gold plating or is it the process which leads to it in the first place? You were indicating that in time it will get reduced in your experience.

**Baroness Young of Old Scone:** The way the companies make their profits is by outperforming on the delivery of these schemes during the course of a five-year period after the programmes are determined and so it is in their interests to get as much headroom as possible in order to allow for that out-performance to be fairly substantial and of benefit to their shareholders. I do not think we are saying that companies are going around flagrantly over-egging, but we have got to recognise that this is a commercial process and that is the way the system works, to be honest. I think the fact is that in AMP2 the companies outperformed by 17% during the course of delivery of their programme and in AMP3 the likelihood is that they are going to outperform by 10% on the current picture. Companies are all muttering into their beards and saying that they are being much more pressurised and they are much heavier constraints on efficiency savings and there is a lot less efficiency to be gained by this out-performance process, so it may well be that the out-performance will not be of a level that we have seen in the past but there will be some out-performance otherwise the system grinds to a halt. That is the dynamic of the process, which is why we are very keen for Ofwat to be absolutely rigorous about the scrutiny of prices. We also think it was probably not the wisest decision in the early stages to ask companies to put forward preferred strategies because although we gained some insight into how they might do it more efficiently, putting a number of schemes together, it did also mean that the preferred strategies that companies put forward in many cases had omissions, duplications, did not contain schemes that we believed were absolutely fundamental, contained schemes that we did not think were that important and that took up quite a lot of everybody's time and perhaps may not have been the best part of the process so far.

**Q43 Sue Doughty:** We are getting to a stage now where they are going to come forward with their final plans fairly soon. Do you think you will see a certain amount of moderation in their plans given the comments that have been made about the original programme? Would you expect to see them tailor their plans more appropriately?

**Baroness Young of Old Scone:** I hope that they will put in their plans what the Minister says they should.

**Dr Skinner:** I am sure they will, but they will have difficulties because the timetable is constrained and there is a limit as to what they can do and I think this is the big worry, that both the customer and the environment risk losing out because time is not being allowed to do the job as rigorously as we would all like and I imagine Ofwat would agree with that.

**Q44 Sue Doughty:** May I turn now to some of the statutory obligations that companies are required to meet. We were talking about issues such as agricultural diffuse pollution. They have said that they cannot put in a plan because other things outside their control are not being dealt with. Do you think they are right to say that we cannot plan for this?

**Dr Skinner:** No, I do not think they are right. This is obviously a critical issue in which we are very mindful of the fact that there are other impacts on the water environment. They will be capable of being addressed given the right tools under the Water Framework Directive, but that is not with us yet. One of the steps that we took in scrutinising and, in some cases, deleting schemes from our programme was that very factor, we had to be satisfied that the environmental objective that we were wanting to meet was one which was being materially impacted by all the companies' actions. If they did not pass that test it is not in our recommendations. On that basis we are comfortable that what they are being asked to do they need to do and they are not being asked to do work because of the pollution of other parties.

**Baroness Young of Old Scone:** There are separate measures underway to try and tackle diffuse pollution particularly from built development and agriculture and Defra's diffuse pollution should be published very shortly for consultation and its aim is to tackle the other impacts.

**Q45 Sue Doughty:** So this really takes away all those reasons if there will be strategies in place?

**Dr Skinner:** This is the great advantage of the Water Framework Directive, it is a multi-sector process which does not look at only one of the polluters. There are challenges there as well, as I mentioned already, particularly in terms of cost benefits which will lead to the whole thing being done in a common cycle, but we are not there yet. We believe very strongly that we have met the obligations of that in terms of the interests of the water industry.

**Q46 Sue Doughty:** Moving back a little bit to the issue about average spend and average cost and the whole discrepancy between what is required in one region as opposed to another and we were talking earlier about the Lake District. You made a comment about not wanting to see this average spend on environmental improvements as £26 because of all the other factors that go into what that £26 is. We also talked about a fizzy drink. Should we not be talking about either £26 or 50p for the fizzy drink? We have got to move right away from this average across the board. Has it not always been a problem right since privatisation that looking at an average cost of water produces huge discrepancies and the cost of the environmental concerns has also been a huge problem right from the beginning of privatisation? Should we not be looking at plans on a regional basis rather than trying to conglomerate them all into one figure which does not mean what we would like it to say?

---

2 March 2004 Baroness Young of Old Scone and Dr Andrew Skinner

---

**Baroness Young of Old Scone:** We do look very much on a regional basis, as does Ofwat, at the regional programmes and the impacts on prices and I think you are absolutely right, for some of the companies that have got very low bills they have got high environmental programmes but low price increases; for some of the companies that have got high bills they have got high environmental programmes and high price increases, and for some of the companies that have got high bills they have got low environmental programmes and low price increases. There is no relationship between the current cost of water, the size of the environment programme and the future cost of water. I think we would probably go back to the point which says that trying to tailor down marginally the cost of the environment programme really does not have that huge an impact on what bill payers will be paying at the end of the five-year period in each of these areas. In fact for the vast majority they will not be paying any more than £10 a year more as a result of the full environmental programme and therefore the sort of arm wrestling that we are currently seeing is immaterial in those regions and the other issues are far bigger.

**Q47 Sue Doughty:** We are getting a skewed view. We have had Water UK suggest to us that we should remove the environmental programme completely from the pricing review and actually have an ongoing review because we do see differences coming along and we are talking about different programmes. We seem to be stuck on to this pricing regime with all the problems it has given us, with a lack of opportunity to consider what we are doing properly, with the discrepancies between the figures that go on all over the place and yet it would appear the environmental programme would need reviewing on a more regular basis to make sure that we are still on course rather than stop-start and we get it right over so many years.

**Baroness Young of Old Scone:** I think there are issues about how the price round is designed, but it all comes down to who is going to pay. If the customer is going to pay it has got to be part of the bill setting process otherwise you will have another one that is a bill setting process later on. If the customer is not going to pay and it is going to be through general taxation I suspect that we would see even more of a challenge when it came to trying to get sufficient funds to do this programme. Let us say we are talking about a £4 billion environmental programme, it is a big programme, probably the biggest part of input into improving the water environment, but across individual members of the British public and households it is a comparatively small element.

**Dr Skinner:** It is hard to imagine how you could depart from a regular review bearing in mind this is actually a monopoly industry that is being regulated. We are talking about issues that go beyond the environmental programme. I agree with what you are saying in terms of the need to look at things in the environment across a number of timescales. As has been alluded to, we have the challenge of dealing

with short-term changes which are going to arise for various reasons. We have also got the fact that five years is quite a short time to set real environmental goals and to have a real sense of where we are trying to get to both for the public, the companies and everybody else. The Water Framework Directive is something that works in a series of cycles and goes up to 2027. Our vision in the Agency for the way we would be doing this in the future is not to dismantle what is accepted as quite a robust process but to have additional flexibility both in terms of the short cycle time for the issues we have just discussed and to make sure that everything is consistent with a longer-term vision. That will make it a lot easier to bring clarity to what the investor is doing over time because when people propose a constraint programme now we have to remind them that there are new challenges coming up. Would it not be better if that was all laid out in the context of the Framework Directive?

**Q48 Sue Doughty:** They have already got these problems that you have been describing about infraction proceedings and the fact that we are now in real danger of this. It would seem that all those problems are not sitting side by side with the pricing review. I appreciate what you are saying about how you are going to pay for this and that the customer must have that input through this review and yet in practice it is not really working.

**Baroness Young of Old Scone:** I think it is working as well as any other system we have looked at so far. You can look at other examples of utility regulation but generally speaking they are competitive environments. You have got energy companies competing with each other in a fairly free market now. It is the monopoly position of the water companies that means that the economic regulator really is the key player in making sure that his rules, in place of competitiveness, drive down prices and look after the interests of the water customer.

**Q49 Chairman:** As a matter of interest, who invented the phrase “constrained programme” in this context?

**Dr Skinner:** I think Philip Fletcher did.

**Q50 Chairman:** It is a wonderful euphemism. Do you accept the term constrained programme?

**Baroness Young of Old Scone:** The one we submitted was pretty damned constrained.

**Q51 Chairman:** Because it implies that there is another programme somewhere which is wholly unconstrained?

**Baroness Young of Old Scone:** Ours was examined with a microscope and pared down to the point where we think ours was the constrained one and constraining it further was knocking the legs out from under our abilities to deliver for the environment at all.

**Chairman:** Thank you very much indeed. We are grateful to you for being relatively unconstrained with your time this afternoon.

### Supplementary memorandum from the Environment Agency

*Response to specific questions from the Environmental Audit Committee following the Environment Agency's oral evidence session, 2 March 2004.*

**How does the Agency judge whether a proposed action will have enough impact on receiving waters to make it worth including in the environmental programme? The Committee is particularly interested in how the judgement is made in areas where there are significant contributions from diffuse pollution from other sources.**

#### HOW THE AGENCY DECIDES WHETHER A PROPOSED ACTION IS WORTH INCLUDING IN THE ENVIRONMENT PROGRAMME

1. During the price review process the Agency identifies future environmental priorities for the water industry by comparing the performance and impact of water company assets (sewage treatment works discharges, storm sewage discharges, water abstractions) against a nationally agreed set of environmental drivers. These drivers set out legal and/or environmental requirements. They derive from EU Directives, domestic statutory obligations, Government policy and local environmental needs. These requirements either apply to the environment, by setting standards that must be achieved in the environment, or by specifying standards that apply to the water company asset. For example, the Bathing Waters Directive specifies microbiological standards that bathing waters must meet to comply with the Directive, whereas the Urban Waste Water Treatment Directive specifies standards of sewage treatment that apply to the water company asset. The list of drivers for the 2004 Periodic Review is included in the Agency's Memorandum of Evidence (Annex B).

2. The Agency applies environmental quality planning techniques to identify damage and risks, to evaluate options to resolve them and to determine when these should be applied. These techniques have been developed over many years in response to increased understanding of the environment we manage, and technologies used by those we regulate.

3. The basic steps are to identify:

- the environmental problem, eg non-compliance with environmental standards, evidence of pollution, or damage or risk to habitats/species caused by lack of water or pollution,
- where standards are not met, we identify the cause of the problem through investigations, which may include water quality modelling or detailed studies of the water flow regime,
- actions required to control the sources of pollution, or to restore river flow.

#### *Identifying the environmental problem*

4. The Agency has an extensive monitoring programme for the aquatic environment; taking over 310,000 samples every year. The results are used to assess compliance with EC Directives and the national set of River Quality Objectives (RQOs). We use ecological monitoring to help us identify environmental damage from pollution and low river flow. When assessing compliance, the statistical confidence that a true failure has been detected is also determined. This allows us to exclude failures, which might be caused by random chance in sampling (statistical sampling error). It allows us to target our pollution prevention activities, and avoid imposing unnecessary expenditure on dischargers.

5. We also receive reports of pollution incidents or sections of river in which flow is abnormally low, either from our own visits or from reports from members of the public. We receive information from other organisations like English Nature on the status of designated conservation sites, and what might be damaging such sites.

6. We then investigate the causes of the problem. The investigations look at all possible sources of the environmental damage, not just water company activities. For EU Directives, the reasons for failure are reported to the EU along with information about the measure being taken to address non-compliance.

#### *Investigations*

7. We use a range of investigation methods depending on the nature and complexity of environmental problem. Water quality models allow us to simulate how different sources of pollution, including diffuse pollution, affect the achievement of environmental standards, and their relative contribution. Surface water and groundwater flow models allow us to simulate how different abstractions affect river flow.

8. We also use field investigations, which allow us to gather more detailed information on environmental damage from abstractions and discharges and their impact on the environment. These range from basic visual inspection for evidence of pollution to the most complex, which may last several years. Some investigations are undertaken by those that we regulate, including by water companies. These investigations help us to determine the impact of their activities on the environment and inform permit conditions (discharge consents and abstraction licences) that set to rectify the problem.

9. Our investigations help us to identify the course of action required, which may include using our statutory powers to review permit conditions for discharges and abstractions, promote pollution prevention campaigns, and the use of the Codes of Good Practice.

#### *Diffuse Pollution*

10. Diffuse pollution can be characterised as follows:

- Intermittent—often weather-related
- Pollution is generated over wide area
- Can be difficult to monitor at source, and quantify
- Individually sources are small—but in combination may have a significant impact
- Requires source control (often land management) rather than end of pipe solutions

11. This contrasts to discharges from sewage treatment works, which operate continuously even during periods of low river flow, when dilution of the discharge is relatively low. The relative impact from diffuse pollution compared to pollution from discharges varies hugely from site-to-site specific dependant on land use, population, river flow regime and the sensitivity of the water environment to pollution. Investigations of the type described in paragraph 8 can be used to inform decisions about the action to be taken to control pollution. If these investigations show that action to a water company discharge would not produce measurable reductions in the levels of the pollution in the environment, we do not require action by the company. If we are uncertain then we have recommended further investigations. At some sites the investigations show that action is required both by water companies and to control diffuse pollution. We await the implementation of the Water Framework Directive and the government's diffuse pollution initiatives, which are integral to it, to provide a more complete set of tools to tackle land, based diffuse pollution inputs.

**Further information on the timeliness of the completion of investigations included in AMP3 by water companies. Does the Agency have any concerns about investigations being postponed and results not being available to feed into the current review?**

#### TIMING OF AMP3 INVESTIGATIONS

12. We are concerned that the scheduling of AMP3 investigations in particular in relation to the environmental impact of water abstractions, in the last Periodic Review did not take sufficient account of the timetable for the 2004 Periodic Review. This means that many investigations have not progressed far enough to inform decisions at this stage of 2004 Periodic Review.

13. We monitor water companies' delivery of the actions in the environment programme, including investigations, and report progress to Ofwat, who would decide what action to take in the event of late delivery. The reasons for any slippage to agreed timetables are discussed with companies. Monitoring has shown that some investigations are falling behind schedule. We rely on Ofwat to take appropriate action in the event of late delivery.

14. For the 2004 Periodic Review, we have advised water companies and Ofwat that investigations should be scheduled early in the programme so that the results are known in time to influence the next price review in 2009.

**You mentioned in evidence to the Committee that the proposed cuts would have an impact on customers' bills of around £3 at most. Could you explain how you arrived at this figure?**

#### IMPACT ON CUSTOMERS' BILLS

15. In evidence to the Committee, the Agency stated that it would be "bad news for the environment if there was a big reduction in bills for something like a £2 to £3 reduction in bills". We explain the background to this comment here.

16. In paragraph 25 of the Agency's Memorandum of Evidence we pointed out that Philip Fletcher had proposed a constrained capital programme of £15 billion in his advice to the Secretary of State.<sup>12</sup> That letter states that: "If, for example, the total capital investment programme could be limited to £15 billion, to a similar level to that assumed for 2000–05, it would, by my estimate, reduce price limits by around 5% over the 5 year period against reference plan A<sup>13</sup> and by around 10% against reference plan B<sup>14</sup>."

---

<sup>12</sup> Open letter from Philip Fletcher to the Secretary of State, 19th December 2003. Advice to inform the Principal Guidance on scale and timing of further Quality Enhancements.

<sup>13</sup> Reference Plan A included a defined package of environmental improvements approximating to the Secretary of States "clear and essential drivers".

<sup>14</sup> Reference Plan B includes a significantly larger package of improvements—but not all the potential improvements. However it should be noted that Plan B is greater than the programme put forward by the Agency and nature conservation agencies' November advice to ministers.

17. By 2010, Ofwat have said that<sup>15</sup> average household bills would be £306 based on companies' preferred strategies. Therefore, a saving of 5% on bills in 2010 equates to approximately £15 over the 5 years or £3 per year, the figure that the Agency quoted in questioning.

18. The environment programme makes up around one-quarter of the cost of reference plan A (approximately £4.8 billion out of a total of a capital expenditure of £19.5 billion). Therefore if the cuts implied by Ofwat's constrained programme fall in similar proportions to the environment programme and other areas of expenditure, then the contribution to savings on bills made by cutting the environment programme would be less than £5 over the 5 years. We set out our Memorandum of Evidence (paragraph 25) the implications of such cuts for the environment programme.

**March 2004**

---

### Memorandum from English Nature

#### SUMMARY

1. AMP4 is of major importance for the protection of statutory nature conservation sites. Schemes proposed by English Nature and the Environment Agency are based on a robust assessment process using best available information and expert judgement. We have advised the Government that the majority of these schemes are necessary to achieve compliance with the EU Habitats and Birds Directives and the Countryside and Rights of Way (CRoW) Act 2000, by protecting European sites known as Natura 2000 and Sites of Special Scientific Interest (SSSIs).

2. Under AMP 3, 90 schemes received funding to protect wildlife on 45 SSSIs. We have advised that AMP4 should include schemes to address water quality on 63 SSSIs and Natura 2000 sites, and water resources schemes on 46 sites, as well as over 120 investigations which may lead to the need for further schemes by 2010. The Habitats Directive and the Government's Public Service Agreement (PSA) target that 95% of SSSIs (by area) should be in favourable condition by 2010 require these schemes to be implemented by 2010, and therefore funded under PR04. Another 43 schemes have been proposed to contribute towards Government commitments to restore priority habitats under the UK Biodiversity Action Plan (UK BAP).

3. In 1998, the Environment Agency and English Nature began a joint Review of Consents process to identify all consents, including water company discharges and abstractions, affecting Natura 2000 sites. This review of over 60,000 consents affecting water quality or water resources will be completed in three phases from 2004, 2006 and 2008, and the Agency must affirm, modify or revoke damaging consents within two years of the completed investigations (ie all within the AMP4 period 2005–10). There is no scope for delaying implementation beyond 2010. Any attempt to do so will pose infraction risks for late or non-compliance with EU Directives, and risks failure to achieve the PSA target for SSSI condition.

4. We have advised the Government that additional schemes are likely to be identified during the AMP4 timetable as the Review of Consents process is completed. These will require funding under logging up or interim determination orders. It is essential therefore that the present impediments to logging up are addressed.

5. Despite a rigorous assessment process by the Environment Agency and English Nature, and robust scrutiny, Ofwat has proposed a constrained environmental programme which we believe would reduce the scope and number of nature conservation schemes below that required to achieve statutory obligations. This would lead to infraction risks, achieve only a minimal reduction in the average overall size of the bill increase and will probably have to be reversed within the AMP4 period to achieve compliance.

#### 1. Introduction

English Nature is the statutory body that champions the conservation and enhancement of the wildlife and geological features of England. We work for wildlife in partnership with others, by:

- **advising**—Government, other agencies, local authorities, interest groups, business, communities, individuals on nature conservation in England;
- **regulating**—activities affecting the special nature conservation sites in England;
- **enabling**—others to manage land for nature conservation, through grants, projects and information;
- **enthusing**—and advocating nature conservation for all and biodiversity as a key test of sustainable development.

We have statutory responsibilities for nationally important nature conservation sites: SSSIs, the most important of which are managed as National Nature Reserves.

---

<sup>15</sup> Periodic Review 2004. Setting water and price limits for 2005–2010: Overview of companies draft business plans. Ofwat, October 2003.

Through the Joint Nature Conservation Committee, English Nature works with sister organisations in Scotland Wales and Northern Ireland to advise Government on UK and international nature conservation issues.

## *2. English Nature's role in the PR04 Process*

2.1 English Nature's role in the periodic review is to advise the Secretary of State on the nature conservation component of the environmental programme in England, including both water quality and water resources aspects, in conjunction with the Environment Agency. English Nature is a member of the regulators group for the PR04 process, and was a member of the working group that designed and commissioned surveys of customer opinions in 2003 and 2004.

## *3. Nature conservation components of the environmental programme*

3.1 Initial Ministerial Guidance (January 2003) identified three key legislative and policy drivers for nature conservation schemes in PR04: the EU Habitats and Birds Directives, the CRoW Act 2000, and UK BAP. Schemes proposed under the Habitats and Birds Directives are needed to comply with the Government's legal obligations to protect European sites known as Natura 2000, to ensure the achievement or maintenance of favourable conservation status for habitats and species protected at such sites.

3.2 Initial Ministerial Guidance required that where schemes under the Habitats and Birds Directives and CRoW Act drivers are identified at a high level of certainty, action must be taken to cease or modify discharges, and that funding must be made available where abstraction licences need to be varied or revoked to ensure favourable conservation status. Work to affirm, modify or revoke consents under the Environment Agency's Review of Consents affecting Natura 2000 sites will be completed by 2006, 2008 and 2010 for high, medium and low priority sites respectively (see para 4.2 below). We advise that there is no scope for delaying implementation beyond 2010, the review programme already fully exploits the time allowable for implementation and any further delay will pose infraction risks.

3.3 Failure to include schemes identified under the CRoW Act driver will place at risk the Government's PSA target that 95% of SSSIs (by area) should be in favourable condition by 2010, and will make it difficult to convince others to play their part. It would also undermine the statutory duty (s28G of the CRoW Act) placed on public bodies, including the Environment Agency, Ofwat and the water companies, to conserve and enhance SSSIs in carrying out their functions.

3.4 Around 43 nature conservation schemes which are not linked to statutorily protected sites have been proposed, which would contribute to meeting UK BAP targets to restore specific priority freshwater habitats. These have been subject to cost benefit analysis. Although falling into the category of schemes for which choices can be made, we believe they offer significant gains with a very small impact on prices. To exclude BAP schemes would delay the achievement of the UK BAP targets and desired outcomes of the England Biodiversity Strategy (October 2002). It would also reflect poorly on Government's regard for the commitments it made with others: (a) at the World Summit on sustainable development in Johannesburg in 2002 to reduce the rate of biodiversity loss by 2010; and (b) to halt biodiversity loss in the EU within the same timescale.

3.5 Three water companies have proposed schemes which should help to tackle some water quality issues at catchment level through land management actions, such as reducing livestock density and blocking moorland gripping, that could be funded through the PR04 process. The majority of these land management actions are directed at water companies' SSSI landholdings and will make a significant contribution to the achievement of favourable condition for these sites. We support these proposals both as schemes or investigations for funding under AMP4, and as an objective for future AMP rounds as part of a more integrated and sustainable approach to managing inputs.

## *4. Process for providing advice on the size and scope of the nature conservation programme*

4.1 Schemes needed to address problems with water quality or water resources in Natura 2000 sites and SSSIs were determined in close collaboration with the Environment Agency. Joint guidance was developed to determine the need for schemes (at a given level of certainty, from LoC 1—high, to LoC 6—low certainty, see Box 1 below) or investigations. The level of certainty with which schemes were proposed for specific sites was determined jointly with Environment Agency, based on jointly agreed criteria for: (a) degree of risk to or impact on a site; and (b) strength of association with water company activity.

4.2 The basis for considering individual sites under this process, depended on present scientific understanding of the association between water quality or water resources/flows, and ecological response within a given water or wetland habitat. In the case of Natura 2000 sites, a programme of research and assessment to inform the Environment Agency Review of Consents process was begun in 1998. Following an initial phase of risk assessment, sites were categorised as high, medium and low priority for completion of the review, with completion dates for the assessment of consents (alone or in combination ) by 2004, 2006 and 2008 respectively. Any necessary revocations or variations in permits must be identified and planned

within two years of these dates. The selection process for relevant schemes under AMP4 is therefore underpinned by a programme of several years of investigation. Implementation of schemes will take place only when each site assessment is complete and the roles of all other permissions assessed.

### Box 1

#### EXPLANATION OF LEVELS OF CERTAINTY USED IN RECOMMENDING NATURE CONSERVATION SCHEMES

Level 1	There is a proven link between a water company abstraction or discharge and damage to the ecological integrity of the site, or failure to meet relevant Environmental Quality Standards (EQS)
Level 2	Signs of deterioration in, or risks to, the ecological integrity of the site are apparent and/or EQS are breached. The current understanding of the site is that there is a high risk that the problem is caused by a water company discharge or abstraction. Investigation work has not established this with sufficient confidence but we expect that such work can resolve the issue.
Level 3	A link between a water company abstraction or discharge and potentially detrimental impact on the hydrology or water quality of a site has been demonstrated sufficiently. Ecological damage may not be readily observable, however, there may be initial signs of the site condition deteriorating.
Level 4	As Level 2 however, there is no established link with water company abstractions or discharges. The site will be showing signs of deterioration in ecological integrity or EQS failure but the risk of this being caused by authorised water company activities is viewed as moderate.
Level 5	The site is showing signs of deterioration in ecological integrity or EQS failure but there is a low risk that this is due to authorised water company activities. There are other factors in evidence, which could have caused the ecological integrity of the site to deteriorate or failure of the EQS.
Level 6	There are no signs of damage to the ecological integrity of the site and that the risk posed by water company abstractions and discharges is low

4.3 For AMP4 planning purposes, our joint advice with the Environment Agency is that all schemes at LoC 1–3 should be included for funding within final business plans (or for funding options appraisal where the precise scheme is uncertain for water resources schemes). Once the assessment process for sites under the Review of Consents is completed, we anticipate that a number of schemes currently at lower levels of certainty are likely to require to be brought into the programme, and there may be some movement of scheme certainty in the opposite direction.

4.4 Ofwat has proposed a constrained programme under which only those schemes at LoC 1 should be included. We have advised that schemes at LoC 2 and 3 are not optional—there is a high probability that these schemes will be confirmed once the Review of Consents process has been completed. Limiting funding to schemes at LoC 1 will lead to infraction risks and misrepresents the costs to water companies of the programme required to achieve compliance. These costs will have to be passed on to customers and funded by Ofwat through logging up or interim determinations. Excluding them now will not achieve real cost savings and will potentially mislead customers about future bill increases.

4.5 Some schemes have been challenged (before or during the development of draft business plans) on the basis of high relative or absolute costs. These have been reviewed with the Environment Agency, and in a limited number of cases where we have agreed that there is uncertainty over the outcome of a proposed scheme, further investigation has been required rather than a costed scheme at this stage.

## 5. Nature conservation achievements under AMP3

### Achievements under AMP3

5.1 PR99 was the first in which substantive consideration had been given to schemes for the protection of nature conservation sites. Included in AMP3 are schemes and investigations on 72 SSSIs. This constitutes a capital investment of £100 million. £40 million is being spent on phosphorus or nitrogen removal at 72 sewage treatment works on 29 SSSIs. £60 million is being spent on schemes to combat over-abstraction on 18 SSSIs and investigations into water resources problems on 27 SSSIs. The AMP3 investment period (covering 2000–05) is not yet complete, and the majority of nature conservation schemes are scheduled for completion towards the end of that period. At the last full reporting period in March 2003, 10 SSSIs had completed investigations and nine SSSIs had completed schemes.

### 5.2 Examples of schemes under AMP3 include:

- restoration of flow levels to parts of the River Eden, Cumbria, a Site of Special Scientific Interest (SSSI) and Special Area of Conservation (SAC) under the EU Habitats Directive, which has enabled fish to migrate through one of the major tributaries;

- restoration of water levels in parts of North Dartmoor SAC and SSSI which have improved habitats for brown trout and valley mire vegetation;
- removal of phosphates for sewage treatment works discharging into Bure Broads SSSI and SAC in Norfolk, Woodwalton Fen in Cambridgeshire, and Loe Pool lagoon SSSI in Cornwall;
- investigation of the impact of numerous point source discharges into the river Wye SAC, which has enabled more targeted recommendations for phosphorus removal at sewage treatment works under AMP4. Installation of some phosphorus and ammonia reduction schemes has already led to reported favourable condition on downstream stretches of the river;
- reduced abstraction has, with other action to restore wetland conditions, allowed a return to good quality reedswamp at East Ruston Common SSSI and improvements are expected to waterfowl populations.

#### The AMP4 nature conservation programme

5.3 A summary of the environmental programme has been published in *A Good Deal for water* (September 2003). A list of schemes was submitted to water companies for costing at the end of May 2003 and has subsequently been further reviewed by English Nature and the Environment Agency in the light of additional information. Table 1 shows numbers of sites affected by schemes submitted under the statutory nature conservation drivers. Around 260 schemes to tackle water quality problems at 63 statutory nature conservation sites were identified at higher levels of certainty. Similarly, schemes are needed at 46 sites to deal with water abstraction problems. A further 121 site investigations also require funding under the AMP4 programme.

**Table 1**

#### SITES SUBMITTED BY EA/ENGLISH NATURE FOR AMP 4 FUNDING FOR SCHEMES OR INVESTIGATIONS UNDER STATUTORY NATURE CONSERVATION DRIVERS

		<i>Sites with schemes at LoC 1–3</i>	<i>Sites with investigations</i>
Water quality	HD	43	35
	SSSI	20	25
	Total	63	60
Water resources	HD	35	42
	SSSI	11	19
	Total	46	61

HD refers to Habitats and Birds Directive and Ramsar sites, LoC refers to the Level of Certainty with which a scheme has been identified.

5.4 For water resources schemes, it is difficult to identify schemes without further options appraisal (eg of water availability or use within a catchment) even though impacts on or risks to sites (and hence need for action) from water abstraction were clearly recognised at a high level of certainty. Hence, where water resources schemes could not be proposed at this stage, the Environment Agency recommended to water companies the use of a “sustainability reduction” approach, to enable an estimate of the scale of compensatory water provision that would need to be made in order to protect sites. Estimates based on sustainability reductions should have been included within draft business plans for schemes with high levels of certainty and on this basis a forecast of the scale of the cost of water resources programme could be made.

5.5 In its advice to Ministers, Ofwat has proposed a constrained capital programme of £15 billion. We believe that this would significantly reduce the scope and number of nature conservation schemes below that required to achieve statutory obligations. As the nature conservation programme comprises only around 10% of the cost of the total quality programme, this reduction is likely to have only minimal impact on the average overall size of the bill increase and will probably have to be reversed within the AMP4 period for reasons set out above (see paras 4.2–4.4). The Environment Agency has advised that the assessment on which Ofwat’s recommendations are based has overestimated the costs of environmental improvements, and that there is scope for greater scrutiny of the other pressures for bill increases. We refer you to the evidence from the Environment Agency on this point.

5.6 English Nature joined the other regulators, as well as Water UK and Wildlife and Countryside Link, in commissioning a survey of customer views on the services provided by the water companies. Nationally, customers confirmed that it is important to maintain current levels of service, rather than allow reduced levels. They also wanted to see some improvements and support was given by the majority of customers to environmental improvements. A similar picture of national support for environmental improvements was evident from the responses to the joint statement launched by regulators in August 2003 (see Ofwat website for a summary of responses).

## Parallel action on diffuse pollution

5.7 In joint advice to Ministers (November 2003), the Environment Agency and English Nature have made it clear that measures to reduce impacts by other sectors are needed in parallel with action on the discharges and abstractions made by water companies. Nutrient pollution, especially from phosphates, causes changes in aquatic plant communities and eventually can lead to algal blooms. Both point and diffuse sources contribute in different ways to this problem and both sources must be tackled together. Diffuse water pollution from agriculture (DWPA) is a major source of nutrient enrichment in many freshwater SSSIs and Natura 2000 sites and English Nature has recently identified those sites most at risk (*Prioritising designated wildlife sites at risk from diffuse agricultural pollution*. English Nature Research Report 551, November 2003). We have proposed a two tier approach with basic measures across all catchments at risk, and targeted action where additional SSSI protection is necessary. We expect Defra to be consulting on its DWPA proposals in the Spring, and it is important that swift action is taken following the consultation. Such action is needed by 2010, in addition to sewage schemes under AMP4, to meet legal obligations under the Habitats Directive, to help achieve the SSSI PSA target and to ensure proportionate action by other sectors in tackling water quality impacts on SSSIs.

## 6. Dealing with uncertainties in this AMP round

6.1 The timetable for the Environment Agency Review of Consents for Natura 2000 sites does not match that for the price review (para 4.2 above) and so a number of assessments to determine which discharges or abstractions are adversely affecting Natura 2000 sites will not be completed in time for this price review

6.2 Similarly, a number of investigations or options appraisals have been identified for funding by the water companies under AMP4, where it is not certain whether schemes, or what type of schemes, are needed to achieve favourable condition of SSSIs. In order to ensure that the PSA target for SSSIs is achieved, it is likely that investigations funded in this price review will lead to a need to take remedial action before the next review.

6.3 Some companies may therefore face changes to costs between this price review and the next. The licences by which water companies operate provide for changes in price limits between reviews under the interim determination order (IDOK) process, where extra costs arising from new obligations exceed a particular threshold related to the turnover of the company. Where the net additional costs do not exceed this threshold, the company must carry these costs under the logging up process until new price limits are set out the next review.

6.4 It is likely that many of the additional nature conservation schemes will be insufficient to trigger the IDOK threshold for changing price limits, although the scope for this is currently being assessed by the Environment Agency with Ofwat. However the uncertainties associated with the present logging up procedure have led to concerns about reliance on it for bringing forward essential nature conservation schemes. We think that measures should be put in place to give companies confidence that funding (including financing costs up to the next price limit period) will be made available for schemes that are justified under the Habitats Directive and CRoW Act drivers outside the timetable for the price review.

6.5 Given that the scale and nature of uncertainty of this element of the environment programme is known already, as well as the timetable for producing further information that will enable schemes to be determined, a planned approach to logging up is both possible and justifiable. We suggest that serious consideration should be given to amending the present procedure such that companies receive assurance that schemes will receive funding as soon as they have been approved by the quality regulators (having considered the additional information), rather than at the end of the AMP programme, so that action can be taken to implement schemes within the timetables required to comply with statutory drivers.

February 2004

---

## Memorandum from the Royal Society for the Protection of Birds

### EXECUTIVE SUMMARY

1. Our aquatic environment is in a poor state, with over 45% of freshwater Sites of Special Scientific Interest (SSSIs) in England in unfavourable condition. Some 69% of river SSSIs in England are also in unfavourable condition, and over 50% of rivers in England and Wales suffer from high levels of phosphate. Water company activities are a major contributing factor to these problems.

2. Water company investment in environmental protection and improvement must be an essential part of the fourth periodic review of water pricing if we are to meet obligations under the Habitats and Birds Directives, and the Water Framework Directive requirement to achieve "good status" for our waters.

3. The RSPB supports the programme of environmental protection and improvement put forward as part of the periodic review by English Nature and the Environment Agency. This package represents a unique opportunity to deliver real progress towards a sustainable water environment.

4. The environment programme contains over 440 actions directed specifically at wildlife and habitats, including innovative multiple benefit catchment projects such as those proposed by United Utilities and Northumbrian Water.

5. The Government is under pressure to secure reductions in customers' bills by cutting the price review's environment programme. However, in putting forward this case, the water industry regulator Ofwat appears to have failed to take account of the 35% cuts to this programme already made since the publication of draft water company business plans, or to scrutinise fully water companies' assessments of the costs of environmental improvements.

6. A high level of scrutiny has already been applied to the environment programme (no other driver within the price review process has been subject to a similar level of examination), and the cuts sought by Ofwat would deliver a saving of only £2 per household on customer bills.

7. Customer research has demonstrated that there is majority support for investment in improving the water environment.

## INTRODUCTION

1. The RSPB works for the conservation of wild birds and their environment. We are Europe's largest wildlife conservation charity, with over one million members. We manage one of the largest conservation estates in the UK, totalling more than 125,000 hectares, including extensive freshwater and coastal wetland habitat. We provide advice on the management of wetland habitats, and contribute to the development of policy on a wide range of water policy issues including water resources, biodiversity, water quality and flood defence.

2. Wetlands are fragile ecosystems, dependent on the way we manage water. Whilst we have seen some important improvements in water quality in recent decades, largely through action to meet European standards for sewage and industrial effluent discharges, much remains to be done to achieve sustainable water management. Action to tackle water company impacts on important wildlife habitats is a critical component of this further work, and must be progressed now.

## STATE OF THE WATER ENVIRONMENT

3. Many rivers, lakes and streams remain heavily polluted. The Environment Agency (EA) reports that more than half of our rivers have high phosphate levels and more than a third have high nitrate concentrations. This "nutrient soup" can choke waters with algal blooms, and damage fragile communities of plants and invertebrates—for example, there has been a sustained, long term decline in the abundance of insect life in chalk rivers, with a serious knock-on impact on wild populations of trout and salmon. Much of this nutrient problem arises from sewerage discharges into watercourses, although the proportion varies from catchment to catchment, with diffuse pollution from intensive agriculture also making a significant contribution.

4. Our wetland wildlife is suffering as the countryside dries out. While much of this is a consequence of land drainage and flood defence policy and practice, the role of water abstraction from surface and ground waters is also significant. The amount licensed for abstraction in England and Wales is 35 million megalitres per year, most of which is for water company supply. There are some 500 rivers, wetlands and lakes on the EA's register of sites at risk of damage from such abstractions, including RSPB nature reserves such as Fowlmere (Cambridgeshire) and Strumpshaw Fen (Norfolk), and important rivers for wildlife such as the Hampshire Avon and the Yorkshire Derwent.

## ENVIRONMENTAL BENEFITS FROM THE 1999 PERIODIC REVIEW

5. The environment programme in the third periodic review provided for £5.3 billion of investment in 7,000 projects between 2000 and 2005. This is now delivering considerable benefits for beaches and coastal waters, for river water quality and for up to 100 important wildlife sites. Many sewerage treatment works and combined sewer overflows are being rebuilt to reduce their pollution impact on the environment, while research is investigating the impact of water industry abstraction on rivers and wetlands. This programme is still underway and, according to the EA, some 3,273 actions will have been completed by this March.

---

**THE ENVIRONMENT PROGRAMME IN THE 2004 PERIODIC REVIEW, AND THE WATER COMPANY RESPONSE**

6. This periodic review is a major opportunity to deliver much needed improvements to the aquatic environment and to reverse the legacy of damage from water abstraction and pollution. The environment programme developed by the EA and English Nature would ensure that water companies contribute their appropriate share to the cost of improving the health of our water environment, and it has the RSPB's full support.

7. The environment programme includes 4,700 actions (fewer than under the last periodic review), of which nearly 450 are directed specifically at wildlife and habitats. Over 4,500 of these actions are required by international and national law. We consider this programme to be a substantial milestone on the way to sustainable water management and the achievement of EC Water Framework Directive targets.

8. The work outlined in the environment programme would improve more than 5,000 kilometres of river and more than 2,200 square kilometres of wetlands, lakes and coastal waters. This would bring huge benefits for wildlife and improve everyone's quality of life. Cleaning up and improving our water environment will boost the economies of city and country alike, as clean, healthy waters offer many opportunities for regeneration. The EA has estimated that the long-term benefits of this programme could amount to between £3.5 and 7 billion, outweighing its costs.

9. At the end of August 2003, water companies published public versions of their business plans containing their preferred investment strategies. Any review of these plans is hampered by their lack of consistency—some water companies have outlined their investment plans in transparent detail, but others lack detail and are extremely difficult to interpret. For the purposes of costing their proposed schemes, the environment programme in each company plan was split into two plans or scenarios (Plan A and Plan B).

10. Plan A (prepared by the water companies following assumptions set by the regulators) contains all statutory environmental schemes. It includes £1.9 billion for tackling intermittent discharges from combined sewer overflows (for River Quality Objectives, Shellfish and Bathing Waters), £1.4 billion for compliance with the Freshwater Fish Directive, £0.8 billion for tackling impacts from sewerage treatment works on nature conservation sites and £0.1 to £0.6 billion for tackling abstractions impacting on such sites.

11. Plan B includes all of plan A plus a range of non-statutory schemes that could help to deliver Government commitments to river water quality, wildlife sites and biodiversity.

12. Alongside plans A and B, companies were asked to prepare "preferred strategies," identifying the schemes they would prefer to take forward. These could be in addition to those from plans A and B, and were based on the water companies' own financial assumptions.

13. The RSPB has been disappointed by the response of many water companies to the proposed environment programme. Most companies have included much of Plan A in their preferred strategies, but very few have proposed to take forward additional schemes from Plan B, despite their value for the environment.

14. Most worryingly of all, in some cases, not all of the statutory requirements are included in company-preferred strategies, and we very much hope that the Secretary of State will rectify these omissions.

15. According to Ofwat's summary of company draft business plans, the cost of the environment programme in the companies' preferred strategies is £4.72 billion out of the total of £19.9 billion. This cost varies considerably from company to company, from £150 million for Wessex Water to £1.8 billion for United Utilities.

16. The investment to improve aquatic habitats and biodiversity comprises only 6.5% of the total environment programme, some £312 million over five years, according to Ofwat's submission to the Secretary of State. The RSPB does not consider this too high a price to pay to protect and enhance our most important sites for nature conservation, and research suggests that a majority of water customers share this concern for the environment.

17. Among the schemes proposed by water companies as part of this periodic review, the RSPB particularly supports two innovative projects put forward by United Utilities and Northumbrian Water, and endorsed by most stakeholders in their local areas. These projects emphasise how multiple benefits for drinking water quality, biodiversity and river water quality can be achieved through influencing the management of catchment land. We believe they are models for the future of periodic review environment programmes, but proposed cuts threaten precisely such innovative and long-sighted approaches.

**POSSIBLE CUTS TO THE ENVIRONMENT PROGRAMME**

18. There has been significant debate about the overall level of projected increases in customers' water bills during the 2005–10 period. We recognise that a balance must be achieved between the cost of delivery of environmental benefits and overall rises in bills, but we do not believe that this need for balance has been adequately reflected in the contributions of the industry regulator, Ofwat, to the debate. Recent statements by Ofwat suggest that it is lobbying Government to cut back the programme of water company investment,

reportedly to achieve a maximum total level of £15 billion. Worryingly, much of its rhetoric concentrates on the scale of and need for the environment programme, whilst its treatment of other aspects of company investment plans is far more lenient.

19. The environmental regulators and the RSPB are concerned that the figures used in Ofwat's assessment of costs are based on the water companies' own figures, which we believe have not been subject to sufficient scrutiny. They could therefore be both out of date and inflated. In November 2003, the environmental regulators jointly asked Ministers to challenge company costings of environmental improvements, but this does not appear to have happened.

20. We are particularly concerned that Ofwat's advice to the Secretary of State may not take into account work already carried out to reduce the costs of the environment programme. Schemes with high costs and minor benefits, notably nitrate removal from estuarine sewerage treatment works (where the links to poor site condition have not yet been proved), were removed from the environment programme by the EA and English Nature in their advice to Ministers in November 2003. This amounted to a cut of 35% to the programme costed by the water companies in their draft business plans. Set in this context, Ofwat's pressure to reduce further the environment programme is even more unjustified and unnecessary.

21. We fear that, while the environment programme is coming under intense pressure, other parts of company investment plans (such as the substantial amounts of money allocated to address maintenance, security of supply and sewer flooding issues) have not been scrutinised with equal rigour. Further investment in the maintenance of company infrastructure is of course vital if leakage and water pollution incidents are to be reduced. However, there seems to us to be scope to look at some of the costings for investment and asset maintenance, to ensure that criteria to justify the deferral or removal of schemes are applied equally across the whole range of company activity.

22. Targeting the environment programme now risks jeopardising the UK's ability to comply with EC Directives, and threatens the health of the water environment. It also jeopardises delivery of Defra's Public Service Agreement target to have at least 95% of all SSSIs in favourable condition by 2010. This approach is all the more difficult to understand given that reports suggest that the proposed cuts would only save each household £2 per year on its water bill.

23. One approach to achieve cuts in the environment programme would be to remove all nature conservation schemes below Level of Certainty 1. Level of Certainty 1 schemes will be carried out in cases where it can be proved beyond any reasonable doubt that damage to environmentally sensitive sites is a result of water company activity. This approach would therefore remove all schemes at Levels of Certainty 2 and 3, where the substantial balance of probability is that damage is being caused by company activity. However, we believe that this presumption against action is incompatible with our legal obligations towards important wildlife sites.

24. Such a differentiated approach to nature conservation schemes would also take no account of the rigorous process that English Nature has undertaken in drawing up its recommendations for investment. Levels of Certainty reflect levels of knowledge about damage rather than degrees of nature conservation importance (comprehensive data is comparatively rare due to the costs involved in modelling damage to sites). Cutting out the schemes with Levels of Certainty 2 and 3 would hit sites designated under the EC Habitats Directive, as well as SSSIs notified under the Wildlife and Countryside Act 1981 (as amended), where water company investment is required to meet statutory standards. Should Ofwat endorse or propose such an approach, we would argue that it is overreaching its competence by threatening delivery of the UK's nature conservation obligations.

#### CUSTOMER RESEARCH AND THE ENVIRONMENT

25. There have been two published customer research reports during the fourth periodic review process. They were commissioned jointly by a consortium of Defra, the National Assembly for Wales, all the regulators of the water industry, WaterVoice and Wildlife and Countryside Link. Both reports have shown that there is majority customer support for water company investment in maintaining and improving the aquatic environment.

26. The customer research produced by MORI in November 2002 demonstrated that customers felt that coastal waters, rivers and wildlife habitats were in most need of further investment (ahead of 11 other aspects of company service), were a priority for action, and an aspect of company service for which they were willing to pay. The executive summary from the MORI research concluded: *Three aspects are considered to be in need of "quite a lot" or "a great deal" of improvement by between 21% and 30% of respondents. These are—the "maintenance of the quality of coastal, and bathing waters" (30%), the "maintenance of the quality of river waters" (26%), and the "protection of important areas of wildlife and plants" (21%).*

27. The Customer research published by MVA in December 2003 used real data on benefits and costs from draft company business plans. Nationally, 87% of customers felt that it was important to maintain environmental standards, while 71% felt that it was important or very important to improve environmental standards. The majority of customers also supported the proposed level of investment for the environment in their company's draft business plan, despite not being informed of the full benefits of the proposed schemes, and relying on unchallenged water company costs.

28. In September and October 2003, the water industry regulators conducted a public consultation to gather opinion on the priorities and scope of water company investment. It is unfortunate that there has been no report collating the results of this exercise, and that the consultation was not mentioned in Ofwat and WaterVoice's reports to the Secretary of State. We understand that the responses that Ofwat and the other regulators received, from many water company customers as well as organisations, were overwhelmingly in favour of water company investment in the environment.

February 2004

*Witnesses: Dr Alastair Burn, Head of Water and Wetlands, Ms Sue Collins, Director of Policy, English Nature; Ms Ruth Davis, Head of Water Policy, Mr Phil Burston, Senior Water Policy Officer, RSPB, examined.*

**Chairman:** Good afternoon. I think you were listening in on that so we will carry straight on from there exploring very similar issues with you. We are very grateful to you for your time.

**Q52 David Wright:** Are you happy with the environmental programme, particularly those aspects relating to nature conservation as it has been presented by the Environment Agency and when you consider what you have just heard?

**Ms Collins:** We are part of the regulators' group. The nature conservation programme set out in the Defra Minimum Plus programme is necessary. It was derived through a rigorous and robust process. We believe that implementing it is essential for three reasons. Firstly, to meet statutory obligations, Habitats Directive, Birds Directive and the Countryside and Rights of Way Act obligations. Secondly, we think it is a cost-effective contribution to implementing the Government's biodiversity strategy. Thirdly, we think it is necessary to help deliver more sustainable development by trialling some innovative approaches to the prevention of pollution, not only end-of-pipe solutions. So we think it has three important components. We also think it is necessary to prevent infraction proceedings, as Barbara Young made very clear, and particularly on the nature conservation side where the European obligations are very clearly on the Government. We think that there are wider benefits in terms of a water company's reputation. We think the public wants it. A study that RSPB has undertaken shows that environmental improvements in nature conservation recovery and nature conservation gains are very important to people. We believe the costs are relatively small.

**Ms Davis:** We do very much support the environment programme. We are aware of the intense scrutiny that the environmental regulators have put on their own schemes and admire the way they have gone about that. We are also aware of the need for the schemes because of our understanding of what is happening out there in the water environment. Some of these schemes are essentially delivering obligations on our own nature reserves, so we have direct experience of why it is necessary to put in place the programme. Our concerns relate to the fact that we have heard quite substantial amounts about the Water Framework Directive during the course of the afternoon. We are aware of the scale of the problem that we are going to face in tackling the requirements of the

Directive and, if anything, we feel that the constrained programme which was originally proposed by the environmental regulators may not take us far enough down the line of doing that. I would just like to support Sue in saying that there is another element of the programme which we particularly would draw your attention to, which is a number of projects we are trying to look at moving us from where we are now, which is essentially an end-of-pipe approach to dealing with water problems, towards a more land-based solution which in the long run is more sustainable and we think also more cost-effective for customers.

**Q53 David Wright:** You mentioned earlier about issues around the public's level of awareness on these issues. I wonder! I go around knocking on doors quite regularly, as I am sure many of us do, and I do not think the public are aware about this element of the programme. They just want a cheap bill at the end of the day. I support your general principle about how we draw investment in. What is your evidence in terms of the fact that the public are aware of the programmes and the outturn of the programmes because I am concerned that we are not conveying that message very well at all?

**Ms Davis:** I agree with you in the sense that I did a vox pop yesterday on the numbers of people who were aware of the size of their water bill and I could not find anybody who was aware. They all knew what the size of their council tax bill was. People may not be aware of what is being delivered in environmental terms from their water bills but that is the not same thing as saying that they do not have any concerns for the state of their environment.

**Q54 David Wright:** How seriously do you take your responsibilities to communicate that to the public? When water bills are going up I do not see groups like yourselves pitching in saying it is very important that your bill goes up in order to support the work of English Nature and RSPB.

**Ms Collins:** It is our public position that the prices consumers pay for goods should reflect their full environmental costs. That is the only rational way to have a more sustainable society. That is as painful in water as it is in transport and other ways and yes, the environmental movement does need to stand up and be counted and say that this is the way society needs to go and that society pays in hidden ways if the consumer does not pay. So the

---

2 March 2004 Dr Alastair Burn, Ms Sue Collins, Ms Ruth Davis and Mr Phil Burston

---

“polluter pays” converts into the consumer ought to pay. The consumer ought to pay to prevent as well as to clean up and that is where we need to move society onto a more sustainable footing.

**Ms Davis:** We promote these benefits in a slightly more fluffy way than the way that Sue has just described. Certainly the RSPB does work very actively to demonstrate the environmental need and also to demonstrate the outcomes of making environmental improvements. It is good to bring this back down to the level of places and people. If you go to the Norfolk Broads you can see the benefits of reducing water pollution directly. It is massively important internationally but it is also actually very dear to the hearts of lots of people. I think we do make an effort to promote. Where I think we could do better is to hold hands with the water companies and celebrate their level of investment in the water environment. I do not think their customers are aware of the amount that they contribute and the amount that we hope they will continue to contribute. Having said that, I would just like to bring in Phil because, as you know, we have done some joint customer research which we think reflects the fact that customers are willing to pay.

**Mr Burston:** There were two rounds that you may well be aware of. The first one was done by Mori in November 2002 and that tested 4,000 customers about what they felt the priorities were for future investment and future improvement to a variety of different levels of company service. The two things they chose above all were the two environmental aspects. They felt those were the things that we were doing most poorly and were most in need of improvement and they were willing to pay for those improvements as well. That was reinforced by the more recent MVA research produced in December 2003 which said that nationally 87% of customers said that maintaining a good quality environment was a very good thing and 71% felt it was also very important to improve that quality of environment. When they were presented with some ideas of what the implications of that would be for their water bill and some benefits from that investment there might be, 54% of people still supported that investment despite the fact that the benefits were not entirely clear and the costs may well, as we have already heard from the Agency’s evidence, have been over-inflated.

**Q55 David Wright:** Moving on. You were involved in the cost/benefit analysis that we have just heard about in terms of the work of the Environment Agency. Have you got anything to add about the results of that?

**Dr Burn:** We were involved with the process of coming up with a scheme for cost/benefit analysis but we were not involved in the individual cost/benefit analysis on particular schemes, other than providing information that was used by the agency to come up with the cost/benefit approach. As far as the overall cost/benefit analysis approach is concerned, yes, we are very happy with the approach that was undertaken. It was a well

scrutinised and very well peer reviewed approach and it did as much as could be done within the limits of economic evaluation to come up with something reasonable. There were gaps in it, so some elements of environmental benefit are not well costed particularly. The role of some of these schemes in delivering environmental services is not one that is well captured by this process. I agree with the Environment Agency that it probably under-estimates some of the benefits rather than the other way round.

**Ms Collins:** For the Biodiversity Action Plan schemes, which are in the plus bit of the Minimum Plus, I think the benefit was assessed at £300 million and the cost at £70 million, so they more than meet their cost/benefit test. Those are some of the things that would not appear in the Ofwat constrained programme.

**Q56 David Wright:** You both mention in your memoranda the possibility of nature conservation programmes being reduced solely to dealing with Level of Certainty 1 schemes and your concerns about that approach. English Nature said in the note that “Ofwat has proposed a constrained programme under which only those LOC 1 should be included”. Where have you got your evidence for this from? We have not seen anything about that. How were you made aware of that as a possibility? Could you tell us what your concerns are?

**Dr Burn:** This is part of the interaction we have had with Ofwat over the last few months. It is probably fairer to say, rather than proposed, this is one option that Ofwat has come up with, but it is realistic, it is there on the table. What we wanted to make clear was that the way in which the schemes are being scrutinised jointly with the Environment Agency is such that, from the best available information, the schemes within Levels of Certainty 1 to 3 are likely to be necessary. We have explained to you in our written evidence how the Levels of Certainty are derived and how they are laid out. Lower Levels of Certainty schemes are in there primarily for investigation purposes, so those are ones where there is quite a lot of uncertainty.

**Ms Collins:** That is Level 4 and below.

**Dr Burn:** Those in 1 to 3 are those where we are confident that there is a link with the water company and that there is an environmental impact or an environmental risk to a site that needs to be addressed. If the 2 and 3 level schemes do not get costed into the programme then the probability is that as the process of investigation goes forward they will have to be brought in hand, so effectively what we are seeing is a risk of under-estimating the total.

**Q57 David Wright:** Do we not have a problem in that if we do not fund the schemes lower down, the programme gets squashed for future years?

**Dr Burn:** Even further, yes. Levels of Certainty 1 to 3 are our best estimate of what is needed now. It is possible that the investigations for those Levels of Certainty for 4 and below will throw up more

---

2 March 2004 Dr Alastair Burn, Ms Sue Collins, Ms Ruth Davis and Mr Phil Burston

---

schemes. On the basis of information we have got and on the sorts of criteria that Andrew Skinner was talking about, they cannot go forward yet as schemes, but they may do once the investigation process is completed.

**Q58 David Wright:** So the danger is there may be schemes lying lower down in the categories that have got very significant impacts and that will not be drawn into the programme because of our inability to examine the issues comprehensively enough. Am I right in that?

**Dr Burn:** They are in the programme as far as there are investigations for schemes at that level.

**Ms Collins:** If they are included.

**Dr Burn:** And there has not been major disagreement over the inclusion of investigations. Later on in the process some of those are likely to be brought in and some may add significantly and the only options then are through the interim processes such as logging up and interim determinations.

**Ms Collins:** If I could just comment on the AMP3 process. There were a number of investigations carried on as part of the environmental discussions with Ofwat last time around. We put in a plea, and the Minister agreed, that they should be undertaken early enough for the results to be available to influence this price round. What actually happened is that in many cases water companies back-ended the investigations with the net result that the knowledge base has not grown as fast as it might have done and there is not as much certainty about some of those water abstraction schemes that there would otherwise have been. This is what happens in actual fact and I think it would be very instructive to ask the water companies and Ofwat to look at what has actually happened in AMP3, what were the estimates of costs and what were the actuals, what happened to the investigation and the timetable of those, did they carry them out so that they could have all the results to inform this round. I think that would be a useful bit of scrutiny.

**Q59 Chairman:** We are seeing them tomorrow. Thank you for that suggestion. Are you implying that they gave undertakings to do certain work in a certain order which they then reneged on?

**Ms Collins:** I think with a complex process as this that would be—

**Q60 Chairman:** —too harsh?

**Ms Collins:** Too harsh, probably, but it would be worth exploring.

**Chairman:** Only a bit too harsh then!

**Q61 David Wright:** You have drawn our attention to the likelihood of further, as yet unknown, work that will need to be carried out by water companies as a result of a review of consents affecting Natura 2000 sites. How significant do you think that will be?

**Ms Collins:** It could be quite significant in some cases.

**Dr Burn:** The starting point of this is the mismatch in timetables between the review of consents under the Habitats Directive and the AMP4 process and essentially the process that has been agreed to complete the programme of investigations by 2008, which of course is far too late for feeding into AMP4. The way we have approached it—and this is a joint exercise with the Environment Agency, the Environment Agency's consents are being reviewed—is to prioritise the review so that high priority sites are reviewed earlier on in the programme and those for which there is a lower degree of concern based on the initial screening process come later on in the programme. As far as we are able we have looked at the evidence relating to the higher priority sites and the lower priority sites where there is evidence available, but there is more progress and investigation on the higher priority sites at this stage than there is for the others. That being the case, it is likely that the really significant stuff is being picked up earlier in the programme rather than later. Issues relating to nutrient thresholds are much better worked out for freshwater sites than they are for marine sites and those may throw up some more problems.

**Ms Davis:** There is an important point about the extent to which this is a transparent process and the extent to which customers are engaged with what is being delivered during a price review. If we end up in a position where more and more of the delivery of our international obligations is shunted into the middle of a programme and is done through a process of logging up or through interim determinations, the ability to scrutinise that process earlier and to understand what the impacts of those bills is and what gets delivered to customers is reduced. It does not reduce the size of your bill in the long run but it does reduce and people understand what it is they are being asked to pay for and appreciate the deliverable outcomes. I think that is quite important because there is an act of trust involved here between the regulator, the customers, environmentalists and everybody else and that is undermined if we attempt to shunt costs into the middle of a programme as opposed to putting them off.

**Q62 Joan Walley:** In view of the meeting we will have with the water companies tomorrow, can I press Sue Collins on what you were saying about how the water companies have costed the nature conservation programmes. What is your view about how they have done this?

**Ms Collins:** We very much share the view put forward by the Environment Agency in the previous evidence session. We think that the cost estimates that are put in the public domain by Ofwat are higher than is likely to prove to be the cost when the schemes are fully worked through.

**Q63 Joan Walley:** How would you have expected the water companies to be able to provide transparency about how they have costed those programmes?

---

2 March 2004 Dr Alastair Burn, Ms Sue Collins, Ms Ruth Davis and Mr Phil Burston

---

**Dr Burn:** The main source of information on how water companies approach this is their draft business plans and we have been able to work with the other regulators on these. Incidentally, we have hugely appreciated being part of the regulators' group this time round which has made for a much more transparent process as far as we are concerned. We have been able to see how draft business plans have been developed. The nub of that is that many water companies have found it very difficult to cost up one category of nature conservation schemes and that is those to do with water resources in particular. There are a lot of uncertainties around that and there are a lot of uncertainties around ways of costing those schemes. The draft business plans are particularly deficient in that area across quite a number of water companies. A few water companies have also challenged some of the water quality schemes and have not included the higher Levels of Certainty schemes that we consider are necessary to achieve the statutory outcomes.

**Ms Collins:** They did not all apply the joint regulators' guidance in drawing up their business plans so there is not comparability across the plans. It is really difficult to work out what is included, what has been excluded and what has been costed at this stage.

**Q64 Chairman:** Do you think there is a degree of deliberate obfuscation going on?

**Ms Collins:** Nature conservation is a tiny part of the programme. We are talking about one-tenth to 15% of the environmental programme. We are talking about something that is not of major significance to a water company, it may appear quite small. It is big for us and we believe it is big in terms of public benefit but it is not the highest thing on their scrutiny horizon. That could account for some of the obscurity in the programme.

**Q65 Joan Walley:** Is it part of the debate that we were having just now about what benefits there might be from having a more regionalised approach to this or do you think it is about different kinds of expertise that is available in some water companies and not available in others, or is it just that there is not the understanding of the sustainability agenda in some water companies? Is it a question of expertise and training or is it a question of not linking the whole issue to what the issues are on the ground?

**Ms Collins:** I think there are three sets of issues. Firstly, more transparency would be helpful about what schemes are being included and where. I think more transparency about the costs would be helpful, but commercial confidentiality is dogging this. There is privileged information here that is not always shared. Thirdly, there are two parts to the technical challenge. Sometimes the solutions are not yet worked through in enough detail to give you decent costings. If you have an over-abstractness from a borehole, there may be a range of alternative solutions to providing the water quantity to meet the need and therefore there are

a series of options which will affect the cost of the solution. It requires an awful lot of work and detailed work and that is probably going to be done in the next phase, but the problem for us is that the political attention is now and the political decision about affordability may risk being made on rather insufficient information really.

**Dr Burn:** There is one other aspect, which is that this is the first time that the statutory obligations behind the nature conservation programme have been really upfront. The CROW Act and the PSA target to achieve that and the Habitats Directive and the timetable on that really have not been there in quite the same way with a timescale for delivery. I think some companies are finding it novel to see these in quite the statutory light that they really have become. That has led to challenges on a number of policy issues and it is fair to say that the draft business plans were among the challenges.

**Q66 Joan Walley:** I think that is interesting because this Committee is trying to monitor sustainable development targets and progress right the way across Government and it is very difficult because we have been talking about the cutting edge way of doing things and it is how much it slots into the depths of the water companies.

**Ms Davis:** There is an interesting point there because I think what you are seeing partly is the clash of some transparency in relation to the statutory drivers, the clear need in relation to the environment and some more complex and opaque issues about water company finance-ability and how they present themselves to those who present themselves and their customers. I would probably be prepared to be a little bit more up front than Sue is and say that I think it is reasonable to assume that some of the variation in company strategies was the result of a deliberate way of doing things, to present themselves to the outside world and that is different between different companies. They have approached the way that they have developed their business plans with a different strategy depending on how they want to be perceived, depending on perhaps the way in which their sustainability appraisal system is incorporated into the company. The difficulty with that is it makes it extremely difficult then to make rational political judgments on the back of something which is being driven by a process that is quite a lot more opaque and complex than simply a matter of what does and does not need to be funded in terms of the environment. I do think there are some important issues about how you achieve a consistent level of approach on the part of companies in the next round.

**Ms Collins:** May I just make a comment on whether or not it is cutting edge in sustainability terms? We are talking here about phosphates stripping from sewage works with very well known technology and that is quite an important part of this programme on Sites of Special Scientific Interest. So that end-of-pipe technology, cleaning up pollution, is essential but not sufficient for sustainability. If we are pushing a cutting edge

---

2 March 2004 Dr Alastair Burn, Ms Sue Collins, Ms Ruth Davis and Mr Phil Burston

---

sustainability approach, we are doing that and we are doing things to prevent the pollution, which is where the catchment schemes to choke off soil erosion, the leaching of phosphates and nitrates from the soil and so on is actually forward looking, innovative, important and on the right scale, a catchment level scale which is going to be necessary to get us towards the Framework Directive way of doing things. There is a tiny bit of innovative sustainability in the whole programme.

**Q67 Joan Walley:** The RSPB talk about each household saving £2 a year under the proposed cuts. Could you just clarify for us how you arrived at that figure and how it varies across the country?

**Ms Davis:** I will leave Phil to explain the details, but I think it is important to say that we did not arrive at that figure. Although at times the RSPB get treated as though we are a statutory agency, in fact we are not part of the regulatory process, we are rather subject to the crumbs off the tables, as other people are, in terms of information.

**Mr Burston:** I think it was touched upon by the Agency in their evidence. This all comes from the Ofwat submission to the Secretary of State, that is where we think the £2 figure comes from. It says, "If, for example, a total capital investment programme can be limited to £15 billion it would, by my estimate, reduce estimates by 5% over the five-year period." We judge that to mean the price increase is about £72 over the five-year period and 5% of that is £3.60. We have the impression that the environmental aspects of the planned cap are quite significant and more than 50%, therefore it is not too hard to imagine that that is where the £2 figure comes from.

**Q68 Joan Walley:** A national framework for this or any benefits from the regional framework where we could link up more locally and greater awareness of the issues, which would you go for? Would you go for a more regional framework?

**Ms Collins:** I think we need both. I think we need to have a national perspective, because these are international and national obligations, but it needs a regional spatial perspective. These water companies do map on to regions or sub-regions.

**Ms Davis:** Sadly, like with all boundaries and all systems, there is not enough overlap as one would like in relation to things like Environment Agency regions or spatial strategies. Am I right in thinking that what you are getting at in a sense is the unequal distribution of costs in relation to the benefits that you might generate from the environment programme? I think that is a very difficult question because if one says that in the past the costs have fallen very heavily in the south-west because of the large areas of important beaches that they have down there, if one starts to slice that off and consider the idea of distributing that in some national way, fundamentally it changes the nature of the process in the sense that the impacts of an individual company are not then related to the way in which they arrange prices and manage their enterprise. That is the attractiveness about the way

that the process works. It is as close as we are likely to get to something like the "polluter pays" principle in relation to these companies. The attractiveness of it is that you would not then find a situation where something like a clean beach is being very heavily subsidised by some parts of the population which are less able to afford it. I think our general feeling is that there are two points to that. We feel that generally speaking the economic benefits of improving the water environment are felt very much by the local populations who pay for that. So if you take something like the south-west, substantial parts of the economy are dependent on tourism and dependent on the quality of those beaches. We do feel that quite a lot of that benefit is recycled back into that region. The second issue is that we feel to some degree the issue about protecting vulnerable groups and protecting people on low incomes has become rather muddled with the idea of whether or not we can somehow afford to provide those same people with a good quality environment. We heard from the Agency earlier that there are a range of mechanisms for trying to make it easier for people to deal with their water bills if they are in vulnerable groups. It is a very important issue. Rather than dealing with it by taking a blunt instrument to the environment programme and essentially saying people in poor regions cannot afford to have a good environment, we would much rather that it was dealt with by taking a more flexible approach to looking at the way in which customers are billed so that you could protect the low income parts of those populations.

**Q69 Joan Walley:** We heard from the Environment Agency about the Periodic Review. Do you think there is a case for an on-going review as far as the environmental programme is concerned?

**Ms Collins:** I rather share the views put forward by the Environment Agency. I think the investors and the water companies need a degree of certainty that comes from a Periodic Review rather than a continuously rolling review. I think it is a question of what period you choose to review over. Five years is a fairly pragmatic period within the longer timescale that the EA advocated for if you are looking at it, but we do think that maybe the logging up process is not very effective. Maybe there need to be some interim looks along the way as these investigations come in. Maybe there ought to be more formal processes for making sure that these investigations do occur early on in the process and that that expectation is fulfilled and that Ofwat scrutinise that maybe, or the four regulators' groups scrutinise it in two years and say to the boards of companies, "Have you done your investigations? What have they found? What are the implications?" I think that sort of mid-term review within the five-year period would be a prudent thing to do.

**Q70 Chairman:** We will see if we can put that to the water companies as well. Dr Burn, you wanted to come in on the previous issue.

---

2 March 2004 Dr Alastair Burn, Ms Sue Collins, Ms Ruth Davis and Mr Phil Burston

---

**Dr Burn:** It was a small point in relation to the question you raised about regional prospects. The vast bulk of the nature conservation programme is down to statutory obligations. I am struggling a bit to see how we could arrive at a different type of programme looked at from a regional perspective than we would from a national perspective. The other thing to say is that all the schemes are driven by the local need effectively. It is not divorced totally from the local constituency in that sense, but we would use the same criteria for deciding on the necessity of the scheme wherever it was.

**Q71 David Wright:** Is this not about information? It is an information problem.

**Ms Collins:** It is how you organise them.

**Q72 David Wright:** I live in Severn Trent. When I am billed by Severn Trent I do not get, as far as I can remember, any information on what kind of impact these programmes are having in my region.

**Ms Collins:** Water company reporting is increasingly taking on biodiversity reporting. The BIE index has now got some biodiversity reports. Increasingly water companies' annual reports will include some quite useful information on the biodiversity outcomes from their investment programmes and I think that is the appropriate

place for it. I think it would be quite interesting and useful for those concerned with regional economic strategies for instance in the RDAs to look at what is happening in terms of outcome in their region in this sector of the economy. They ought to look harder at agriculture, but that is a different story. They could look at water outcomes because, as the RSPB have said, the water environment and the quality of it and so on is a vital asset that underpins the economic and social welfare, which is the stuff of regional economic diversity strategies. It is not irrelevant, but I do not think we want to change the process so that it is all regionalised.

**Q73 Mrs Clark:** I do not think the average person in my constituency in Peterborough is going to read the annual report of a water company. I think what my colleague, David Wright, was talking about was actually making this type of information much more accessible, whether we are talking about local papers, the media, etcetera.

**Ms Collins:** Perhaps they could put in a flyer with the bills.

**Chairman:** I sense we are going to drift steadily back towards recycling. May I thank you very much for your time. It has been a very helpful session. We are grateful to you for that and also for the written evidence which you have both submitted to us.

---

### Supplementary memorandum from English Nature

Response to Specific Questions from the Environmental Audit Committee following English Nature's Oral Evidence Session, 2 March 2004.

**Question 1. Further details of the concerns expressed during evidence that investigations were not completed in a timely manner during AMP3, including examples of where results have not been available to feed into the current review.**

*The initial profile of completion dates originally arrived at for AMP 3 investigations with nature conservation drivers is set out in English Nature's memorandum provided to the EAC for its previous enquiry in 2000. This is set out in Appendix 5 of volume II of "Water prices and the Environment", and is presented graphically in figure 1 below. From this it can be seen that for water resources 18 of 37 investigations were timetabled for completion in 2004 or later. For sewage effluent the figures are similar, with 12 out of 22 schemes timetabled for completion in 2004 or later. Given the need to finalise schemes for inclusion in final business plans in March 2004, investigations with completion dates later than this cannot be used to inform inclusion of schemes in AMP 4 business plans.*

**Figure 1: Planned completion date for AMP 3 investigations at the start of the process**

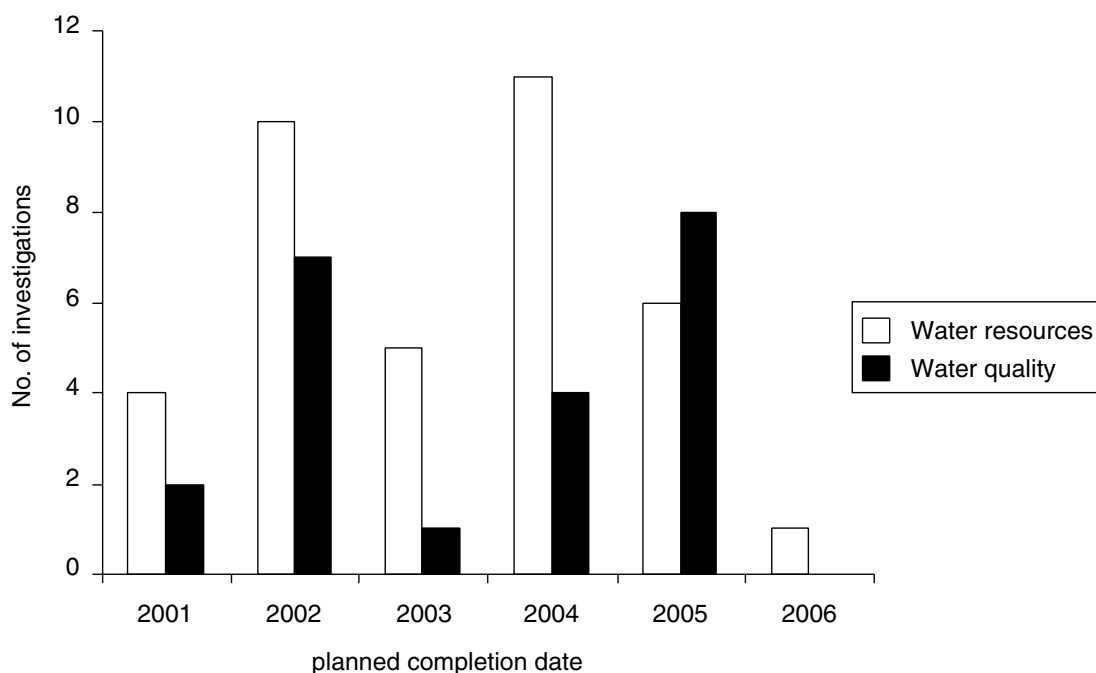


Figure 1. Planned completion date for AMP 3 investigations at the start of the process.

Additionally, some slippage has occurred with investigations. Fourteen water resources investigations were delayed by a year or more (10 were completed ahead of schedule by one year), and five water quality investigations were delayed by one year (none were completed ahead of schedule). These data are summarised in Tables 1 and 2.

**Table 1**

**WATER RESOURCE INVESTIGATIONS UNDER AMP 3, AND  
SUBSEQUENT STATUS IN AMP4**

Water Company	SSSI name	Completion date proposed by EA for AMP3 investigation	Actual Completion/ Forecast Completion	AMP4 scheme (+ indicates that a scheme or investigation is proposed under AMP4)
Anglian	Beetley and Hoe Meadows	2003	2004	+
Anglian	Booton Common	2002	2004	+
Anglian	Coston Fen, Runhall	2002	2004	+
Anglian	Didlington Park Lakes	2005	2005	-
Anglian	Foulden Common	2002	2004	+
Anglian	Great Cressingham Fen	2002	2004	+
Anglian	Kenninghamll and Banham Fens and Quidenham Mere	2005	2005	-
Anglian	Nene Washes	2004	2003	+
Anglian (and Essex & Suffolk)	Ouse Washes/The Wash and North Norfolk Coast	2004	2004	+
Anglian	Scoulton Mere	2003	2004	+
Anglian	Sheringham and Beeston Regis Common	2005	2003	-
Anglian	Whitwell Common	2003	2003	+
Anglian	Yare Broads and Marshes	2005	2005	+

Water Company	SSSI name	Completion date proposed by EA for AMP3 investigation	Actual Completion/ Forecast Completion	AMP4 scheme (+ indicates that a scheme or investigation is proposed under AMP4)
Bristol Water	Max Bog	2001	2001	—
Cambridge	Dernford Fen	2004	2003	+
Cambridge	Fowlmere	2002	2003	—
Cambridge	Sawston Hall Meadows	2004	2003	+
Essex and Suffolk	Burgh Common and Muckfleet Marshes	2002	2003	—
Essex and Suffolk	Cattawade Marshes	2002	2003	+
Folkestone and Dover Water Services	Dungeness	2003	2002	—
North West Water	Bowland Fells	2003	—	+
North West	River Eden Tributaries	2001	—	+
Portsmouth	Chichester Harbour	2004	2003	+
Severn Trent	Aqualate Mere	2005	2005	+
Southern	Rainworth Lake	2002	2001	+
Southern Water and Portsmouth Water	River Itchen	2004	2004	+
Southern and Mid Kent	North Kent Marshes	2004	2006	+
South East	Penvensey Levels	2004	2005	+
South West Water	East Devon Pebblebed Heaths	2001	2002	+
South West Water	River Camel	2001	2001	—
South West Water	North Dartmoor (Taw Marsh)	2002	2000	—
Thames	Sulham and Tidmarsh Woods and Meadows	2005	2003	+
Thames	Kennet and Lambourn Floodplain, Boxford Water Meadows, Chilton Foliat Meadows, Thatcham Reedbeds	2002	2003	+
Thames	River Kennet	2006	2005	+
Welsh	River Wye (Upper Wye and Lower Wye)	2004	2004	—
Yorkshire	Hatfield Moors, Thorne, Crowle and Goole Moors	2004	2004	+
Yorkshire	River Derwent, Derwent Ings, Melbourne and Thornton Ings, Brighton Meadows	2004	2005	+

Table 2

## SEWAGE DISCHARGE INVESTIGATIONS UNDER AMP 3, AND SUBSEQUENT STATUS IN AMP4

Water Company	SSSI name	STW	Scheme	Completion date agreed by EA	Actual Completion/ Forecast Completion	AMP 4 scheme proposed
Northumbrian	Lindisfarne	Belford	N&P removal	31.03.05	31.03.05	+
		Haggerston Castle	N&P removal	31.03.04	31.03.04	—
Severn Trent	River Eye	Somerby	<2mg/1P	31.03.05	31.03.05	+
		Langham	<2mg/1P	31.03.05	31.03.05	+
		Whissendine	<2mg/1P	31.03.05	31.03.05	—

Water Company	SSSI name	STW	Scheme	Completion date agreed by EA	Actual Completion/ Forecast Completion	AMP 4 scheme proposed
Severn Trent	River Teme	Tenbury Knighton	1mg/P < 2mg/1P	31.12.04 31.03.04		– +
Southern	Pagham Harbour	Sidlesham		31.02.02	2003	+
Southern	Walland Marsh	Walland Marsh		31.03.02	2003	–
Southern	Lymington	Brockenhurst Boldre Bridge	P removal P removal	31.03.02	May 2003	+
South West	Slapton Ley	Slapton	< 2mg/1P (Scheme underway)	31.03.05	31.03.05	–
Thames	River Kennet	Blackawton Marlborough	2mg/1P	31.03.05 31.03.01	31.03.05	– +
		Fyfield	2mg/1P	31.03.04		+
		Hungerford	2mg/1P	31.03.03		
Welsh	Dee Estuary	Bodenham		31.03.01	March 2003	–
		River Lugg		31.03.02	2003	–
Welsh	River Wye	River Wye	Schemes as	31.03.02		+
		Monmouth	outcome to investigations	31.03.05		+
Yorkshire	Pocklington	Pocklington	1mg/1P	31.03.05	–	

**Question 2: Further detail about the difficulty of comparing different water companies' business plans due to the different criteria used to prepare them, together with examples of cases where water companies have not included work to meet their statutory obligations for nature conservation.**

In our joint advice in November 2003, English Nature and the Environment Agency advised Ministers to ask Ofwat to require companies to adopt a consistent format for presenting the pressures on prices of the improvements sought in their business plans. We expressed our concern about the lack of transparency, and comparability, of the information in draft business plans. In some cases companies had omitted from their draft business plans, environmental schemes which are required by legislation.

#### WATER RESOURCES

The inconsistency in approach was particularly problematic in the case of water resources schemes. As a result of the mismatch in timetables for PR04, the review of consents process required under the Habitats Regulations, and the delivery of many investigations funded under the last review (AMP3), there is uncertainty over the final size of the water resources programme. With the exception of a small number of schemes the actions required to restore and protect sites will not become clear until the results of investigations become available.

In order to inform the PR04 process, at sites where the outcome of investigation are as yet unknown, the Agency made an estimate of the likely impact of abstraction. This was based, where possible, on local knowledge of the site in question. Where local knowledge was insufficient to make a reasonable estimate, a simplified generic approach was used, based on a proportion of the total licensed volume of the water company abstractions in question in the catchment. The process of estimating "sustainability reductions" within water resources plans was thus an important way of accounting for water abstraction schemes under nature conservation drivers which were submitted at high levels of certainty, but where details for schemes could not be identified until a fuller options appraisal had been carried out by the company.

Many companies did not follow the Agency's and Ministerial guidance, in developing their preferred plans, and excluded Sustainability Reductions from draft business plans even where these related to statutory obligations. The differing approach by companies is summarised in table 3 (taken from our joint advice to Ministers, November 2003). As an example, Thames Water, which excluded all water resources sustainability reductions for nature conservation schemes, stated in the public summary to their draft business plan that: "The availability of reliable water resources is a major concern with the impending implementation of the European Habitats Directive, which will have an impact on the volumes of water we are allowed to abstract from specific water sources. We have excluded further water availability reductions from our draft plan because of the overriding public interest in supplying water to customers."

## WATER QUALITY

A number of concerns about the nature conservation component of water quality improvements required in the environment programme were identified in companies' draft business plans. The most serious of this was the failure of several companies to include the minimum statutory environment programme in their preferred strategy, (summarised in Table 3 below) whilst some included environmental schemes which were not sought by the Agency or English Nature.

Table 3

SUMMARY OF COMPANIES' DRAFT BUSINESS PLANS BASED ON WHETHER THESE INCLUDE THE MINIMUM STATUTORY ENVIRONMENT PROGRAMME IN THEIR PREFERRED STRATEGY. BASED ON THE JOINT ENVIRONMENT AGENCY/ENGLISH NATURE NOVEMBER ADVICE TO MINISTERS

<i>Company</i>	<i>Environment Programme fully addressed in company preferred strategies</i>	
	<i>Improvements to water quality</i>	<i>Improvements to restore sustainable abstractions</i>
Anglian Waterv	✓	×
Welsh Water	✓	×
Northumbrian Water	✓	✓
United Utilities	✓	✓
Southern Water	×	✓
Severn Trent	×	×
South West Water	×	No environment programme required
Thames Water	×	Environment programme (water resources) excluded
Wessex Water	×	×
Yorkshire Water	×	—

✓ Minimum statutory environment programme fully addressed in company preferred strategy.

× Minimum statutory environment programme not fully addressed in company preferred strategy.

As an example, one company (Wessex Water) had not included 21 schemes to remove phosphates from a number of nationally and internationally designated river systems in its preferred strategy. The Wessex area is especially notable for chalk rivers, containing by far the highest proportion of river SSSI of this type in Britain. The schemes required reflect the large extent of designated nature conservation sites in this area, their importance—many of the SSSIs are also Natura 2000 sites and Ramsar sites—and population pressures on the freshwater environment. Two other companies had excluded six nutrient removal schemes from their preferred strategies.

March 2003

## Wednesday 3 March 2004

Members present

Mr Peter Ainsworth, in the Chair

Gregory Barker  
Mr Colin Challen  
Mr David Chaytor  
Sue Doughty

Paul Flynn  
Mr Malcolm Savidge  
Joan Walley

---

### Memorandum from Water UK

#### INTRODUCTION

Water UK is the representative body for the statutory water and sewerage undertakers of the United Kingdom.

1. Water UK welcomes the inquiry. The Environmental Audit Committee's previous report on water prices and the environment was an important milestone for regulation of the water industry and we hope that some important lessons will also emerge from this inquiry.

2. In framing our evidence to the Committee we have addressed a number of key issues in addition to those raised by the committee:

- What happens if the investment programme is reduced below £20 billion?
- Who should make the hard choices?
- How do we cope with the current delays in the issue of guidance?
- What improvements to the process of price setting do we need for the future?

#### BACKGROUND

3. The water industry has an excellent track record since privatisation, delivering a huge investment programme to time and to budget, £50 billion will have taken place from 1989 to 2005. It is widely regarded as one of the successes of the privatisation programme.

4. Companies are looking for the periodic review process to deliver a price settlement that will enable companies to invest in what they believe will be a sustainable programme to maintain a good service to customers, avoid deterioration to existing assets, and meet statutory obligations. At the last review significant price cuts were achieved in part by squeezing and deferring essential maintenance. We would not want to see this happen again.

5. We believe that the periodic review process up to January of this year had gone well, with all parties seeking to make it work. The Efra Select Committee in their recent report on Water Pricing said:

“Although this Periodic Review of water prices is at an early stage, we are encouraged by signs that it is being conducted in a transparent and mature way. It seems likely that price limits will be raised in this Review. While it is absolutely imperative that Ofwat should rigorously examine the claims companies make about their costs, we have seen no evidence to make us doubt that it will do so.”

6. Companies submitted draft business plans in August 2003 that recommended a total capital programme of the order of £20 billion for 2005–10. These plans represented their best view of what was required to deliver a sustainable business. The Efra Select Committee supported this approach:

“11 We welcome the introduction of draft business plans produced by the water and sewerage companies themselves and the greater scope for scrutiny and debate that this allows at an early stage in the price review process.”

7. Philip Fletcher in his letter of 19 December 2003 to the Secretary of State expressed his continued confidence in the process and what companies have delivered so far in their draft business plans, which proposed, on average, a price increase of 30% over five years in real terms, or £15 per year.

8. We are concerned that the Committee may have been slightly misled by the recent press reports, which implied that the Director General of Ofwat was considering a £5 billion cut in the water industry's environment programme for the period 2005–09. In his letter to the Secretary of State of 19 December 2003, Philip Fletcher said that if the total capital programme could, for example, be limited to £15 billion then it

was likely to reduce price limits by around 5% over the period 2005–09 from that proposed by companies. He was putting a question to the Secretary of State, suggesting that it might not be practicable to carry out all possible improvements in the next five years, and that priorities would need to be established.

9. In his letter the Director General raised the possibility that capex might be constrained in some way, and gave the example of £15 billion. A cut of 25% would not just affect the environmental programme, it would hit all elements of the capital programme including maintenance, network expansion to cope with growth and development, and asset renewal. Removing elements of one part of the programme will have a knock-on effect on other parts of the programme. We suggest that the committee should seek to clarify with the Director General whether he is setting £15 billion as the investment target for the 2004 price review.

10. In fact what the Director General appeared to have in mind in the letter was a level of spending “similar to that assumed for 2000–05”. Given that this was £15.7 billion in May 1999 prices the equivalent figure in projected May 2004 prices might be of the order of £17.5–18 billion.

11. What companies put forward in their draft plans was an integrated programme, which also seeks to meet all the criteria which have been set down by the Director General for quality schemes in the final business plan:

- Schemes must be required by the quality regulators and confirmed by Ministers, or be a new obligation under current legislation.
- Schemes must deliver a measurable defined output which is enforceable.
- Schemes must have a clearly defined timetable and due date for delivery in line with regulations or other legislation.
- Schemes must have defined asset improvements or changes to operational procedures to deliver the output.
- The costs of schemes must be identified and the solution challenged and validated by the company’s reporter.

12. The exact nature of the draft plans submitted by companies and the final business plans currently in preparation varies from company to company, and is related to history, geography and geology. For example, a company such as South West Water with its very long coastline has through the previous and current AMP period concentrated on the environmental programme to improve bathing water. This time around their proposed programme focuses on maintenance and the replacement of an ageing infrastructure. In contrast companies in the South East are emphasising new resource development and water efficiency measures to maintain security of supply in the face of population growth and water scarcity.

13. We are concerned that an arbitrary cut in the proposed investment programme is not a sustainable approach and will not deliver the optimal solution for customers. Short-term fixes can lead to additional costs. For example, if there is a decision to delay the adoption of known higher standards at sewage treatment works until post-2009, over the next five years new kit and works will inevitably be commissioned. But the plant will have to be upgraded within a matter of years to meet these standards. Deferring work has the potential to build up an even larger programme in 2009 and to result in infraction proceedings for the UK. We already know that work to meet the requirements of the Water Framework Directive will need to be funded in AMP5.

14. Philip Fletcher has indicated prices will need to rise and that hard choices are inevitable. There are many factors forcing prices upwards including capital maintenance, infrastructure renewal, network expansion, the environment and quality programme, and operating costs. For some companies rising operating costs are the main issue. In his letter to Margaret Beckett of 19 December the Director General said:

“Companies’ day-to-day running costs are also increasing, partly as a result of Government policy . . . So even before we consider enhancing the service already received by customers, bills can be expected to rise over the period 2005–10.”

Many of these cost drivers are completely outside of the control of companies or Ofwat such as tax and business rates changes, charges for streetworks or new security measures. For example, the Ofwat document “*setting water and sewerage price limits for 2005–10: Overview of companies’ draft business plans*” shows that whilst the scope for future efficiencies is estimated at £10 this is nearly wiped out by the impact of new taxation, estimated to be £9.

15. Customers have been consulted and research has shown that about 60% of customers in England & Wales have indicated they would be willing to accept price increases while not welcoming them. We recognise that there are issues of affordability if prices are to rise by levels indicated so far and this will need to be discussed further with Government. The Efra committee supported the joint research:

“We welcome the introduction of joint customer research, as it has limited the degree to which stakeholders have made competing and conflicting claims about what customers really want”.

The initiative to undertake joint research was a direct result of the specific recommendation from the EAC inquiry that took place after the last periodic review.

16. It is not just customers that are being asked to fund the capex programme. The capital markets will have to fund the bulk of any agreed programme by providing new debt and new equity. Another new joint initiative since the last periodic review has been for water companies to work collectively, and in cooperation with Ofwat, to understand the perceptions of investors about the industry. Water UK's investor survey shows that regulatory risk has lessened since 1999, but that investors believe that there is more political risk. It is important to note that investors no longer view water shares as a "must have" in a balanced portfolio, and there is a risk that they could walk away from the industry if the "right" programme is not agreed at the "right" allowed rate of return.

17. The water industry is very different from many other businesses in that it has a number of roles and functions. The prime function is of course to manage the distribution of water and sewerage services. These are essential services for all customers. To a greater or lesser degree the companies pick up the Government's social agenda; no domestic customers may be disconnected and vulnerable customers must be supported. In practice the water industry also operates as an environmental contractor, implementing many EU water directives on behalf of the nation.

18. It is the totality of the customer base that picks up the bill for things that arguably should be paid for by specific groups of customers or polluters, or Government. For example diffuse pollution is mainly caused by poor agricultural practices. There are rising levels of customer debt which might be better addressed by Government through the benefits system. Developers and their customers do not pick up the true cost of new infrastructure, as companies have a duty to provide public water supply and to accept sewer connections from new developments.

## THE ISSUES

### *What happens if the investment programme is reduced below £20 billion?*

19. We believe that arbitrary cuts in the programme will store up problems for the future. Companies have submitted business plans, which take a clear view of what is needed for securing a sustainable industry. Delivery of essential services could be at risk if these plans are compromised. Ministers have made it clear that it would not be acceptable to see leakage rates rising after the successes that have been achieved in tackling this problem since 1997. Companies are however funded to carry out work at the economic level of leakage, not the political level of leakage. They are now finding it increasingly difficult to maintain these leakage levels. We believe that in order to make further progress on leakage companies will have to undertake mains renewal programmes rather than a "patch and mend" approach.

20. In the "sustainable development" section of Defra's "Directing the Flow" (Nov 2002), under "the water industry", (page 11) it states,

"The water industry must be strong and viable in the long term. This is essential for delivering public water policy objectives. A key element of this is an effective, independent, stable and predictable system of regulation".

Stability and predictability are essential if we are to maintain long-term sustainability of the industry.

21. Although built to a high standard the infrastructure needs repair and renewal to maintain what are essential services. Since the last periodic review the industry in cooperation with the regulators has developed a new "common framework" for assessing the capital maintenance programme. Again this is a direct result of a recommendation in the previous EAC report which criticized Ofwat for "intellectual neglect" of this important issue.

22. We would not wish to see capital maintenance spending squeezed in this price review. It is central to a sustainable future to ensure that the nation's assets remain fit for purpose.

23. The network was built for a much smaller population. In some areas the systems of water or sewerage do not have the capacity to meet the current or expected future needs of the local economy and its population. Customers and Water Voice want to see problems such as sewer flooding eliminated through network improvements. In southern and eastern England a huge expansion of population and housing is expected. In Wales and the north and west of England economic development is hampered by inadequate networks. There is also a concern that the design of networks assumed continuity of rainfall patterns and in many cases will not be able to accommodate the impacts of a changing climate.

### *Who should make the hard choices?*

24. We strongly support the concept that the independent regulator should be able to set price limits without political interference, which was another EAC recommendation, nevertheless this needs to be done sensitively, taking into account the views of stakeholders.

25. There is a real need for shared understanding and shared views. We have previously suggested that there should be a national water forum which can discuss and agree long-term objectives for what is a long-term industry. A comprehensive framework was a recommendation from the previous EAC inquiry:

“However, the Committee recommends that the DETR, companies and the regulators ensure that the five year investment programmes of the Periodic Review are set in a clear, comprehensive framework of longer-term policies and goals including those relating to water resources and environmental quality and serviceability goals.”

26. The delays with Ministerial guidance that have occurred indicate that there is a problem for government in delivering timely decisions. There may be a case to decouple decisions on the environment programme from the rest of the Periodic Review process. The down side might be a series of interim determinations as new environmental programmes came on stream. This would not deliver certainty to customers going forward about their likely bills.

27. Elsewhere in Europe water operators receive grants from central government to implement the provisions of European directives. This has the advantage of making it clear how much such directives are costing. Although in England and Wales water operators are private sector companies there are precedents for private companies to receive state aid, for example in the railways sector. Another approach might be to have an explicit tax for environmental clean-ups.

28. Water UK is not recommending any of these options but recognizes that they may have to be considered.

29. We are concerned that other political factors could override the need for a sustainable price determination for the water industry. There has been a lot of publicity about increases in Council tax with a media perception that this is something the Government is powerless to control. Ministers may feel that other high profile price rises cannot be tolerated.

#### *How do we cope with the current delays in the issue of guidance?*

30. Delays on an agreed timetable cause great difficulty for companies. They cannot finalise their business plans without knowing the priorities that ministers will want to see met over the next five years. The current delays put the process under great strain, and indeed may wreck it. A squeezed timetable also puts heavy pressure on the decision making process which may lead to decisions that are viewed as less than satisfactory for all parties. It should also be noted that appropriate additional consideration by the Welsh Assembly Government and interpretation by the Environment Agency Wales, will mean that guidance in Wales could be delayed by an additional four weeks, exacerbating the problems for Welsh Water and complicating the situation for cross-border companies who rely on liaison between the English and Welsh Environment Agency staff.

31. We advised the Secretary of State of the need for timely decisions 19 November 2003 (see annex). The Director General has to set price limits that are effective from April 2005, just over a year away. The timetable was set out clearly at an early stage of the price review process in agreement with the Departments concerned. We believe that any delay in the price determination will have a negative impact on investor confidence and ability to manage customer and stakeholder expectations. It could also hamper companies' ability to agree charges for 2005–06 with the regulator and to issue bills with a consequent impact on cash flow.

#### *What improvements to the process of price setting do we need for the future?*

32. It is clear that we cannot go on indefinitely with the current approach. It was set up to deal with a particular set of circumstances, to get a large amount of investment into the business over a short period of time. It was assumed that high levels of environmental investment would only be needed over a relatively short period, the first ten years, and that after that maintenance and a programme of asset replacement was all that would be required. This has not turned out to be the case and it could be argued that the current Periodic Review process is no longer fit for purpose.

33. The process needs a radical rethink. Extending the period between reviews is not likely to be the solution. However, we would like to see the review become more of a check on progress on delivering an agreed long-term programme.

#### THE COMMITTEE'S QUESTIONS

34. *What should be the key components of the environmental programme?* This is essentially for government and regulators to decide. It is for Ministers to challenge the Environment Agency on the cost-benefit analysis of the environmental programme. The Government must assess whether the Agency's interpretation of Directives is in line with other member states. Non-compliance with obligations agreed by Ministers in Brussels, whilst the responsibility of the Government, may be seen by our stakeholders as a

failing of the industry. What we need is as much clarity and certainty as possible over long term goals and outcomes. Otherwise there is a risk of wasted investment, with companies putting in place solutions that will become redundant in a few years time.

35. The industry's environmental duties are not an optional extra, they are statutory requirements and the actions the companies take have a significant effect on both the state of the natural environment and the quality of life in England and Wales.

36. The Companies have a statutory duty to promote the Government's Habitat Action Plan and Biodiversity Action Plan agenda and meet the agreed levels of service in this area. The absence of water company spend would have a significant impact in this area.

37. The investment in capital maintenance is closely linked to the environment programme. Long-term investment in underground assets is essential for long-term environmental protection.

38. A key component of the environment programme should be an integrated catchment approach to environmental protection and water quality. This is in keeping with the multi-barrier approach to drinking water protection and the aims of the Water Framework Directive.

39. Longer-term we need regulatory impact assessments to be strengthened in Europe. We also believe that the UK Government must be more consultative at an earlier stage to understand the likely impacts on the water industry of proposed new European legislation. This will put the Government in a better position as they develop and agree policy in Europe.

#### *Adequacy of EA and Defra guidance so far?*

40. This has generally worked reasonably well, although there have been some problems with delays. At present a lot of issues remain uncertain (habitats, infractions, WFD) and will remain so until well after the price review is complete. The process for handling uncertainties is frequently discussed with Ofwat. We believe that there is a need to have more robust financial variation mechanisms to deal with both environmental and other uncertainties. There is an additional problem of a timetable mismatch between the Periodic Review process and EU Directives.

41. The main problem is not the adequacy of the guidance received so far, but the adequacy of the process. There was a general acceptance amongst stakeholders that hard choices would have to be made, however the options were not discussed early enough and there has been a lack of debate on the general issue of water services and the environment with all the key players. We believe that decisions on what is included in the guidance are made by Government collectively and not by Defra alone, so that the effectiveness of the debate between what are normally seen as the key players (Defra, industry, customer groups and regulators) is in reality constrained.

#### *Extent of environmental achievements in PR99?*

42. The report attached to Ofwat's letter to regulatory directors RD03/04 confirms companies are on track to deliver agreed programmes.

*February 2004*

**Annex**

### **Letter to Rt Hon Margaret Beckett MP, Secretary of State for Environment, Food & Rural Affairs from Pamela Taylor, Chief Executive, Water UK**

#### **WATER PRICE REVIEW 2004. PRINCIPAL GUIDANCE FROM DEFRA**

Early in the new year you will issue principal guidance to Ofwat on quality and social programmes required for implementation in the period 2005–10. The purpose of this letter is to advise you of the issues the water companies would like you to address.

In the guidance you have an opportunity to secure the progress the industry has made in recent years and help it contribute fully in the future to the national strategy for sustainable development.

Our advice is divided into eight sections:

1. Context: industry role and requirements of PR04.
2. Benefits of the draft business plan approach.
3. Views of stakeholders.
4. Clarity and timeliness.
5. Scale, value and timing of quality enhancement.
6. Future uncertainties.

7. Water framework directive.
8. Other issues.

## 1. CONTEXT: INDUSTRY ROLE AND REQUIREMENTS OF PR04

### 1.1 *New demands*

The industry has a unique set of responsibilities. It has achieved much recently in its core roles of protecting and enhancing economic, environmental and community health. More will be expected of it in these areas. But the industry is also now a required and willing partner in delivering public policy for a more demanding and fast-changing society. For example it is active in the location and design of new urban settlements; in the regeneration of rural communities; in delivering industry and transport policy sensitive to fragile natural environments; and in waste management and resource productivity.

In the same vein, beyond the UK, our water companies are working with others to strengthen our national response to the biggest threat to global sustainability, the poverty and deprivation of the developing world.

The prospect of companies meeting these challenges will depend to a large degree on two conditions: their ability to build closer and more informed relationships with customers, and ensuring the reliability of their assets.

### 1.2 *Customer relationships*

Among the most important industry achievements of recent years has been the improvement of customer services. This tends to receive less attention than notable environmental and quality improvements. However customer confidence will arguably be more important in enabling the industry to contribute fully from now on.

Modern customers increasingly expect service providers to meet their particular needs. Linked to this is a strong current in society and government towards local delivery and away from centralised decision-making. Water companies are conscious of these trends. While working hard to ensure that their PR04 draft business plans would meet the requirements of Ofwat and the other regulators, they were also keen to ensure that their proposals met the needs and expectations of local people and environments.

We hope that your guidance will emphasise the importance of recognising local conditions and priorities in company business plans.

### 1.3 *National infrastructure*

The reliability of essential utility infrastructure is among the most important long-term issues facing the country. It is widely accepted that for many years we have not invested enough in maintaining and renewing critical assets. The results are: a level of insecurity most people feel is inappropriate for an advanced nation in 2003; and a drag on the national economy and quality of life.

Both these characteristics are visible in the water sector. Many companies provide evidence of threats to existing levels of service let alone the newer challenges, unless capital maintenance increases in the PR04 period. While your guidance will not apply directly to maintenance proposals, we are conscious that plans could be reduced if the overall bill is judged too high.

We hope that you will recognise the need for adequate capital maintenance in 2005–10.

### 1.4 *Summary*

We hope you will give timely and unambiguous guidance that reflects local customers' preferences and priorities, accepts the need to secure vital national infrastructure, and allows companies to maximise their contribution to national sustainability.

## 2. BENEFITS OF THE DRAFT BUSINESS PLAN APPROACH

### 2.1 *Early information allows informed debate*

We believe the new element of the periodic review process—the publication of draft business plans—has been a success. It enables the cost of quality debate to be set within its wider context. It has put the issues in front of a wider range of stakeholders than in the past, and enabled them to participate.

Companies have developed careful proposals setting out their views on how to secure and develop services for their customers. We think the diversity of “company preferred” proposals across companies is a strength; it indicates that solutions have been tailored to local circumstances and reflect regional differences in customer priorities, quality of the environment, the endowment of assets, geography and geology.

Ofwat has acknowledged that prices will have to rise and in essence now the issue is by how much. There will have to be hard choices, given that the prospect for off-setting efficiency gains is less than in the past. It is important to secure existing levels of service and ensure that a huge ageing asset base is adequately maintained.

## 2.2 *Involvement of investors*

The greater involvement of industry investors is an additional improvement to the price review process.

The prospective size of the investment programme implies that companies need to maintain access to capital markets—debt and equity investors are therefore a key stakeholder group. Evidence from Water UK's investor survey is that the size of the capital programme itself raises concerns with investors, and Ofwat has accepted that this raises the cost of capital and therefore customer bills.

In summary we hope you will continue to emphasise the need for coordinated policy, and collaboration as appropriate, between the different participants in the price review.

## 3. VIEWS OF STAKEHOLDERS

### 3.1 *Customers*

The results of the joint stakeholder customer research will shortly be available. This work will provide valuable first hand information on how customers have reacted to the draft plans. The evidence so far suggests limited customer appetite for big increases in bills. We would urge you to listen carefully to what customers themselves have said in the light of the new information presented to them.

### 3.2 *Investors*

Water UK is repeating its investor survey during November and December. The survey will provide updated information on how investors are responding to draft business plans and recent Ofwat statements. We will keep your officials informed of the results.

### 3.3 *Consumer and environmental champions and the public*

We look forward to seeing the views of other stakeholders—especially environmental and consumer representative groups and members of the public—on the joint statement issued by Defra and the regulators on 12 August. We understand that non-confidential responses will be published on the regulators' websites. We hope that you will take into account the views of those interest groups that are champions of the environment in the context of sustainable development.

We also hope that you will have due regard to the views of the Efra Committee when they report on their current inquiry into water pricing.

## 4. CLARITY AND TIMELINESS

### 4.1 *Clarity*

We believe that the Principal Guidance should identify as clearly as possible those schemes that should proceed and those that should not.

We hope that the material provided in the two reference plans A and B will prove useful in framing your decisions. Companies remain concerned that the Ofwat reference assumptions are not realistic; in particular the efficiency assumptions are too ambitious looking forward.

### 4.2 *Timeliness*

There are some process issues relating to the timely provision of information and the Ofwat financial model that we will need to discuss with the regulators and your officials in due course.

Final business plans have to be submitted to Ofwat on 7 April and should be based on a firm view of the obligations companies are expected to deliver. It is also important that the regulators should not use this valuable time re-interpreting your guidance.

We hope that the date of issue of your Principal Guidance will not slip as the timetable is very tight. There will be only nine weeks between end January and 7 April for companies to analyse several thousand capital schemes, prepare final business plans, have them reviewed by company reporters, and clear company plans with boards.

We hope that all the key decisions will be taken by end January 2004. We understand that there will be “final” guidance in September 2004. Companies will only be able to deal with minor adjustments to their business plans at this stage.

## 5. SCALE, VALUE AND TIMING OF QUALITY ENHANCEMENT

### 5.1 *Hard choices*

It is clear that hard choices will have to be made given the possible implications for water prices. Your preliminary guidance indicated that costs and benefits would be fully taken into account and Ofwat has said that it will adopt a rigorous approach to proposals for extra obligations. We hope that the outcome will reflect this. Several companies have identified areas where they think the evidence of value for money is weak.

Many customers will be resistant to price increases if they do not think the proposed schemes are good value for money. It is important to be transparent about the expected benefits and costs.

### 5.2 *Options*

One option would be to delay the timing of schemes. In a number of instances this may be the sensible outcome. However the number of items to be dealt with in future price reviews is already high and decisions to delay should be set within a longer-term context.

A particular flaw in the 1999 price review was that it did not look beyond 2005 in any systematic way and produced a non-sustainable outcome. Taking the long-term view is essential for planning efficient investment in long-lived water sector assets.

We hope that you will ensure that an environmental agenda seen as too ambitious does not lead to a squeeze on investment capital maintenance, returns that are too low in the eyes of investors, increased risk of service failure, or excessive reductions in abstractions (especially in the dry South East).

We are concerned to see that, in its guidance to you, the Environment Agency has suggested that some companies have over-stated the costs of environmental schemes. There is an effective system in place for challenging and auditing these costs, and we have no doubt that this will be used. Some companies have been hampered by delays in the delivery of scheme details to them by the Environment Agency.

## 6. FUTURE UNCERTAINTIES

It is clear that in some areas decisions will not have been taken in time to influence the current price review. These include: obligations under the Water Framework Directive; revision of the Bathing Waters Directive; the impact of the Habitats Directive and other nature conservation measures; and the outcome of infraction proceedings under the Urban Waste Water Treatment Directive.

We have discussed these issues in general terms with Ofwat with a view to greater clarity on how they will be dealt with outside price reviews, through interim price determinations and logging up and down. This has been helpful, but we remain convinced that the mechanisms could be improved and that greater flexibility is required.

We therefore urge you not to assume that decisions can be delayed because the mechanisms work well and customers always pay. There is a danger that obligations imposed between price reviews are not subjected to the same rigorous cost/benefit tests as decisions at price reviews leading to excessive price increases.

## 7. WATER FRAMEWORK DIRECTIVE

### 7.1 *Preliminary work*

Your initial guidance in January 2003 said that some preliminary work and some schemes may need a start date within 2005–10. We hope your guidance will address what should be planned now. We are concerned that little seems to be expected by your officials or the regulators before 2009. This is too late if measures are to be operational by 2012.

### 7.2 *Pressures on raw water*

Some companies are experiencing deteriorating raw water quality. The problem is accentuated this year by the dry summer and autumn in that reservoirs collecting water from agricultural land are affected by excess nutrients, sediments and algal blooms. Climate change will increase the difficulties. Programmes to improve raw water quality should be developed for the next pricing period and better co-ordination of actions by the regulators is required to facilitate this.

### 7.3 *Efra select committee*

It is plain that members of the Efra committee are concerned about how this directive is handled and we ask that you ensure the matter is properly addressed.

## 8. OTHER ISSUES

### 8.1 *General points*

There are a number of other issues under discussion now between your Department, the regulators and the industry. These include (by way of example) the lead replacement programme, odour at sewage treatment works, unsatisfactory intermittent discharges, the implications of recent legal cases, IPPC, and first time sewerage.

In all these cases we are seeking greater clarity in time for final business plans, and a better understanding of how they should be handled between price reviews if not resolved shortly.

Longer term there is the impact of proposed 'sustainability reductions' to secure nature conservation, CAMS and the Water Bill in reducing the availability and reliability of raw water supplies. These may compromise the ability of companies to supply and increase the cost of new investment. Proposed future population growth in the South East will put severe pressure on water resources at a time when supply is becoming more uncertain and more costly.

You will be well aware that initiatives outside the remit of Defra such as proposed tax changes and the Traffic Management Bill have a substantial impact on customers' bills.

### 8.2 *Specific concerns at present*

Specific concerns we have at present include the following:

Freshwater fish directive. The options considered in your Department's recent consultation and what has been costed in business plans do not appear to match up. This has been picked up by WaterVoice in their evidence to the Efra committee. This may be a matter where the timing of action can help to ease the problem.

Unsatisfactory intermittent discharges. The Environment Agency and Ofwat are assuming that previously unidentified discharges that are now unsatisfactory are already allowed for in companies' capital maintenance. This clearly cannot be the case if they were not known to exist.

Debt. Debt has been increasing steadily since domestic disconnections were banned by the 1999 Act (long term debt may have increased by 50%). Water companies are working with others to find solutions and in particular to help those in difficulty pay their bills. However, primary legislation is needed to remove loopholes that allow various households—not necessarily vulnerable ones—to avoid paying water charges. Your department was unwilling to include the required legislation in the Water Bill, but recent interim determinations of prices demonstrate that debt has a significant cost. It raises customers' bills by an average of up to £10 per year and diverts resources away from other more valuable activities that could be undertaken if debt were better controlled.

19 November 2003

---

## **Memorandum from Northumbrian Water Limited**

### 1. INTRODUCTION

1.1 The Environmental Audit Committee (EAC) has announced an enquiry into PR04 and the environment. Views were sought on three key questions. This memorandum provides a brief response to each of the key questions listed by the Committee and also some context which may be useful for the Committee.

1.2 Northumbrian Water Limited (NWL) is a water and sewerage Undertaker supplying over 1.1 million customers in the North East of England with water and sewerage services. It also incorporates Essex & Suffolk Water, which supplies water services only to 720,000 customers in these southern counties.

### 2. BACKGROUND

2.1 NWL welcomed the EAC report on Water Prices and the Environment in 2000. Many of the key recommendations have since been acted upon, including those relating to joint customer surveys, a new approach to assessing capital maintenance requirements, and a clearer framework for leakage targets. The comments regarding the importance of emphasising the customer and public benefits of environmental and quality investment alongside the upward pressure on prices remain valid.

2.2 NWL considered the recent report by the Environmental, Food and Rural Affairs Committee on Water Pricing to be a valuable contribution to the debate on water charges. We agree with the comment in the report that there are encouraging signs that the review “is being conducted in a transparent and mature way”.

### 3. RESPONSES TO SPECIFIC QUESTIONS RAISED

Q. *What should be the key components of the environmental programme allowed for in Ofwat’s price limits?*

**The environmental programme is not the only factor driving higher water bills.**

3.1 In considering this question it is important to consider the wider context of upward pressure on water bills from a variety of sources. Much of the public debate has focused on the environmental investment programme often to the exclusion of other factors such as changes in tax legislation that may have a greater impact on bills. In fact, the environment programme is not the only or even the largest driver of bill increases. Other reasons for increased bills include:

- unavoidable increases in tax, operating costs and depreciation (arising from a growing asset base);
- the requirement to increase capital maintenance expenditure to sustainable levels;
- statutory drinking water quality requirements;
- maintaining security of supply to meet increases in population and housing development in more variable climatic conditions (this is particularly important in an arid area with growing population such as Essex);
- meeting customer expectations that more should be done to alleviate sewer flooding;
- customer service improvements (in NWL’s case measures to reduce discoloured water complaints);
- increased site security requirements, particularly at key drinking water installations, and emergency planning measures, arising from enhanced threat of terrorist activity and informed by guidance from DEFRA and the UK Security Service;
- meeting increased customer demands to control odour from sewage treatment works (in line with a draft DEFRA Code of Practice);
- ensuring that financial returns are sustainable, so that companies can continue to deliver the required investment; and
- declining demand for water from heavy industry due to structural changes in the economy (this is a particular problem in the North East).

3.2 In addition, there is a significant divergence in the scale of the anticipated environmental programme between regions. In focusing on national totals these important regional variances are often overlooked.

#### REGIONAL DIMENSION: NORTH EAST SPECIFIC POSITION

3.3 The major population centers in the North East are all on the coast and this is where our major sewage treatment works are located. There has been a huge amount of investment in recent years to meet the Urban Wastewater and Bathing Water Directives with many new or extensively re-built works along the coast. As a result of this successful investment treatment standards are very high and the required environment programme for 2005–10 is significantly reduced.

3.4 The preferred scenario in NWL’s Draft Business Plan showed a 70% reduction from the environmental programme delivered in AMP3. This programme was developed in close liaison with the EA and met all of the Agency’s priority requirements. It now appears that we may need to invest at further works to comply with the Freshwater Fisheries Directive. Requirements need to be confirmed by Ministers. The most likely scenario is that this would require investment of over £20 million. This would still mean a reduction of around 60% in the environmental programme relative to AMP3.

3.5 NWL’s forecast AMP4 environmental programme is around half the company’s water quality investment programme to meet statutory requirements, which is supported by DWI. Indeed the environmental programme is only around ten per cent of the total investment requirement in AMP4 with the largest element being the maintenance of the asset base to secure existing standards.

3.6 The context in the North East may be different to elsewhere. Northumbrian Water faces a reduced environmental investment requirement but there are many other drivers, which collectively produce a requirement for a significant increase in bills.

3.7 In this context we believe the environmental programme should ensure the delivery of the priority outputs designated by the EA and ensure compliance with statutory requirements. We do not support investment beyond statutory requirements except where there is strong customer support and a clear environmental benefit. We have included in our plan a number of studies into holistic catchment solutions that may alleviate the need for expensive investment in future. Whilst not statutory these are low cost and are strongly supported by the EA and English Nature.

3.8 It is important to recognise that maintenance investment in existing assets plays an essential role in protecting the environment by safeguarding the achievement of existing high standards.

3.9 We feel strongly that investment to tackle sewer flooding should be given a high priority. We are aware that WaterVoice considers this the top priority for customers. Our customer research confirms this viewpoint. Ofwat classifies this as a service enhancement rather than environmental investment but we believe that this needs to be considered alongside the environmental quality programme.

3.10 NWL has worked very closely with WaterVoice, the EA and DWI to develop our investment proposals. We believe that PR04 should recognise local circumstances and reflect regional variations. For instance, it would be inappropriate to impose a national economic cut off on investment on sewer flooding. NWL has relatively few properties affected but many of these would be relatively expensive to deal with. Given the small number of properties the total investment and impact on bills would be modest. We would like to tackle all properties in the North East at risk of sewer flooding in AMP4 but accept this approach may not be affordable in all regions.

*Q. Has the guidance given by the Environment Agency and DEFRA to date, on the size and scope of the environmental programme been adequate?*

4.1 The Draft Business Plan presented data in three scenarios. Reference Plan A included largely statutory minimum requirements. Reference Plan B included those drivers in Reference Plan A plus a number of further drivers. Some of the additional drivers in Reference Plan B were in excess of the statutory minimum and some concerned areas where Ministers would have to make choices (eg Freshwater Fish Directive) In addition companies provided their Preferred Scenario. The Reference Plans required a huge amount of effort from EA and DWI as well as companies. This exercise produced much useful information.

4.2 The EA, DWI and Ofwat have all advised Ministers on their perspective on required investment for AMP4. In developing its plans NWL has worked very closely with colleagues at EA, DWI and WaterVoice. We have had regular meetings with each of these organizations individually and collectively. We have worked particularly closely with the North East Regional EA on the size and scope of environmental obligations as they affect our region. We are grateful for the close co-operation extended by the EA and WaterVoice in our region, which we consider a model that others could follow.

4.3 We believe the EA has made its position clear. Initial guidance from DEFRA on the objectives for the review and on the longer-term framework for the water industry was helpful although left many questions unanswered. However, a key point in the PR04 timetable is the issue of main Ministerial Guidance. This is already late and as a consequence there is a risk that the PR04 timetable will need to be reconsidered. This may unduly constrain time for decision-making and consultation since price limits must be issued by mid-December if bills are to be issued on time.

4.4 We believe that decisions on the environmental programme should not be taken in isolation and need to consider the wider context described above. Arbitrary cuts in maintenance investment would put the huge improvements in environmental performance in recent years under threat and would in themselves only have a marginal impact on bills.

*Q. What is the extent of the environmental achievements delivered as a result of the 1999 Periodic Review?*

5.1 We have already mentioned the huge improvements in sewage treatment throughout the region. We summarise here the improvements made over the last few years under the main statutory drivers for investment.

(a) Urban Waste Water Treatment Directive (UWWTD) and Bathing Water Improvements.

Installation of high quality sewage treatment facilities has continued in AMP3 to comply with the UWWTD. Improvements to 88 No. sewage treatment works will be delivered by 2005. This will result in a total of over 96% of the company total population equivalent (pe) of 3.7 million having the high level of secondary treatment.

We have installed ultraviolet disinfection of discharges to comply with mandatory bathing water standards and to assist in achieving blue flag status at key holiday resorts. NWL has delivered major improvements to the quality of coastal and estuarial discharges in the North East during AMP2 and the early part of AMP3. These substantive works were completed in 2002–03. Six major discharges (Bran Sands, Hendon, Howdon, Marske, Billingham and Seaton Carew now have ultraviolet disinfection (53% of the company total population equivalent of 3.7 million). The North East has the highest proportion of its discharges disinfected (by percentage of population equivalent) in England and Wales. This has major benefits for bathing waters and the Tyne and Tees Estuaries.

(b) Freshwater Fish Directive

Improvements are being delivered to 26 sewage treatment works during AMP3, with a combined pe of 0.1 million. The key output is the removal of ammonia.

(c) Habitats Directive

Improvements are being delivered to 2 sewage treatment works by 2005. The key output is the removal of both nitrates and phosphates.

(d) River Quality Objectives

This concerns improvements to reduce current shortfalls on River Quality Objectives as identified by the EA. The key output is 100km of river protected from deterioration of standards and 72 kilometres of river improved. A total of 26 No sites will be improved by 2005.

(e) Unsatisfactory Intermittent Discharges.

The company also has a major programme ongoing to improve unsatisfactory intermittent discharges (sometimes called combined sewer overflows or CSOs). This programme has increased in AMP3 from that included in the PR99 Determination in the light of new information. A total of 236 outputs will be delivered by 2005, instead of the 199 included in the PR99 Final Determination. This still leaves around 175 unsatisfactory intermittent discharges to be addressed in AMP4 and we believe that provision in the PR04 Final Determination should be made for these outputs.

5.2 The environmental improvement brought about by work in AMP1 and AMP2, together with the benefits that will accrue in AMP3, are substantial in the North East of England and the remaining potential improvements are by comparison low.

February 2004

---

*Witnesses:* **Mr Bob Baty**, Chief Executive, South West Water Ltd., **Ms Pamela Taylor**, Chief Executive, Water UK, and **Mr Ceri Jones**, Regulation Director, Northumbrian Water, examined.

**Chairman:** Thank you very much for joining us. As you may know, we had an interesting evidence session yesterday with the Environment Agency, English Nature and the RSPB, who raised a number of issues which we would like to explore with you today. We want to kick off by seeking your views on the draft business plans.

**Q74 Sue Doughty:** Could you summarise briefly for us the process by which you developed the draft business plans that went to Ofwat last year?

**Ms Taylor:** Ofwat set the parameters, which the companies would then have to cost; so the companies would then go through those parameters and produce their costings. Those costings were then checked independently by Ofwat reporters, who are independent. This is an iterative process, so as time goes on, Ofwat will get further and further understanding into the detail. They also have a bank of knowledge and information from previous periodic reviews; so this is not the first time and obviously they have got previous data with which they can compare.

**Q75 Sue Doughty:** Do you find the process satisfactory?

**Ms Taylor:** The process this time around has been different from before, and we think that this time the process has been an improvement compared with before. We have liked the idea that Ofwat has asked companies to produce the draft business plans because we welcomed the opportunity of being able to put those into the public domain. It has meant that customers, and also customers' representatives such as their members of parliament, consumer groups and environmental groups, have been able to look at the plans at an early stage. We welcomed that.

**Mr Baty:** The framework of the plans of course offers the opportunity for three scenarios. One is a price and environmental programme, which was

deemed reference plan A, which was identified as being the minimum requirement to deliver statutory obligations; and reference plan B, which was that programme plus those investments which were considered to have a cost benefit by the Environment Agency; and we were also invited as individual companies to submit a company-preferred plan, and that varies from company to company. For some companies these will be below reference plan A; some are between (A and B) and some are at reference plan A; so this time it was a broader spectrum to work on.

**Mr Jones:** It is also worth stressing that in developing company business plans there has been quite extensive consultation between companies and a range of stakeholders, including in particular the Environment Agency, the Drinking Water Inspectorate and WaterVoice. Much of that consultation has been at a regional level between specific companies and the agencies in respect of that region.

**Q76 Sue Doughty:** The whole idea of preferred plans is very interesting. Is a preferred plan really a preferred plan? Is it an ideal for you about what you would like to be able to spend over the next five years, or is it something that you have moderated as to what you think you are going to be able to put in?

**Mr Baty:** Individual companies are at liberty to assess the issues that that particular company may be wrestling with; and certainly in the South West customer affordability is very high on the agenda, and we are very conscious about the impact of customer charges. In the South West we have invested over £1 billion on environmental improvements since privatisation, so there is a significant environmental benefit already being enjoyed in the South West. We were looking to see whether during this coming period, it is appropriate to balance that out a little bit more given the pressure it is putting on customer charges. We have done that

---

3 March 2004 Mr Bob Baty, Ms Pamela Taylor and Mr Ceri Jones

---

in dialogue with the Environment Agency, and that dialogue is continuing even today. We are waiting for ministerial guidance as to just how that will balance up when ministers' guidance is public.

**Sue Doughty:** Are there any other factors that will affect your final plans that you would want to factor in as well at that stage?

**Ms Taylor:** At this stage there are still some things that we just will not be aware of and we will not know how much they will cost or when they are going to come in, because a lot of our spend—around 80% of it—is driven by directives from Brussels. Obviously, one of the problems we have is that the timescale for the periodic review, which is in five-yearly chunks, does not fit with the timescales of Brussels directives. There will be some issues therefore that we will not yet know whether or not we will have to deal with them. A little while ago, for example, it looked pretty certain as if we would get a revised Bathing Waters Directive, but now we do not seem to be getting one—at least we do not think so. There are issues such as that, which, with the best will in the world, the current system that we work in cannot cope with.

**Q77 Sue Doughty:** We had the Environment Agency in yesterday, and they gave us a written submission.<sup>1</sup> It was fairly critical with some of the submissions, in terms of over costing projects and proposing work that the Agency does not consider necessary, and some work that was not costed in there that the Agency felt was necessary to establish the obligations. What is your view of the environment programme that they are proposing along with English Nature? We have had their views, but what are your views on the programme?

**Ms Taylor:** We have to bear in mind that this is deliberately quite a long process. We are attempting to put more and more information into the public domain and to engage more people. We are satisfied that, company by company, the discussions that are happening between the Environment Agency and companies are going extremely well. Initially, there was perhaps some positioning publicly, as there is bound to be in a national arena, regarding what is being said; but when you get into the detail, company by company, we have been satisfied with the discussions that individual companies have been able to have with the Environment Agency. This is a long process and an iterative process, and we would expect to see a coming-together rather than a pulling-apart on things that had to be discussed. That does not mean that every company is the same. We see wide variations between one company and another as to what it is that they are specifying that they believe they require for their environmental spend, and that is to be expected because companies vary, company by company. In terms of the process, so far, apart from that ministerial guidance, we are happy with how it is developing.

**Q78 Chairman:** You have just said exactly the reverse of what we were told yesterday. We were told that all was fine and dandy to start with, and it was a much better process and everyone was happy; but as we get to the crunch period, the decision time, inevitably conflicts and disagreements are bound to arise. I am not quite sure how we are getting such a different picture from you.

**Ms Taylor:** Maybe because we have been there before. We have been through so many crunches and so many previous periodic reviews that this time around the crunch does not feel particularly worse than other times. I suppose because we are, understandably, pulled in different directions by an economic regulator, and environmental regulator, a quality regulator and the Government, we are just used to being in this position. We think that the way in which Ofwat has conducted the process this time around has been an improvement on the last time around; but of course there will be differences of opinion as we go forward—and you could say that is healthy.

**Mr Jones:** From the regional perspective, the environmental programme we have put forward as a company is exactly in line with what we understand the Environment Agency and English Nature would wish to see. We believe that they support it entirely. That has been very much guided by detailed consultation and discussion with both of those agencies in respect of our area. On the issue of costing, one of the problems we have sometimes faced in the past is a lack of clarity about the outputs that we need to deliver. It is quite difficult to come up with robust costing if you are not sure what you are trying to cost. I think we are in a much better position this time. We are in receipt of some very detailed information from the Agency about what each of the drivers would mean on a work-specific basis, and the only way you can come up with very robust costs is to do it bottom-up, assess exactly what will be required at each site and then add those up. I think we are in a much better position than we have been at previous reviews because we do understand what the impact of the drivers will be on a work-specific basis; and we are therefore able to put together some fairly robust cost estimates.

**Mr Baty:** We are not free, as companies, just to say how much they will cost; there is a process we go through in conjunction with Ofwat on a cost-based report to price out individual typical schemes. They are compared by Ofwat to set efficiency targets to feed back to companies, so there is a competitive edge in terms of how much those different companies think those particular schemes are going to cost. Then we use that work back in to pricing against particular requirements in an individual company. All that is monitored and checked by the independent reporters, who are operating for Ofwat as the independent regulator. It is not for the companies to freely decide how much these are going to cost. The whole thing is audited and scrutinised as it goes through. We are challenged, understandably, with improved efficiency at each review, and year on year.

<sup>1</sup> Please see written memorandum, Ev. 1–10.

---

3 March 2004 Mr Bob Baty, Ms Pamela Taylor and Mr Ceri Jones

---

**Q79 Sue Doughty:** You are reasonably comfortable with the cost-benefit analysis that the Environment Agency and English Nature have done. Do you think it is giving good value for money from where you are coming from?

**Mr Baty:** The cost benefit is a slightly different element of it. This is getting the base costs for the three programmes which we would be submitting, that is the reference plan A, reference plan B and company-preferred solution. In terms of the cost benefits on reference plan B, the methodology for determining that—again, we have some reservations as to whether or not that is appropriate in the way that cost-benefit analysis is being carried out. Certainly, in the South West, affordability is a key issue, and recognising the work that we have delivered over the last 15 years we are reluctant to be moving significantly into that particular part because of customer affordability. There are one or two schemes where, clearly, we accept there is a good cost-benefit, and it is very rational, but it gets into a grey area. Clearly, there would be differences between ourselves and our local Environment Agency, and that is where ministerial guidance would clarify that part of it. As a company, we would be reluctant to move too far on that cost benefit purely because of the affordability in relation to customers in the South West, given the burden placed on them over the last 15 years.

**Ms Taylor:** We think that more work is needed on the economics of environmental measures. We have been working with the Environment Agency and with NGOs on some projects to look at environmental cost benefits because we think there needs to be improvements in this area.

**Mr Jones:** Can I add, as an economist, that it is a difficult area; cost-benefit analysis on environmental improvements is not straightforward. It is pleasing that the Agency is putting more effort into this area. They have made a very good start, but there is a lot more work to be done. As far as the preferred programme that we have put forward is concerned, we have discussed any schemes where we had doubts about the cost benefit with the Agency at a local level, and we are quite happy that the schemes we are putting forward are good value for money.

**Q80 Sue Doughty:** You feel that they will fulfil a good environment programme?

**Mr Jones:** The scope of the environmental programme depends ultimately on decisions from ministers, but we are happy that the programme we have agreed on a local basis with the Agency represents a reasonable way forward.

**Mr Baty:** I should also point out that it will vary with different companies across the country. I can only speak on behalf of the South West, and again in this particular review, our environmental programme is tiny compared with the enormous investment we have made in the past, and the impact on customer bills is very low with the programme we are talking about—perhaps between £4–6 increase in bill over five years. In relative terms it is a much smaller environmental programme than we have ever delivered in the past. Our challenge is carrying the

financial burden of the environmental programmes we have already delivered because that carries cost going forward. As an industry we all spend more money than we have in every day, so we are all cash negative; and the cost of borrowing that money carries on beyond the delivery programme itself. It is quite important that people are looking at the cost of the programme going forward and carrying also the cost of the previous investment over the past fifteen years.

**Q81 Sue Doughty:** You have had some disagreement, have you not, about the Environment Agency's version of the costs and your version of the costs, certainly in the submissions they have given to us? Do you think they have been fair in their comments, or was it gold-plating?

**Ms Taylor:** No, we do not think they have been fair in the comments they have made at all. We do not think the comments have been necessary, and we are satisfied that the system is completely robust enough for any differences to be worked out as we go forward. We do not accept the criticisms at all.

**Q82 Sue Doughty:** You are quite happy with what you are doing.

**Mr Baty:** We believe that the costings we have carried out and the submissions we have made are as accurate as we can possibly get in the circumstances. There is no gold-plating in any way, shape or form. We have confidence in our company, and that is the way we have tackled it.

**Ms Taylor:** If you look at the programmes that we will be looking at as we go forward, say with the Water Framework Directive, if we are looking at the money that companies will have to raise because, as Bob has just said, the companies are cash negative, we have got to retain the confidence of the markets as we move forward because we will need to borrow that money to carry out the future environmental improvements that will be required of us; so it is in nobody's interests to get these figures wrong.

**Q83 Chairman:** The Environment Agency said yesterday that they had underestimated the benefits in their analysis, for the reason that some of the benefits could not be costed. Do you accept that as a possibility?

**Mr Baty:** You may say it is a possibility, but it is terribly subjective because at the end of the day, when we are looking at how much the customers can actually afford to pay in the South West, that is a big issue. I am anxious to keep the charges to customers as low as possible, recognising that over £1 billion of investment has already been made, and they are carrying the cost of that. As we look forward, it is diminishing returns. We get into a subjective area in terms of how robust the cost-benefit analysis is. We do accept—and I am not saying they are all totally wrong, but some of those included diminish very quickly relative to what the customers can afford to pay in our region.

**Mr Jones:** The cost-benefit analysis is quite a difficult issue because it is as much art as science. It is very difficult to know whether any errors of omission are

---

**3 March 2004 Mr Bob Baty, Ms Pamela Taylor and Mr Ceri Jones**

---

in one direction or another. I am not quite sure how the agency could be sure that they have underestimated the benefits.

**Chairman:** They have certainly given a wide range of potential benefits, which indicates the uncertainty of the exercise, but you are not prepared to say that you think that it is unlikely that they have underestimated the benefits. You are not prepared to say anything!

**Gregory Barker:** May I ask you a question arising from evidence that the Environment Agency gave us yesterday? They said that the very detailed and vigorous work they carried out to determine what should be included in the environmental programme represents the absolute bare minimum that needs to be done. Do you agree?

**Q84 Chairman:** Can we leave you to ponder that while we vote?

*The Committee suspended from 16.10 pm to 16.22 pm for a division in the House*

**Ms Taylor:** We need to bear in mind that we have been talking about three plans here. Plan A would be the minimum; plan B would be more than that, and decisions to be taken; and then there is the third plan, which is the company-preferred plan. At this stage, to say that what is being discussed is the bare minimum we do not believe to be correct because we are discussing three possibilities at this stage. Obviously, when we see the ministerial guidance, that should give us an indication as to what we are looking at as we go forward. At this stage, it would be premature to make a comment.

**Q85 Gregory Barker:** You have stated to us that the industry's environmental duties are not an optional extra; that they are a statutory requirement. However, not all water companies have included all statutory requirements in their preferred plans. Do you support this?

**Ms Taylor:** Companies have looked at, and made a judgment, company by company, so we think that is right. We also think it is right that that information should be in the public domain, and we also think it is right that it should be open to challenge and scrutiny. What you will then see going forward, is to whether or not a judgment that has been taken will stand.

**Q86 Gregory Barker:** How will that be challenged? You say you will see how it stands.

**Mr Baty:** One of the issues we have been wrestling with is where there is a statutory driver and that is clear, the grey area is how much investment by the water company will address that statutory driver. Is it 5%; is it 10%? If it is 100%—there is no doubt about it at all; but if it is maybe 20% or 10% and there are no plans to address the other 80%, is it appropriate at this stage to be delivering that proportion of that statutory obligation while the rest of it is still exposed, given the pressure that the customer charges are under? That is where there is a subjective area. One would hope that that sort of area will be clarified by ministerial guidance.

**Q87 Gregory Barker:** A statutory obligation is a statutory obligation.

**Ms Taylor:** It is, you are absolutely right. The question in our minds however is to how much of that obligation has to be met by the water company and the water company's customers picking up the price for it. If you take an issue such as diffuse pollution, there are many, many policy levers that, if you like, could be pooled in terms of addressing the issue of diffuse pollution but we do not own them. In terms of point source pollution, we have cleaned up our act, but if you look at poor agricultural practice, for example, that will be a major driver of diffuse pollution. The question has to be, going forward: should the investment be carried out by the water company and the bill picked up by the water company's customers, or should we look at another way of tackling the issue, namely looking at farming practice and improving that? That is where the grey area is. It is not that we would dispute at all what is the statutory requirement because we absolutely agree. The point is though how much of that should be picked up by the water operator. That is where the discussion is.

**Q88 Gregory Barker:** The bill does not have to be picked up by the water company's customers, does it? You could accept a lowering of your margins.

**Ms Taylor:** It would not be a lowering of your margins because at the moment, as we explained earlier, companies are cash negative. They are spending more than they are collecting from their customers each day in any case; so companies have to go to the markets in order to borrow the money to carry out the work. It is a bit like taking out a mortgage on behalf of your customers, so companies have to go to the markets to borrow that money in any case. We need to make sure that we continue to be attractive to the markets, because we can see the considerable investments not only this year, in this period review, but in future years in future periodic reviews; and the City will have to be confident that it is funding something which, frankly, in their minds, stands up.

**Mr Baty:** There are two very narrow tramlines. One is customer affordability and their ability to pay for it; and the second is the ability to raise money in the market, as Pamela said. Those tramlines are very narrow, and the industry has been investing over the last 15 years.

**Q89 Chairman:** Are you saying that where companies have not included efforts to meet their statutory requirements, it is only in cases where the industry does not have direct responsibility for the problem and it is only in those areas?

**Ms Taylor:** Not always.

**Mr Jones:** It is not as clear-cut as that. The existence of statutory obligation is generally fairly clear, but exactly what you need to do when you discharge that obligation is not always absolutely clear, and there is some room for difference of opinion in that respect. I think Northumbrian Water is in a fairly fortunate position in that we believe we did include all of our statutory obligations and I do not think there is any

---

3 March 2004 Mr Bob Baty, Ms Pamela Taylor and Mr Ceri Jones

---

dispute about that from the Environment Agency. In defence of my colleagues in other parts of the country, I can easily see that there are areas where it is not entirely clear what one has to do in order to fully discharge one's obligation. One can see that parties would come to slightly different views about what would be appropriate to do, particularly in a given timescale of the next five years.

**Q90 Chairman:** But if you have been able to do it, why can others not do it? Is it to do with geography?

**Mr Jones:** It is clear that the different drivers impact very differently in different parts of the country. Both of the companies here today are fortunate in that the environmental programme appears to be somewhat lower than it is in some other parts of the country. The drivers are the same, but the way in which they impact on the locality are very much determined by geography.

**Q91 Mr Challen:** Are there regional variations in the margins that you can deliver?

**Mr Baty:** Not in the costing of them; it is a standard costing arrangement where the companies will price the standard things recommended by Ofwat, and they are certified by the reporters as fair costings; so there is not a margin as such; it is a question of the cost of providing that particular facility. When adjustments are made for efficiency, if one company thinks it can do it for X and another one says Y, understandably the Regulator says "if they can do it for that price we want the rest of you to be as close to that price as possible".

**Q92 Mr Challen:** I asked the question because some water companies wanted to get rid of their water side of the business. Yorkshire Water wanted to put that side of the business into some kind of mutual arrangement, and one or two other companies looked at other ownership structures so that they could free themselves of the regulatory burden.

**Ms Taylor:** They could never do that.

**Mr Baty:** Sorry, no, the regulatory burden will stay with the licence-holder, however it is separated out. The reason for assessing some of these optional structures is the financeability issue and whether or not it is more cost-effective to raise money for debt or equity and to get that balance right is quite a difficult challenge. Ceri is an economist and I am a poor engineer, but some companies make an assessment as to whether raising debt is cheaper than raising equity. The difficulty there is that going forward, if there is a bigger capital programme in future that we do not know about, how do you raise still more debt?

**Q93 Mr Chaytor:** What I am trying to say is that these companies, like Kelda, had diversified. Yorkshire Water, the original part of the business, seemed to them to be a bit of a burden at the time, and they wanted to shunt it off to one side and give it to the customers, as it were, with a mutual arrangement, so that they were not then the whole business, the group business, and burdened with these regulatory requirements.

**Ms Taylor:** There are no circumstances in which a water operator can avoid the regulatory burden, either from the economic regulator, the environmental regulator or the quality regulator, or indeed the Government guidance. There is no structure that would enable them to do that. They were looking at their finance-ability as they go forward and making a decision at board level as to what would be the best way of taking out that mortgage we were talking about earlier on behalf of their customers. They were shaping themselves to be able to shop around in the market for the easiest and least expensive way of raising the finances they needed in order to carry out the work they needed to do. In those circumstances you are always trying to see how much of the risk you get, in terms of what the City would perceive as risk. That was something that admittedly Yorkshire Water flirted with at the time, but now they are certainly on record as saying that their board does not believe that it is the right way for them to go in the future. That does not mean that boards do not keep this constantly under review because, obviously, they have a responsibility to do that because they will need to raise money for the future.

**Mr Jones:** Thinking about the original point about margins varying, if one is thinking about the margin used when setting price limits, it is Ofwat that assumes the financing costs in that calculation; they assume the cost of capital, and that is done on an industry-wide basis. It is the same cost of capital, the same financing costs, that are assumed for all companies when prices are set.

**Q94 Gregory Barker:** How aware do you think your customers and indeed the public at large are of the environmental improvement work that the water companies are doing? Do you have a policy of raising that awareness?

**Ms Taylor:** Yes, we do. We think it is important that customers should appreciate what it is that they are paying for when they pay their water bill, and we also think it is important that customers should have a view on what it is they are paying for in their water bill. In the beginning it was easier for customers to understand; now I think it is a little more difficult when you are looking at issues that we touched on earlier such as diffuse pollution. Is it right for a water industry customer to pick up the bill for cleaning up water that has been polluted by chemicals from farming? I do not think that is right. In terms of raising customer awareness, as to what it is they are paying for, we work with other environmental groups. We work in partnership with the RSPB and the Wildlife Trust to reach customers more effectively. We join and fund programmes jointly with them in order to raise awareness and to bring projects and issues to communities. There is a whole raft of things that we do.

**Q95 Gregory Barker:** What does it actually mean?

**Ms Taylor:** For example, in the Wildlife Trust, we will fund programmes that they carry out, and that is then something that local communities will be part of, so they will understand through the work that the

---

3 March 2004 Mr Bob Baty, Ms Pamela Taylor and Mr Ceri Jones

---

Wildlife Trust does, the role that the water company also plays. Then they will begin to have a practical understanding of where some of their money is going.

*Mr Baty:* We also write and tell the customers.

**Q96 Gregory Barker:** Could you do more?

*Ms Taylor:* Always.

**Q97 Gregory Barker:** If you did do more, they might be more willing to pay for the environmental improvements.

*Ms Taylor:* We carried out research this time around, and are very pleased that for the first time it has been joint research with the regulators, WaterVoice and environmental groups and so on. The headlines of the research show that customers would be willing to pay a little more—not all of them—for environmental improvements. It is important that they should understand that as we go forward, particularly if we look at the Water Framework Directive. We have to not just persuade customers more and more and more that they should pick up more and more of the bill, but we should be looking at how appropriate it is for customers in the future to be picking up all the bill. Should farming be picking up some of the bill; should transport be picking up the bill? I think there is some cleverer thinking that needs to be done.

**Q98 Gregory Barker:** I want to touch on investigations by water companies. We understand that some of the actions you are due to carry out during AMP3 were investigations you agreed to carry out so that the results could be fed in to the current review. However, English Nature told us yesterday that this has often not been the case. Why is this? Does it mean that once some of the investigations are completed, as you are committed to doing, there may be more work that will still need to be carried out and perhaps be postponed to the next review.

*Ms Taylor:* I am pretty scared about the thought of your Chairman saying we have been silent twice, but I am not sure I understand. I cannot think what that may be. If it would help, we would take that away and look at that issue.

**Q99 Gregory Barker:** I was not here at the evidence session when it arose, but perhaps colleagues can shed light on that.

*Ms Taylor:* We would happily take it up and write to the Committee.

**Chairman:** The allegation was that there was work that you had agreed to do which was going to help in future assessments in the periodic review process, which for certain cases was possibly deliberately being deferred so that it was not possible to analyse the outcome of that work in time for the next periodic review.

**Q100 Joan Walley:** It was also about the transparency of what you are doing and who is doing it, and how that is adequately monitored.

*Mr Jones:* The industry does publish a lot of information; indeed Ofwat publishes a lot of information each year on the output being delivered. Generally, the industry is very much on track to deliver all the outputs that were allowed at the last periodic review. I cannot think what the specific issues are that were being alluded to, but generally the context is that we are very much delivering on all of the outputs that were assumed for this five-year programme.

*Mr Baty:* There is a June return to the Regulator every year certifying where we are up to in delivering the programme, and that will appear in public documents in the course of the year and published on the performance of each company.

**Gregory Barker:** Perhaps we can invite English Nature to specify.

**Q101 Chairman:** They did not specify yesterday particular examples of this, but indicated that it was a practice of which they were aware and which they deprecated.

*Ms Taylor:* In that case—

**Q102 Chairman:** Given the close and warm relationship that you described earlier yourselves—

*Ms Taylor:* That was the Environment Agency. I am sure we will have no problem at all.

**Q103 Chairman:** It is something that you would like to sort out, and we may wish to make further inquiries into it.

*Mr Jones:* Of course.

**Q104 Mr Chaytor:** I would like to ask about the judgments made on the environment programmes, particularly in respect of Northumbrian Water. You appear to have deferred a substantial amount of your environmental programme, and the Regulator has expressed some concern about the deferral aspects in 2010. Can you give us a flavour of how you come to the judgment as to what to defer, and what you think the long-term consequences will be? Are you not simply storing up problems for the future?

*Mr Jones:* The only area that I can think you are referring to is the intermittent discharge, or combined sewer overflow programme, where we have proposed delivery over a 15-year period. The distinction is between the outputs the Environment Agency has identified which they see as a priority and would wish us to do quickly, and outputs that we as a company have identified that had they not been investigated the Agency would not have known anything about. The Agency at this time does not believe they are currently resulting in problems in terms of the quality in the water course. But we are aware that work does need to be done to improve those assets over a period of time. The programme we have put forward would deliver all of the priorities that the Agency has identified within the next five years, and it would make a start on the other assets that we, through our proactive investigation, have identified. We think it is appropriate to deliver that latter category over a

---

3 March 2004 Mr Bob Baty, Ms Pamela Taylor and Mr Ceri Jones

---

longer period. That is something that we have agreed with the Agency locally, and it meets their priority requirements.

**Q105 Mr Chaytor:** Are you saying categorically that there would be no impact on water quality and—

**Mr Jones:** Yes, that was very much the basis of that decision.

**Q106 Mr Chaytor:** In the preferred plan you published the bill increase for environmental issues, which is modest compared to the increase introduced for routine maintenance—

**Mr Jones:** That is right.

**Q107 Mr Chaytor:** If the Regulator were to propose reducing that, how would you respond? You are suggesting that there should be an increase of £8 over a five-year period to cover environmental works.

**Mr Jones:** We believe that our proposal is pretty much the statutory minimum programme. It is possible that in some areas the Regulator could take a different view. However, the programme we have put forward is what the Agency considers to be the statutory minimum, and we do not really dispute that. We do recognise that there are areas for judgment. So we are not saying that the Agency are wrong but we are saying that there are some areas where it might be possible to take a different view. We have come to the view that the programme proposed by the Agency is a sensible one. It is likely that unless ministers take radical decisions, they would not be able to reduce the programme by that much, but I am not saying that every single programme in there is absolutely a minimum requirement. There was always an element of judgment. I suspect that any reduction would be less in our case than in those companies which have much larger programmes, quite simply because if you just took a driver out, for us the impact of taking that driver out would be much more modest than it would be in certain other areas of the country.

**Q108 Mr Chaytor:** Turning to South West Water, your projected increase again is absolutely insignificant. Why are you so unambitious in your approach to environmental—

**Mr Baty:** Probably because the improvements we have delivered in the past have been enormous, and the maintenance costs of carrying that work forward and maintaining it going forward is a big cost driver for us. But in terms of dealing with the Environment Agency as to what is required, there again, as I mentioned earlier, there is little between us in terms of the size of that; but it is relatively small because of the enormous environmental investment we have made in the past. The price we are paying for that is that we are now having to spend a lot of our money on renovation of the water distribution network, which was curtailed during the previous 15 years to give headroom to enable us to deliver the coastal programme. It is getting that balance right which is the challenge we face, against the background of the

highest charges driven mainly by that environmental programme, and the ability of customers in the South West to pay those bills.

**Q109 Mr Chaytor:** Can you say, hand on heart, to customers and visitors to the South West that the beach clean-up programme, which you have invested in fairly heavily, has now been entirely successful and you are absolutely satisfied?

**Mr Baty:** Of the 141 beaches that we have, 140 of them met mandatory standards and 85% met the guideline standard, and that is exactly in line with—

**Q110 Mr Chaytor:** So 15% of them obviously did not.

**Mr Baty:** Eight-five per cent complied with it.

**Q111 Mr Chaytor:** That is 15% which did not.

**Mr Baty:** That is correct, but that is because those pollution sources are from other discharges, nothing to do with us. That is ahead of the Government target that was set when we embarked on that programme. We are very satisfied and very delighted, but it is the cost to our community that we represent and work with that we are very mindful of.

**Q112 Mr Chaytor:** Given that we are talking about increasing customer bills by £4 per customer by 2010, is this not a lost opportunity, because the nature of environmental improvement programmes surely is that this is not a finite activity? There are infinite improvements that can be made going beyond the minimum. Are you not again losing the chance of building up your work now, and will you not find that beyond 2010 you are likely to have to put up customer bills even higher to compensate for that? From the customers' point of view, is it better not to have a gradual steady year-on-year increase rather than as a political fix for a few years to keep the name of South West Water in lights, in terms of their customers, and then you are going to lose out after 2010?

**Mr Baty:** To some extent it is the reverse because if you go back to the early nineties, our charges were going up 16% year on year and that is why we are away from the pack, driven by the cost of that enormous environmental programme. The standards that we have achieved—we have got the best bathing waters in the country and the highest percentage of top-quality river water in England. Our environmental standards are high; it is a highly sensitive environmental area and we need to sustain that, but we have to be careful about pushing it any further at this stage, given the impact it has on customers in the region and the money they are paying for it. Our bill is significantly higher than many other parts of the region. You say that it is only £4 but it is £4 on top of a bill which will be £407, given our draft business plan, compared with figures significantly less than that for the rest of the country. One cannot look at this in isolation. You reach a point where customers say, “we are not going to pay at all”, and that is a bigger issue for the industry and the environment.

---

3 March 2004 Mr Bob Baty, Ms Pamela Taylor and Mr Ceri Jones

---

**Ms Taylor:** We also have to bear in mind that expenditure on maintenance of the infrastructure, which is what Bob is looking at in terms of a profile of his spend as he goes forward, is spent that will have great impact in terms of the environment as well. Obviously, if you have a faulty infrastructure, then you would have pollution that seeps out and so on. It is therefore important not to think that there is environmental spend over there, and infrastructure spend over here; that one does not have an impact on the other, because it does. What Bob is looking to do is progress the work that has been done and underpin that work. He believes the profile is best done by at this stage looking at maintenance.

**Mr Baty:** The capital investment programme in total will be at the same level as the last five years, but it will be focused on different areas of responsibility.

**Mr Jones:** The very large quality programme that we have invested in over the past decade and more has created a lot of new assets, which themselves need to be maintained.

**Q113 Mr Chaytor:** I appreciate that. Can I ask Water UK about your attitude to the environmental programme, because you have stated that you think the concept of the environmental programme within a five-year review is—the time has been and gone really and you are arguing that the environmental part should be taken out. Can you tell us why this is; and what is your view about the current arrangements for the five-year review? How should it be improved?

**Ms Taylor:** It is certainly one of the things that we suggest needs to be addressed, along with a raft of possible ways forward. We are not pretending that we have got a perfect solution to this. What we are concerned about is that if we look at the position when the periodic review was first set up, when it was felt wrongly, but people did not know at the time that if you put a large amount of expenditure in at the beginning, a bit like setting up the NHS, then everything will get jolly healthy and then you could afford to keep it topped up as you go along. Obviously, that is not true with the environment. If we look ahead to the directives that we will need to implement, then we can see that the investment profile on the environment is going to get higher, not lower. We believe that we need to make sure that we have a process that enables us all to be fit to face those issues in the future. One of the things that we do not have, that we think we should have, is a clearer overall framework. We think that that is the job of government. Defra made a good start with its publication directing *Directing the Flow*. However, it has gone quiet and they have not taken that further forward. As we have been exploring with you earlier today, there are some issues that the periodic review process cannot deal with, for example diffuse pollution. It cannot tackle those. There are some policy levers that the economic regulator does not own; the Government owns them, it has created them, such as looking at diffuse pollution. We believe that we will need to look at how we can get hold of this idea of integrated catchment management, which requires a range of

policy considerations and levers, many of which are outside the periodic review. That is just a fact. We need to make sure we know how to get hold of these levers and make sure that in the future we can look at the environment in a sensible and constructive way. If not, we are in danger of demonising spend on the environment, and that would not be right.

**Q114 Mr Chaytor:** Do you have support for this from any other players in the field?

**Ms Taylor:** We have been very pleased that just with the initial discussions—and I would not want to make it any more than that because it would be unfair to tie in our regulators—with Ofwat and the Environment Agency, English Nature and Defra, nobody is saying “we do not want to have those discussions” or “this is absolutely perfect so leave it as it is”. We have signalled that we would like to look at this as we go forward.

**Mr Chaytor:** Am I right, Chairman, that that is what they said at yesterday’s meeting?

**Q115 Chairman:** I do not want another show-stopper here, but the fact is they did express satisfaction at the present arrangements and saw no merit in ending the process of periodic reviews.

**Ms Taylor:** If that was the Environment Agency, I have to say that surprises me. At the last meeting with the Environment Agency, where we specifically raised the issue of carrying out joint research to look at how this might be better done, they agreed that that would be a very good idea.

**Q116 Chairman:** The quality of the liaison between the various organisations is coming under increasing doubt.

**Ms Taylor:** I do not think it is. I think perhaps the quality of evidence given to you might be because I am absolutely satisfied with the liaison we have had with the Environment Agency, and I am satisfied that what I am saying is accurate.

**Q117 Joan Walley:** In the light of the debate and dialogue we are having, is it your view that as far as Ofwat is concerned there could be some useful strengthening of Ofwat’s environmental duties?

**Ms Taylor:** That is something that can certainly be discussed. What you have to be careful about is the periodic review process that was set up in a different era from now, and hanging more and more bits on to it—you have to make sure it is viable as you go forward and we do not just pull the whole process down. They could take further account. Already there will be additional duties in terms of sustainability and so on, but how can the economic regulator take into account policies to do with farming or transport? It cannot be done, so there has to be a broad framework within which we set these discussions.

**Q118 Mr Chaytor:** What is that broader framework? Who else is involved? All the key players are talking to each other already.

---

3 March 2004 Mr Bob Baty, Ms Pamela Taylor and Mr Ceri Jones

---

**Ms Taylor:** They talk to each other already, but it is very much a dance where the steps are agreed in advance. When you get up on to the dance floor, you know what steps you are going to be taking, even if you are a little late taking them as the Government is right now! At this stage all that the Government is able to do is comment on the environmental aspects of it; but would it not be good if the Government had re-read its own paper *Directing the Flow* and said “long-term this is what we are looking for; these are the objectives” so that periodic reviews would become milestones rather than an argument as to which direction you need to go in for the next five years. That is what we are looking for.

**Mr Baty:** In the early days of privatisation it was very clear that a lot of the environmental impact was as a direct result of the activities of the water industry, which water customers were paying for. The background to that has changed now and as those have been removed then the issues are coming from other sources. Is it right that water customers should be paying for those improvements going forward, and that is a question for society generally not for the water industry or for customers to make a judgment on. That needs to be put in a much bigger forum to understand the position.

**Q119 Paul Flynn:** You have mentioned diffuse pollution several times. Can you put a figure on the extent that diffuse pollution affects your finances? Is it a problem that those that cause the pollution find that someone else picks up the tab for it?

**Ms Taylor:** At the moment, diffuse pollution already costs customers around £7 per year, and that is set to rise.

**Q120 Paul Flynn:** Why is it set to rise?

**Ms Taylor:** Because we will need to implement the Water Framework Directive. What concerns us is if the only way of implementing the Water Framework Directive—which we hope will not be the case—is to say that there is more and more end-of-pipe solutions that we are looking for, more kit to be put on the end of pipes, then this will cost even more. If you contrast that £7 at the moment, which is set to rise, say with South West Water £4 in the year for the environment programme, that cannot be right.

**Q121 Paul Flynn:** It is a problem that the farmers and farming industry are not paying and there is really no pressure on them to reduce them. What is diffuse pollution? Is it mainly silage, pesticides—

**Mr Baty:** Cattle grazing—in the ground and it rains and it washes into the river.

**Q122 Paul Flynn:** So in this case the polluter is not paying.

**Ms Taylor:** Exactly. When Bob mentioned beaches and how there are some that are not under his control, that will be because it will be washed off from the land.

**Mr Baty:** That is the river just going into the bathing area.

**Q123 Paul Flynn:** This does not come out clearly in your written evidence as far as I can see.

**Ms Taylor:** Sorry if it does not.

**Q124 Paul Flynn:** Perhaps you could give us some more on this.

**Ms Taylor:** Of course.

**Q125 Joan Walley:** I am slightly struggling with the need for investments, which may not have been apparent at the start of the periodic review however many years ago and which has come up very quickly on the radar screen, perhaps in relation to the serviceability of pipes for example, which might prevent pollution in one way or another. I am not exactly sure in relation to the sequencing of the need for action and getting that into the long-term periodic review and whether more could be done to get greater flexibility so that we could all sign up to an environmental inspired programme that would be fit for purpose as far as the water companies were concerned and also as far as the needs are concerned, where there clearly are ongoing problems; but because we have missed the boat, we have had to wait a very long time to get the next boat, as it were.

**Ms Taylor:** I think that what we are both saying is that the chunks of five years may have been appropriate in the beginning when the industry itself had to do the work and could put its arms around the work in terms of if it was our responsibility; but now, as we look forward to more complex circumstances, and we look at the time frames that are coming in for other directives—the Water Framework Directive, the Revised Soil Directive and so on—we are looking at time frames that are quite, quite different from the periodic review type frames. We are going to need to find a more flexible way of going forward and a way that is transparent and has the confidence of stakeholders.

**Q126 Joan Walley:** Do you feel that that is being taken care of, and in the sequencing of how things fit together there is a framework in which you can do that; or what needs to change for that to happen?

**Ms Taylor:** I think what we fear is that when we get towards the end of the current process, when prices have to be set, we will then see there are still some issues unresolved and we will have to attempt to agree with the Economic Regulator and in discussion with the Environmental Regulators as to how these issues, which will be outstanding, should be resolved. We do foresee that that will be a challenge.

**Q127 Mr Challen:** With customers nationally £434 million in debt in the last financial year could you tell me if there are regional variations in levels of debt between Northumbrian Water and South West Water?

---

3 March 2004 Mr Bob Baty, Ms Pamela Taylor and Mr Ceri Jones

---

**Ms Taylor:** Yes, there are differences company by company. I am afraid we do not have the actual figures with us but we could let you have that information.

**Chairman:** That would be helpful.

**Q128 Mr Challen:** Could you give us a brief description of why that might be the case, these variations?

**Mr Jones:** I am not sure about the regional variation. I think it is clear that the rising level in customer debt is an issue in all regions to a greater or lesser extent. We are going to see that having an impact on bills going forward. Just last year we had an interim price increase in the North East and about half of that was due to increases in customer debt since the ban on disconnection, so it is a significant issue. Historically our levels of debt have not been particularly high but it is a growing issue and regardless of the starting position it is increasingly a significant issue round the country.

**Ms Taylor:** It is a relatively small number of people but the relatively small number of people is getting more into debt. As far as the companies are concerned for the people who cannot afford to pay they have a range of payment schemes to try to help people, a charitable trust that was set up, there are free phone help lines, and so on. If you are a customer who is not paying, if your bills are increased next year you are going to continue to be a customer who is not paying and that debt will increase. Whilst we are talking about an increasing problem in terms of the amount owed we do not know yet whether it will be an increasing problem in terms of the numbers of people who cannot afford to pay. It is something that I have written to the Secretary of State Margaret Beckett about and it is something that we very much want to engage with her on and with consumer groups as regards people's ability to pay.

**Q129 Mr Challen:** This is a major issue in the periodic review as well, is it?

**Ms Taylor:** We believe it is an issue that we should as a responsible industry want to address. It is something that we cannot address alone. There may well be some social issues that Government could help with. North of the border it is dealt with in a different way from south of the border.

**Q130 Mr Challen:** It does sound like an affordability issue, what can the Government or Ofwat do to help, have you put forward any specific proposals?

**Ms Taylor:** We have talked to Government about measures they might be able to introduce, ways in which we might be able to help customers through social security, and so on. We have looked at a raft of possible measures and we are continuing to have discussions with Government departments on that. I am pleased that Margaret Beckett has said that she specifically does want to engage in looking at this.

**Q131 Mr Chaytor:** If I just can add to that, is there any evidence that the level of debt varies according to householders who are on meter or paying according to the ratable value of their house? Is the method of calculating the bill a factor in the level of debt?

**Mr Baty:** I do not know about that relationship but one of the options we do when people are on an unmeasured arrangement and getting into debt if it is going to be cheaper for them to have a meter, to get them on to a meter as soon as we can. I am not sure on the relationship, I will have to look that up.

**Q132 Mr Chaytor:** The implication of that advice is that those on unmeasured bills save money with a meter, the implication of that is that the ratable value system is a regressive system, it is more expensive for poorer people.

**Mr Baty:** It depends on the individual circumstances, it is not a clear-cut arrangement.

**Q133 Mr Chaytor:** How do you feel about that as the basis of the system? Do you feel that the ratable value system provides a fair bill in relation to the typical consumption of different kinds of properties?

**Mr Baty:** It is up to individuals to choose on that basis. Customers who think they are going to save money by using a meter switch over to a meter.

**Ms Taylor:** If they are wrong they can have it taken out after a year if they are not satisfied.

**Mr Baty:** It will depend on individual circumstances as to what is the most appropriate way of paying.

**Q134 Mr Chaytor:** Would the general approach of water companies be to make up the shortfall as a result of debt through this interim charge or would you also consider making cuts, and if that were the case would the environmental aspects of your work be the first target?

**Mr Baty:** Once we have the regulatory contract for the five years we are obligated to deliver the output, and that is what we monitor on an annual basis, and it is monitored very assiduously. The option for not delivering is not something that is open to us because, quite rightly, the Regulator will take issue if we have not delivered an output he believes within the five year contractual arrangement we are obligated and have been funded for. If the change to that funding stream is affected by circumstances outside our control then there is the opportunity to go back to the Regulator and explain to him the background and he will take due process and he will make an adjustment if necessary.

**Mr Jones:** Part of that scrutiny will be to satisfy himself the companies have done everything they could to manage the debt position.

**Q135 Chairman:** Picking up on the final part of Colin Challen's question, there is a feeling amongst some that when there is pressure on budgets, when the Government is looking to keep bills down it is

---

3 March 2004 Mr Bob Baty, Ms Pamela Taylor and Mr Ceri Jones

---

always the environment that gets itself into the firing line first, is that an impression you share?

**Ms Taylor:** I think it is an impression, how accurate this is we are not sure. We do not want to demonise spend on the environment but if you took a red pen to the whole of the environmental spend you are still going to see prices rising. It would be wrong to say that the only problem with all of this beautiful system is the environment, it is not. As far as we

are concerned the environmental spend should be considered fairly and sensibly along with all other aspects of the spend.

**Q136 Chairman:** It is as important. Thank you very much and thank you for your evidence and also your written evidence.

**Ms Taylor:** Thank you very much.

---

### Supplementary memorandum from Water UK

*Response to specific questions from the Environmental Audit Committee following Water UK's oral evidence session, 3 March 2004*

#### INTRODUCTION

The Committee asked Water UK to provide additional information on a number of matters, both at the oral hearing and in a subsequent letter.

**English Nature raised the issue of the timing of investigations carried out by water companies included in the AMP3 programme. They were concerned that some of the work was carried out too late for results to be fed into the current review, despite commitments being made that this would not be the case. The Committee would like further clarification on this from Water UK. In particular whether there was a specific timetable within AMP3 for completions of actions some or all the actions that the companies were committed to.**

**Work on sites covered by the Habitats and Birds Directives and SSSIs affected by over abstraction or effluent discharge**

We understand that in its oral evidence to the EAC English Nature said that companies had been laggardly in carrying out investigations under AMP3 on sensitive sites covered by various nature designations and taking the appropriate action. At the last price review DETR in its guidance document "Raising the Quality" (issued to Ofwat September 1998) advised that companies should be funded to carry out investigations on such sites adversely affected by water company activities. It also said that if an investigation shows that a scheme needs to be completed or commences within the period 2000–05 there should be effective arrangements to ensure that this can happen.

The problem is that these "effective arrangements" were not put in place. Under existing arrangements capital costs (but not the operating costs) of schemes added to the programme between price reviews may be "logged-up" and allowed for Ofwat at the next price review. As that mechanism does not allow for the full costs of such schemes "logging-up" is an arrangement that companies are not very happy with.

Repeated discussions between Ofwat, Water UK and companies did result in Ofwat issuing a consultation document but little changed as a result of the consultation. Therefore companies continue to believe that it is best to deal with such schemes within business plans put forward at price reviews, to establish sensible priorities for these schemes within a wider plan, and to ensure that the costs of the schemes are properly funded.

#### Looking Ahead Beyond PR04

We believe that the PR process does need reviewing and we have already said to Government and regulators that we would like to look at the process. We do not have a firm view about the environment programme coming out of the periodic review but believe that there are some fundamental issues that it would be useful for the Committee to discuss.

The process worked well in the past but the goalposts have moved. When the industry was privatised in 1989 and the huge capital investment programme was started there was a huge problem with point source pollution to be tackled by the industry. That problem has largely been solved with huge improvements in river quality and bathing water quality. Many issues to be addressed on the environmental side now fall outside the periodic review.

#### Diffuse Pollution

What we now have to tackle now is diffuse sources of pollution and catchment based approaches to water management. Dealing with diffuse pollution from a plethora of sources already costs water industry customers £7 per year. This figure is rising. For example the drinking water directive has tighter standards on nitrates. Nitrate problems arise from farming practices. To comply with these standards companies have

been blending waters so that the standard is not breached. However, the problem of nitrates is growing and we are now running out of these low nitrate waters and so having to put in additional treatment at additional costs.

The same type of issue arises with implementation of the bathing waters directive. Point source pollution has been addressed. In order to improve the standards of beaches further we need to work with farmers, for which there is no funding, or ratchet up standards at waste water treatment works. Improving the last 10% using end of pipe solutions is very expensive.

The policy levers for working with those causing the diffuse pollution are in Government's gift not water companies. There will be new requirements from the water framework directive to achieve "good ecological status". Diffuse pollution is likely to be the main cause of not complying with the directive. So far there is no positive action coming from Defra in terms of measures, finding mechanisms or regulations. This is in contrast with the situation in Scotland where Scottish Water has seconded a member of staff to the Executive to develop and draft regulations on diffuse pollution.

Water companies are undertaking work with other stakeholders, including farmers and the chemicals industry on the voluntary initiative on pesticides. Such work is not funded by Ofwat and does not form part of the periodic review negotiations.

We believe that what is needed going forward is a clear and agreed framework for water. In Directing the Flow a start was made by Defra in creating a framework for the delivery of water services and protecting the water environment. However, we have not seen this followed through by any actions. We think that an agreed framework would mean that investment is made at the right time to produce the most cost effective solutions.

An example of how the lack of framework adds to costs comes from implementation of two directives. Investment made as part of compliance with the Freshwater Fish Directive over AMP4 may well become redundant if tighter standards are introduced as part of the Water Framework Directive post 2009. Early clarity on requirements would help avoid this.

There is no doubt that the water industry could continue to take the responsibility for cleaning up the environment indefinitely. But we believe that using an end-of-pipe approach to tackle wider catchment problems is inefficient. It means higher costs for customers without providing the best environmental solutions.

Already customer groups are questioning the cost of water services and on behalf of our customers we have to ask why they should be forced to pay for problems caused by others, when these problems could be addressed by a range of other policy tools.

We think that a wider groups of stakeholders needs to be involved in discussing and developing solutions to these problems. In previous evidence to the EAC we have raised the idea of a water forum, to be convened by Defra, to provide a place for these discussions to take place. We still believe that this would be a positive development.

### **Publicising Environmental Activity**

The EAC asked what steps companies took to inform customers about the scope of their activities. All water companies produce environmental reports which are available to customers. These detail environmental improvements. These are also promoted through customer newsletters, websites and at visitor centres. Companies are pro-active in letting the media know about the work that is carried out. However, the industry faces the same difficulties as other organisations, including Government in that good news is not considered newsworthy. As you heard companies also work in partnership with environmental groups such as RSPB and the Wildlife Trusts either on campaigns or research to reach customers more effectively. The industry's work on otters is well known and currently we support the Wildlife Trust's Wild Rivers project.

### **Information on the Levels of Customer Debt and Impacts on Customer Bills**

#### **How has the figure of an average of up to £10 per year per customer been arrived at?**

Ofwat collects information on an annual basis from the water companies on the level of household debt. This includes revenue outstanding, revenue written off and the operational costs associated with revenue collection.

Ofwat published household debt figures for the industry in their letter RD32/03<sup>1</sup> issued on 28 August 2003. This indicated that the average debt collection cost per household billed had risen to £2.38 in 2002–03. Added to this are the write-off costs and the financing costs of the ongoing debt. These numbers are not in the public domain but we understand from private correspondence with Ofwat that the total charge per household billed for write-off and financing costs is £5.95. The total average cost of debt is therefore

<sup>1</sup> RD32/03 is available on the Ofwat website under Regulation Director letters.

£8.33 per household billed. Since the amount of household revenue outstanding (up to 48 months) is equivalent to 16% of household revenue billed, the companies will under-recover from the paying customer base the costs of managing debt. If we assume the figure of 16% under-recovery a further £1.33 has to be added to paying customers bills. This gives a total value of £9.66, i.e. approaching £10 per year per customer.

#### **Are there significant variation within different water regions?**

Ofwat states that the annual cost of collecting outstanding household revenue varies significantly between companies. Five companies reported reductions in operating expenditure whilst eight companies reported increases. Costs will vary with the policies adopted by the particular company. However, as discussed above these operating costs account for only about 30% of the total debt management cost.

#### **What systems do companies have in place to monitor customer debt?**

In 2003 the industry commissioned an independent report by CreditScorer Ltd on Water Industry Debt—Current Trends and Good Practice Approaches<sup>2</sup>. The report concluded that the water companies have developed and adopted good practices in debt management, collection and recovery. CreditScorer pointed out that adopting all aspects of “best practice” as used e.g. in the large volume financial services industry, is not feasible for the water sector due to regulatory and legal constraints and the technological investments that are only feasible for large scale operations.

The report gives case study examples of practices within large and small organisations with outsourced or in-house collection operations, reflecting both urban and rural situations and north and south locations.

The report includes a matrix of good practice in debt management against which the performance of the case study examples were judged. The good practice principles covered.

- Customer type and knowledge.
- Database management.
- Absconder management.
- Billing cycle.
- Billing—clarity and timely.
- Queries and disputes.
- Payment methods and arrangements.
- Customer contact and account management.
- Collections and recovery.
- Litigation.
- External debt collection.
- People, training, technology.

#### **Are some companies more successful than others in dealing with the problem?**

It is inevitable that some companies will be more successful. Smaller companies for example will not have scale economies or the financial resources to invest in the more powerful call centre technologies and information systems available to the very large companies.

On overall industry performance the CreditScorer report demonstrated that the water sector is comparable with the competitive gas and electricity sectors across a number of key indicators

<b>Factor</b>	<b>Water</b>	<b>Gas/Electricity</b>
% Customer base on direct debit	41%	41%
% Customer base with known phone nr	56%	60%
Customer contact rate per FTE/hour	11	10

#### **Details of cases where water companies’ have not included actions in their draft plans because they think they will have minimal impact compared to other sources of pollution**

Most companies have included only statutory schemes requested by the EA in their plans. Some companies question the value of some of these statutory schemes, for example schemes to deliver tighter dangerous substances limits. They have however, included such schemes in the business plans.

<sup>2</sup> This report can be supplied to the Committee if required.

---

**Some general information of the cost to companies of dealing with polluted drinking water sources and how much of this can be attributed to diffuse pollution**

Ofwat has published figures for the average capex cost per customer per year of dealing with nitrates and pesticides during AMP3. This has been assessed at £7 per customer. This does not include the cost of dealing with cryptosporidium. One medium sized company has estimated that the costs of dealing with nitrates and pesticides during AMP4 will be £16.50 per customer per year.

The problem with nitrates has increased significantly over the past ten years. Since 1997 capex expenditure on nitrates removal has been £36 million for the industry as a whole. Contrast this with one large company which is putting in for nitrate removal schemes in excess of £100 million during AMP4.

It is becoming more expensive to supply water that meets all the standards of the Drinking Water Directive, because the levels of pesticides and nitrates in raw water sources continue to increase. In the past it was possible for companies to blend water with high levels of nitrates with those sources with no nitrates or to switch sources. However, in the UK we are now reaching the point where all groundwater sources are polluted to some degree, meaning that there is currently no option but to go for expensive end of pipe solutions.

We need much more widespread catchment protection to prevent the problem occurring. For example in Lower Saxony, in Germany, water operators have been buying forest land to protect catchments. Taking pro-active land management of the catchment has had the effect of reducing nitrate levels from 120mg/litre to 46mg/litre. The cost of doing this has been no more than for end of pipe solutions and much more sustainable. This type of approach is becoming more popular in northern European countries.

Further details of costs can be found in the June Returns supplied to and available from Ofwat.

**The Committee would like clarification on your evidence regarding diffuse pollution. Is Water UK, together with water companies, arguing that some of the actions included in the environment programme are not necessary because there are other sources of pollution to the water bodies in question, which are more significant, and therefore no action should be taken by water companies to deal with the pollution they cause? If this is the case could you please give us examples of where this is an issue, including the levels of pollution caused by the water companies compared to the input from diffuse pollution.**

Companies treat wastewater to the standards required by European and UK law. Water company discharges are therefore agreed with the EA. It would be wrong to suggest that these discharges could be described as pollution.

Companies do however have views about the effectiveness of actions that they may be required to take. For example, companies have included costs for nutrient removal schemes where directed to do so. However, they consider that these schemes will only be of limited value unless there is a commensurate reduction in agricultural sources of nutrients.

*March 2004*

---

**Memorandum from the Office of Water Services (Ofwat)**

**SUMMARY**

1. We are now entering the final stage of the price review. Each water company will submit its final business plan to us in April. We will scrutinise all the plans thoroughly and plan to publish our draft decisions on price limits, for consultation, in late July. We will listen carefully to all representations made on our draft decisions and publish final price limits for each company for the years 2005–06 to 2009–10 in November. We will explain fully the basis of both our draft and final decisions consistent with the principles of good regulation that we follow in all matters. Each company has a right to appeal our final decisions to the Competition Commission.

*What should be the key components of the environmental programme allowed for in Ofwat's price limits?*

2. It is for Ministers, on the basis of advice from the quality regulators, to provide guidance on the key components of the environmental and the drinking water quality improvement programmes at this review. These enhancements need to be set in the context of the very substantial improvements that have been delivered by the industry since 1990 at considerable continuing cost to customers. The full benefits of the current improvement programmes will not be realised until well into the next period. We will not countenance any deterioration of performance achieved to date.

3. A number of factors are pushing up water company costs; for example increasing levels of asset maintenance, changes to taxation, rising power costs, rising pension costs, rising levels of bad debt and servicing the statutory "free meter" scheme, all of which must be reflected in customers' bills. The water companies are becoming more efficient and we will expect this to continue year-on-year; however this will

not be sufficient to offset the upward cost pressures. This is likely to mean that customers' bills will now have to rise between 2005–10 even before the impact of additional drinking water and environmental quality and other service improvements.

4. The water companies need to raise finance from the financial markets each year in order to pay for the improvements required. Ofwat will set price limits that allow companies to raise finance but, as investment programmes increase, this will become progressively more expensive. Customers' bills may consequently need to rise disproportionately. This could be mitigated if improvements could be undertaken over a longer time frame.

5. Our guidance to Ministers in December set out for illustrative purposes the impact on price limits, and hence bills for customers, of constraining all capital investment in the period 2005–10 to £15 billion, roughly the level of investment assumed for 2000–05.

*Has the guidance given by the Environment Agency and Defra to date on the size and scope of the environmental programme been adequate?*

6. Yes, from the standpoint of enabling us all to gauge the implications of meeting a very ambitious improvement agenda. "Directing the flow: Priorities for future water policy" (November 2002), the Secretary of State's initial guidance on the periodic review (January 2003) and the subsequent schedules of potential improvements prepared by the Environment Agency, English Nature and the Countryside Council for Wales have guided the content of companies' draft business plans. The draft business plans indicated that that on average price limits could rise by 6% per year in real terms, a 30% real term increase to customers' bills over the five-year period. This is before the effects of inflation.

7. We await Ministers' principal guidance that, together with the appropriate schedules from the quality regulators, companies need to prepare their final business plans. The late delivery of this guidance may impact on the timetables for producing the draft and final determinations.

*What is the extent of the environmental achievements delivered as a result of the 1999 periodic review?*

8. Since privatisation water companies have invested over £1 billion per year in improving the water environment. The improvements delivered have been impressive. For example, in 1994 only 84% of rivers were of good or fair biological quality compared to the latest figure of 95%. On drinking water quality 99.87% of tests now comply with the standards laid down. Thus where in 1990 tests at the tap failed one in 100 times, it is now one in 800 times.

9. In January, with the Environment Agency, we set out an assessment of the progress companies are making towards completing the current five-year National Environment Programme. The industry is confident that the vast bulk of this programme will be completed by April 2005. The improvements arising from this year's tranche of investment will start to be reflected in the performance statistics in 2005, but will not be fully realised until two or three years later.

## BACKGROUND

1. Ofwat is the economic regulator of the licensed water and sewerage companies that operate in England and Wales. Our role is to oversee the regulated water companies and to set price limits that enable a well managed company to deliver services in a sustainable and efficient way.

2. On 28 July 2004 we plan to set draft price limits for the water and sewerage companies in England and Wales covering the period 2005–10. We will consult on these throughout the summer and make our final decisions in November 2004. Our decisions will be based in large part on the companies' final business plans, which they will submit in April 2004.

3. We must set price limits that are high enough to enable well managed companies to finance their businesses and deliver services in line with related standards and requirements; and provide incentives for each company to improve its efficiency and service delivery. But, to protect the interests of customers of these monopoly companies, prices should be no higher than they have to be. We are also committed to regulating in an efficient and transparent way.

4. In considering our approach to the review we have taken account of the findings of the Environmental Audit Committee as set out in its report "Water prices and the Environment" (November 2000). For example, at this price review customer research has been conducted jointly to avoid the "confusing plethora" of customer surveys produced for the 1999 price review. And we have with the companies developed the approach needed to ensure that capital maintenance is not neglected.

*Companies' draft business plans*

5. Each company submitted a draft business plan in August 2003. These plans set out each company's preferred strategy for the future and the price limits that could result from these. In addition, the companies also included the costs of set packages of improvements for illustration.

6. The draft plans have exposed a large number of issues as well as illustrating the implications for costs and prices of a series of potential ways forward. If the companies' preferred strategies were followed then this would lead to large increases in customers' bills, over 30% in real terms for the period 2005–10. The company plans highlighted that price increases are needed simply to maintain the huge improvements made over the last 15 years.

7. There are other upward pressures on bills at this review as well as those resulting from new requirements to improve drinking water and environmental quality. These include:

- Taxation—Companies will experience a step change in tax charges in 2005–06.
- Capital maintenance—A number of companies are already spending more than was allowed in price limits in 1999 to maintain their infrastructure. Companies' draft business plans indicate that more will be required in the next five-year period.
- Financing—For some companies a significant element of the price increase sought in 2005–06 is required in order to achieve what, in their view, is an acceptable financial profile. This is both to allow them to maintain an adequate financial profile to provide assurance to investors, and to allow them to secure finance to fund new capital expenditure projects.

8. The companies set out in their draft business plans the increases to bills they expect to need to finance their preferred strategies. The following table shows the factors driving these increases in bills. One half of the net increase in bills is accounted for by improvements to the environment and drinking water quality.

**Table 1**

**CHANGE IN AVERAGE WATER AND SEWERAGE BILL 2004–05 TO 2009–10 ARISING FROM COMPANIES' PREFERRED STRATEGIES**

<b>Average household bill in 2004–05</b>		<b>234</b>
<b>Less</b>	(1) past efficiency savings and outperformance	<b>(8)</b>
	(2) scope for reduction through future efficiency improvements	<b>(10)</b>
	<b>(3) maintaining base services</b>	<b>37</b>
	of which (a) changes in revenue resulting from reduction in revenue yield from the customer base	3
	(b) increases in operating costs	6
	(c) increases in capital maintenance	19
<b>Plus</b>	(d) increases in taxation	9
	<b>(4) improving services</b>	<b>41</b>
	of which (a) drinking water quality	10
	(b) environmental improvements	26
	(c) service performance (mostly sewer flooding)	5
	<b>(5) maintaining security of supply to all customers</b>	<b>12</b>
<b>Average household bill in 2009–10</b>		<b>306</b>

9. After 15 years of progressive improvements the scope to offset increases by further substantial efficiency savings is less than at previous reviews. We know there are hard choices to be made ahead if we are to limit the cost pressures on companies to those that can be appropriately financed and set price limits that customers perceive as necessary.

10. In making our decisions on price limits we must consider customers' interests. We have conducted joint customer research into customers' opinions and priorities for investment. This research was published in December 2003. Nationally customers confirmed that it is important to maintain current levels of service. They also wanted to see some improvements.

11. The majority of bill paying customers stated that they were definitely (14%) or probably (46%) willing to pay the bill increases associated with the companies' preferred strategies. However, a significant proportion of customers were probably not (19%) or definitely not (14%) willing to pay.

12. Analysis of patterns of responses shows that customers' willingness to pay reduces as bill increases rise. Not unexpectedly there is a correlation between income levels and willingness to pay. Bad debt levels are already rising for various reasons. The costs of this unrecovered revenue and of debt collection falls on

the customers who do pay. The Environment, Food and Rural Affairs Committee in its report into Water Pricing (December 2003) drew attention to the difficulties some customers already face in meeting their water and sewerage bills.

*Advice to Ministers—December 2003*

13. In our “Advice to inform the principal guidance on scale and timing of further quality enhancements” (see annex) we set out our view that we expect significant overall bill increases at this price review. These are needed to ensure continued good service and accommodate capital programmes.

14. We also set out for illustrative purposes the impact on price limits of limiting the total capital investment programme for 2005–10 to £15 billion, approximately the same scale as for 2000–05. The total capital investment programme included in companies’ draft business plans for their preferred strategy is £19.9 billion.

15. There are longer-term implications for customers’ bills arising from significant increases to companies’ capital expenditure. Already some one third of customers’ bills represents payments needed to service the dividends and interest payments on financing the capital expenditure incurred by the companies in carrying out the large scale and successful programme of improvements made since privatisation in 1989. The further programme will add permanently to that burden.

16. Once additional capital expenditure has been allowed in price limits expenditure it forms part of companies’ ongoing costs. If no additional enhancement capital expenditure were allowed at PR04 there would be no deterioration to the current water environment and drinking water quality. There would continue to be improvements as investment now leads to longer-term improvements. The benefits of investment incurred do not always happen immediately. For example investment to improve sewage treatment works takes time to have a beneficial effect on the aquatic environment.

17. At this price review financeability is an issue for some companies. The water companies need to raise capital from the financial markets each year in order to deliver the environmental improvements required from them. We will set price limits that should allow efficient companies to do this but, as investment programmes increase, this will become progressively more expensive to finance. Customers’ bills will consequently need to rise disproportionately to meet the higher costs of raising finance.

*Progress with the current investment programme*

18. In January, with the Environment Agency, we set out the progress that companies are making towards completing the National Environment Programme for 2000–05. We are generally satisfied that that this programme will be substantially completed by April 2005, with a few schemes planned for delivery by December 2005.

18. To reduce problems with the uneven profile of investment experienced following price reviews we have asked companies to identify schemes to be completed early in the next five-year period. We have made allowance for these so that companies can begin to undertake preliminary work to set these schemes up ahead of the new price limits coming into effect—the “early start programme”.

*Next steps*

19. Once Ministers’ principal guidance is available the next step will be for companies to submit their business plans. We will scrutinise them and publish our draft determinations setting out what price limits we think the companies need to finance their functions. We will consult on our draft determinations.

20. In September we expect Ministers to fine-tune their guidance on the drinking water quality and environmental programme. We plan to make our final decisions in November. The companies then have two months in which to decide whether they wish to refer our decisions to the Competition Commission.

*February 2004*

**Annex**

**Letter to The Rt Hon Margaret Beckett MP, Secretary of State for Environment, Food and Rural Affairs  
from Philip Fletcher, Director General, Ofwat**

**ADVICE TO INFORM THE PRINCIPAL GUIDANCE ON SCALE AND TIMING OF FURTHER  
QUALITY ENHANCEMENTS**

In your initial guidance to me, last January, you set out a list of potential policies to be investigated. You indicated that the Government would require the water industry to meet domestic and European statutory requirements, but you also emphasised that there is room to explore how best and to what timetable to meet these and other improvements. You stressed the need for cost effective solutions taking into account what is practicable and affordable, both in its effect on customers’ bills and on the financeability of the industry

as a whole, and the benefits of stability both for companies and customers. You asked me, with fellow regulators and the companies, to explore all the potential improvements listed in the initial guidance and in particular their costs and benefits, before decisions could be taken on whether, how and when they should proceed.

This letter sets out my views on the way forward. I will be writing to the Welsh Assembly Government along similar lines. I attach a paper, which takes up some of these points in more detail.

### *Draft business plans*

As part of the preparations for the 2004 review of water company price limits I asked each company to develop a draft business plan setting out its preferred strategy and, for comparison, reference plans drawn up on common assumptions provided by Ofwat. The preparation of these business plans has been a considerable task for each company. I believe it has been well worthwhile. We now have the information we need to advise you on the decisions you need to take as part of the review process.

In their draft business plans companies proposed significant increases in bills, before inflation, to maintain their services and to finance further enhancements to the environment and water quality. Companies proposed investing a further £19.9 billion in the five-year period on top of the £50 billion of investment between privatisation in 1989 and 2005. In their preferred strategies companies propose significant increases in bills by 2009–10 (on average +31%, maximum +70% proposed by United Utilities<sup>3</sup>).

The companies' preferred strategies proposed an average increase of £72 by 2009–10, from an industry annual average household bill of £234), driven by:

- continuing to run the business day-to-day +£37—this includes maintaining assets (+£19), the impact of taxation (+£9), changes in operating costs (+£6) and changes in revenue (+£3);
- sustaining security of supply and the right to “free metering” +£12;
- improvements in service +£41—this includes environmental improvements (+£26), drinking water quality improvements (+£10) and improvements in service performance, largely sewer flooding (+£5).

These increases are partly offset by projected efficiency savings past and future—£18.

We recognise your need for appropriate information, on company investment projections, as a robust basis for your guidance to me. At the last review, concerns in this area led us to require an update of the costs of the possible quality improvements in December 1998, before decisions were taken by Ministers in February 1999. Learning from this experience we have structured the information requirements differently for draft business plans, including an earlier requirement for comparative capital costs (March 2003). We reviewed the comparative capital costs and provided feedback to each company (May 2003) well before its draft business plan submission (August 2003). Going forward we will continue to test vigorously the cost assumptions. In line with a recommendation from the Environment Food and Rural Affairs (EFRA) Committee<sup>4</sup> of the House of Commons.

Following examination of the draft business plans, I believe they are sufficiently robust to use for the guidance you intend to issue at the end of January 2004. The draft business plan costs supersede the numbers used by the Environment Agency in “A good deal for water”, published in September. We note that the EFRA Committee welcome the introduction of the draft business plans, which provide greater scope for scrutiny and debate at this stage in the review.

### *Cost pressures*

It is too early to signal the outcome of the review. Our analysis shows that there will be hard choices to make if we are to limit the cost pressures faced by companies to those that can be appropriately financed and to set price limits that are perceived by customers as necessary. If we are to limit the increases in bills, we must test the basis of each of the upward pressures.

Some of the proposed increases arise from Government policies, which affect the day-to-day running of water companies, for example, known changes in taxation policy, optional metering and the ban on disconnection for non-payment of household bills. Half of the net increase arises from enhancements to drinking water quality and the environment proposed by the Drinking Water Inspectorate and the Environment Agency/English Nature.

<sup>3</sup> These numbers are not adjusted to take account of the interim determinations for Northumbrian Water and United Utilities announced on 11 December 2003.

<sup>4</sup> House of Commons—Environment, Food and Rural Affairs Committee—Water Pricing, 18 December 2003, HC121.

After 15 years of progressive improvements the scope to offset these increases by further substantial efficiency savings past and future will be less than at previous reviews. We have commissioned a number of studies to inform our view in this area. The latest<sup>5</sup> suggest that the scope for future efficiency savings, beyond the performance of the economy at large, is less than we assumed when we set reference assumptions for use in the draft business plans.

I expect the companies to provide revised costings in their final business plans in April 2004 taking account of our challenges and we will review again the costs provided by companies at that stage.

Other uncertainties facing the companies are not reflected in the company proposals. These include possible changes arising from Government policy, for example:

- the cost to companies of adopting private sewers;
- further changes in taxation; and
- requirements on the water and sewerage companies as a result of traffic management legislation.

We have just received the House of Lords' judgement on the Marcic sewer flooding case. The judgement clarifies the existing regulatory responsibilities but does raise issues about compensation arrangements where customers experience sewer flooding.

We have looked for but not found changes that could significantly reduce costs and customers' bills.

The financeability of large capital programmes can also be a constraint, which increases customers' bills across all aspects of their draft business plans. The EFRA Committee recognised the difficult balance we will need to reach between minimising the costs of financing the investment and providing an adequate cost of capital. My view is that significant overall bill increases are going to be needed to ensure continued good service and accommodate capital programmes on the scale signalled both for capital maintenance and enhancement.

#### *Customers' views*

Customers, and WaterVoice, have expressed concern at the scale of potential price increases. WaterVoice, in its submission to you, recognises the need for some price increases, but expresses alarm at the scale proposed. It also acknowledges that the draft business plans may in some areas understate the potential bill increases. Customer research jointly commissioned by periodic review stakeholders<sup>6</sup> shows that although a majority of customers are willing to pay for the proposed investment, 30–40% were probably or definitely not willing to pay for the proposals. They were slightly more willing to pay for their company's preferred strategy and reference plan A than reference plan B. About half of those not willing to pay said the cost was too much for the improvements provided and about a third said they could not afford it. Customers on low incomes, in socio-economic groups D or E and living in rural areas were least willing to pay for any of the plans.

#### *Affordability*

The law requires me to set price limits, which will allow efficient companies to finance their businesses. I cannot set limits with regard to affordability by assuming implausibly low levels of costs for the delivery of all expectations. So bill increases will place real pressures on low-income customers. We note the EFRA Committee's concerns in this area. WaterVoice is also very concerned about this and so am I. Outside of the vulnerable groups' regulations, companies may not set tariffs that subsidise poorer customers. Any support for poorer households would be a matter for Government, either by reducing pressures on companies or in terms of social support.

#### *Options*

I particularly seek your guidance in relation to the quality improvements to be made for drinking water and the environment. As you indicated in your initial guidance to me there are choices about how best and to what timetable even statutory requirements are to be met. As with all aspects of the companies' activities I shall want to seek to provide as much assurance to customers as possible that increases in price limits will reflect value for money. It is important that any scheme put forward in final business plans meets all of the following criteria.

- It is required by the quality regulators, and confirmed by Ministers, or is a new obligation under current legislation.
- It delivers a measurable defined output, which is enforceable.

---

<sup>5</sup> London Economics, PR04—Scope for efficiency studies (November 2003) and Europe Economics, PR04—Scope for efficiency improvement—uncertainties and measurement issues (November 2003). Both reports are available on our website—[www.ofwat.gov.uk](http://www.ofwat.gov.uk).

<sup>6</sup> Customer research 2003: Periodic review commissioned by the Department for Environment, Food and Rural Affairs, Welsh Assembly Government, Ofwat, WaterVoice, Water UK, Environment Agency, Drinking Water Inspectorate, English Nature and the Wildlife and Countryside Link.

- It has a clearly defined timetable and due date for delivery in line with regulations or other legislation.
- There are defined asset improvements or changes to operational procedures to deliver the output.
- The costs are identified and the proposed solution has been challenged and validated by the company's reporter (an independent professional who scrutinises and gives his opinion on the company's business plan to Ofwat).

If, for example, the total capital investment programme could be limited to £15 billion, to a similar level to that assumed for 2000–05, it would, by my estimate, reduce price limits by around 5% over the five year period against reference plan A<sup>7</sup> and by around 10% against reference plan B<sup>8</sup>. And there are longer-term implications for customers' bills. Already some one third of customers' bills represents payments needed to service the dividends and interest payments on capital expenditure incurred by the companies in carrying out the large scale and successful programme of improvements made since privatisation in 1989. The further programme will add permanently to that burden.

For my part, I shall be seeking to ensure, as I must by law, that well managed companies have sufficient revenues to carry out and finance their functions. If, as seems likely, it is not practical to include all possible improvements in the next five years, we need to establish our priorities. In reaching decisions, Ofwat's priorities will be as set out at the start of this review, to allow the companies to:

- run their businesses day-to-day to meet all service, quality and environmental compliance obligations;
- maintain asset systems for current and future customers;
- ensure a sufficient balance between supply and demand for both services;
- meet drinking water quality and service improvements required to safeguard public health;
- meet obligations on environmental improvements decided by Ministers; and
- make other desirable drinking water quality, service and environmental improvements, for example reducing the number of homes at risk of sewer flooding.

#### *Next steps*

I look forward to receiving your principal guidance on the scope and pace of the drinking water quality and environmental improvement programmes you will be expecting from the water and sewerage companies for the period 2005–10. This will enable me, with the quality regulators, to give the companies clear guidance on the schemes they should cost in their final business plans on 7 April 2004. I will assume these schemes are required when I set draft determinations on 28 July 2004. You will have an opportunity in September 2004 for fine-tuning the programme for inclusion in the final package of drinking water quality and environmental improvements each company will be expected to deliver with the price limits I will determine on 25 November 2004.

*19 November 2003*

### **Supporting Notes to Ofwat's Advice to Ministers—December 2003**

In preparation for the periodic review next year, and to provide the information needed to guide Ministers in considering the scope and timing of new quality enhancements, we asked each company to submit draft business plans in August 2003. We are currently scrutinising these and providing feedback to each company to help it to produce a final business plan next year.

Each draft business plan comprises the following items.

- The company's preferred strategy—including its own view of the quality enhancements it considers are necessary during the period.
- Reference plan A—a fully worked up draft business plan including a defined package of quality and environmental improvements with prescribed reference level assumptions for the following key issues:
  - the cost of capital;
  - the scope to reduce costs through efficiency;
  - the rate of take up of free meters; and
  - forecast inflation.

<sup>7</sup> Reference Plan A included a defined package of environmental improvements approximating to your "clear and essential drivers".

<sup>8</sup> Reference Plan B includes a significantly larger package of improvements—but not all the potential improvements.

- Reference plan B (for the water and sewerage companies and Three Valleys Water the largest water only company) including a fully worked up draft business plan but with a larger defined package of improvements with the same reference level assumptions.

These alternative packages of environmental improvements were discussed with Defra, the Welsh Assembly Government and the quality regulators.

#### BRIEF OVERVIEW OF COMPANY PREFERRED STRATEGIES

Companies have set out in their business plans their own preferred strategies for the period 2005–10. In these preferred strategies companies propose significant increases in bills (on average +31%, maximum +70%—United Utilities). See the map below. The bill increases in the water only companies' preferred strategies vary between +3% Tendring Hundred and +36% Three Valleys.

Some companies have chosen not to specify their preferred cost of capital, but to use the reference level. This was the same as that used for setting price limits in 1999. However, the majority of these commented that this is too low. Consequently for these companies the bill effects will be understated.

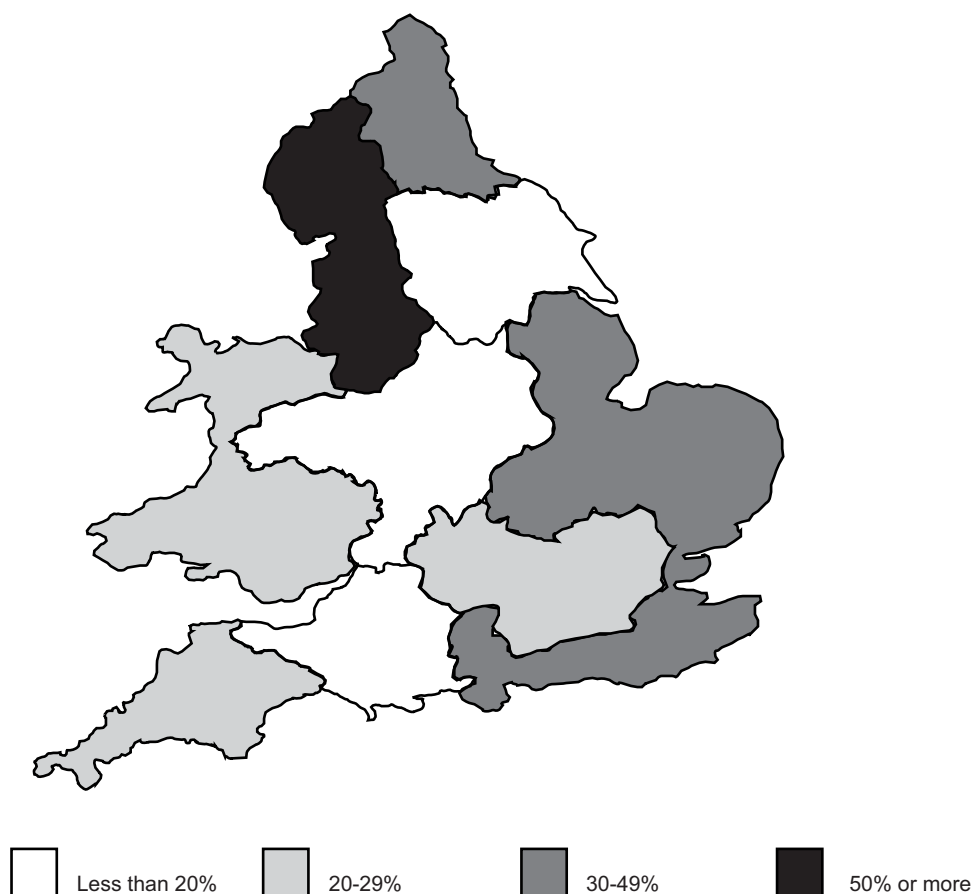
Table 1 shows the factors driving the changes in bills as proposed in the companies' preferred strategies.

**Table 1**

#### WHAT IS DRIVING THE CHANGES IN BILLS IN ENGLAND AND WALES? (COMPANY PREFERRED STRATEGIES)

<b>Average household bill in 2004–05</b>		<b>£234</b>
<b>Less</b>	(1) past efficiency savings and outperformance	<b>(8)</b>
	(2) scope for reduction through future efficiency improvements	<b>(10)</b>
	(3) maintaining base services	<b>37</b>
	of which (a) changes in revenue	3
	(b) changes in operating costs	6
<b>Plus</b>	(c) changes in capital maintenance	19
	(d) impact of taxation	9
	(4) maintaining security of supply to all customers	<b>12</b>
	(5) the impact of improvements in services	<b>41</b>
	of which (a) drinking water quality	10
	(b) environmental improvements	26
	1. (c) service performance	5
<b>Average household bill in 2009–10</b>		<b>£306</b>

## Water and sewerage company proposals for percentage increases in bills

*Comparison with the 1999 determinations*

At the 1999 review Ofwat was able to transfer to customers the benefits of significant efficiency gains made in the previous five years in excess of those assumed in price limits in 1994. Outperformance since 1999 has been very limited by comparison. Moreover, the scope for efficiency gains going forward is unlikely to match those sought at 1999 (see table below). Ofwat will however continue to use the incentive based price-cap system to pursue challenging targets for efficiency. But unlike 1999 we will not be able to offset large efficiency gains past and future against additional expenditure on improvements or maintaining services.

**Table 2**

## COMPARISON OF BILL DRIVERS IN 2000–05 AND 2005–10

		1999–2000	2004–05 <sup>9</sup>
Average household bill		% change	% change
<b>Less</b>	(1) past efficiency savings and outperformance	(14)	(3)
	(2) scope for reduction through future efficiency improvements	(10)	(4)
<b>Plus</b>	(3) maintaining base services	—	16
	(4) maintaining security of supply to all customers	< 1	5
	(5) improvements in drinking water and environmental quality	12	15
	(6) improvements in service performance	< 1	2
<b>Average household bill % change</b>		<b>2004–05 (12)%</b>	<b>2009–10 + 31%</b>

<sup>9</sup> Company preferred strategy.

### *Reference plans*

Reference plan A approximates to the package of environmental improvements in your “clear and essential” drivers categories. Most companies’ preferred strategies are very similar to reference plan A. Reference plan B includes a significantly larger package of improvements, but not all the potential improvements. One example is any work on the Water Framework Directive in advance of identification of the measures required in river basin management plans.

The advice in this paper is based on reference plan A. The purpose of requiring these reference plans was to ensure we had broadly comparable information across companies. Some companies have included in reference plan A schemes that were not sought by the quality regulators, others have excluded schemes proposed by quality regulators but considered by the company to be poor value for money or not clearly defined.

### *Cost of capital*

It is too early to draw any firm conclusions on the appropriate cost of capital for the water industry. However, we consider that there is no strong case for setting a cost of capital below that used in 1999.

In their preferred strategies companies draw heavily on work done for Water UK by NERA which suggested a post tax real cost of capital of 5.75%. We consider that this is likely to overstate the required return.

Price limits are very sensitive to the cost of capital. Broadly, each percentage change in the cost of capital is worth around a 5% change in price limits.

### *Efficiency*

We include an assumption on the scope for future efficiency in price limits for all companies. At the time of draft business plans we used a central estimate of 3% per annum reduction for the industry. Since then we have sought more advice<sup>10</sup> and companies have explained their own views on future costs. On the basis of all this evidence the 3% assumption is unlikely to be sustainable. As we continue to consider the scope for future efficiency and work on the targets for individual companies we are mindful of external pressures on base costs that did not exist in 1999.

### *Capital maintenance*

Companies are proposing significant increases in expenditure on capital maintenance. We are reviewing each plan on its merits. The companies will need to justify any major step changes in expenditure and we will look carefully at any change in the allocation of risk between companies and their customers.

### *Supply/demand*

Sustaining security of supply and meeting customers’ demands for free meters are also adding to companies’ costs and customers’ bills.

### *Sewer flooding*

In their draft business plans companies proposed to make very significant reductions in the number of properties at risk of flooding internally from sewers once or more in 10 years and to tackle the most severe cases of external flooding. The costs companies propose vary significantly and we will examine them closely, particularly where the cost of solving problems is very high. However it is clear that customers and other stakeholders would like to see significant early progress in tackling this unpleasant problem. We will also need to consider the implications of the House of Lords judgement on the Marcic<sup>11</sup> case for the periodic review.

### *Running costs*

Companies’ day-to-day running costs are also increasing, partly as a result of Government policy. The following factors all increase costs and will need to be reflected in customers bills going forward: changes to the tax regime for water companies, pensions, the ban on disconnection, and the right to a free meter.

So even before we consider enhancing the service already received by customers, bills can be expected to rise over the period 2005–10. Many of the costs outlined above will have significant implications in the first year, and this is the prime reason for the jump in prices in 2005–06 identified in companies’ plans.

---

<sup>10</sup> See footnote 3.

<sup>11</sup> Marcic -v- Thames Water Utilities [2003] UKHL 66.

### Uncertainties

Other Government decisions in the pipeline could also impact on customers' bills. These include security issues, the adoption of private sewers, odour and lane rental/traffic management proposals.

There are other areas of uncertainty. These include the implications of a court case on odour, business rates etc. All these uncertainties could add to bills. We have mechanisms for dealing with changes between price reviews and for taking account of significant changes in costs arising from changes in legislation which have a disproportionate effect on the water industry or from potential changes which are identified when we set price limits.

### Financeability

The size of the companies' capital investment programmes since privatisation has meant that, each year, they have been "cash flow negative" (ie their expenditure has exceeded their revenue. Companies have had to raise capital from the financial markets each year in order to deliver the outputs required of them). This will continue to be the case for at least the next five years and possibly well beyond.

Given this persistent "cash negative" position, my duty to act in a way that I judge enables companies to finance their functions cannot be discharged by simply allowing an appropriate cost of capital. I must also enable companies, in a practical sense, to access capital markets in order to raise finance on reasonable terms. This can be described as setting price limits that are financeable. We try to achieve this by checking that the financial profiles of an efficient company are such that they meet the normal financial tests applied by lenders and investors before investing. These tests can be a significant constraint and may mean that, to raise finance for capital programmes, customers have to pay more in their bills than simply the cost of capital. One of the key tests used by credit rating agencies is the cash interest cover. At the last review, eight companies (including four water and sewerage companies) out of 26 had their price limits increased to meet these financial tests. The capital programmes set out in the draft business plans for 2005–10 will mean that a significant element of the price increases in 2005–10 will be required in order to maintain an acceptable financial profile for each company.

### Customer survey

The results of a survey of 6,000 water customers in England and Wales which was commissioned jointly by the periodic review stakeholders were published earlier this week. Customers were given details of the service they currently receive and the average bill in their area. They were shown details of their water company's draft business plan, and potential associated costs for the period 2005–10, including proposals related to the company's preferred strategy and reference plans A and B<sup>12</sup>, which were plans with different service levels defined by water regulators.

*Nationally customers confirmed that it is important to maintain current levels of service, rather than allow reduced levels. They also wanted to see some improvements. When looking at the specific costed plans, most support was given to drinking water quality and supply aspects, followed by maintaining water and sewerage systems. Less support was given to environmental and customer service aspects although this was still supported by the majority of customers.*

The majority of bill paying customers stated that they were definitely or probably willing to pay the price increases associated with the companies' preferred strategies and with the reference plans, as illustrated in the table below. However, there was in each case a significant proportion of customers who were not willing to pay. The majority of customers were not decided in their views, with about two thirds only "probably willing" or "probably not willing" to pay the price increases.

**Table 3**

#### WILLINGNESS TO PAY FOR IMPROVEMENTS

	Percentage of all bill paying customers		
	Company preferred plan	Reference plan A	Reference plan B
Definitely not willing to pay	14%	14%	19%
Probably not willing to pay	19%	20%	22%
Probably willing to pay	46%	46%	41%
Definitely willing to pay	14%	14%	12%
Don't know / can't say	7%	6%	6%

<sup>12</sup> See footnotes 5 and 6.

Analysis of patterns of responses show that customers' willingness to pay reduces as bill increases go up. Similar work to identify whether willingness to pay was linked to the number of improvements provided showed no such correlation.

Those who were definitely or probably not willing to pay the increase were asked why not. The majority of these customers nationally said the cost was too much for the improvements provided or that they could not afford it. Nine per cent of the whole sample said they would not pay because they could not afford the forecast level of bills.

There is a correlation between income levels and willingness to pay. Lower income customers are less willing than other customers generally to pay the bill increases associated with companies' preferred strategies and reference plans, and their willingness declines more steeply than other groups as bill increases go up.

*We know that some customers cannot or will not pay bills now. The costs of this unrecovered revenue and of debt collection fall on the customers who do pay. Higher bills could lead to more non-payment.*

*It is important to note that the national results mask variations in the price increases and benefits of plans in different areas.*

At a national level more customers felt the companies' preferred strategies and reference plan A were fairly to extremely good value for money rather than fairly to extremely poor value for money. This view was reversed for reference plan B.

It is with this background that the further enhancements costed in the draft business plans need to be considered.

### *Improvements*

Our determination in 1999 assumed investment of £7.9 billion (including £5.6 billion for the national environment programme) in today's prices for quality and environmental improvements for 2000–05, the largest quality programme ever. The Environment Agency responded warmly. Its then Chairman, Lord de Ramsay, said, "By 2005 we will have reached a position where the significant environmental damage created over the past 200 years will have been repaired". The companies are progressing with this work but, with 15 months of the current period to run, a substantial proportion of this work has yet to be completed. The full benefit of environmental improvements is not usually apparent until some time after the completion of the capital works. It is unlikely that the full effects of schemes implemented before 2000 are yet being reflected in current river quality figures. That is before the benefits of the current (2000–05) £5.6 billion national environment programme add further to their improvements and become apparent by 2007–08 or some time later.

The Drinking Water Inspectorate, Environment Agency and English Nature have advised you separately of the improvements they want to see in the next five-year period. We have worked with them to understand better the companies' costings of these schemes. We have also identified schemes that are:

- particularly costly; or
- identified by the companies as being of limited benefit to customers; or
- within catchments with particularly high levels of investment.

As a result of these challenges we understand that some schemes costed in draft business plans will not be included in the quality regulators' advice to you. It is too early to say what impact these changes will have on price limits.

### *Costs of the proposed programmes*

We have examined carefully the companies' proposed costs. Most schemes are designed to meet more than one driver so reducing the requirements does not always reduce the costs. Table 4 sets out the costs by driver as included in reference plans A and B originally costed by the companies and revised following queries and further information from companies. These costs are for the water and sewerage companies only, but as the total water only companies' quality programme only amounted to about £200 million the impact on the industry total is small.

We await companies revised costings in their final business plans.

Table 4

ESTIMATES OF CAPITAL EXPENDITURE IN PERIOD 2005–06 TO 2009–10 TO MEET  
DRINKING WATER QUALITY, ENVIRONMENTAL AND OTHER RELATED  
IMPROVEMENT DRIVERS

Main drivers for drinking water quality, environmental and other related improvements	4. Capital expenditure in 2005–10 £m	
	5. Reference Plan A	6. Reference Plan B
<b>Water Service</b>		
Water treatment works improvements	570	640
Distribution system renovation	740	740
Lead communication pipe replacement	370	870
Improvements to taste and odour of drinking water	210	260
Other improvements (includes resilience of water systems )	60	60
<b>Drinking Water Quality Sub Total</b>	<b>1,950</b>	<b>2,570</b>
Changes to water systems to improve the environment	230	540
<b>Water Service Sub Total</b>	<b>2,180</b>	<b>3,110</b>
<b>7. Sewerage Service</b>		
Urban waste water treatment directive at STWks	740	1,120
Intermittent discharges from sewerage systems	950	1,030
Sewage sludge treatment and IPPC requirements	90	170
Freshwater fish directive (see note 2)	30	1,620
Bathing waters directive	160	390
Shellfish waters directive	0	1,790
Nature conservation (includes Habitats directive & SSSIs)	870	930
Ground water protection	660	670
Removal of trace contaminants from STWks effluents	100	220
Endocrine disruptors demonstration project	0	40
Land management schemes	0	340
Local schemes for improving the water environment	220	870
Completing the AMP3 programme + other (see note 3)	450	490
Section A (see note 4)	620	620
<b>Sewerage Service Sub Total</b>	<b>4,890</b>	<b>10,300</b>
<b>Total—Quality Enhancements</b>	<b>7,070</b>	<b>13,410</b>

*Notes:*

1. These estimates are drawn from the supporting information submitted by water companies with their Draft Business Plans but expressed in net terms after the application of the reference level assumptions for improvements in efficiency.

2. The plan B number includes some companies' estimates for more work than sought by the EA.

3. At PR99 Ofwat assumed some quality enhancement schemes would be delivered in the period April to December 2005. The costs for these schemes will need to be allowed for in setting price limits for 2005–10.

4. Section A covers improvements falling outside the formal National Environment Programme and improvement requirements that have arisen since the 1999 determination.

## PROFILING BILLS

Most companies are proposing a significant increase in the first year of new price limits and smaller changes thereafter. A few companies proposed a more even (smoothed) increase year-on-year.

The impact on customers' bills presented in this report is based on price limit profiles that have not been smoothed. The joint stakeholder survey showed that customers strongly prefer smoothed bill increases to a step change. I shall need to consider the case for smoothing in relation to each company. On the one hand there are arguments for smoothing to help customers to budget for increases. On the other hand many of the companies are facing additional costs which need to be financed from the first year of the period—to defer the increase to later years might in some cases be imprudent. An increase in 2005–06, followed by

broadly constant bills keeps the average bills at the end of the period lower than if the price limit profile is smoothed. Our analysis shows that smoothing price limits to maintain the same net present value of revenue over the five year review period would add a further 7% on average to customers' bills in 2009–10. The effect of smoothing would be different for each company.

Ofwat

19 December 2003

---

*Witnesses: Ms Fiona Pethick*, Periodic Review Project Manager, *Mr Philip Fletcher*, Director General and *Mr Bill Emery*, Director of Costs and Performance Division, Ofwat examined.

**Q137 Chairman:** Good afternoon, thank you for joining us and thank you for your written submission. You were able to hear the evidence session immediately before you and no doubt you may wish to comment on some of the things we have been discussing. Can I ask you first about one of the new elements in the process which is the cost of the benefit analysis which has been developed by the Environment Agency, I think you were involved in determining the methodology behind that?

*Mr Fletcher:* We have certainly consulted as the methodology has developed and we accept that what the Environment Agency is now doing is a considerable improvement on their multi-attribute techniques approach, which was the approach used, as some of the longer standing members of the Committee may remember at the previous review. However, I do think it is worth pointing out that cost-benefit analysis, echoing Water UK, in the environmental field is a very difficult science and it is still being developed. We believe there is more to be done and it is worth noting that cost-benefit analysis, even in this still fairly elementary form, has only been applied to some 10% of the programme which the environmental regulators are seeking because the rest of it is driven by the statutory requirements and is therefore declared to be necessary. I think for customers it is regrettable we are not looking more at everything in terms of whether cost matches the value to be achieved, but I recognise we can only make progress over time.

**Q138 Chairman:** Given those caveats in practical terms, has it been a worthwhile exercise for you?

*Mr Fletcher:* Yes, it has. It all helps to advance things. We are not in this whole business for a year, two years, five or 10 years, it is a very long-term industry, it will be making progress over a very long time and the progress that we make incrementally will yield fruit steadily over time. Could I on the back of that just make the point that we are not going to go backwards. This sort of debate can get rather confused with issues like cuts. The huge improvements that have been secured by the water industry at the expense of its customers, many of them environmental improvements, over the last 15 years are secure and will remain secure, more or less whatever it takes, in terms of additional pressures on customers' bills.

**Q139 Chairman:** That is of some comfort. We were told yesterday by the Environment Agency that more than just querying the reliability of the cost-benefit process, which is known to be difficult, you

had some specific criticisms to make about some of the outcomes of that, are you able to shed any light on that?

*Mr Fletcher:* I was not unfortunately able to be here and for some reason my colleague who was here was not able to get into the room for the first ten minutes so I am not fully aware of what was said.

**Q140 Chairman:** Sorry.

*Mr Fletcher:* This may be about some of the inherent difficulties in cost-benefit analysis in the environmental field. First of all we are talking on the benefit side about the straight use benefits, much more difficult are the less tangible but still real benefits, the benefits that come from the mere existence of an environmental good, even if it is not always apparent to those of us living in the middle of London that those environmental benefits exist. Those aspects are largely addressed through willingness to pay studies and obviously a lot depends on the way you frame the question and just how you get the balance right. I shall be appearing in a fortnight's time in front of the Public Accounts Committee where the same issue will come up in relation to sewer flooding. There has only been one decent study so far by Yorkshire Water and the lessons from that study were not readily transferable to all sorts of other sites. I have to say that the Environment Agency's approach does involve transferring in all sorts of ways from site to site, from one set of customers to another set of customers. I am not doing that in a spoiling manner, I recognise the difficulties confronting the Environment Agency, I am giving it as an example of some of the difficulties that confront all of us who are engaged in the process.

**Q141 Chairman:** Your primary function is economic, is it not?

*Mr Fletcher:* Yes, although partly as a result of the previous recommendations of this Committee but with my very full support Parliament has passed legislation which will apply to Ofwat once the provisions are implemented, a sustainable development duty. I am now more than happy to feel accountable to this Committee and to Parliament at large in terms of all four legs of that duty: the economic issues are obvious enough but there are social issues as well, social inclusivity, environmental improvement and prudent use of natural resources I see all of those as important factors for Ofwat in carrying out our own specific role and needs.

---

3 March 2004 Ms Fiona Pethick, Mr Philip Fletcher and Mr Bill Emery

---

**Q142 Chairman:** Although you are not yet required to take into account sustainable development, you are already doing so and decisions that you are taking reflect that.

**Mr Fletcher:** Yes. It frankly hurt when this Committee in its previous report talked about Ofwat demonising the environment. That was under my eminent predecessor but I do not demonise the environment and I do not think he would have accepted that either. It stung. We are trying to go out of our way to ensure that we have a balanced approach to the issues, and the environment is a crucial issue within that balance.

**Q143 Chairman:** Do you take that commitment to the environment as making a judgment on the necessity of individual environmental measures, are you qualified to make that judgment?

**Mr Fletcher:** The key issue for which we are all waiting is the ministerial guidance. It is a bit like the Secretary of State saying “Godot must be round the corner soon”. Some of the friction you have detected in the evidence given to you is all of us itching a bit as we wait for the Secretary of State and the Welsh Assembly Government’s guidance on this key issue. I, of course, accept it is for the democratically elected government in both cases to tell not just the regulators but the industry and all of the stakeholders what they think is needed to deliver the international and national and statutory obligations which the United Kingdom has incurred. I do not try and set myself up as a rival authority in that. What I do look for is that the environmental improvements, which have been huge, and which will go on being a very important driver of the programme, should be delivered in the most cost-effective way possible. That is an area where we can raise questions and do raise questions and seek to ensure that an outcome desired is delivered in the best possible way.

**Q144 Chairman:** I am not entirely clear what I have to say on that answer.

**Mr Fletcher:** Can I give you an example?

**Q145 Chairman:** Yes, that might be helpful.

**Mr Fletcher:** From the last review we have the issue of the chalk streams in Wessex in the Downs, very important for all of the SSSIs, and the concern about the problems of low flow in these streams in dry periods, particularly where that is caused by heavy water company extraction. There were various ways of dealing with that in the initial guidance, the proposition was to spend over £100 million on developing new sources. The proposition, which at the moment I believe has every prospect of proceeding, has been put in place to test out other means of maintaining that flow, including permission for Wessex to draw extra water if they need it from the Severn through another water company, Bristol Water, and provide it with a reserve if needed. That hardly costs the customer anything. It is a very stark example but I believe there will be other examples where if we had more time to develop appropriate approaches we would

get the environmental goods at very much less cost to the customer than is possible within a heavy end of pipe solution.

**Q146 Chairman:** Which touches on an issue we came across yesterday and in other submissions about the suggestion that some water companies are inflating environmental costs when preparing their draft plans, do you think that is a fair allegation?

**Mr Fletcher:** It fits in with the costs issue that you were exploring with Water UK witnesses. We believe, as Bob Baty was describing, we have improved the process of cost testing this time round so that the draft business plan submitted by the companies were a whole lot more robust than a simple bidding exercise with inflated costs in them. As Mr Baty explained those costs have been examined and audited by engineering consultants to ensure they are not mere stabs in the dark, they are reasonably robust costs. We will go on scrutinising them very carefully. We are alive to the possibility that some companies might still, I think it is fewer and fewer, see some sort of company advantage in very large and inflated programmes and we will be seeking to ensure that any such inflation is cut out. I do believe we start in a much more robust position than last time round and any appearance from the witnesses you had yesterday that it was very different last time and the costs are all going to come tumbling down at a later stage in the process I really think is a misunderstanding. We have advanced the process, the costs are now more robust than they were at this stage in the previous review.

**Q147 Chairman:** Thank you. Are you grappling with the question of diffuse pollution that you would have heard us discussing? Nobody seems to own that and somebody needs to.

**Mr Fletcher:** I absolutely accept that. I have no doubt when you call Elliot Morley in front of you, I believe next week, he will accept—I am not speaking for him—that the Government is not only due to produce any time now their principal guidance to me on this issue but they are also due to produce for consultation their action plan on diffuse pollution. This must be a key issue for Government to give us all a lead on. All of us, and I include in this the Environment Agency, English Nature and RSPB see the very difficult issue of controlling diffuse pollution as the key challenge over the period that will develop from 2010 onwards. We need to get on with it now so that we are ready for the key implementation stages of the Water Framework Directive when controlling diffuse pollution and the production of really good outcomes for the water environment must be a key driver.

**Q148 Chairman:** Lastly, there have been reports, I am sure you will have seen them, that there has been political pressure in the run-up to this process, sensitivity about the forthcoming election, prices going up and suggestions that the environmental side of all this process is going to be—no pun

---

3 March 2004 Ms Fiona Pethick, Mr Philip Fletcher and Mr Bill Emery

---

intended—watered down. Are you aware of any direct pressure being applied in relation to these issues?

**Mr Fletcher:** No, Chairman. I am the independent Regulator and Parliament has given me the job of setting these price limits through statute. I do not expect it to be an easy ride when I announce it in the summer but they will be my decisions. Of course Government has key inputs to make and I have been, boot on the other foot, offering them advice, as have the Environment Agency, English Nature and others. I think the process has been absolutely proper, the fact there is a bit of friction in it at the moment I would agree with Pamela Taylor is a sign of transparency and health rather than something to get too concerned about.

**Q149 Chairman:** Friction but no heavy breathing.

**Mr Fletcher:** I think that is right. We do have a good working relationship with the environmental regulators, even though we do not agree about everything, which ensures that the basic work gets done properly. That is rightly a concern the Committee has and I offer my assurance about it.

**Q150 Joan Walley:** As a long-standing member of this Committee I have to say in view of your previous comments there has been some progress in terms of sustainable duties in terms of Ofwat. In respect of the agreement about the guidance given by the Environment Agency on the size and scope of the environment programme of I think in the region of a 6% rise per annum, which would work out at 30% over five years, given the concerns that the Environment Agency are addressing about the over-estimation or possible over-estimation of the cost of carrying out the environmental improvements by the water companies do you agree with that? What have you done to address the concerns?

**Mr Fletcher:** Can I say that we can quickly bury ourselves with the figures because they are difficult to grapple with. Not least on the costs side we have the issue raised by the water companies that we are not talking about a steady cost for everything, there are incremental rises. The moment that a company starts bumping into problems with financability and the ratios that the City insist on before it will lend money then we see the cost of that marginal increment escalating very sharply. The table I offered in our evidence shows the various drivers in terms of an average bill, the overall net increase that the companies in their preferred strategies offered in their draft business plans—this is not an Ofwat view, it is a company view—50% of that net increase after the efficiency gains which have been taken away is down to the overall quality improvements. Nobody thinks for a moment, certainly not me, that you could remove those quality improvements, we are going to go on making improvements, they will go on being a heavy part of the bill but this overall percentage increase for any given adjustment to the environmental programme will vary. The RSPB offered a figure, I have no idea where they got it from at all, of £2, I do not recognise that at all. The figure that I offer is if you are talking about £20 billion on

the one hand and £15 billion on the other then you might be talking about somewhere between 5% and 10% on the bill.

**Q151 Joan Walley:** What would that 5% or 10% mean?

**Mr Fletcher:** You are talking about somewhere between £15 and £25, it will vary a lot from company to company depending on where they are in terms of financability. It is very difficult to pin. It is impossible. I am not going to reach a view on this until I have the guidance from the Secretary of State, I have the final plans from the companies and I am in a position to set draft price limits and they are available to the world for comment and criticism.

**Q152 Joan Walley:** I think you have said that the scope for improving efficiencies this time round is small, are you sure you have that right this time?

**Mr Fletcher:** What we know is that the companies have under the pressure of economic incentive-based regulation made huge strides in efficiency over the last 15 years, it is almost self-evident. The easier gains have now been made and it will get significantly harder from now on, what we will never accept is that somehow there is a ceiling on this and you will never get more efficiency gains, we will always be pushing for more and efficient companies will always have something more that they can do. It is getting harder. We cannot make wild assumptions on efficiency gains going forward, we have to make realistic assumptions and all of the evidence, including various consultant studies that we and others have had done, show the scope this time is very much less than it was in the first ten years of the period since privatisation and even significantly less than the five years 2000–05.

**Q153 Joan Walley:** In the scope of greater transparency that we have heard a lot about this afternoon do you have anything else up your sleeve in terms of reducing costs? Are you having any talks with the Treasury about any possible tax concessions that are on-going?

**Mr Fletcher:** I believe Barbara Young suggested that I should talk to the Treasury despite the fact that companies do face a change in their tax regime which from my point of view—

**Q154 Chairman:** She did not suggest that you should be, she pointed out that you might.

**Mr Fletcher:** Thank you, Chairman. She can trust me that I will pull every obvious lever to try and reduce the pressure on customers via the pressures on companies. There are a lot of pressures this time and tax is one of them.

**Q155 Joan Walley:** What sort of concessions are you thinking about?

**Mr Fletcher:** I am not thinking of concessions, almost all of the pressures we are talking about on companies come through the economic facts of life or through one way and another statutory or government pressures, I include tax within that. You talked about debt, the ban on disconnection, has

---

3 March 2004 Ms Fiona Pethick, Mr Philip Fletcher and Mr Bill Emery

---

very good social justification, nonetheless it is helping to drive up bad debt which unfortunately other customers have to meet through the price limits I shall set. We face extra pressure through the right to opt for a meter, which again has all sorts of good justification but it leads to capital costs and loss of revenue which are borne by customers as a body.

**Q156 Joan Walley:** How might the Chancellor respond to some of those concerns?

**Mr Fletcher:** This is where it gets difficult, I have a lot of sympathy, let us say with the Inland Revenue to keep it nice and neutral, because the water industry here has been on a rather different tax basis from most of the rest of industry. They have enjoyed a tax advantage. The Revenue signaled five years ago they would lose that tax advantage from 1 April 2005. That is a transparent process, it would have required a very clear perception on the part of the Treasury that they did not want additional pressure on the companies to rescind that view taken five years ago. That is even-handed. The main pressures that can be reduced come from all those involved in putting on the pressure, thinking very hard about whether that pressure is absolutely essential in the five years we now face. Five years which, in my judgment, are going to see significant price increases for customers overall despite Ofwat's best endeavours to ensure that customers pay no more than they have to. I am very conscious that the customers are customers of monopolies and they have no choice and they depend on Ofwat to ensure that they are not paying more than they have to. I want to earn that trust.

**Q157 Joan Walley:** Finally, briefly, going back to the issue about the robustness of the draft business plans, are you anticipating any significant changes in the costing in the final business plans?

**Mr Fletcher:** Yes, they will be up and down. The companies are submitting their final plans to me. Once I have the principal guidance from the Secretary of State we will have to take account of factors that have appeared since they did their draft, including rafts of critical comment behind closed doors from Ofwat about aspects of their plans and public comment too, which we have made clear in our published documents. I cannot be absolutely sure that when those plans are submitted, they will be submitted with figures lower than those we saw in the drafts.

**Q158 Joan Walley:** Presumably you would say to this Committee that pending duties in relation to discussing sustainable issues it would underpin any changes that you might require in relation to those—

**Mr Fletcher:** I will look to those balanced four elements of the sustainable development duty.

**Q159 Joan Walley:** Will the sustainable development duty will be prioritised?

**Mr Fletcher:** I will be taking all of that into account within my primary statutory duty to enable efficient companies to carry out and finance their function. I

must take account of everything that is placed on them and be realistic in my assumptions about what it is going to cost them to carry on while at the same time protect customers to ensure that when I get the guidance that guidance is properly reflected in the draft price limits.

**Q160 Chairman:** Thank you for that answer. I notice that you aim to include elements of sustainability within the framework. Is it in fact the case that given issues of fincability the economic arguments are always going to come ahead of the environmental ones?

**Mr Fletcher:** I do not think I do accept that, Chairman. We have got to ensure that the price limits are realistic, we cannot do a King Canute job on them. The environmental improvements which are going to be required of the companies will be very significant.

**Q161 Chairman:** And indeed required in the country?

**Mr Fletcher:** Particularly through the European Directives, of course I accept that.

**Q162 Paul Flynn:** Bearing in mind what you have already said about the cuts in the letter to the Secretary of State in your memorandum to us, you use the example of cutting capital expenditure for the period of 2005–10 to 15 billion roughly at the level of at 2000–05 investment. Is this before or after inflation?

**Mr Fletcher:** That would be before inflation. I noted the points that have been made by Water UK on what it looks like when you add inflation in. Again when you get into figures you can cut them different ways, the figure in the 1999 price rise was about 15.6, that was before the companies implement those plans, they have made efficiency gains which the system is designed to encourage which we shall build into the floor for this review so that all of that benefit comes back to customers in terms of lower bills than they would otherwise have been. The £15 billion I was using was an illustration, it has appeared as the Ofwat proposal and I can see why. It is trying to ensure that all of the stakeholders, including Ofwat, are thinking very hard about whether all elements of the capital programme: maintenance, sewer flooding, security of supply and the environmental element all need to be done in terms of the £20 billion or £25 billion programme that was being talked about in the different exemplifications over this particular five-year period.

**Q163 Paul Flynn:** You also said that improvements can be undertaken over a longer time frame therefore as we all understand the costs would then be mitigated. When you say the improvements, are you referring only to the environmental improvements?

**Mr Fletcher:** I have to take a view about all of the elements here, I am regarding all of them as improvements. If I can take maintenance as one example it has focused our attention in a previous look at the 1999 review on whether enough was

---

3 March 2004 Ms Fiona Pethick, Mr Philip Fletcher and Mr Bill Emery

---

being done on maintenance and we responded to that challenge. The industry and Ofwat under the auspices of the industry research body have a much better approach this time round, that means that I cannot ignore the evidence that there is likely to need to be significantly more invested in maintenance in this coming periodic review period.

**Q164 Paul Flynn:** Could you put a figure on the five billion plus that you have used?

**Mr Fletcher:** Can I give you broad orders of magnitude. The overall figure you might use for illustration in relation to that £15 billion would see £8 billion to retain base service, to ensure all of those assets, including the recently installed and rather short-lived vital high technology assets that companies have purchased are maintained, that would be £8 billion against the £9 billion the companies have firmly said they need in their draft preferred strategy. In enhanced service, at the last review the Regulator only allowed £100 million, £0.1 billion for enhanced service, most of it went into dealing with the very nasty problem of sewer flooding. We have had to say subsequently frankly that was not enough and the companies are doing significantly more in 2000 to 2005 to deal with that, all of that will be taken into account in the price limits I set this summer. There is very heavy pressure on me, very understandably, from water companies representing customers to do yet more on the basis that it is unacceptable to have sewage in your living room. Say £1 billion against the £1.2 the companies say they really need for mostly sewer flooding in the next five years. Supply and demand issues, we got through nine to 10 months of very dry weather last summer because of the improvements already made by companies and without any hose pipe ban across the country. We were very pleased. We are relieved it has rained for a large chunk of the winter. The companies say they need £2.8. If I were using an illustration of that £15 billion it might be of the order of £2 billion. Then the quality issues, the companies said in their preferred strategy they wanted just under £7 billion for drinking water and environmental improvements, my question was would £4 billion be enough? One can understand the extreme vexation and unhappiness of the environmental interests and regulators at such a figure. Again the question I recognise needs to put in the context of our statutory obligations was just that, a question, would this be a tolerable level to hold down the capital programme to a level round the scale that it has been running at since 1989, which itself was roughly double the level that the water industry used to be able to invest when they were clamped by the Treasury?

**Q165 Paul Flynn:** You mentioned the statutory obligations, do you agree this programme you have means water companies do not have to abide by their statutory obligations?

**Mr Fletcher:** They always have to abide by their statutory obligations, the issue is really one for government on what they think the water and sewage companies need to carry out to fulfill their

statutory obligations. That is the question for government. It is not one where I try to take Mrs Beckett's difficult decisions from her but it is a question from me to her head of principal guidance on what is the least that would be necessary to fulfil those obligations rather than do other things, which we all recognise as desirable. But which maybe could be done over a slightly longer period, and bring in the important new information we will have through river basement management plans, catchment area management strategies, bringing in the diffuse pollution elements from 2010 onwards.

**Q166 Paul Flynn:** It might be said after reading your guidance to ministers and your memorandum to us that the environment is at the top of your "how to cut costs" list. Would that be an unfair conclusion?

**Mr Fletcher:** We are back to the "whose cuts?". What has been happening since 1989 is that the environmental programme, I think rightly, has been given very great prominence, priority indeed. I think if my predecessor was sitting here, and Bill Emery can almost speak for him because he has sat through various reviews, he would say that the last time round we were still being very constrained, though not, we believe, running any risks with the maintenance of the assets, so that the overall programme was not set in being whilst the environmental programme went through its last peak, five years, 2000–05. And it was not just Ian Byatt. Lord de Ramsay, the then Chairman of the Environment Agency, was saying five years ago that most of the damage from the last 200 years (the Industrial Revolution) will have been repaired by 2005. The expectation was that 2005 will be when maintenance really does get its proper chance along with the other things, like sewer flooding. I am resigned to the fact that we shall see probably a significantly larger programme than £15 billion. I do hope very much that I shall be able to stand up in front of customers and assure them that that programme represents value even though it will increase their bills. I would feel more confidence in that if we had been able to develop the cost benefit work—I say "we" because it is a collective effort—further than we have actually managed in this review period.

**Q167 Paul Flynn:** There have been some press reports that there has been pressure from other departments on Defra regarding water pricing. Water UK in their memorandum have said, "We believe that decisions on what is included in the guidance are made by Government collectively and not by Defra alone, so that the effectiveness of the debate between what are normally seen as key players is in reality constrained".<sup>2</sup> Would you agree with that?

**Mr Fletcher:** I think that is, if I may say so, properly a question for Elliot Morley when he comes in, but it would not be surprising if the government recognised that there are some really difficult issues here, and they confront all of us involved in the

---

<sup>2</sup> Please see written memorandum, Ev. 45.

---

3 March 2004 Ms Fiona Pethick, Mr Philip Fletcher and Mr Bill Emery

---

process. None of us wants to see bills going up, yet I am afraid overall they will and maybe quite significantly. None of us wants to play fast and loose with our international obligations, let alone with maintenance of these absolutely essential assets which have brought these huge improvements. It is a huge success story. There is a danger in focusing on what still needs to be done and losing sight of how big a success it has been.

**Paul Flynn:** I think we recognise that. I am very grateful.

**Q168 Mr Challen:** I was quite encouraged to read the outcome of the customer survey that you did. Looking at table 3 in your submission, "Willingness to pay for improvements", we have, under "Company preferred plan" a two to one majority in favour of probably willing to pay more than definitely willing to pay more, a two to one majority on those under reference plan A and still an overall majority under reference plan B. I was just wondering to what extent this research has influenced your decisions and whether after this research you will be taking a more liberal line on price increases.

**Mr Fletcher:** The first thing to do is to pay tribute to the committee. It was again part of your last report that the various players in the last review had done themselves no favours by coming up each with their own little survey with their own carefully prepared questions. What we have done this time, and it has not been easy, is get all the stakeholders together, including Wildlife Link, representing the environmental NGOs, and the customer representatives. We have agreed on the list of questions, we have jointly financed a large survey, we have reasonable confidence that a very proper job has been done in these responses that all of us are committed to. Yes, I find it encouraging that we have sophisticated customers who appreciate the need overall to make various changes, including continuing environmental improvements, on the basis of (when they gave these answers) some basic understanding of what had been included in their own companies' draft business plans. I am less comforted by the fact that there are still significant numbers of customers who are really very unhappy about the prospect of significant increases in their bills and a minority, admittedly, but a significant one, who just do not see how they could meet that sort of increase. In relation to those areas like the south west where the bills are very high, even in relation to energy bills, I think that is a very real problem.

**Q169 Mr Challen:** I have suggested that support for the poorer customers should be a matter for government but that is not currently the case, so does that influence your decisions in these matters more to that end, if you like, rather than being encouraged by the large majority that is in favour of paying more?

**Mr Fletcher:** The water regulator cannot really bale out the poorer customer by acting as a sort of Robin Hood to charge richer customers more in order to

subsidise the poorer customers. We already have, and perhaps that will give my view on the point earlier made by Mr Chaytor, the rateable value system which is a progressive system. It is very crude but those who have got the bigger houses will pay more for their water bills, with the rescue of the poorer individual pensioner who finishes up in a higher rateable value house having the safety hatch of going on to a meter and reflecting his or her usage. That is one safeguard, one reason why I am not too sorry that we have a mixed regime of metering and rateable value at the moment, but I do see metering as increasingly important to help safeguard supplies. It is the only sure way of making sure that people really pay attention to their water usage. Exhortation never does all that much except when you have got a drought, so again it is a nice balance of how you go forward. What the government can do is think about the tax system. I have to say I am not holding my breath for changes to the benefits system to give special help to water customers. The Vulnerable Group Regulations, which at the moment only help a tiny fraction of those on meters, themselves only 25% on average, and those who are in particular need with very large families on benefit or with medical conditions that require very high use of water.

**Q170 Mr Challen:** If the government did provide more support for poorer customers would that then let prices rise a bit quicker, do you think?

**Mr Fletcher:** I think a 30% average increase is already a pretty dramatic increase before you start adding inflation. If it turned out to be necessary to have a price increase of anything like that scale I would be concerned about customer reaction to it, and not just the poorest customers. Although obviously I should be particularly concerned about the affordability implications for poorer customers in high bill companies.

**Q171 Mr Chaytor:** Just pursuing the rateable value question, which exercises me greatly, as you will have appreciated, are you saying that the ratio between the lowest band of rateable values and the highest band of rateable values is proportionate to the ratio between the typical levels of consumption between the smallest and the poorest ones and the most affluent ones?

**Mr Fletcher:** It is not perfect. It is a bit like democracy. It is the least bad system that one can possibly have.

**Q172 Mr Chaytor:** Why is it not a universal metering system?

**Mr Fletcher:** Because to implement it instantly would be hugely costly. We would be looking at vastly bigger increases in bills. There would be, for you rather than for me, I am glad to say, questions of whether this was politically acceptable, and in terms of its major benefit to the environment of reducing demand it would be not very effective. It would be universal. It would apply in those areas which have plenty of water, Northumbria, for example, with Kielder Water, just as much as the dry

---

3 March 2004 Ms Fiona Pethick, Mr Philip Fletcher and Mr Bill Emery

---

south east, whereas Parliament has passed legislation which gives the government, if companies and government want to use it, a much more precise instrument in water scarce areas where mandatory metering could be introduced, provided the government were convinced by the case for it.

**Q173 Mr Chaytor:** But you would accept that the limitations of the rateable value system are partly due to the age of the property because of the lack of revaluations up to date?

**Mr Fletcher:** Yes. The valuation is still there. It is pretty arbitrary, I know, but it still bears a rough approximation I am not trying to argue for it more than that. I think myself it is better to stick to rateable values than move to council tax which would have all sorts of winners and losers in relation to whether we stick with rateable value until we are ready to move on to meters almost universally, and while we have still got it it is not that bad as some means of enabling people to pay their bills and recognise that water and sewerage services represent a significant service.

**Q174 Chairman:** Thank you, Mr Fletcher. We are nearly at the end. I just wondered whether you had any inkling as to when you might be going to get this long-awaited review.

**Mr Fletcher:** I do hope very soon because it is now over a month since the promised time. The government were aware of my very strong hope that they would produce it at the end of January. Every few days that now go by put the timetable for the review at some risk. This is perhaps for the benefit of others. I am not putting off the final delivery of price

limits for Christmas in time for all the bills to be properly set from April 2005. That is not at risk but what is at risk to a degree is proper process, the process not least of companies discussing the proposals with their customers, including their business customers as well as their domestic customers, all parties having proper time to think about each of the remaining stages. The final business plans, in the light of the guidance, are due in on 7 April. I am afraid that is probably very difficult to sustain given that we have lost a month. Delivery of draft price limits by the end of July. It was hoped for before the House rose. That may not be possible. Frankly, I do not want to announce them in August but I might be driven to it. The timetable has been in place for a very long time. It reassures the City. We have had the end of November in place for the final price limits. I do not want to slip on that. At the moment I cannot absolutely guarantee that I will hit that date.

**Q175 Chairman:** These are all points which we will no doubt want to put to Mr Morley when we see him a week tomorrow if the government has not already announced its review.

**Mr Fletcher:** Exactly. Maybe your committee's inquiry will help to ensure it.

**Q176 Chairman:** Let us hope that the argument has moved on by then. We are very grateful to you for your time. We may have a few further questions for you. I hope you will not mind if we send them to you in writing.<sup>3</sup>

**Mr Fletcher:** Please do and we will reply promptly.

**Chairman:** Thanks very much.

---

<sup>3</sup> Please see supplementary memorandum below

#### Supplementary memorandum from the Office of Water Services (Ofwat)

*Response to specific questions from the Environmental Audit Committee following Ofwat's oral evidence session, 3 March 2004*

#### Constrained Environmental Programme

- **The Committee would like details, if available, of the constrained environmental programme put forward by Ofwat. Is it correct that with regard to the nature conservation schemes it proposed only including projects of level of certainty 1?**
- **Do you feel qualified as regulator to make a judgement on whether certain projects are necessary or not, from an environmental perspective?**

1. To help decision-makers understand the implications for price limits of the decisions they were taking we provided an illustration showing the price limits that would result if new investment continued at broadly the same rate as for the current five year period—£15 billion. We also checked that we could compile a credible programme made up of companies' costed proposals. In some areas we assumed that the timescales for improvements could be extended a little and in other areas, for example the nature conservation schemes we assumed that only the most serious problems needed to be addressed without further assessment of the most cost effective way of achieving the benefits required.

2. A programme of improvements costing £15 billion could have been arrived at in various ways. However, our illustration is now overtaken by Ministers' Principal Guidance.

3. It is not my role as the economic regulator to make environmental policy but my duties require me to set price limits at a level that I judge will allow an effective and efficient company to finance its functions. Part of this does require me to make judgements, as to these functions. I also have a duty to protect the interests of customers. As an independent regulator Ofwat employs expert staff including environmental

economists, engineers and scientists experienced in the water industry, so we are in a position to review and where appropriate challenge proposals put forward by companies, environmental and water quality regulators. I will ensure that all schemes included in price limits meet the following five criteria:

- It is required by the quality regulators, and confirmed by Ministers, or is a new obligation under current legislation.
- It delivers a measurable defined output, which is enforceable.
- It has a clearly defined timetable and due date for delivery in line with regulations or other legislation.
- There are defined asset improvements or changes to operational procedures to deliver the output.
- The costs are identified and the proposed solution has been challenged and validated by the company's reporter (an independent professional who scrutinises and gives his opinion on the company's business plan to Ofwat).

4. We seek guidance from the environmental and water quality regulators and the Department for Environment, Food and Rural Affairs on the improvements they consider are necessary. We make decisions on the information that is available at the time of our determinations on the outputs that need to be delivered.

5. New requirements placed on companies during the price review period can be financed through an interim determination or through logging up the net additional costs to be financed at the 2009 periodic review.

6. We now have Ministers' Principal Guidance on the improvements they expect the companies to make in the period 2005–10. The Environment Agency and the Drinking Water Inspectorate are confirming what this means in detail for companies. Companies will provide us with costs in their final business plans in April.

#### Customer Debt and Affordability

**Water UK has stated the level of bad debt "raises customers" bills by an average of up to £10 a year'. This could be, assuming levels do not increase, up to £50 per customer over the next review period.**

- **How much does this affect Ofwat consideration of water pricing?**
- **Is Ofwat happy that companies are doing enough to address this issue?**
- **If debt rises, as it is likely to do if prices go up as expected, this may become a very significant problem and have an increasing impact on paying customers' bills.**
- **Would Ofwat consider limiting future price rises if a water company was not making enough effort to prevent or recover long-term debt?**

7. The costs of managing debt are considered as part of each company's operating costs when we set price limits. Since the ban on disconnection of domestic customers, in the Water Industry Act 1999, we have seen a rise in the numbers of customers in debt and the levels of customers' debt. In "Setting water and sewerage price limits for 2005–10: Framework and approach" (page 51) we said that companies' base operating costs will include a provision for the current costs of providing for bad debt and for the costs of debt recovery. We will assume continuing efficiency as we do for all operating costs. At the 1999 price review we introduced a specific bad debt notified item. This means that if a company's costs rise significantly it can include the net additional costs in any interim determination it pursues. We propose to retain the notified item at this price review.

8. Generally, we are assured that companies are taking reasonable, practical and cost-effective steps to address the issue of rising debt. Although there is scope for continuing improvement as with other costs. We have worked closely with companies to ensure that they take appropriate action to deal with customers in debt. Companies are refining their approaches to debt recovery and becoming more effective in managing the issue. At this stage it is therefore difficult to predict, with any confidence, what will happen to debt and recovery costs in the future. To avoid the risk of asking customers to fund costs that may not materialise and to keep the incentive on companies to manage the issue, we do not currently propose making any assumptions about increases to base costs to cover increasing costs for bad debts in the next period. We will review our position in the light of the companies' final business plans and the data on 2003–04 debt related costs once available.

9. We expect all companies to manage debt efficiently. We have issued guidance to companies on best practice in dealing with customers in debt. In making our considerations of companies' applications for price increases at a price review or any interim determinations to cover increasing debt we will consider and challenge, as we have in the past, companies' activities to manage and recover long-term debt. We also assume that companies will become more efficient over time.

### Water Framework Directive

**In their evidence to the Committee the Environment Agency has suggested that Ofwat and Defra are taking a short-term view on capital expenditure and that cutting costs now would simply store up problems for the future. This is particularly seen as being the case with the Water Framework Directive. The Government has taken the position in its draft guidelines that water companies do [not] need to take much action over any of the provisions as yet.**

- **Is this point of view supported by Ofwat and if so why?**
- **Is Ofwat looking forward to the impact the Directive will have on the next review period? What are your views on the issues so far?**
- **In an ideal world, where there were not so many other demands on water company expenditure, would you be happier if some of the work required were begun within this period rather than waiting until 2010–15?**
- **Would you be happy to accept a programme, following guidance from Ministers, which resulted in the UK failing to meet statutory obligations?**

10. It is for Government to decide what must be done to ensure that the UK meets its national and international obligations. There are legitimate questions to ask on how these obligations are best met and by whom. We agree with Defra that it would not be sensible for the companies to take action on the provisions of the Water Framework Directive until it is clear what is needed. There is a great deal of investigation and preparatory work to be done. There is a long process ahead to develop the river basin management plans. In due course, the confirmation of the programme of measures by the Secretary of State will inform the companies' future investment priorities. The Secretary of State will need to make informed judgements on the approach to implementing the Directive, we are at too early a stage for that at present.

11. Decisions need to be made across all the sectors involved on the improvements required to meet the Directive's objectives. Diffuse and point pollution from sources other than the water and sewerage companies will need to be tackled if we are to meet our national obligations under the Directive. We understand the Government will be consulting, this spring, on the approach to controlling diffuse pollution control.

12. We recognise that this Directive could have an impact on the price limits we set in 2009 for the period 2010–15. Well-developed river basin management plans, thorough investigations and action on diffuse pollution should provide the information needed for the Government to make the necessary judgements on what to do in the first round of river basin plans.

13. We do not consider it prudent to build assets on the assumption that these might be required to meet the Water Framework Directive. The Government's decisions on the measures required will arise from the river basin management plans. We expect that many of the outputs that are delivered as a result of investment confirmed at this price review, many in response to other subject specific European Directives, will go a long way towards achieving compliance with the Water Framework Directive. At future reviews the river basin management plans, endorsed by Ministers, will give the details of all schemes necessary to ensure that companies meet their obligations under this Directive. And thus help to ensure that the polluter pays principle is observed in relation to the costs that should properly be borne by the water customer.

*March 2004*

---

**Thursday 11 March 2004**

Members present

Mr Peter Ainsworth, in the Chair

Mr Colin Challen  
Mr David Chaytor  
Mr Malcolm Savidge

Mr Simon Thomas  
David Wright

---

**Memorandum from the Department for Environment, Food and Rural Affairs**

**WATER: THE PERIODIC REVIEW 2004 AND THE ENVIRONMENTAL PROGRAMME**

**INTRODUCTION**

1. Department of Environment, Food and Rural Affairs (Defra) welcomes this inquiry of the Environmental Audit Committee, as a constructive contribution to the debate on The Periodic Review of water limits for 2005–10. The Review is currently in progress, with the principal guidance from the Secretary of State to the Director-General of Water Services expected to be issued shortly.

2. It is for Government to inform companies and Ofwat of relevant policies, legal requirements and their interpretation that may apply in the review period. The relevant policies include the drinking water and environment investment programmes. The regulator has responsibility for setting prices.

3. In taking decisions on policies affecting price limits, the Government will have regard to advice both from Ofwat on the price limit consequences of imposing requirements on companies, and from the Drinking Water Inspectorate, English Nature and the Environment Agency on potential gains. The Government will also take into account the views of water customers, environmental groups and the water companies.

**ACHIEVEMENTS SINCE PERIODIC REVIEW 1999**

4. The Government's guidance on the environment programme to be delivered by the Periodic Review 1999, *Raising the Quality* published in September 1998, identified a number of areas where action was needed to protect inland and coastal waters and the seas from pollution and to protect important habitats. Amongst the particular areas to be addressed were limiting of pollution from sewage systems during rainstorms, ensuring that all significant discharges from sewage treatment works receive at least secondary treatment (using bacteria to breakdown biological matter), improving the standard of designated bathing waters to meet EU requirements, improvements in river water quality and action to deal with the adverse effects of abstraction and effluent discharges on important nature conservation sites.

5. The planning period covered by this review (2000–05) is not yet complete. Water companies had delivered approximately half of the improvements required by the end of 2003, the last full reporting period. It is in the nature of the process of delivery of environmental benefits of this kind that there will be an overlap. Some of the improvements currently being observed will result from water company actions in the previous planning period (1995–2000) and the full benefits of the programme delivered in 2000–05 will not be seen until the next planning period when all the water company improvements are in place and operational.

6. There is nevertheless cumulative evidence of improvements to the quality of the water environment resulting from water company actions. For example in England, in 2002, the last year for which figures are available, 65% of monitored river length was of good chemical quality or better compared with 43% in 1990. Over the same period compliance with mandatory EU standards for microbiological quality of bathing waters has increased from 79% to almost 99%.

**KEY COMPONENTS OF THE POTENTIAL ENVIRONMENT PROGRAMME**

7. The Government's strategic aims and future priorities and direction for all aspects of water policy were set out in *Directing the flow: Priorities for future water policy*, published in November 2002. This set the background for the Secretary of State's initial guidance to the Director General of Water Services on the Periodic Review, published in January 2003. This included a detailed analysis of the potential environment programme (chapter 3.7 and chapter 6) which Ministers wished to see included in draft business plans.

8. This guidance took into account the advice submitted by the Environment Agency, English Nature and the Countryside Council for Wales on a programme of improvements. This advice, which took into account improvements made or expected from the 2000–05 programme, recognised that compliance with

EU and domestic statutory obligations would not offer all the desirable environmental improvements. A number of additional discretionary elements which Ministers might choose in order to make a well rounded programme were also proposed.

9. Other factors taken into account in drawing up this initial guidance were the results of the first part of the joint customer survey, which indicated that there was some desire amongst water customers for improvements to the water environment, and the need to consider how water company activity in the period under review should be related to other initiatives, such as on diffuse pollution and on implementation of the Water Framework Directive, which will fall mostly in the next review period. Although work on characterisation of water bodies under that Directive is still in progress, it is likely that this will require significant further action to meet the Directive's requirements. In some cases this will fall to water companies but farmers and others who contribute to the serious problem of diffuse pollution will also have a role to play. As announced in the Chancellor's pre-budget report, the Government will shortly be consulting further on action to address agricultural diffuse pollution.

10. EU and domestic obligations play a large part in determining the size, scope and pace of the environment programme, setting, for example, the standards for urban waste water treatment, bathing waters and for internationally important nature conservation sites. The initial guidance also asked that companies should include the discretionary elements identified in the Environment Agency's advice in draft business plans in order to inform later choices. A third category of drivers comprised those where companies were invited to make a case, for example in relation to compliance with the Dangerous Substances Directive.

11. In addition to identifying the potential components of the environment programme, the initial guidance set out the Secretary of State's expectations that there should be an appraisal process designed to ensure that, as a minimum, the schemes put forward by companies delivered the desired improvements in the most cost-effective way. The purpose of this appraisal process was to inform the next round of Environment Agency and English Nature advice and to allow Ministers to consider the extent to which proposed measures would deliver environmental benefits and represent value for money. This included an assessment of the overall environmental benefits of the proposed environment programme (including essential schemes). In the case of the discretionary part of the programme, the Environment Agency was asked to separately assess scheme benefits in order that decisions could be informed by a scheme level cost-benefit analysis.

#### DEVELOPMENT OF THE FINAL PROGRAMME

12. On submission of draft business plans, the Environment Agency, English Nature and Ofwat (through the use of company reporters) collaborated to assess the effectiveness of the companies' proposals in delivering the required environmental improvements and whether the solutions put forward were reasonable. The Environment Agency and English Nature also undertook further technical appraisal of some parts of the programme and some high cost schemes were subject to further scrutiny. The outcome of this process, together with the cost/benefit analysis of discretionary schemes, substantially reduced the number of schemes needed to deliver the proposed programme and was reflected in the further advice given by Environment Agency, English Nature and the Countryside Council for Wales in November 2003. This further advice has informed the development of the environment programme, which is set out in the Secretary of State's principal guidance.

13. In developing the environment programme, the Secretary of State is also taking into account the advice she has received from the Director General of Water Services on scale, timing and bill implications; the results of the second phase of the joint customer survey and comments from stakeholder interests including those made in response to the joint stakeholder letter of 12 August sent by Defra, Welsh Assembly Government and the regulators.

*March 2004*

---

*Witnesses:* **Elliot Morley**, a Member of the House, Minister of State for Environment and Agriculture, and **Daniel Instone**, Head, Water Quality Division, Department for Environment, Food and Rural Affairs, examined.

**Q177 Chairman:** Good afternoon, Minister. Welcome back again to our Committee. We appreciate that you are a little pressed for time. Could you possibly introduce your colleague?

**Mr Morley:** Certainly, Chairman. I am joined by Daniel Instone, who is the Head of our Water Quality Division.

**Q178 Chairman:** Thank you very much. Not for the first time, you appear before us on a day when a substantive announcement has been made. In this case, the long-awaited guidance issued by the Secretary of State on the Periodic Review.<sup>1</sup> I take it that the date of the announcement and the timing of this meeting are coincidental?

**Mr Morley:** They are, Chairman, actually. I know you might find that hard to believe.

**Q179 Chairman:** I think it seems to have been generally well received, so far, which is a good thing. As far as the guidance is concerned, do you think there are likely to be any substantive changes between now and the final guidance to be issued in the autumn?

**Mr Morley:** I am happy to deal with that, Chairman. Can I start by offering the Committee an apology in relation to the lateness of our memorandum, from DEFRA to the Committee. It is not satisfactory that you received it this morning and I do apologise to the Committee. I take responsibility for that, and I will certainly make sure that you have more notice in future, in relation to the memorandum. In terms of the price guidance, that has been a very complex and lengthy process, and I do not apologise for that, Chairman, because this comes round only once every five years, as you know. It is a very important statement. In relation to your question, it is still part of the process. This is the second guidance which has been issued by the Secretary of State, and there will be a third and final guidance after which Ofwat, obviously, will respond and look at the detail of the guidance which has been provided. Ofwat then will bring forward their draft prices, which will be some time this summer, and there will be the final guidance by the Secretary of State some time in the autumn, with a view to Ofwat producing the final price limits probably at the end of the year, December time. Very roughly, that is the kind of timescale that we are looking at. This is not the final word and I would not expect it to be. One of the reasons why it has been delayed, Chairman, is that there has been intense discussion within the Department, with the Department and the Treasury, in relation to, first of all, our responsibilities for the environmental programme and quality programme, which relate to English Nature, the Environment Agency and the Drinking Water Inspectorate. Is it justified, are there other ways it can be achieved, is the timescale realistic, is the pricing realistic? All these things have had to be tested. It has had to be

put under the microscope, they have had to be justified, and that is quite right and proper, because what we are seeking here is a balance, in relation to the kind of quality and environmental improvements that we want to see from Defra. Obviously, the companies have their requirements and they produce that in their draft business plans, and the regulator will examine that. Of course, we are sensitive to the issue of affordability, and, in fact, the Secretary of State made that very clear in her Introduction, that affordability is an issue. We are going to review the whole issue of affordability and the kinds of mechanisms. It is a balance. In the end, it is for the regulator to set the prices, that is what the regulator is for, we respect the regulator's independence and we have confidence in the regulator, that a regulator will, of course, test all these business plans, all these hypotheses, all the justification. That is part of the process, and a proper part of the process.

**Q180 Chairman:** What I guess I was getting at was, given that this is interim guidance, so to speak, and part of the process, a reassurance that we are not going to go through the whole business all over again in the autumn, and, in particular, that you are not prepared to reopen issues to do with compliance with EU Directives, the protection of SSSIs, and that kind of thing?

**Mr Morley:** That is right. There will be further work on the costings. The costings have changed, the costings are still changing, we would expect to see that, so there is still a great deal of work to be done.

**Q181 Chairman:** The regulator, when we met him at our last evidence session, indicated that he was looking at a proposal for a constrained budget of around £15 billion, as opposed to nearly £20 billion. To what extent have you been able to accommodate that suggestion?

**Mr Morley:** In relation to the areas which are our responsibility, which is the environment and quality programme, in relation to what the regulator was putting forward as an idea, I really do not think that we could accommodate what are our statutory obligations, let alone some of the extra quality and environmental objectives that we would like to see, within that level of budget. Whether the company business plans could be accommodated within that, of course, is a matter for the regulator. I could not comment on that. In relation to our responsibilities in Defra, I am not at all sure that we could deliver our statutory responsibilities at that level.

**Q182 Chairman:** Within the overall budget, he was telling us that the environment and water quality programme was about £7 billion and he was thinking in terms of reducing that down to £4 billion. I take it that what you are suggesting today is that we are still looking at around £7 billion?

<sup>1</sup> House of Commons Hansard Report, Vol. 418, 11 March 2004, 106-8WS.

---

11 March 2004 Elliot Morley MP and Daniel Instone

---

**Mr Morley:** I think it is difficult to put an exact price on this, Chairman, and please do not think I am trying to evade the question. The reason why it is difficult for me is that prices are changing all the time, and we are very pleased to see prices come down, because, of course, there are assumptions which have to be tested, we do have to examine whether or not the costings are right. We expect our figures to be challenged, in relation to the programmes that we have put forward, in the same way we expect the company figures to be challenged.

**Q183 Chairman:** Presumably, you must have come up with some kind of estimate, even if it is only an internal one, which I will ask you to share with us, if you will, as to how much the programme implied by the Secretary of State's guidance will cost?

**Mr Morley:** We do have an estimate, it is true, Chairman, and certainly I will be happy to look to see whether or not there is anything we can give you. The only problem is that whatever estimate we give you today will have changed by tomorrow, that is the problem.

**Chairman:** We do understand that, Minister.

**Q184 Mr Thomas:** I want to follow up on just one specific point in what you said, Minister, a question or two ago, around not just the statutory environmental objectives but the extra quality objectives that you were seeking to have in this guidance. Can you give an assurance to the Committee that, at this stage, at least, and despite what the regulator did say in his evidence, you are not seeking to cut those extra quality assurances as well as his statutory duties?

**Mr Morley:** We have included in the guidance a number of improvements which are non-statutory. I will be quite frank with you, Chairman, this programme has been through the wringer, and quite rightly so, we expect the programme to be put through the wringer, and the Environment Agency may not get absolutely everything—absolutely everything—for which they have asked. I still think that the programme is a very fair balance and it will include both quality improvements and environmental improvements which are non-statutory, but we are trying to strike this balance. We want to see improvements but we are sensitive to the impact on consumers, but we believe a balance can be struck and in the end it is a decision for the regulator to make and our guidance is part of helping him come to the decision.

**Q185 Chairman:** Just coming back to the estimate that you made of the environmental cost element of this, it would be very helpful if we could have something, and we would understand that this is a dynamic process and it is only a snapshot of what the Department is looking at?

**Mr Morley:** It will have to have some very severe health warnings. Do you want to comment on that, Daniel, in relation to the customers?

**Mr Instone:** I think that is something we will look at, as the Minister said.

**Mr Morley:** Yes, we will do that.

**Q186 Chairman:** What does that mean?

**Mr Morley:** It means I think we are going to have to write to you with it, Chairman.<sup>2</sup>

**Chairman:** Thank you.

**Q187 Mr Challen:** We had some witnesses here last week, including the regulator, who left me rather concerned and I had to come back to this question of the timing of the guidance. It was three months late. I am wondering if that was because there has been some reinventing of the wheel perhaps and you have been taking on board lots of new things. The problem with having the guidance late is it has knock-on effects on all the other people who have to contribute to this, but also in terms of the City. Financing the plans that water companies have is a major headache for them, and I quite accept that. I wonder if you could expand on why the guidance was late. This seems, to me, to be a process which is very much like Christmas, you can plan for it well ahead, you know when it is coming round, so there must be something a bit more really which you can say about the delay?

**Mr Morley:** The situation is that our figures have been challenged, we challenge them ourselves. We have discussed it with the Treasury, of course we kept the regulator in the picture, in terms of what was going on. We talked to regulators, in relation to their submissions and how they have come to their costings and how crucial they were, where there are other ways in which we could achieve those objectives. Indeed, there are some other policy drivers, Chairman. For example, we will be looking at the whole issue of diffuse pollution, through our agricultural programmes and our agri-environment programmes. We will be producing a draft policy statement in April, and I will make sure the Committee gets a copy, in relation to some of the proposals we have on that. All these issues do need to be examined very closely, and I think that is quite right and proper, and the process did take a bit longer than was envisaged, that is true, that is certainly true. Of course, from the Defra point of view and from my point of view as Environment Minister, there are some very important issues within the guidance, which I am very glad to see and I am glad that they are there, and they have had to be justified, and it is right and proper that they were justified. I come back to the point that this is a very important stage in the process, in relation to the ministerial guidance at this stage. It is important we get it right, and we have spent a bit of time on it, because it is a process which comes round only once every five years, I am very glad to say, actually, Chairman. Therefore, it is worth going that extra distance to make sure that what we put in is justifiable, they are the kinds of key issues which are required absolutely and are what we want to see, and I believe that consumers want to see as well, in relation to further improvements in relation to quality and environment. We believe that we have

<sup>2</sup> Please see supplementary memorandum, Ev. 99–101.

---

11 March 2004 Elliot Morley MP and Daniel Instone

---

got that approach right, basically. It is not the end of the story, it is not the end of the process, but this is a key milestone in relation to giving guidance from the Government to the regulator about what we think is important in areas which are our responsibility.

**Q188 Mr Challen:** Obviously, we welcome the new duty on the water regulator to take account of sustainable development, that is very welcome, but is it something which is likely to be squeezed a bit, when we look at the finance issues? Do you have fears over that?

**Mr Morley:** It is going to be a tough balancing act, there is no doubt about it. The regulator himself is sensitive to the impact on consumer prices, I am sure he would have said that, and, of course, that was why he was thinking in the way that he was in relation to his price package. Basically, we want to get the maximum amount of benefit at the minimum increase in cost to consumers, and that means everything, every element of the package, has to be put through the wringer. We would expect that, and we have certainly been through the wringer, Chairman, on our side.

**Q189 David Wright:** Minister, can I turn to the environmental programme and the methodology used to carry out the cost-benefit analysis of the work proposed by the Environment Agency. I understand the cost-benefit analysis was developed with Ofwat involved and Defra, but Ofwat were expressing to us in recent evidence some concerns about the methodology, in particular whether conclusions about costs could be transferred from one scheme to another. Do you share their concerns?—clearly not, from the fact that you are confident about the guidance. Do you not share those concerns, have you taken them on board in the process?

**Mr Morley:** They are perfectly reasonable concerns and I think that we have to demonstrate, in relation to our reasoning, that we have taken that issue into account in the way that we have applied cost-benefit analysis. Incidentally, this package will be subject to a full regulatory impact assessment as well, so it is part of what we want to see is an open and transparent process, and all these things should be tested. Do you want to say a word on the cost-benefit point?

**Mr Instone:** I would say just that we have had extremely close working with Ofwat all the way through this process. We have had a cost-benefit sub-group which has worked very closely, this has included Defra and all the regulators, therefore including Ofwat and the other regulators. We have been trying to establish a very close relationship in the way we have gone about it, so I think we have got pretty good communications on this. The basic point, I think, on cost-benefit effectiveness analysis is that we had to factor into that very clearly the mandatory requirements, particularly under EU Directives, and that has to be allowed as a kind of base in doing our cost-benefit analysis. It is

particularly important though that where there are not statutory drivers the benefits are extremely clearly identified on top of that.

**Mr Morley:** I think I am right in saying that English Nature have been involved in a steering group in the process of this, have they not?

**Mr Instone:** Yes, all the regulators have been involved: Ofwat, the Environment Agency, English Nature and the Drinking Water Inspectorate.

**Mr Morley:** All I can say to you is, on this, I think the process has been a more successful one than the last round, which was marred by some acrimony, I have to say, between the various partners. While I would not want to pretend that there has not been the odd tension here and there, I think this has been a much better process than the last one.

**Q190 David Wright:** Why do we not publicise the programme more effectively?

**Mr Morley:** The programme is being publicised now. Basically, we have been working up the programme. I do not think there was any secret about the submission which was made to us by our statutory advisers, that was available, and now, of course, this is the public process, which is the publication of the guidance.

**Q191 David Wright:** The Environment Agency told us that the programme as it stood, and what is mostly in the guidance, was the minimum that should be considered and that if we did not implement in full we would be open to infraction proceedings. Did you ever consider at any stage allowing water companies not to meet their statutory obligations?

**Mr Morley:** No. We take our statutory obligations very seriously. Indeed, as you say quite rightly, if we do not then we run the risk of court challenge and infraction. It is important to distinguish between what is in the guidance here and the environmental programmes. We have accepted the Environment Agency's minimum package in full. The minimum package, as you state quite rightly, deals with the statutory obligations, in relation to a range of Directives which we are obliged to implement, and that has been included in full. We have also included elements within the environment and the quality package, from the Environment Agency, English Nature and the Drinking Water Inspectorate, which are non-statutory. These are some improvements which we think are important. Also there are things like a very important research programme that we are proposing on endocrine disrupters, for example, which is non-statutory, but we think that is quite important and we know that the agencies think it is quite important. Those elements of the guidance which are non-statutory have been subject to the most rigorous scrutiny, I can assure you, and they have survived that scrutiny, because we believe that they do offer good value for money in relation to the scale of the overall package.

**Q192 Chairman:** In relation to the statutory requirements, obviously you did not countenance for a moment that we might have a regime which

---

11 March 2004 Elliot Morley MP and Daniel Instone

---

failed to meet this. Were there others who did, and was that one of the issues which were put through the wringer?

**Mr Morley:** In our discussions, of course, part of the discussion was the fact that we did have to emphasise that there were certain requirements which were non-discretionary but statutory. I am not aware of any government department which suggested that we deliberately did not meet our requirements. Obviously, in relation to the regulator's discussions and the idea that he floated, I do not think even the regulator was saying deliberately we should not meet our targets. I think what the regulator was suggesting was whether or not the timescales could be such that you could spread the cost but still meet the obligations. We believe that, in relation to the minimum package, we are meeting the timescales satisfactorily, both in terms of trying to spread some of the cost but also in making sure we meet our obligations.

**Q193 Chairman:** It seems that you may have had quite a job to educate other departments, perhaps the Treasury, and indeed the regulator, about the importance of meeting statutory requirements?

**Mr Morley:** It is perfectly reasonable that all our proposals are given the most rigorous scrutiny. We have no objection to that and, I repeat, we expect these things to go through the wringer, and I have been through the wringer.

**Chairman:** Thank you very much.

**Q194 David Wright:** Turning to diffuse pollution, Water UK have suggested to us that diffuse pollution costs customers around £7 per year, and that is set to increase when the Water Framework Directive comes into effect. The statement today announced that you will be publishing an action plan, outlining possible options. You will be looking at that, I understand, for around two years. Why for so long?

**Mr Morley:** In terms of its implementation over two years, do you mean?

**Q195 David Wright:** Why will you be consulting about something for two years? It is a draft, I understand.

**Mr Morley:** That is right. This is because it relates to the Water Framework Directive, and I think we have had three consultation rounds on the Water Framework Directive, because it is the largest ever Directive which has come out of the European Union. It is due for implementation in 2015, but, of course, there is a great deal of work that needs to be done on that. One of the big aspects of that is diffuse pollution. Is that what you are referring to?

**Q196 David Wright:** Yes.

**Mr Instone:** Just picking up on that. It is important to remember also that the consultation document, the action plan document, which we are planning to publish next month, is the third consultation document on diffuse pollution from agriculture. That is over and above the consultation documents that we have done on the Water Framework

Directive more generally. If you are saying, "Well, why has that taken so long?" I think it goes back to the point that, compared with all the investment that the water industry has put in, in successive periodic reviews, there has been far less done.

**Q197 David Wright:** At some point there has got to be an action plan, has there not, some proposal?

**Mr Morley:** Yes, it will come out in April. That was what I was referring to in relation to diffuse pollution. That will be related to agriculture, but agriculture is not the only contributor, although it is the largest in relation to diffuse pollution. There are other sources, such as highways, for example, which run off, but it will all be dealt with within the proposed action plan in April, which will be for consultation.

**Q198 Mr Thomas:** Minister, sometimes, when we talk about regulators and five-year programmes, and all the rest of it, to the ordinary consumer this sounds very esoteric, so if I can give you an example from my own constituency which relates directly to diffuse pollution. One of the best-known beaches in Wales, called Llangrannog Beach, lost its Blue Flag this year due to diffuse pollution. It is being investigated by the Environment Agency at the moment. It could be farm run-off, it could be private sewerage run-off as well, so we will look into that. I think what consumers will want to know is what the action plan will be doing in order to tackle those different aspects of pollution. One of the suggestions has been economic instruments, and one of the things which this Committee has been interested in is a pesticide tax. How will that be taken into account?

**Mr Morley:** It will include consultation on economic instruments in relation to nitrates and phosphates, so that will be included.

**Q199 Mr Thomas:** Specific ones or just general consultation, specific proposals to consult upon?

**Mr Morley:** As it is a consultation paper, it will have proposals to consult upon, but it will be consulting on the principle of applying economic instruments. We do recognise that it could be one of a range of measures. Probably you need to have a whole range of measures, in terms of dealing with diffuse pollution, but economic instruments could well be one of the measures.

**Q200 Mr Thomas:** Just to be clear then. You are not at the moment in a position to say never mind what economic instrument, we are not yet in a position to say you will be using economic instruments to tackle this aspect. It is just costing the consumer and is adding costs, and more costs under the Water Framework Directive as well, considerable costs on the whole industry?

**Mr Morley:** It will feature in the consultation. The consultation still is not quite ready, because it goes out in April, so therefore I have seen only the drafts of this, but I can assure you that economic instruments are part of it.

---

11 March 2004 Elliot Morley MP and Daniel Instone

---

**Q201 Mr Thomas:** When would you expect the consultation to end?

**Mr Morley:** Normally, it is three months.

**Q202 Mr Chaytor:** I want to ask about affordability. Before I do that, can I touch on another issue which arouses a lot of concern, particularly in urban areas, and that is the question of the odour from sewage treatment works. In the guidance you have issued this morning, you refer to the High Court decision some time ago which said that odour from sewage treatment works could now be a matter for environmental protection officers to take action on. Since that High Court decision, are you aware of any successful prosecutions by environmental health officers?

**Mr Morley:** Since the Court decision, I am not aware of any. Are you aware of any, Daniel?

**Mr Instone:** No.

**Mr Morley:** I do not think there have been, no.

**Q203 Mr Chaytor:** You have also issued a consultation document which was launched in December 2002 and closed in March 2003, so that is 12 months ago now. Since the ending of the consultation there, what has been the process? Has something surfaced since then of which we are unaware, or is this still being considered within Defra?

**Mr Morley:** In our regular discussions with the regulator, not necessarily to do with the price guidance, because, of course, it is on general issues, we have talked about the issue of odour and the fact that it does cause problems in certain parts of the country and we acknowledge that. We have been discussing with the regulator what is perhaps the most appropriate way of dealing with this. Because it is not every single sewage works in every part of the country, what we need to avoid are measures which add yet more costs, in a way, which are unjustified. What I think we want to address is, where there are specific problems, and we do acknowledge that there are specific problems in certain parts of the country, what action we can take in terms of dealing with that. We have been talking to the water and sewage companies about that. We would like to see some progress on that and that currently is still under discussion.

**Q204 Mr Chaytor:** How high a priority will that have? It takes up three paragraphs out of a 40-odd page document, so it does not seem to have a very high priority.

**Mr Morley:** It is because it is a localised problem, but where it is a problem we recognise it is quite a major problem, we do concede that.

**Q205 Mr Chaytor:** Can we move on to affordability. I represent a constituency served by United Utilities, and United Utilities is recommending, I think, the largest increase in prices over the next five-year period, so affordability is of great importance to my constituents. I gather that you are reconsidering the question of the Vulnerable Groups scheme for people on benefits and you are going to issue some

guidance shortly. Is that imminent, or when we will know exactly what changes you are making to the Vulnerable Groups scheme?

**Mr Morley:** We intend to start the process by setting up a working group involving all the relevant government departments and the devolved administrations as well, because, of course, they would be interested in this work. That group has been set up, I think, Daniel. The group is set up so that the work is under way. What we are looking at is the existing measures to help vulnerable groups, how successful they are, whether there should be amendments or additional measures to that, and any other ways in which we can address the issue of affordability for those people who are the most vulnerable.

**Q206 Mr Chaytor:** The vulnerable groups are those on benefit?

**Mr Morley:** Yes, sickness benefit and benefits, yes.

**Q207 Mr Chaytor:** Will your proposals be in place for the start of the new charging period?

**Mr Morley:** Certainly we hope to achieve that, yes.

**Q208 Mr Chaytor:** Is that a guarantee, that the new higher bills will land on the doorstep when the new system is in place?

**Mr Morley:** I cannot give you an absolute guarantee at this stage. I think that is something I might need to give you, as a Committee, further information on.<sup>3</sup>

**Q209 Mr Chaytor:** On the question of non-vulnerable groups and the affordability for the population as a whole, you have issued your initial guidance, restating the Government's policy on metering, and there is a general encouragement of the advantages of metering and demand management, and so on. Ideally, would you like to see everybody on a meter? Would that be the ideal way forward?

**Mr Morley:** I think, ultimately, Chairman, the answer is, yes, that we would. We recognise that clearly there would be serious difficulties to have a policy of compulsory metering at the moment, but metering does offer benefits to a great many people, in relation to reducing costs, and, of course, it offers benefits in relation to the sustainable management of water. It is where we would like to get to, and, of course, the percentage of people on meters is increasing all the time.

**Q210 Mr Chaytor:** Do you have a figure for the current percentage?

**Mr Morley:** It varies from company to company, but we can let you have those figures. We do have them. They vary, but we will let you have them.<sup>4</sup>

**Q211 Mr Chaytor:** It will be very useful to see it, company by company?

---

<sup>3</sup> Please see supplementary memorandum, Ev. 99–101.

<sup>4</sup> Please see supplementary memorandum, Ev. 99–101.

---

11 March 2004 Elliot Morley MP and Daniel Instone

---

*Mr Morley:* Yes, certainly.

**Q212 David Wright:** Are you concerned, Minister, that one of the problems for people using and wanting to have a water meter, particularly older people, is that the cost of having that put in is prohibitive?

*Mr Morley:* No. It is free, Chairman. The companies will pay for it.

**Q213 David Wright:** I have talked to people who have got experience, that they have been told over many years that it costs money to put in, and we are not publicising the fact that they can have a water meter. Old age pensioners have come into my surgery saying to me, "Look, I'm not doing this because I think it's going to cost me more money." In fact, clearly it is not. The point I am making is that actually we are not telling people that it is cheaper.

*Mr Morley:* I emphasise that the installation of meters is free. If there is a problem of lack of awareness, I think that is something I will have to consider, Chairman.

**Q214 David Wright:** Certainly it has been raised with me in my surgery.

*Mr Morley:* I will discuss that certainly with both Ofwat and the companies to see what we can do to try to improve that.

**Q215 Mr Chaytor:** Of those who are not on meters then, everyone else is subject to the rateable value system, and the rateable value system was abolished for property tax purposes 14 years ago. Are you content that the differential between rateable values, between the lowest and the highest, for example, or the lowest bands and the highest bands, accurately reflects the differential in levels of consumption between low-income households and high-income households?

*Mr Morley:* It is a rough and ready system.

**Q216 Mr Chaytor:** How big is the rough?

*Mr Morley:* It is never going to be entirely accurate, and you are always going to have anomalies with a system of that kind. It is rough and ready. As a generalisation, people who live in big houses tend to have more disposable income than people who live in small houses. That is a bit of a generalisation within the system, but nevertheless, roughly, it tends to work.

**Q217 Mr Chaytor:** My argument is, people who live in big houses tend to use vastly more quantities of water than people who live in small houses.

*Mr Morley:* Not necessarily, of course. Sometimes you get single people living in large houses and large families in small houses, that is why they were part of generalisations. When you look at people who have swimming pools, for example, or sprinklers, most water companies insist on metering, if you are a big water user in that way, which is perfectly reasonable.

**Q218 Mr Chaytor:** Why stick with rateable values and not switch to council tax bands?

*Mr Morley:* It is because of the costs and the fact that it is established and the fact that it is understood, and I am not sure whether switching to council tax bands would remove all the anomalies necessarily. I think you get just a different set of anomalies, basically.

**Q219 Chairman:** Obviously, affordability is a crucial issue but so is financeability. I believe you have announced that you are looking at the structure of the water industry. What are you going to take account of, in doing that?

*Mr Morley:* We are not actively looking at that, at the actual structures, at the moment. Obviously, we are sensitive to the needs of the water industry in relation to the way in which they raise funds. I have spoken at a number of seminars, to investors and City institutions. In fact, I will be speaking to a group of City analysts tonight, as it happens, Chairman, so they will also think it is a coincidence that this is being announced, when I go to speak to them. It is part of our ongoing contact with the industry, which also includes me going down a sewer in two weeks' time, which some people will say is long overdue, no doubt.

**Chairman:** Thank you for that.

**Q220 Mr Savidge:** Minister, the Environment Agency suggested, in evidence to this Committee, that Defra and Ofwat, by taking a short-term view of environmental expenditure and cutting costs now, might be storing up problems for the future. Are you satisfied that, with this new guidance, you can answer those concerns?

*Mr Morley:* Broadly speaking, I am. It is an important consideration and that is a very sensible point to make. I think we do need to think carefully about the guidance and the pricing, because, of course, there is this pressure to keep the price increases down, perfectly understandable, very important. It is back to the balance again, to the balance the regulator must take in relation to having the minimum price increase, but also not storing up trouble for the future, and that can come, of course. It is partly an example, in the last round there was a 12% reduction. The regulator at the time felt there was justification for that, and, in relation to the circumstances, in the potential for cost savings within the companies and also a restriction in relation to capital maintenance, clearly the regulator felt that he was in a position to do that five years ago. Now, of course, we start off with an increased gap, in relation to where we are, and you do have to take into account, in relation to what you include within the pricing, if you do not address issues now then you are storing up more trouble in the future. I think that is a perfectly fair consideration. Also it opens the argument about whether or not the actual pricing process should be longer than five years, perhaps ten years with a mid-term review at five years, for example. I am open to that kind of approach. Obviously, we need to get through the present price round because all our attention and resources are dedicated to that, but I think, in the

---

11 March 2004 Elliot Morley MP and Daniel Instone

---

longer term, I would have no objection to looking at longer-term price-setting in relation to giving stability to the companies.

**Q221 Mr Savidge:** In that context, the Water Framework Directive is described in today's ministerial statement as setting demanding future objectives, and you have said already that it might come into force as soon as 2015.

**Mr Morley:** It must come into force then, yes.

**Q222 Mr Savidge:** Does the Government still take the view that the water companies do not need to take any immediate action?

**Mr Morley:** They are, in a sense, in that there are aspects, Chairman, within this current guidance that we have provided from Defra, and I know also, within the company business plans, that will contribute to our objectives under the Water Framework Directive, under PR4. There may be other aspects that we may have to address in PR5, but in relation to the timescales of 2015 we are on track within the timescales. Also the additional work we are doing, for example, the policy statement in April on diffuse pollution, certainly will have an impact on meeting the requirements of the Water Framework Directive, because that is one of the big implications, diffuse pollution. In relation to both some elements of PR4 and some elements of what we are doing in relation to diffuse management and land resource management now, we are progressively beginning to address the issues of the Water Framework Directive. I think we are on track for that.

**Q223 Mr Savidge:** Can I ask you just to amplify slightly how far you feel the Directive will impact on the next periodic review?

**Mr Morley:** We are seeing work, for example, on the extension and designation of shellfish waters, which is an improvement in the ecological quality as well as the chemical quality. We are seeing further investment in relation to upgrades of sewage treatment, addressing issues within the guidance in terms of eutrophication of some of our still waters, which is a big factor in SSSIs being in poor condition. Of course, that also addresses the requirements of the Water Framework Directive, that waters must be in good ecological condition as well as in good chemical condition. There are lots of aspects, actually, within this PR4, which is likely to have a very beneficial effect in terms of our obligations under the Water Framework Directive.

**Q224 Mr Savidge:** Coming back to some of what you said in response to my first question. You have indicated in your guidance that sudden changes in bills can have unfortunate social and economic consequences. Might there be an argument for saying that a gradual increase in bills now might be more desirable than having a position where, in order to meet the Directive, there was a large rise later?

**Mr Morley:** That is my personal view, absolutely. You will appreciate that these decisions are ones for the regulator, let us say.

**Q225 Chairman:** Can I return to the question of affordability, because the Secretary of State's statement today does say that she will be reviewing the way in which lower-income households are helped with their bills. Can you elaborate a bit more on precisely what you have in mind there and whether this review will be conducted in public?

**Mr Morley:** There is no reason why the review cannot be made public. Obviously, we would like input from various organisations, National Consumer Council, WaterVoice, the key stakeholders are very keen to have their views and their involvement in this. An example of this would be, at the present time there is a cap on vulnerable groups who are on water meters, there is a cap which is applied, and we want to look at that. Different companies have different ways of supporting those on low incomes and those who are vulnerable. For example, I think it is Severn Trent who have a very interesting fund which was set up under public ownership and has been maintained by the company, it is quite interesting actually, with trustees, and how they help those people who are having specific difficulties. Also there is the issue of debt, and there are quite big differences between individual companies and the level of debt. Of course, if you have a high level of debt then there is an aspect of a bill which can fall onto consumers, so you are adding to the bill because of a failure to collect debt. Can we improve that? Why is it that some companies are better than others? I think that will form part of the review.

**Q226 Chairman:** It is a review aimed at looking at things which the industry can do to help, not looking at things which the Government can do?

**Mr Morley:** I think there may be aspects in relation to Government strategies, in terms of helping people on low income. There has been a lot of emphasis in the last few years in terms of shipping extra resources into low-income families; pensioners, for example, who are on fixed incomes, minimum state pensions. As you are aware, the pensioner's tax credit has been extended to take into account those pensioners who have got savings. There is a minimum guarantee in terms of pensions. Again, in relation to families with children, there are minimum guarantees, in terms of top-up, in relation to the working families' tax credits. They are all designed to address the issues of pressures on families. That might be something which we could look at as well.

**Q227 Mr Chaytor:** Just pursuing the issue of debt and affordability, can I draw the analogy with fuel costs. In the area of fuel costs we are used now to the concept of fuel poverty, and the Government's definition of fuel poverty, as I recall, is where a household is spending more than 10% of its income on its fuel costs. Are we likely to hear in the near future about a concept of water poverty? I gather, for example, in the South West area, which currently

11 March 2004 Elliot Morley MP and Daniel Instone

has the highest costs, although they are likely to have the lowest level of increase over the next five years, it will result in the lowest-income households paying 8% of their net income at the end of the five-year period. Is this an emerging concern about certain groups of households, or ought it to be a concern, and ought the Government to set a threshold, in terms of the percentage of household net income which it is unacceptable to exceed, in terms of water costs?

**Mr Morley:** I think it is a fair point, Chairman. We do not have a definition of water policy at the present time, it does not exist. Of course, we are acutely aware that there are certain parts of the country where water bills have increased quite a lot in relation to disposable income. I think that is part of the consideration that we will need to look at, in terms of the impact of water prices on different regions, and also exactly what is the impact on average incomes. I think that will have to be a consideration that we must take into account.

**Q228 Chairman:** Do you have any idea, and I am afraid I do not, how the City has reacted to the statement which the Secretary of State made today?

**Mr Morley:** I will know tonight, Chairman.

**Q229 Chairman:** When the stale buns start to fly. There has been no immediate or dramatic reaction?

**Mr Morley:** It was announced only this morning, so it is a bit early to have picked up a reaction. What reactions we have picked up have not been unfavourable, but really that is very provisional, Chairman. Really I will know tonight.

**Chairman:** Thank you very much. Without a great deal of prior warning, I think you were aware that the Committee would like to return briefly to the issue of genetically-modified crops. You will be aware that there has been some tension between your Department and the Committee over this issue in recent days, following the publication of our report<sup>5</sup> and the Government's announcement<sup>6</sup>, and we would like to ask you just a few questions about that right now.

**Q230 Mr Challen:** I just thinking, if I were asked to characterise the statement on Tuesday, probably I would compare it to a lump of Swiss cheese. There is some solid stuff in it, it does refer to what I think is perhaps the Government's precautionary approach, which actually has brought about a delay of several years to the commercialisation of these crops. But there are quite a few holes in the statement, as well, and I will point out, for example, the Secretary of State's reference to the Science Review, saying that it reaffirmed there were some gaps in scientific knowledge. It does not say whether those are large gaps or small gaps, but there are gaps in scientific knowledge, and that is across the board. Also, obviously it states that the reason for going ahead with or approving the idea of planting forage maize

is based on the trials which were held. Yet then it does say that the second condition of allowing the approval "is that the consent holders should be required to carry out further scientific analysis to monitor changes in herbicide use on conventional maize," obviously, referring to the atrazine context. If that was the case, and this is the reason for allowing this approval to take place, should not we expect those tests, so far as maize goes, to be rerun completely, under the same scientific control conditions as were the first tests, or people will not have any confidence that really that was a standard way of approaching it?

**Mr Morley:** I understand your point, and can I say at the beginning, Chairman, that there was no intention to have any discourtesy or tension between Defra and the Committee. The issue of the FSEs and the response to it, which itself was a bit overdue because, quite understandably, you have to consult with the devolved administrations and you listen to their point of view on that, we agreed a common position in the detailed response from the FSEs and public consultation in relation to that, and of course that takes a bit of time. That timescale was locked in, in that respect. Of course, we are interested in what you have to say in your report, and I read it from beginning to end over the weekend, before the announcement. All the points which were raised in your report are perfectly reasonable but points which were already under consideration by Defra and also were matters which we had referred to our expert advisory committee, ACRE. That includes, in particular, the question of atrazine. We are aware of the claims that, because atrazine is to be phased out, and the decision to phase it out, incidentally, was taken after the trials began, just to put that on the record, because at the time it was the industry standard, atrazine, and triazines were very common in relation to conventional maize, we have looked at this question. There has been a re-evaluation of the herbicide trials by the scientists who were involved in the FSEs, but which has been independently peer reviewed by scientists who were not involved in the FSEs or the trials. They came to the conclusion, which you saw in the *Nature* article, I know you may not agree with it absolutely, Chairman, listening to your comments, but, nevertheless, they came to the conclusion that, although the benefits will be reduced, the herbicide-tolerant maize, the forage maize, would still be better for biodiversity than conventional maize. In that respect, and it was referred to ACRE, and ACRE's advice is that there is no justification for going through the full field-scale evaluation again, there is no justification for that, that is their expert advice. What we have said, as you pointed out quite rightly, is that, as a condition of the Part C consent, there should be further evaluation of the GM forage maize compared to herbicide regimes in the conventional maize. We do not have to do that, Chairman, because, in relation to the analysis, it is still the conclusion by our experts that the GM maize comes out better. We do not have to do that, but we are doing it because we are respecting the opinion from your own Committee, for example, about the

<sup>5</sup> GM Food—Evaluating the Farm Scale Trials, HC 90, 2003–04.

<sup>6</sup> House of Commons Hansard Report, Vol. 418, 9 March 2004, c. 1381.

---

 11 March 2004 Elliot Morley MP and Daniel Instone
 

---

concerns which you have expressed, and also concerns which have been expressed by others. While we do not have to do it, we do not want people to say that the actual test is flawed. We want to address this properly and scientifically and we believe that a regime of comparisons can be put in place without going through the full FSE process again. The Part C does run out in 2006, as the Secretary of State made very clear in her statement, so therefore, before the Part C is renewed, there will be an evaluation and it will be made public, in relation to that further work. It does have to be borne in mind that the atrazine is a pre-emergent herbicide, that is the basis of it, and it is likely that its replacements also will be pre-emergents, while the regime, in relation to the herbicide-tolerant is different, it is a post-emergent spray, and it is the effects of the pre-emergent spray which really are detrimental to biodiversity. It is true that atrazine was a very powerful chemical, that is true, that is why it is being banned, and we support that fully. It is not the case that you should assume automatically that the trials have been invalid because there are going to be different herbicides. We are sensitive to this concern and that is why it will be a condition, it is a condition, of the planting that this further work is carried out.

**Q231 Mr Thomas:** Specifically on that, the difference between the herbicide regimes, we did hear that in the American context, in fact, GM herbicide-resistant modified maize was being grown with a liberty/atrazine mix, and that was not the case in these field evaluations. That would suggest that the use and the growth of the maize over a period whereby there is an encouragement about weeds are tolerant, and so forth, in the American context has led to the use of atrazine. That would suggest a possibility of a similar use of a herbicide in this context. Have you taken that into account at all, in this discussion?

**Mr Morley:** It has been considered by ACRE, and indeed it is a question really to put to the experts who are involved in the FSEs. As you say quite rightly, that atrazine/liberty mix is not allowed in this country and it will not be allowed because, of course, atrazine and triazines are to be banned, so that is not a condition which will arise.

**Q232 Mr Thomas:** Is it not the case, from what you have just said, that it may be that pre-emergent herbicide which replaces atrazine will be allowed in the case of GM maize, and does not that reduce, thereby, diversity benefits?

**Mr Morley:** No, because that is an atrazine mix and that will not be allowed at all in this country. There is not the slightest chance of that. Also, the maize, the consent is also being changed, as the Secretary of State made clear, to include the same regime, exactly the same regime which was applied to the forage maize in the FSEs. What cannot happen is that you can have consent for the maize and then completely change the management regime. You cannot do that because you will be locked into that, in the consent.

**Q233 Chairman:** What chance have you got of getting the EU to agree to change that consent?

**Mr Morley:** I would have thought, a very good chance, obviously, I cannot say for certain all seven, Chairman, but we have a sound scientific case. Also, it is a part of our commitment to approach it on a cautious basis, taking into account people's concerns, which I think are very, very important, and also addressing the points which you made in your own report, so that we try to deal with it beyond doubt. In that respect, we have a very powerful case to put to the EU and I will be very surprised if they turn that down.

**Q234 Mr Savidge:** Can I just clarify something on timing. Obviously, there has been reference to the important article published in *Nature*. It was published on the same day as this Committee's report, as is referred to by the Secretary of State, in fact, in what she said in questions after her statement. As we know, the Cabinet decision was taken before the EAC report was published. Would the Cabinet have been aware of the article in *Nature* prior to its publication, or did it take the decision, in fact, without the scientific evidence of the *Nature* article?

**Mr Morley:** The Cabinet would have been aware of the research that was underway, but, more importantly, ACRE would have been aware as well. While I cannot comment on leaked minutes, as you will appreciate, what I can say is that we were guided by the advice that we received from ACRE. They are our expert advisory body.

**Q235 Mr Challen:** I would like just to ask really who will be in charge of deciding the criteria for your co-existence measures? It was mentioned in the statement.

**Mr Morley:** The co-existence measures will be decided by Defra, following a public consultation which we intend to hold this summer.

**Mr Challen:** Following on from that, the possibility of voluntary GM-free zones has been mooted. I do not know how far down the road you are with the thinking on that, but I seem to recall, from my period in local government in the 1980s, we used to have things called nuclear-free zones and it is a concept which I supported and it was a statement of principle, if you like, rather than fact.

**Chairman:** Now you tell us.

**Q236 Mr Chaytor:** Chairman, can I say, I live not far from the central Manchester nuclear-free zone and I can assure you there are no nuclear weapons in the centre of Manchester.

**Mr Morley:** As far as you know.

**Q237 Mr Challen:** It did work in some places but only by default. Personally, I think that to have a voluntary arrangement is fine, as long as we have 100% agreement to it in the country, but we have not, have we? It is going to be very difficult for these things to work in practice if some farmer, right in the

---

11 March 2004 Elliot Morley MP and Daniel Instone

---

middle of that area, decides, perhaps having been offered some major bribes by the industry, to blow a hole right through it. Is that a possible scenario?

**Mr Morley:** There is always an odd difficult farmer, in my experience, it is true, Chairman. However, it is the case that there are parts of the country where I think there is a consensus, that there are groups of landowners and farmers, of course some local authorities do own land themselves, in relation to smallholdings, and they may wish to band together in a co-operative way to declare themselves GM-free. We have no problem with that at all, as a Government, and we made it very clear that we are willing to assist in relation to advice or any other appropriate help that we can give.

**Q238 Mr Challen:** There is no way that it can be enforced, is there?

**Mr Morley:** No. There is absolutely no way it can be enforced, because clearly this is an EU rule. It is not statutory, therefore you cannot force people to be GM-free, and, indeed, we have been very keen on choice and there are issues of choice here as well. Where there is freedom of choice and where people have come together, and I think there will be examples of this, I will be very surprised if there are not. There is no reason why they cannot declare themselves GM-free.

**Q239 Mr Challen:** Would it not be worth going to the EU to try to get some change in the rule, because some part of Austria wanted to be GM-free and other places might want to be GM-free, Wales and Scotland? Should not we be working to change that rule?

**Mr Morley:** There has been discussion in the EU on this, and we are fairly relaxed about this approach, if an area wants to declare itself GM-free. However, there is clearly no support for it within the EU. What support there is is limited, the Commission are against it, there is clearly a majority against it. It is not likely to happen, I am afraid.

**Q240 Mr Chaytor:** The Secretary of State, in her statement to the House on Tuesday, said, and I quote: "I will also consult stakeholders on options for providing compensation to non-GM farmers who suffer financial loss through no fault of their own." Interestingly, the Opposition spokesperson did not pick up on this point. My question is, although there will be a consultation about liability, this is not a prerequisite of the approval?

**Mr Morley:** No, it is definitely not a prerequisite of the approval, because, of course, there are many countries in the world where GM crops are grown

now and where there are no liability regimes, so it is not a prerequisite. However, it is not an unreasonable request for people to make, and we take that seriously, which is why we will be consulting on it.

**Q241 Mr Chaytor:** Given that she said that any such compensation scheme would need to be funded by the GM sector, what is the likelihood of the biotech companies agreeing to set up a fund for compensation?

**Mr Morley:** Really I could not say what their reaction is. I would guess they are not exactly dancing in the streets about it. Nevertheless, if there is someone who has to pay I do not think it should be the taxpayer and I do not think it should be conventional farmers, and I think if anyone is responsible it should be the GM companies.

**Q242 Chairman:** You do think there is someone who should be there to pay?

**Mr Morley:** I think there is a very strong case, Chairman, for a facility for compensation, if there is the justification for it.

**Q243 Chairman:** A strong case, or a requirement?

**Mr Morley:** We cannot make it a legal requirement, but I think there is a very strong case to do it. I think, from the biotech companies' point of view, if they are confident that this is a technology which can be grown without affecting conventional and organic crops, and they are, if they are confident about that and if they want to reassure people then it is something I believe they should be supporting.

**Q244 Mr Chaytor:** If there were an odd, awkward, bloody-minded farmer who was a member of the Soil Association and Greenpeace, and he, or she, decided their organic crops had been contaminated by GM, then would they sue the producer of the GM crop, the biotech company or the Government?

**Mr Morley:** Probably there are provisions under UK law at the present time, that when clearly there is someone responsible we believe probably there is provision to take action now. The problem comes, for example, when you may have two or three people growing GM crops and therefore you are not quite sure who is responsible. In that case, a fund on the basis of no fault might be a better way of approaching it. That is all going to be part of the consultation process and where we can explore all these points in that process.

**Chairman:** Minister, thank you very much indeed. We appreciate you have got a busy day and we are grateful to you. Thank you.

---

**Supplementary letter to the Chairman of the Committee from Elliot Morley MP, Minister for Environment and Agri-Environment, Department for Environment, Food and Rural Affairs**

1. When I appeared before your committee on 11 March, I was invited to send supplementary information in response to some questions.

**COSTS OF THE ENVIRONMENT PROGRAMME**

2. The Committee asked for an estimate of the costs of the environment programme outlined in the Principal Guidance.

3. While I wish to assist the Committee there are difficulties in providing a figure. Our policy decisions for the principal guidance used costs and price limit implications derived, by Ofwat, from companies' draft business plans submitted in August 2003. I made the point in my evidence that the costs of all elements of companies' business plans will continue to move until Ofwat sets final price limits at the end of the year.

4. Ofwat offered advice to the Secretary of State, published on 19 December 2003. This set out the capital costs associated with two different policy packages, according to the costings used by companies in their draft business plans (Annex A). Neither of these packages corresponds to the combination of policies set out in the principal guidance. But it may help the Committee to note that the principal guidance includes virtually all the measures costed by companies as reference plan A and in addition some of those in reference plan B. In looking at the figures in Ofwat's December advice, whether for the capital costs of investment or the price limit consequences, the Committee will also wish to note that the environment investment programme is a subset of the quality investment programme (which also includes drinking water improvements) which in turn is part of total capital investment (including also capital maintenance).

5. I share with the Committee the wish to see fully scrutinised and challenged figures of costs and their effect on customer bills, for the exact programme that we have asked companies to develop. Companies will now prepare their final business plans, based on the principal guidance programme. I look to Ofwat to scrutinise and challenge the costs. Information about the plans will be made public.

**DIFFUSE POLLUTION**

6. The Committee requested copies of the diffuse pollution papers when they are available. We will be consulting on a broad range of economic instruments to tackle agricultural diffuse pollution at the end of this month. We will send the Committee the consultation document, along with any supplementary papers.

**AFFORDABILITY**

7. The Committee asked whether new measures on the affordability of water will be in place when the new price limits are implemented on 1 April 2005. It is too early to say what might be the outcome of our review of existing measures on water affordability. The only specific Government measure already in preparation is the further proposed changes to the Vulnerable Groups scheme, on which we consulted in 2003. In the light of the responses received to the consultation paper, the Government is finalising plans for revised regulations. The changes will be announced in a response to the consultation and will come into effect in April 2005 to coincide with the new price limits.

**METERING**

8. The Committee asked for the percentage of customers who are metered and how to increase awareness that meters are free to install and may offer savings to customers. Overall, 24% of customers in England and Wales are metered and this figure is increasing at a rate of 1–2% per year. There is variation between household and non-household customers and also between companies (Annex B).

9. Companies, encouraged by Ofwat, give customers information about the free meter option and meter savings along with their water bills.

10. The Department has also published a free information leaflet, "*Water Metering: Your new rights*", setting out household water customers' new rights under the Water Industry Act 1999 including the new right to free meter installation. Copies were supplied to all water companies and were also distributed widely through such routes as Citizens' Advice Bureaux, libraries, benefits offices and local authorities. We have also continued to co-operate with others in disseminating information, for example the Consumers' Association published an article about the basis of water charging and the choices open to customers.

March 2004

Table 1

**ESTIMATES OF CAPITAL EXPENDITURE IN PERIOD 2005–06 TO 2009–10 TO MEET  
DRINKING WATER QUALITY, ENVIRONMENTAL AND OTHER RELATED  
IMPROVEMENT DRIVERS**

Advice to inform the principal guidance on scale and timing of further quality enhancements: open letter to Ministers (Ofwat 19/12/03)

**Updates of company estimates**

Following queries and further information from some companies (see note 1)

<b>Main drivers</b> for drinking water quality, environmental and other related improvements	Capital expenditure in 2005–10 £ million	
	<b>Reference Plan A</b>	<b>Reference Plan B</b>
<b>WATER SERVICE</b>		
Water treatment works improvements	570	640
Distribution system renovation	740	740
Lead communication pipe replacement	370	870
Improvements to taste and odour of drinking water	210	260
Other improvements (includes resilience of water systems)	60	60
<b>DRINKING WATER QUALITY SUB TOTAL</b>	<b>1,950</b>	<b>2,570</b>
Changes to water systems to improve the environment	230	540
<b>WATER SERVICE SUB TOTAL</b>	<b>2,180</b>	<b>3,110</b>
<b>SEWERAGE SERVICE</b>		
Urban waste water treatment directive at STWks	740	1,120
Intermittent discharges from sewerage systems	950	1,030
Sewage sludge treatment and IPPC requirements	90	170
Freshwater fish directive (see note 2)	30	1,620
Bathing waters directive	160	390
Shellfish waters directive	0	1,790
Nature conservation (includes Habitats directive & SSSIs)	870	930
Ground water protection	660	670
Removal of trace contaminants from STWks effluents	100	220
Endocrine disruptors demonstration project	0	40
Land management schemes	0	340
Local schemes for improving the water environment	220	870
Completing the AMP3 programme + other (see note 3)	450	490
Section A (see note 4)	620	620
<b>SEWERAGE SERVICE SUB TOTAL</b>	<b>4,890</b>	<b>10,300</b>
<b>TOTAL—QUALITY ENHANCEMENTS</b>	<b>7,070</b>	<b>13,410</b>

Notes

1. These estimates are drawn from the supporting information submitted by water companies with their Draft Business Plans but expressed in net terms after the application of the reference level assumptions for improvements in efficiency.

2. The plan B number includes some companies' estimates for more work than sought by the EA.

3. At PR99 Ofwat assumed some quality enhancement schemes would be delivered in the period April to December 2005. The costs for these schemes will need to be allowed for in setting price limits for 2005–10.

4. Section A covers improvements falling outside the formal National Environment Programme and improvement requirements that have arisen since the 1999 determination.

Table 2

## WATER CUSTOMERS 2003–04

	<i>Unmeasured Supplies</i>		<i>Metered Supplies</i>		<i>Proportion metered</i>	
	<i>Households</i>	<i>Non-households</i>	<i>Households</i>	<i>Non-households</i>	<i>Households</i>	<i>Non-households</i>
	<i>(thousands of customers)</i>				<i>(percentage)</i>	
<b>Water &amp; sewerage companies</b>						
Anglian	859.5	15.5	926.3	109.3	51.9	87.6
Dwr Cymru	964.7	14.8	205.8	87.1	17.6	85.5
Northumbrian:						
Northumbrian	931.5	16.7	92.0	46.5	9.0	73.5
Essex & Suffolk	438.7	4.9	249.7	38.0	36.3	88.5
Severn Trent	2,308.0	14.0	694.0	211.0	23.1	93.8
South West	383.2	5.5	260.3	65.7	40.5	92.3
Southern	691.4	14.5	231.4	51.1	25.1	77.9
Thames	2,549.1	24.6	639.4	179.6	20.1	87.9
United Utilities	2,328.2	21.2	412.8	183.2	15.1	89.6
Wessex	324.5	7.8	150.9	46.1	31.7	85.5
Yorkshire:						
Yorkshire	1,334.7	19.5	466.7	109.4	25.9	84.9
York	67.2	0.6	7.3	4.5	9.8	88.7
<b>WaSC Total</b>	<b>13,180.7</b>	<b>159.6</b>	<b>4,336.5</b>	<b>1,131.4</b>	<b>24.8</b>	<b>87.6</b>
<b>Water only companies</b>						
Bournemouth & W Hampshire	115.1	1.1	55.6	13.3	32.6	92.6
Bristol	346.7	8.3	92.8	33.8	21.1	80.3
Cambridge	52.5	1.0	57.1	8.9	52.1	89.6
Cholderton	0.6	0.0	0.0	13.6	28.6	
Dee Valley	72.2	0.9	31.0	7.4	30.0	89.3
Folkestone & Dover	40.7	0.8	24.4	4.4	37.4	84.3
Mid Kent	144.3	1.8	72.6	19.8	33.5	91.5
Portsmouth	259.4	2.6	9.8	15.0	3.7	85.2
South East	388.1	7.1	149.6	34.1	27.8	82.8
South Staffordshire	426.9	6.6	69.9	31.1	14.1	82.6
Sutton & East Surrey	206.8	2.8	41.1	13.3	16.6	82.7
Tendring Hundred	26.8	0.1	37.2	4.9	58.1	98.4
Three Valleys:						
Three Valleys	773.2	9.4	186.9	46.3	19.5	83.1
North Surrey	145.7	1.7	37.8	10.1	20.6	85.8
<b>WoC Total</b>	<b>2,999.1</b>	<b>44.1</b>	<b>865.8</b>	<b>242.3</b>	<b>22.4</b>	<b>84.6</b>
<b>Industry Total</b>	<b>16,179.8</b>	<b>203.7</b>	<b>5,202.3</b>	<b>1,373.7</b>	<b>24.3</b>	<b>87.1</b>

## Notes:

a. Figures are company estimates of customers served in 2003–04.

b. The totals may not add up due to rounding.

Ofwat: Tarrif structure and charges 2003–04 report.

# Written evidence

---

## APPENDIX 1

### Letter and Memorandum from the Campaign Against Monopoly Abuse (CAMA)

WATER: THE PERIODIC REVIEW 2004

We have pleasure in submitting these comments to the Committee's inquiry concerning the 2004 Periodic Review of water price limits for England and Wales.

As you will see, there are two main areas of concern. The first is the enormous debt which has already prompted serious questions about the creditworthiness of at least one company. As we show in the attached annex, this debt is largely due to the £1.5 billion (an average of about £65 per household) taken out of the regulated businesses as parent company rake-off—plus of course the spiralling interest charges which this year will no doubt top £1 billion. These details are not generally known to the public which highlights the second major matter of concern. There is no doubt that the companies, Ofwat and WaterVoice (the customers' friend) are "economical with the truth" but the problem goes even deeper. As the presentation of annex in the attached submission shows, there is more than a little outright deceit.

As it is beyond the Ofwat Director's powers to secure that companies will be able to continue indefinitely to borrow in order "to Finance their functions", it is probable that the duties laid down by Act of Parliament are not being properly honoured but, in any case, urgent action other than an increase in prices is obviously called for to ensure the continued solvency of the companies. Some action is clearly desirable before the next tranche of dividend is taken in March. Other problems are identified for which the preferred solutions will come from an informed public debate. A most important item for debate—in view of the huge amounts siphoned off by way of dividend—is whether customer financing of the capital investment programme for improved water quality and a clean environment should continue as at present.

We shall be pleased to substantiate and clarify as required and look forward to your report.

For convenience the links below are to further papers referred to in our submission.

*Comments on "Setting price limits for 2005–10: Framework and Approach"*

([http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/650f3eec0dfb990fca25692100069854/ea1409cf4a85f14b80256cf5003e20db/\\$FILE/Campaign%20Against%20Monopoly%20Abuse.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/650f3eec0dfb990fca25692100069854/ea1409cf4a85f14b80256cf5003e20db/$FILE/Campaign%20Against%20Monopoly%20Abuse.pdf))

*Comments on "Ofwat Forward Programme: 2003–04 and 2004–04"*

([http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/650f3eec0dfb990fca25692100069854/597bfdc683fd735080256d0400363aa2/\\$FILE/cama.doc](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/650f3eec0dfb990fca25692100069854/597bfdc683fd735080256d0400363aa2/$FILE/cama.doc))

*Comments on Draft Water Bill "Memorandum DWB 32"*

(<http://www.parliament.the-stationery-office.co.uk/pa/cm200001/cmselect/cmenvtra/145/145ap11.htm>)

Memorandum DWB 32 is available on the Parliament website, the other two papers are available on the Ofwat website.

February 2004

### Memorandum from the Campaign Against Monopoly Abuse (CAMA)

PREAMBLE

It need hardly be said that the first requirement for sustainable water and sewerage operations in England and Wales, with due regard for water quality and environmental protection, is that the licensed operating companies should be adequately financed. This was recognised in the 1991 Act and now in the 2003 Water Bill which, in paragraph 2A(c) requires the regulator:

*to secure that companies holding appointments under Chapter 1 of Part 2 of this Act as relevant undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions*

## NOTE

Indeed, the requirement for securing “returns on capital” might even be considered as “over-financing” since, as Ofwat informs us, customers are actually financing the capital investment programme so that this gives a double benefit to the shareholders who would otherwise have to find the investment capital themselves. It also inflicts a double penalty on customers since those who are financing the biggest capital investment programmes will also be required to provide the most generous “returns on capital”.

As well as requiring that water companies are adequately financed, the 2003 Water Bill perceptively requires—as did the 1991 Act—that the money is not wasted, diverted or otherwise misspent. These duties are given in the “Conclusions” below but essentially the regulator is required to promote economy and efficiency and to prevent expenditure not attributable to the licensed operations in particular by ensuring that the companies present proper accounts. Some notion of the extent to which these statutory requirements are being respected by the regulator may be gained from the 2002–03 aggregate “profit and loss” account given in Table 2 below.

The aggregate net debt at 31 March 2003 stood at nearly £19 billion which accounts for the £992 million interest payable. Interest charges alone can be expected to add at least a further £1 billion to the debt in the present financial year—even at current low interest rates—so that the total debt by the end of this 5 year period, in March 2005, will no doubt be well in excess of £20 billion. It will also be seen that the dividend taken by the parent companies in 2002–03 is a total of nearly £1.5 billion or 22% of the total revenue and an absurdly generous return for routine utility operations by monopoly companies with assured revenues and no commercial exposure. This expense is clearly a major contribution to the colossal debt and a massive, but not necessarily the only, cash transfer to the associate group. The group auditor will not be particularly concerned, if at all, about licensed company revenues funding activities which might not be attributable to the licensed operations. By Act of Parliament this remains the statutory obligation of the Ofwat Director whose notions of strict accountability will be evident from a comparison of Tables 1 and 2 below. The 20% or more of revenue regularly taken from licensed company funds by way of dividends should raise serious questions as to whether the Ofwat policy of “arm’s length regulation” (sic)—a peculiar interpretation of the statutory duties imposed by Act of Parliament—is really giving water and sewerage customers anything like a square deal. In pursuing this policy, the Ofwat Director also shows a remarkable lack of concern about the persistent overspend and the escalating debt which is hardly a recipe for sustainability with the creditworthiness of at least one licensed company being questioned in 2003.

In the interests of the financial sustainability of the licensed water companies, it is essential that any guidance should take account of the implications of the Ofwat policy of “arm’s length regulation”. It is also highly desirable that the public should be properly informed so that they might sensibly join the debate. The debate should also consider whether customers are to continue to finance the capital investment programme when the shareholders take such extravagant dividends.

## ARM’S LENGTH REGULATION (SIC)

*“concerned with outputs not inputs—outcomes not expenditure”*

There can be no serious dispute about the fact that, since 1989, the public has been given to understand that water and sewerage charges by the private companies were high because of the high additional cost of the quality improvement programme. The Ofwat Director even put a figure on the costs in his 1999 report *Future water and sewerage charges 2000–05*:

*“In the 15 years from 1989 to 2005, water companies will have invested £50 billion to improve water quality and to protect the environment, **all financed by customers.**”*

The same report also gave the total costs included in the 2000–05 price limits as £15 billion and set out the total projected capital and operating costs allowed in the price limits by type of expenditure. The average annual figures derived from these projections are given in Table 1 below. The 1999 Ofwat report also details the annual average capital expenditure allowed in the price limits for each company, in absolute terms and on a £ per property basis. These figures are given in columns 1 and 2 of Table 3 below which also shows the average projected annual household bill for each company in column 3 and the percentage of the household bill attributed by Ofwat to quality charges in column 4. It is worth noting from the figures in Tables 1 that the allowance for the projected capital expenditure of £3,123 million a year included in the 2000–05 price determinations represents no less than 55% of the total revenue for the period and confirms the Ofwat Director’s assertion that the quality improvement programme is “all financed by customers”.

Despite this huge provision for funding the investment programme, prices in 2000–01 were reduced by an average of 12%, attributed by Ofwat to improved company efficiency but probably also bearing some relation to the outrageous reported profits. As the Ofwat Director also noted:

*“Customers will now benefit from lower bills for the first time since the industry was privatised in 1989. They can look forward to a higher quality water service and an improved environment **within a frame work of falling prices**, thanks to the growing efficiency of the water companies.”*

In promising this framework of falling prices, the Director may have had in mind the statement by the Chairman of the Environment Agency, also quoted in the report, that:

*“By 2005 we will have reached a position where the significant environmental damage created over the past 200 years will have been repaired.”*

These comments by the Ofwat Director and the Chairman of the Environment Agency indeed confirm the general expectation, encouraged by reports of individual water companies, that much of the capital investment programme, which is blamed for the high water and sewerage charges, is now nearing completion. They appear to signal the probability of a substantial reduction in capital expenditure from 2005 onwards which could then be reflected in a dramatic reduction—even as much as a 55% cut—in household water and sewerage bills.

Having submitted their spending proposals for 2005–10, the water companies are now looking for substantial price increases amounting to 30% or more. The reasons given include past under funding, infrastructure renewals and the need to further improve environmental standards. There has been no reference, by the water companies or by Ofwat, to reduced capital expenditure as the 2000–05 capital projects are completed so we must assume a massive expansion in the capital investment programme—a more than 60% increase in real terms over the £15 billion expenditure originally projected for 2000–05. This level of projected expenditure, will have such a heavy impact on customers, in particular those with low incomes, that it must be properly detailed and justified as an essential function of the price review. It is even more important than previously that the actual expenditure is adequately and properly accounted for.

Concerning the present regulatory accounts, it might be expected that companies would be required to submit their financial reports under the same sub-headings as the capital and operating expenditure budgets on which the Director’s price determinations, and therefore the company revenues, were based. However, this is not the case as can be seen from the aggregate profit and loss account for 2002–03 which is given in Table 2. The “Operating expenditure” is accounted as a single item and is deducted from total revenue along with the depreciation charges and virtually the whole of the remainder is then booked as “Operating profit” from which no less than nearly £1.5 billion is taken by parent companies by way of dividends. These dividends amount to 22% of total revenue (see Table 6) and are a spectacular return for a low risk operation, with assured revenue and low operating costs. A further item of expense that is worthy of note—the Ofwat Director being required by Act of Parliament to secure that companies are able to finance the proper carrying out of their functions—is the nearly £1 billion interest charges that had to be paid in 2002–03. This expense relates to the net debt of £19 billion which includes the £2.6 billion borrowed in 2002–03 and presumably spent on capital projects although there are no detailed accounts.

From a comparison of Tables 1 and 2 (see annex) therefore, it seems that, in broad terms, the water company revenues are established by price determinations based on estimated capital and operating expenditure budgets but are accounted for under the main headings of “Operating costs” and “Operating profit”. This then leaves the bulk of any capital expenditure, as is now being publicly admitted, to be financed by debt. This so contradicts the previous story, that the capital programme has been the cause of high water and sewerage charges, that consumer groups should be demanding explanations from Ofwat and the companies as a matter of urgency.

Not the least ridiculous aspect of this peculiarly lax regulatory arrangement is that it is the capital expenditure budgets that determine the potential profitability of the companies. A company with a high proportion of revenue from capital expenditure allowances will obviously be better able to declare a higher “Operating profit” after the deduction of “Operating costs”. See column 4 of Table 3 (see annex).

Further insights into the flaws in “arm’s length regulation” can be gained from an examination of the regulatory financial reports of individual companies. As an example, the 2001–02 and 2002–03 “profit and loss” and “operating costs” as reported by South West Water are given in Tables 4 and 5 (see annex) respectively. The “profit and loss” account sub-headings are similar to those given in Table 2, an obvious difference being that in South West Water accounts depreciation is included in the operating costs in Table 5. As can also be seen in Table 5, there is very little detailed accounting for the operating expenditure. The aggregate items “Other external charges” and “Other operating charges” amount to £61.6 million and with the depreciation charges of £60.9 million, for which no detailed account of expenditure is given, there remains only £37 million of expenditure to be detailed and this includes the single item of £26.8 million for “Manpower costs”. Also in 2002–03 there was further borrowing of £100.2 million for which there are again no detailed accounts of expenditure.

From the South West Water accounts presented in Tables 4 and 5 it is clear that, as stated, the Ofwat policy of “arm’s length regulation” really is not concerned with expenditure and it is equally clear that this laxity is grossly unfair, not to say costly, for customers. The cost is particularly evident in the 2002–03 dividend taken by the South West Water parent company, Pennon Group Plc. The £72.7 million dividend represents 27% of the total revenue—in effect, 27 pence of every £1 paid by South West Water customers was skimmed off by Pennon. This means that from a typical 2002–03 household bill of (say) £380, no less than £100 was taken to pay by Pennon as dividend. A further interesting perspective on the £72.7 dividend is that, with a total of 1,339 employees (including Directors) the dividend per employee is an amazing £54,294. Presumably this is seen as “securing a reasonable return on capital” for shareholders and is not listed as reason for price increase. As previously indicated, the peculiar Ofwat regulatory arrangements provide a

higher profit potential where the quality investment charges are high and South West Water charges are the highest in England and Wales due, it is said, to the long South West peninsular coastline. As can be seen from column 4 of Table 3, 68% of South West Water prices can be attributed to the Ofwat allowances for capital expenditure and is the basis for the total of £171.7 million—68% of revenue—that was charged as “Depreciation” and “Operating profit” after the deduction of “Operating costs” in the 2002–03 “profit and loss” account shown in Table 4.

## CONCLUSIONS

It is to be expected that there will be flaws in a financial regulatory system where the Director himself declares a policy of “arm’s length regulation” which is not much concerned about expenditure. The lack of financial coherence is also evident from the discrepancies between the budgetary projections in Table 1 and the regulatory accounts as represented in Tables 2 and 4. The lack of financial restraint is obvious from the huge dividends taken by the parent companies (see columns 2 and 3 of Table 6) which are outrageous for operations with assured revenues and such low risk. For several companies the dividends amount to a charge of £100 or more on the average household bill which may come as a surprise to customers who have been led to believe that high water and sewerage bills were entirely due to the cost of the quality improvement programme. This lax regulation must prompt questions as to the statutory duties of the Ofwat Director and the extent to which this casual policy of “arm’s length regulation” can be regarded as permissible. The key duties in this respect, as defined in the Water Industry Act 1991—and now carried forward into the new Water Bill—are as follows:

- to promote economy and efficiency on the part of companies in the carrying out of the functions of a relevant undertaker;
- to ensure that consumers are also protected as respects any activities of such a company which are not attributable to the exercise of functions of a relevant undertaker and in particular by ensuring;
- that the company, in relation to the exercise of its functions as a relevant undertaker, maintains and presents accounts in a suitable form and manner.

The fact that these statutory duties are being blatantly and outrageously flouted is clear and obvious with no need for further elaboration. Ofwat and the water companies must be well pleased with their success in keeping levels of debt and the dividends taken by parent companies out of the public debate about the proposed 30% price increases. In this they have the apparent support of the nominal “consumer watchdogs” such as WaterVoice, the National Consumer Council and the Parliamentary representatives of water and sewerage customers in England and Wales.

These “watchdogs” must have been aware of the fact that there are serious financial flaws in the Ofwat regulatory process since 1997 when Gordon Brown declared the companies to be “awash with cash” and imposed a special tax on the excessive profits which yielded £1.69 billion. Since 1997, the net debt has increased by more than £12 billion, which includes the additional borrowing for the payment of Mr Brown’s tax. The total dividends taken by parent companies since 1997 also, no doubt by sheer coincidence, amount to more than £12 billion. In customer terms, these figures represent a debt increase of about £75 per property per year plus an average £75 a year from every customer in England and Wales taken as dividend. It is to be hoped that the regulatory authority to be appointed under the new Water Bill will not only be aware of the statutory duties of customer protection as defined in the Bill but will take them seriously.

February 2004

Annex

**Table 1**

### PROJECTIONS OF EXPENDITURE 2000–05 (£ MILLION)

The following table sets out the average annual capital and operating expenditures allowed in the Ofwat price limits by type of investment.

#### CAPITAL EXPENDITURE

Base services:	
infrastructure renewals expenditure	430
non-infrastructure capital maintenance	852
Enhanced service levels	28
Supply/demand balance	337
Quality enhancements	1,476
Total capital expenditure	3,123

## OPERATING EXPENDITURE

Base service	2,312
Enhanced service levels	0
Supply/demand balance	47
Quality enhancements	189
Total operating expenditure	2,548
Total projected average annual expenditure	5,671

Table 2

## AGGREGATE PROFIT AND LOSS ACCOUNT 2002–03 (£ MILLION)

Turnover	6,631
Operating expenditure	(2,699)
Capital maintenance charges:	
current cost depreciation	(1,596)
infrastructure renewals charge	(470)
Working capital adjustment	10
Operating profit	1,876
Other income	23
Net interest	(992)
Financing adjustment	527
Profit before tax	1,434
Tax	(53)
Deferred tax	(355)
Dividend payable to group	(1,464)
Deficit	(438)

Table 3

## PROJECTED AVERAGE ANNUAL CAPITAL EXPENDITURE 2000–05 BY COMPANY

Columns 1 and 2 are taken from Table 8 in the Ofwat report Future water and sewerage charges 2000–0 which “sets out for each company, the annual average capital expenditure allowed in its price limits, absolute terms and on a £ per property basis”. Column 3 gives the estimated average household bill for 2000–05 taken from figures set out in the same report. Column 4 is then derived from columns 3 and 4 to show, by company, the approximate percentage of the household bill that is attributable, as reported by Ofwat, to the financing of the capital investment programme.

	£M	£/property	h'hold bill	%/property
<b>Water and sewerage companies</b>				
Anglian	280	126	245	51
Welsh	222	167	264	63
North West	603	194	225	86
Northumbrian	146	125	196	64
Severn Trent	391	112	195	57
South West	145	213	312	68
Southern	217	140	238	59
Thames	435	99	181	55
Wessex	153	182	240	76
Yorkshire	291	139	209	67
<b>Water companies</b>				
B'm'th and W Hants	10	52	97	54
Bristol	25	52	102	51
Cambridge	4	31	84	37
Dee Valley	5	46	122	38
Essex and Suffolk	34	45	109	41
F'stone and Dover	6	80	120	67
Mid Kent	17	73	117	62
North Surrey	8	40	105	38
Portsmouth	10	33	76	43
South East	36	60	111	54
South Staffs	22	40	83	48
Sutton and E Surrey	13	49	101	49

	£M	£/property	h'hold bill	%/property
Tendring Hundred	3	46	130	35
Three Valleys	44	43	104	41
York	3	34	85	40

Table 4

SOUTH WEST WATER PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED  
31 MARCH 2003 (£ MILLION)

	2002-03	2001-02
Turnover	270.3	260.4
Operating costs*	(159.5)	(153.4)
Operating profit	110.8	107.0
Net interest payable	(44.4)	(40.2)
Profit before tax	66.4	66.8
Tax	(15.0)	(4.1)
Profit after tax	51.4	62.7
Dividends	(72.7)	(66.7)
Deficit	(21.3)	(4.0)

\* includes depreciation (see Table 5)

Table 5

SOUTH WEST WATER OPERATING COSTS FOR THE YEAR ENDED  
31 MARCH 2003 (£ MILLION)

	2002-03	2001-02
Manpower costs	26.8	28.8
Raw materials and consumables	9.4	9.7
Rentals and operating leases:		
Hire of plant and machinery	0.7	0.9
Other operating leases	1.3	1.2
Research and development expenditure	0.1	0.1
Auditors' remuneration	0.1	0.1
Other external charges	51.7	47.9
Depreciation:		
On owned non-infrastructure assets	31.6	30.2
On owned infrastructure assets	12.1	11.4
On assets held under finance leases	17.2	16.2
Provision for impairment of fixed asset investments	0.3	0.1
Profit on disposal of fixed assets	(0.5)	(0.8)
Deferred income released to profits	(1.2)	(1.2)
Other operating charges	9.9	8.7
Totals	159.5	153.4

Table 6

WATER AND SEWERAGE COMPANY REVENUES  
including dividends paid to parent companies and net debt

	Revenue (£M)	Dividend (£M)	Debt (%)	(£M)	Yrs
<b>Water and sewerage companies</b>					
Anglian	719.3	273.1	38%	3,307.5	4.6
Welsh	457.6	14.0	3%	2,006.1	4.4
Northumbrian	421.7	74.9	18%	1,358.5	3.2
Severn Trent	905.0	141.9	16%	2,174.7	2.3
South West	262.2	72.7	28%	869.3	0.3
Southern	431.1	68.0	16%	1,257.3	2.9
Thames	1,073.7	127.1	12%	2,260.5	2.1
North West	965.1	202.2	21%	2,487.4	2.6

	Revenue (£M)	Dividend (£M)	Debt (%)	(£M)	Yrs
Wessex	261.3	275.4	105%	1,028.4	3.9
Yorkshire	567.8	100.8	18%	1,170.5	2.0
<b>Water companies</b>					
B'm'th and W Hants	27.2	3.5	13%	22.3	0.8
Bristol	67.9	16.9	25%	74.8	1.1
Cambridge	14.5	2.3	16%	12.7	0.9
Dee Valley	16.2	1.2	7%	21.8	1.3
F'stone and Dover	13.1	2.3	18%	15.7	1.2
Mid Kent	36.8	29.7	81%	127.6	3.5
Portsmouth	29.5	7.0	24%	69.1	2.3
South East	88.6	12.1	14%	141.8	1.6
South Staffs	58.8	4.8	8%	96.3	1.6
Sutton and E Surrey	38.8	5.0	13%	53.3	1.4
Tendring Hundred	12.1	3.0	25%	10.5	0.9
Three Valleys	162.2	25.9	16%	185.6	1.1
<b>Industry totals</b>	<b>6,630.5</b>	<b>1,463.8</b>	<b>22%</b>	<b>18,751.7</b>	<b>2.8</b>

Details extracted from the Ofwat 2002–03 Report—Financial performance and expenditure of the water companies in England and Wales.

## APPENDIX 2

### Letter to the Chairman of the Committee from Mr Nick Reeves Executive Director, the Chartered Institution of Water and Environmental Management

The Chartered Institution of Water and Environmental Management (CIWEM) is the leading professional and qualifying body for those who are responsible for the stewardship of environmental assets. The Institution provides independent comment, within a multi-disciplinary framework, on the wide range of issues related to water and environmental management and sustainable development.

CIWEM welcomes this enquiry and we are pleased that the Committee has identified the threat of potential political interference in a process which had hitherto been agreed in the proper way between water companies, the relevant environmental bodies and Defra. The Institution shares the concern of the Committee that a necessary and appropriate environmental programme is threatened by political considerations.

Whilst emphasising the importance of delivering the proposed environmental programme, the Institution also understands that water should be affordable to all as it is essential to life. CIWEM considers, however, that the Government should assist those vulnerable groups who may have difficulty in paying their bills, and should not control overall prices of a resource which is if anything undervalued at the present time.

CIWEM is concerned that water continues to be recognised as an inexpensive necessity and considers that price rises are an unfortunate necessity to not only satisfy our environmental commitments but also to maintain assets at an acceptable level. This will require real investment and the true cost of delivering water services to a level which meets the requirements of European legislation as well as ensuring the long term sustainability of infrastructure must be recognised sooner rather than later.

It is essential that the implications of any constraints in financing the environmental programme are fully recognised and acknowledged against the requirements of the Water Framework Directive and other legislation. It is also important that the polluter pays principle is properly applied so as to minimise the financial implications of environmental improvements on customers and the general public, and deliver the right messages to those who damage the environment.

We hope that our comments are of use to you. Should you wish us to expand upon or clarify any points we have raised, please do not hesitate to contact us.

February 2004

---

**APPENDIX 3****Memorandum from Dieter Helm, New College, Oxford**

1. The periodic review of the water industry sets prices for the next five years. These prices should produce sufficient revenues to finance the functions of the water companies.

2. There are two ways in which the functions can be determined. The first, bottom-up, approach is to add up the costs of maintaining an appropriate service level, maintaining and renewing the assets, and incorporating environmental expenditure, arriving at the appropriate price level. The second, top-down, approach is to decide *ex ante* the politically acceptable and “affordable” price level, and work out what can be financed from this predetermined limit. There is considerable evidence to suggest that the second approach has, implicitly, conditioned the current periodic review, to the detriment of legitimate environmental concerns.

3. When the water industry was privatised, there was a division of regulatory responsibility between the National Rivers Authority (which was subsequently merged into the Environment Agency) and Ofwat. This division allocated the determination of the environmental quality standards and outputs to the environmental regulator, with Ofwat having the role of ensuring that these outputs were delivered efficiently, setting prices to enable the water companies to finance their functions.

4. At the last periodic review in 1999, the then water regulator questioned the value to customers of much of the environmental spending, and introduced a new concept—“affordability”. His primary focus was to get the industry “off the price escalator”, and in determining both a one-off cut in prices, and then a tight RPI—X price cap, he imposed a regime which reduced the market value of the industry to below its regulatory asset base (RAB), despite subsequent efficiency gains.

5. The 1999–2000 determination sowed the seeds for the difficulties subsequently experienced by the industry, and was a direct cause of the flight from equity. Had interest rates not fallen much further than anticipated between 2000 and 2004, a crisis may have materialised.

6. In approaching the 2004–05 review, both the Environment Agency and Ofwat set out to avoid the “mistakes” of 1999–2000 (even if these could not be publicly admitted). In particular, the Environment Agency greatly improved its approach to the environmental outputs by embarking on systematic cost–benefit analysis (CBA) of each part of the environmental programme which was beyond the statutory requirements (themselves largely determined by EU legislation). The “correct” environmental spending was that for which the benefits could be comfortably assumed to exceed the costs.

7. Although CBA techniques are subject to considerable uncertainty, and particular care needs to be applied in case studies, the Environment Agency’s work for the 2004–05 review has generally been of good quality and the assumptions made have generally been cautious. The schemes taken forward as a result have been those for which the benefits can be assumed to comfortably exceed the costs.

8. After a decade and a half in which such environmental costs could be roughly absorbed by efficiency gains, this is no longer the case, and the result of robust CBA has been to add to price increases which already incorporate substantial capital maintenance and reflect the fact that any further efficiency gains will be much harder to achieve.

9. The political and regulatory response has been to consider a sharp reduction in the environmental quality programme, to bring price increases closer to the RPI—0 to RPI + 2 boundary. This undermines the purpose of the Environment Agency’s CBA, and moves environmental spending from the rational grounds of the public interest to the purposes of shorter-term expediency.

10. This short-termism has been caused by a legitimate concern for the social consequences of rising water bills on the part of Ofwat and the government. However, the curbing of the environmental quality programme is not the right response; rather, there are at least three avenues which should be explored to reconcile the environmental and social objectives: to address the structure of water charges; to look for more efficient solutions to diffuse pollution by incentivising the water industry to address the agricultural causes; and to move away from the set-piece five-year, fixed-price periodic reviews. There are also adjustments to the financial arrangements which could further ameliorate the pressures for this review.

11. First, water charges present affordability problems for poor customers, which in turn create bad-debt problems for the companies. The existing system of charging is, in any event, widely acknowledged to be seriously flawed and outdated. Water charges affordability for the poor would be greatly ameliorated by a revision of the charging structure.

12. Second, a number of environmental schemes are of the “end-of-the-pipe” variety—responding to the diffuse pollution caused by agriculture. It would be more efficient—saving resources and improving environmental outcomes—to address the problem at source. Water companies could be incentivised to use their revenues to solve this problem directly, if Defra (which combines water and agricultural sectoral responsibility) and Ofwat were to develop an appropriate regulatory regime.

13. Third, the stark nature of the environmental/affordability trade-off is a product of the current five-year, fixed-price periodic reviews. This is a very crude regulatory approach, and it is far from obvious that the environmental quality issues should be tackled once every five years. A longer period and more flexibility would reduce the tensions, be more efficient, and help to depoliticise the water industry. A number of reforms are set out in Helm (2004).

14. In addition to the above major steps, the financial structure of the industry lends itself to reduced incentives for investment, and helps to explain why the industry has tended to side with Ofwat against the Environment Agency in the determination of environmental quality expenditure in this periodic review. By providing an *average* return across the (low-risk) RAB and the (more high-risk) capital expenditure, the companies are encouraged to exit from equity. As proposed in Helm (2003), a split cost of capital, with a lower RAB return and a higher capital expenditure return, would help to align the companies' incentives more closely with the economic and environmental investment requirements of water customers.

15. In conclusion:

- the environmental quality programme should, to a significant degree, be determined by its costs and benefits, through CBA;
- the EA has conducted CBA on its programme;
- affordability is not an appropriate criterion to determine the environmental quality programme;
- affordability is, however, important to the social dimension, and should be addressed through a thorough reform of the charging structure;
- the costs of tackling diffuse pollution would be lower if the source rather than the end-of-pipe solution were adopted, and an incentive regime for this purpose can and should be devised;
- the five-year, fixed-price approach to environmental quality spending should be abandoned in favour of a longer-term framework with flexibility;
- a split cost of capital will improve the financial incentives on the companies to invest and retain equity in the industry.

#### References

Helm, D. (2003), "Whither Water Regulation?", chapter 1 in D. Helm (ed), *Water, Sustainability and Regulation*, Oxford: OXERA, May, pp. 1–12.

Helm, D. (2004), "The New Regulatory Agenda", London: Social Market Foundation, January.  
*February 2004*

---

## APPENDIX 4

### Memorandum from the Drinking Water Inspectorate

#### INTRODUCTION

1. The Drinking Water Inspectorate is responsible for identifying requirements for drinking water quality, and for agreeing specific drinking water quality programmes of work with individual water companies, which are then funded through the Periodic Review 2004 (PR04) process.

2. For PR04, DWI objectives are to:

- meet current and future drinking water quality standards.
- facilitate the transition from large quality-driven programmes of work (the typical post-privatisation model) to a water company-driven strategic maintenance programme to achieve agreed minimum levels of service, using mechanisms such as Distribution Operation and Maintenance Strategies (DOMS) and the Capital Maintenance Planning Common Framework methodology.

#### KEY COMPONENTS OF THE DRINKING WATER QUALITY PROGRAMME

3. The main drivers for drinking water quality for PR04 are as follows:

- completion of the 20-year distribution mains improvement programme. This applies to mainly five companies whose renovation programmes will run through most of AMP4,
- improvements to water treatment facilities where necessary to meet current and future standards,
- programmes of strategic lead pipe replacement where necessary to meet revised lead standards, and

- improving the acceptability of water to consumers, by reducing consumer complaints of discoloured water, and addressing taste and odour issues.

To gain support from DWI, and thus inclusion in business plans, any scheme proposed by a water company has to demonstrate justification of need, and have a mechanism to demonstrate the benefits that accrue to consumers.

#### GUIDANCE GIVEN TO DATE ON THE SIZE AND SCOPE OF THE DRINKING WATER QUALITY PROGRAMME

4. The policies and priorities for drinking water quality for PR04 were set by the Secretary of State for Environment, Food and Rural Affairs in the documents “Directing the flow—Priorities for future water policy”, November 2002, and “Initial guidance from the Secretary of State to the Director-General of Water Services—2004 periodic review of water price limits”, January 2003. Further guidance is expected from the Secretary of State to inform the submission of final business plan proposals, and final determinations by the Director-General.

5. Regular guidance has also been issued by Ofwat on process matters.

6. To date DWI has issued a number of Information Letters<sup>1,2,3,4,5</sup> to companies, outlining expectations and requirements for PR04. This guidance is in the public domain. We have met with individual water companies throughout the process, as well as other Regulators and interested parties.

7. Water companies submitted their preliminary assessment of drinking water requirements in response to Information Letter 13/02. After an initial technical challenge by DWI, the costs were used to gauge the potential size of the drinking water quality programme and any areas of difficulty.

8. Water companies submitted detailed proposals for each individual scheme in June/July 2003 in response to Information Letter 4/03. DWI carried out a preliminary assessment of the schemes and issued Preliminary Opinion Letters (PoLs) setting out whether DWI was minded, or not, to provide technical support for the schemes to be included as quality programmes in water company draft business plans. PoLs were circulated to other stakeholders for comment. Detailed assessment and technical audit of these schemes is substantially complete, with a view to providing water companies with a Letter of Support (LoS), or otherwise, for them to include the schemes in their final business plan proposals to be submitted to Ofwat in April 2004. PoLs and LoS take account of Ministerial guidance on the quality programme, and will be confirmed, or otherwise, on issue of further Ministerial guidance. Customer consultation.

9. DWI was a contributor to the joint water industry research into customers’ views on water and sewerage services in England and Wales. Stage 1 was wide ranging, and among its main findings was a desire by customers for improvements in tap water taste and smell.

10. Stage 2 explored customers’ views on more localised water related issues and the impact this would have on their bills. Among the main findings were:

#### *Importance of maintaining services*

- A large majority of customers consider it either “important” or “very important” that the current service levels are maintained and not reduced. “Maintaining the quality and safety of drinking water” and “ensuring a reliable and continuous water supply” were given the highest levels of support nationally.

#### *Importance of improving services*

- The top two areas for improvement, without any additional costs, were “improving the appearance, taste and smell of tap water” and “drinking water quality/safety of tap water”.

#### *Appeal of individual elements of each plan*

- The area of service delivery in the plans most supported by customers nationally was “ensuring the safety of tap water”. “Managing the appearance, taste and smell of tap water” and “ensuring reliable and continuous water supply” were the next most supported service elements.

<sup>1</sup> IL 13/02—The 2004 Periodic Review of Prices and AMP4—Initial Guidance.

<sup>2</sup> IL 14/02—The 2004 Periodic Review of Prices and AMP4—Confirmation of Initial Guidance.

<sup>3</sup> IL 15/02—Distribution Operation & Maintenance Strategies—DWI Requirements and Expectations.

<sup>4</sup> IL 4/03—The 2004 Periodic Review of Prices and AMP4—Further Guidance.

<sup>5</sup> IL 5/03—The 2004 Periodic Review of Prices and AMP4—Appraisal Methodology for Water Company Proposals for Drinking Water Quality Improvement Schemes.

---

DRINKING WATER QUALITY ACHIEVEMENTS DELIVERED AS A RESULT OF THE PERIODIC REVIEW 1999 PROCESS

11. The drinking water quality programme determined by the PR99 process is currently being delivered by water companies. The main elements of this programme enable water companies to meet existing standards, the new standards in the Water Supply (Water Quality) Regulations 2000, and key improvements in meeting regulatory requirements for cryptosporidium. Substantial progress has been made to date, and we expect all schemes to be completed by 30 March 2005. Progress is monitored by DWI by means of regular information returns, and audits, and is reported annually.

February 2004

---

APPENDIX 5

**Letter to the Chairman of the Committee from Merlin Hyman, Director,  
the Environmental Industries Commission (EIC)**

Thank you for the opportunity to provide evidence to this inquiry.

1. THE ENVIRONMENTAL INDUSTRIES COMMISSION

EIC was launched in 1995 to give the UK's environmental technology and services industry a strong and effective voice with Government.

With over 240 Member companies, including over 80 supplying water pollution prevention and control equipment, EIC has grown to be the largest trade association in Europe for the environmental technology and services (ETS) industry. It enjoys the support of leading politicians from all three major parties, as well as industrialists, trade union leaders, environmentalists and academics.

2. WATER QUALITY IMPROVEMENTS

Recent years have seen good progress in improving water quality. The recent "River Water Quality Headline Indicator for Sustainable Development: 2002" showed that 75% of UK river lengths were of good chemical quality, and 25% were fair.

However this masks the huge challenge of achieving the standards of the Water Framework Directive (WFD) which sets a clear objective that they must all reach "good" status by 2015. Although "good" has not yet been defined it is clear that much of the 20% of UK watercourses currently rated as being of "fair" status will not meet the EU's "good" status.

Furthermore, according to the recent House of Commons Environment, Food and Rural Affairs Committee Report on the WFD, it is likely some rivers currently ranked as "good" will not meet the broader EU definition of "good". A very significant proportion of UK watercourses will, therefore, have to be improved by 2015.

The Government's current approach appears to be to leave implementation of measures towards the WFD standards until 2012 when the Directive requires the "programme of measures" is made operational. Consequently it appears that PR04 will include few if any measures specifically designed towards this massive task of meeting the requirements of the WFD.

If investment towards meeting the quality requirements of the WFD does not commence until 2012, as part of the PR05, it will be verging on impossible to meet the requirements of the Directive within just three years—without liberal uses of derogations. Furthermore, as the House of Commons inquiry made clear, a last gasp rush to achieve the requirements of the Directive is an economically inefficient approach, increasing the costs for industry, the water industry and consumers. This approach will also ensure that we use overseas technology to achieve the standards, rather than developing it in the UK and (also thereby creating export opportunities abroad).

Whilst we cannot be sure of exactly what investment will be required until the definition of "good" quality is finalised and the analysis to develop a programme of measures done, this must not be used as an excuse to do nothing—we have seen the results of this approach recently with the fridge debacle. We do know today where the key problems areas are and we can put in place measures now that will move us towards the WFD standards we are legally obliged to meet in a way that gives mainstream industry, the water companies and the environmental technology and services industry time to design and implement innovative and cost effective water quality solutions.

**The Environment Agency, English Nature and Countryside Council for Wales document "A Good Deal for Water" document sets out an environment programme that will address many of the problem areas in water quality. EIC considers that the full programme should be implemented under PR04.**

**EIC further considers that PR04 should include a review of where the main challenges in meeting the WFD requirements for good quality are likely to fall in order to ensure projects to move towards these requirements are funded under PR04.**

### 3. ECONOMIC BENEFITS OF HIGHER WATER QUALITY STANDARDS

Delivering environmental improvements will cost money—and therefore raise water bills. Although this may be significant in terms of the percentage increase in bills, the absolute increase in bills to pay for the environment programme under PR04 will still be small (estimated by the Environment Agency at, on average, no more than the cost of a can of fizzy drink for each household).

To be set against this are the huge economic benefits to England and Wales of cleaner water. These are estimated by the Environment Agency at £0.4 to £0.6 billion per year (totalling £5 to £8 billion). They include improving more than 6,500 km of river and 3,000 sq km of lakes and coastal water—unlocking opportunities for leisure and regeneration and improving the quality of life for everyone.

EIC considers that this assessment of the benefits is not complete and thereby underestimates these benefits. In particular it does not consider the opportunities created in the environmental technology and services industry by the environmental investment programme which will create a home market from which to export UK products and services in the global market for water pollution control projects.

And the export opportunities are huge—the Government’s report, “Global Environmental Markets and the UK Environmental Industry: Opportunities to 2010” (DTI/DEFRA Joint Environmental Markets Unit, 2002) reveals the value of the industry—the world market for water and waste water treatment services is currently US\$200 billion and is forecast to grow to US\$250 billion by 2010.

The PR04 environment programme could provide a strong home for UK waste water treatment companies from which they can develop to export to the growing world market for waste water treatment services. It is important the economic benefits to the UK waste water treatment sector are taken account of in calculating the net benefit of these measures.

### 4. TIMING OF ENVIRONMENT PROGRAMME

During past Periodic Reviews projects under the environment programme have been back-loaded toward the last three years of the five year period. For suppliers of technologies and services to the projects funded under the programme this creates extremely difficult working conditions. EIC Members have reported to EIC having to lay off a significant proportion of their staff for the first two years of the Periodic Review, only to have to recruit again for the last three years. This expensive process makes it difficult for UK companies to develop and maintain the expertise required to deliver improvements to water quality in the most efficient and cost-effective way—let alone to bring innovative products and services to market that will reduce the costs of these improvements.

**EIC, therefore, considers that the investment under the PR04 Environment Programme should be spread out much more evenly over the five year period than in previous Periodic Reviews.**

*February 2004*

---

## APPENDIX 6

### Memorandum from the National Consumer Council

1. The National Consumer Council is a Non Departmental Public Body independently championing the consumer interest to bring about change for the benefit of all consumers. We have a particular remit to promote the interests of disadvantaged consumers. NCC has a history of work on water policy dating back to water privatisation in 1991, and we campaigned for the price reductions that were delivered in the last price review. We have been active in the current price review, responding to Ofwat’s consultations, and the EFRA Committee inquiry on water pricing. Our chief concern has been the need to ensure that water bills are affordable for all consumers.

2. NCC is aware that this inquiry was stimulated by press reports about cuts to the quality programme to keep prices low. We are not in a position to offer detailed comment on the environmental programme. However, in our view simply ordering a reduction in the environmental improvement programme will not be in the interest of the environment or of consumers. Too often the need to invest in the water environment and developing sustainable water resources is portrayed as conflicting with the consumer interest in low water prices. It is, however, in the interest of current and future generations of consumers that water resources are developed and managed so as to be as sustainable as possible. In fact environmental improvements amount to £26 of the projected £90 water bill increases (offset by £18 efficiency savings), ie less than one third of the increase. Even if the programmes were cut dramatically, water bills are still set to rise beyond the rate of inflation. The focus on the costing on the environmental improvement programme both stifles debate on the value for money of other aspects of the expenditure programme, and fails to tackle

the impact that above inflation increases will have on consumers. Rather, the issue of affordability of water bills needs to be urgently addressed, alongside well-judged and well-costed environmental programmes. The debate highlights the inadequacy of arrangements and structures to balance social, environmental and economic factors in setting prices.

3. At present the investment programme seems to fall short of being well judged and well costed. Both the Environment Agency and environmental NGOs have judged that companies have costed environmental programmes too highly. Other aspects of the expenditure programme also come in for criticism—Ofwat has suggested for example that companies have supplied inadequate information for the projected £19 per customer rise in capital maintenance costs. During the 1990s industry had a persistent record of overestimating capital spending. We are extremely concerned that these patterns are not repeated. It would be a great shame if environment and other programmes were curtailed as unaffordable, where in fact they were merely ill costed. NCC has highlighted the complexity of the price setting process, which makes it difficult for those outside the industry to assess the merits of companies' plans. It is absolutely essential therefore that the regulator and Government subject company plans to close scrutiny and that all players make strenuous efforts to debate them in lay terms.

4. We would urge the Committee, in its conclusions, to consider how price setting can better contribute to sustainable development by improving the approach to environmental, social and economic assessment. NCC welcomes the introduction in the Water Act 2003 of a sustainable development duty on Ofwat, which will give priority to social and environmental objectives alongside economic goals. We are also pleased that Ofwat will have a new primary duty to protect the interests of consumers and a duty to have specific regard to the interests of consumers who are chronically sick or disabled, or pensionable age, with low incomes or living in rural areas. These duties will take effect in 2005, and so need to be reflected in the Price Review, which will set prices from 2005–10. For disadvantaged consumers in particular this means addressing the issue of affordability. At present however, there is little evidence of an approach that prioritises social, environmental and economic objectives equally. The initial guidance from the Secretary of State to Ofwat suggested that this price review should be characterised by due weight to the economic and social effect of policies, especially the impact of water bills on vulnerable customers. However in his 3 December advice to the Secretary of State the DG stated that any support for poorer households would be a matter for Government. There appears to be an urgent need for leadership on the issue of affordability, with a clarification of roles and responsibilities between Government, the regulator and industry.

5. Whilst affordability considerations are not included in this inquiry, we hope our evidence shows that they are relevant to a meaningful approach to sustainable development. Affordability is a problem for many consumers now, and price increases will only exacerbate the problem. If environmental and other programmes are to be adequately resourced, and the water industry adequately financed, customers need to be able to pay their bills. We therefore take this opportunity to outline the major problems of water affordability and some action to address them:

6. High levels of consumer debt to water companies, and the numbers of people who spend an unacceptable proportion of their income on water are evidence of a growing problem of unaffordable bills. This problem will only worsen if bills do indeed increase beyond inflation as is being suggested. Average household bills vary widely, as do proposed price increases. An average water and sewerage bill for South West Water in 2003–04 at £342 represents 12% of the income of a single person on Jobseeker's Allowance, and 6% of the income of a single pensioner receiving Minimum Income Guarantee. The proposed price rises will increase this proportion. In the North West, where bills are currently not at the extreme, the proposed 70% increase over five years would mean a single person on current levels of Jobseeker's Allowance would be spending a massive 15% of their income on the average water bill. DEFRA's own sustainable development indicator affordability measure is 3% income threshold. DEFRA estimated that in 1997–98, 18% of households, some 4.3 million spent more than this 3% threshold. These figures exemplify the substantial numbers of water customers who struggle to pay their water bill. Indebted customers typically have the water bill as one unpaid bill among many, and juggle which bill to pay next. In our opinion, a major cause of this indebtedness is that many consumers are spending an unsustainable proportion of their income on water and simply cannot afford it. Also consumers are given insufficient opportunities to manage their payments in a way that suits their budgeting requirements.

7. Current provision for tackling these affordability problems is almost non-existent. Income support has not kept pace with rising water bills. The Vulnerable Groups regulations give very limited support. They are designed only to cap the bills of metered customers who for reasons of ill health or family size use a disproportionate amount of water. The scheme has been a failure with latest figures showing only a 1.4% take up amongst eligible customers. The scheme also cost more to administer than is paid out to customers. The solution to the affordability problem will go far beyond the current review of the Vulnerable Groups Regulations, and requires coordinated Government, regulator and industry action. We would like to see Ofwat, industry and Government place far more emphasis on affordability as a factor in price setting. This will mean re-examining charging for water, the benefits system, tariff packages for vulnerable consumers, and payment methods.

## APPENDIX 7

## Memorandum from Dr Neil Summerton, CB

1. I am an independent non-executive director of both Three Valleys Water and Folkestone and Dover Water Services, both of which are subsidiaries of Veolia Water UK. In 1991–97 I was Director Water, and then Water and Land, in the Department of the Environment. In 1997–2002 I was Director of the Oxford Centre for the Environment, Ethics and Society at Mansfield College Oxford and Director of the Oxford Centre for Water Research. I was a specialist adviser to the Environmental Audit Committee’s inquiry into Water Prices and the Environment in Session 1999–2000.

2. I submitted evidence to the Environment, Food and Rural Affairs Committee’s inquiry into Water Pricing (First Report, Session 2003–04). Paragraphs 21–31 are relevant to the Environmental Audit Committee’s present inquiry and they are annexed.

## KEY VARIABLES FOR PRICE LEVELS

3. The Committee’s announcement of its inquiry refers to the balance that needs to be struck between the size of the environmental programme and price increases to customers, and the proposal. To my mind, this is to put the matter too simply. There is a number of interacting variables which have to be taken into account in deciding the appropriate level of water prices (bearing in mind the important statutory constraint that the regulator must ensure that water companies properly carry out their functions and must ensure that the companies have the necessary revenue to enable them to do so (s. 2 of the Water Industry Act 1991)). The main ones are:

- (a) new investment to **protect and improve**
  - (i) the **quality of drinking water**
  - (ii) the **environment** (whether from upstream risks of over-abstraction or from downstream risks of pollution)

This new investment can result from the requirements of European law or of domestic law. The scope for discretion in respect of the former tends to be limited. The extent to which the latter is discretionary depends very much on the structure of the particular legislation, in particular the degree of discretion allowed to the Environment Agency and other regulatory bodies concerned, and to sewerage companies in so far as statutory duties may bear directly upon them.

- (b) The cost of **maintaining and improving standards of service** (these cover a wide range of matters such as meeting growing demand against the background of the effects of climate change, customer care, water pressure, sewer flooding, containing and reducing leakage, and so on). Statutory regulators judge and penalise water companies on these matters.
- (c) capital and operational **expenditure to maintain networks and plant**. System assets are crucial to effective water and sewerage services which are highly capital intensive. These assets have been acquired over two centuries with important spurts at various points in the 20th century. Their lives vary with the nature of the asset and the character and quality of the original provision. They can also vary with the changing environment of the network, eg, with changing ground conditions over time and, where pipes are laid under the highway, with increasing traffic volumes and axle weights. Generally water networks have long lives, but they do not last for ever. Refurbishment and/or replacement is necessary, as with the capital equipment of other industries (which almost always have much shorter replacement cycles than is the case with water). If refurbishment and replacement are not done in a timely way, even with such long-lived assets, the result will be deteriorating standards of service for customers and/or greater operational costs to be borne by customers in order to try to maintain a given standard of service.
- (d) The **scope for efficiency savings** on the part of companies. There is an increasing recognition that the high rate of efficiency savings achieved in the 15 years since privatisation cannot be sustained into the future, though some will still be possible. A once-for-all price cut was possible in 2000 as a result of efficiency savings since 1989, but it is not likely to be repeatable.
- (e) The **cost of capital**, that is, the price that must be paid in the capital markets in competition with other demands for capital, to obtain the capital needed by the companies, whether by way of equity money or loans. Clearly, customers should not be burdened with a higher cost of capital than is necessary to obtain the capital that is needed. Any regulated sector is susceptible to what is seen by investors as “regulatory risk”. In this case if the regulator depresses the allowed cost too far in his price determinations, the capital markets may be discouraged from investing in the sector. As Dr Dieter Helm told the Environment, Food and Rural Affairs Committee last October the cost of capital allowed in 2000 “induced a significant flight-from-equity” (House of Commons Environment, Food and Rural Affairs Committee, *Water Pricing*, First Report of Session 2003–04, Ev. 83, para. 12).

4. At different stages in the Periodic Review, attention tends to shift between these variables. At present, the focus is on the level of new investment for quality purposes, since the government must make what are quite rightly political decisions about the level of new investment which the regulator must take into account

in reaching his price determination. But it should not be forgotten that, for any given level of prices, the variables are interactive. The regulator has a statutory duty to enable each company to finance its functions. Statutorily speaking, whether customers can afford the outcome does not come into the matter. Politically and practically, of course, affordability does matter, particularly as the protections hitherto afforded to poorer customers are gradually eroded.

#### SCALE OF NEW INVESTMENT

5. At this stage, the scale of new investment required is critical. It has to be considered in the light of the implications for price levels *and for the other key variables*. The decisions must bear in mind the possibility that, in the interests of keeping price levels down, the regulator will be forced to make unrealistic decisions about efficiency savings and the cost of capital, and forced to cut back, yet again, on the necessary maintenance and replacement of assets. The decision on new quality investment is not easy, of course, precisely because of the extent to which it is statutorily required. This is not a new phenomenon in Periodic Reviews. Nor is this a question of demonising quality investment (see recommendation (b) of the Committee's report of November 2000). It is to recognise that the matter should not be considered in isolation.

#### MAINTENANCE AND REPLACEMENT OF ASSETS

6. The point about maintenance and replacement of assets should be of particular concern to the Committee. In November 2000 the Committee was particularly critical (recommendation (l)) of the way in which the matter was treated in the 2000 Periodic Review and it recommended a collaborative approach between those concerned, to deal with the "intellectual neglect of this important problem". The approach was to be "forward looking and should enable the companies to adequately prepare to renew and repair the cohorts of sewers and mains which will come up for renewal/rehabilitation . . ." The regulators and the companies have worked together closely to implement that recommendation and I believe that it is accepted that, in general, estimates of future requirements are better founded than in the past. It would be a pity if decisions on other matters were again to result in neglect of replacement and to frustrate the benefits of the Committee's earlier recommendations on this topic.

7. More generally, the needs of clean water supply should not be crowded out by pressure from the wastewater side.

*February 2004*

**Annex**

#### **Extract from evidence to the Environment, Food and Rural Affairs Committee, October 2003**

##### *(a) Reasons for price increases*

21. The main reason for rising prices in real terms since 1989 has been the cost of investment to raise standards of performance in a number of ways:

- Improvements in drinking water quality, in particular investment to deal with nitrates, pesticides, lead and parasites such as cryptosporidium. This investment has been necessary to enable regulatory standards to be met. This has also entailed extra operating costs.
- The costs of protecting the environment in two ways:
  - Dealing with the effects of abstractions, including improving flow in low-flow rivers and protecting and enhancing wetland habitats
  - Reducing environmental impacts of sewage discharge and sludges. Here, a very wide range of regulatory requirements have had to be met, ranging from the bathing waters directive, the freshwater fish and shellfish waters directives, and the urban wastewater treatment directive. These requirements have been exceptionally heavy.
  - Costs of raising quality of service in a variety of ways—nothing equivalent to levels of service requirements existed under the previous nationalised regime.

#### PROSPECTS FOR THE 2005 REVIEW

22. At privatisation, there was a tendency to regard extra investment as a hump that could be surmounted within a decade or so. Thereafter, it was expected, cost pressure would reduce, allowing water prices to fall back to a pattern of RPI—X rather than the RPI + X needed in the first phase. It is already clear however that this happy position will not be achieved in the next review.

*(a) Continuing cost pressures*

23. There continues to be a wide variety of pressures requiring further new investment, pressures which will also result in new operating costs. Among the more important are:

- Achieving the requirements of existing EU directives.
- The Water Framework Directive.
- Protection of SSSIs and other EU and domestic environmental areas.
- Climate change and water scarcity, coupled with rising demand from domestic users.
- Leakage control.
- Ending sewer flooding.
- Eliminating lead from drinking water.
- The requirements of the Security and Emergency Measures Directive.

Beyond this, is the risk of newly-perceived health threats resulting from water re-use. There is also a variety of other variables over which neither the industry nor regulators have any control, such as levels of business rates after the next revaluation, tax and NI changes, the prospect of statutory lane rental charges for works in the highway, abstraction charges, pensions costs, energy costs, general insurance costs, and so on.

*(b) Replacement and renewal*

24. Additionally, replacement and renewal cannot continue to be neglected. Water companies have to invest in replacing underground networks and above ground plant. At replacement cost, the total value of water assets now exceeds £204 billion. While the life of some categories of this investment is long, it does not and cannot last for ever. That provided in former generations varied in quality through time and geographically. Some old networks need surprisingly little maintenance; others do not last as long or otherwise need replacement in order to provide a good standard of service and reduce maintenance costs. In general, above ground plant needs replacement more frequently than networks.

25. Adequate levels of replacement are essential if customers of the future are to receive good service. Assets worth over £200 billion presuppose an annual replacement cost in excess of the current peak rate of £1.7 billion, if an appropriate spread of asset lives is assumed. As noted by the Environmental Audit Committee in 2000, there was a tendency in earlier reviews for OFWAT to neglect this aspect of investment. Since 1999 there have been improvements in the system for identifying these needs. It is important that regulators should recognise the implications for investment levels.

*(c) Implications for prices*

26. These investment requirements are not well understood by the public. Nor is it appreciated that, while there is no charge for water as a raw material, the costs of networks and treatment plants and operating them are inevitably substantial. Price pressures derive from the extra costs of the service rather than from profits per se, though the costs of capital must be met (as they would have to be met in a publicly-funded service).

27. Many of the price pressures are on the wastewater side. What is of particular concern to water suppliers is the possible temptation to achieve environmental improvement at the expense of investment in water supply, and replacement and renewal generally—that the needs of the clean water sector will be crowded out by the wastewater side. The regulator must discharge his statutory duty company by company and he must guard against the possibility of successful appeal to the Competition Commission if he were to allow the needs of the wastewater side to cloud his judgment about those of water suppliers. But it is possible to contain pressures by taking a narrow view of the functions of water suppliers.

## FINANCIAL AND EFFICIENCY VARIABLES

28. Prices also depend on assumptions about a number of financial and other variables. Here again there are limits to the regulator's room for manoeuvre.

29. First, the economic regulator has statutory duties which cannot be ignored and have implications of price levels:

- To ensure that water companies carry out their functions; there is little room for manoeuvre to manipulate interpretations of those functions.
- To ensure that these functions can be financed, particularly but not exclusively as regards the cost of capital. This is determined by the markets. If efforts are made to squeeze margins below the level that the markets deem acceptable, they will react accordingly. This is in essence what happened following the 1999 price determination.

30. Since 1999 there has been extensive revision of the financial structure of companies, increasing levels of debt finance and reducing equity. To some extent, this has been in the longer-term interests of customers, that is, if the level of equity exceeded that necessary for entities with the risk-profile of water companies. However, the result of squeezing returns may have been to cause a reduction of equity beyond the level that is wise. Equity capital in water companies represents a buffer which protects customers from unforeseen or miscalculated risks. If equity has been reduced to below the “right” level, risks will have been increased for customers. These considerations need to be borne very carefully in mind in the present price review, especially in considering the temptation to keep down prices by manipulating financial variables in the face of unavoidable investment pressures.

31. A further variable which may be prayed in aid to keep prices down in the face of other pressures is assumptions on the efficiency gains which companies can be expected to make in the next price period. Insofar as private companies can be expected to be more efficient than nationalised companies (or than the former statutory private companies), the period since 1989 ought to have been sufficient to enable the implicit step change to have been completed. Henceforth, it is questionable whether water companies can make greater efficiency gains than private sector companies generally. In this context, two points need to be borne in mind:

- The RPI subsumes the underlying rate of efficiency gains across the economy as a whole. If there was no extra investment and prices were restricted to the increase in the RPI, companies would need to achieve at least the average efficiency gain across the economy as a whole. The RPI—X formula therefore requires regulated companies to achieve an additional efficiency gain over and above the underlying average.
- As in the case of any company, water companies have costs that they can control and costs (like tax, rates and so on) which they cannot control or even influence. The ratio of controllable to uncontrollable costs is roughly 80:20. Efficiency gains must be concentrated in the area of controllable costs. This means that if the regulator’s efficiency assumption is 4% overall, water companies must actually achieve a gain of 5% on controllable costs. This point is of significance if the level of uncontrollable costs is comparatively high compared with the activities which the regulator uses as the benchmark.

32. All this emphasises the need for the Committee to be realistic both about the cost pressures on the industry and the extent to which there is freedom nevertheless to hold down prices in the face of these pressures.

---

## APPENDIX 8

### Memorandum from the Public Utilities Access Forum

#### SUSTAINABLE DEVELOPMENT, THE ENVIRONMENTAL PROGRAMME, AND THE AFFORDABILITY OF WATER

Founded in 1989, the Public Utilities Access Forum (PUAF) is an informal association of organisations that helps to develop policy on the regulation of the public utilities providing electricity, gas, communications and water services in England and Wales. PUAF facilitates the exchange of information and opinions between bodies concerned with the provision of those utilities to consumers with low incomes or special service needs, such as the elderly and people with mental and physical disabilities. It draws the particular problems of such consumers to the attention of the industries, the regulators and other relevant bodies, promoting the adoption of policies and practices that cater for their needs, exchanging information about service provision and promoting research.

#### SUMMARY

The difficulty that a significant number of householders face over paying for water is long-standing. Because of increasing charges and burgeoning water debt this difficulty is now coming to the fore and requires reconciliation with the water industry’s rightly ambitious but costly environmental programme. Our institutional and procedural arrangements for managing this reconciliation—for “doing sustainable development”—are unsatisfactory. In addition to recommendations the Committee may wish to make to deal with the difficulty encountered in the present Periodic Review, we invite the Committee to consider recommending that Ministers establish procedures for securing sustainable development in a routine and considered fashion. We draw attention to some measures that might in the longer term be available to remove the affordability obstacle to achieving environmental protection.

## EVIDENCE

1. In submitting evidence to the Environment, Food and Rural Affairs Select Committee enquiry into water pricing, the Public Utilities Access Forum concluded that between two and four million householders in England and Wales could not afford their water charges, that no effective measures were in place to assist them, and that the increases in charges anticipated as a consequence of the Periodic Review would significantly worsen their water poverty.

2. Noting your Committee's concern that the environmental programme should not fall victim to inappropriate considerations, we would think it unfortunate if the present stage of the Periodic Review were to be seen as a contest between environmental and social objectives. We take it as axiomatic that the "three pillars" of the Government's sustainable development strategy—economic, social, and environmental—have to be accommodated together for our water services to be sustainable.

3. Our institutional arrangements for achieving sustainable development are underdeveloped and we illustrate this in the diagram below. The upshot is that we presently lack the facility to settle the current impasse in the Periodic Review in a satisfactory way—it looks set to be the kind of contest we deplore. The arrangement in which Defra, the Department with *environmental* responsibility, has lead responsibility for sustainable development cannot be considered satisfactory. As well as being effectively leaderless, the sustainable development enterprise has no institution that it can look to to champion social protection, in the way that Defra and other bodies represent environmental concerns and Ofwat carries the torch for economic considerations. There is the no place at the table for social protection—in fact, there is no table either!

THE ABSENCE OF INSTITUTIONAL REPRESENTATION FOR THE SOCIAL DIMENSION IN SUSTAINABLE DEVELOPMENT

Economic	Environmental	Social
	Defra	
	Environment Agency	
Ofwat	Drinking Water Inspectorate	
	English Nature Countryside Council for Wales	?

4. Anxiety about the affordability of water that the Environment, Food and Rural Affairs Select Committee has expressed has taken the Periodic Review by surprise because the industry regulator has over the years steadfastly declined to be drawn in any meaningful way into social protection concerns, and in addition, because Government, in moving—correctly—to abolish disconnection for non-payment of charges, failed simultaneously to address the question of the affordability of charges. Dedicated provision for water charges in the social security benefit that preceded income support has been discontinued, and the water charges capping arrangement known as the Vulnerable Groups Regulations has been blighted by the double weakness of being far too narrowly drawn and by a virtually total failure of take up. In consequence, so far as the water sector is concerned, sustainable development has neglected the social dimension and has limited itself to dealing with environmental sustainability—still indeed a common understanding of "sustainable development".

5. A key device that is in theory available to ministers is the opportunity afforded by the 1999 Water Industry Act to offer guidance to the regulator on approval of company charging schemes. Prior to the implementation of new charges in April 2000, the Government set out its concerns, stressing fairness and affordability, and dwelling on the burden that water charges were to low-income consumers. The Government emphasised its enthusiasm for "social tariffs". Yet once again, the regulator proved unwilling to countenance social considerations in his economic regulation of the industry, and the initiative failed.

6. In the present review, the neglect of social protection is apparent in the Secretary of State's Initial Guidance to the Director General of Water Services. The Secretary's claim runs, "The Government's policies for the water industry embody the principles of sustainable development, covering economic, environmental and social aspects" (introduction). But whereas "The water environment" gets a section to itself, social protection creeps in anonymously in a sweep-up section at the end, perhaps as "Water charging", trailing along after "Sewer flooding", "Odour and nuisance", and other matters. The sub-section about water charging starts off boldly enough: "Policies affecting water price limits must take account of the need for essential water services to be affordable" (7.7.1.). But the critical issue in affordability is non-payment, and this is addressed as follows in the sub-sub-section "Customer debt" (7.7.10.):

The Government believes that customers should pay their water charges and that companies are entitled to recover those charges. The Government will consider ideas from Ofwat or the water industry for changes to help achieve this. However, the Government remains committed to the view that no-one should be deprived of water services in their home essential to their life and health because of an inability to pay.

The proposition this amounts to is as follows:

Your water will not be cut off because you can't afford your bill; however, we think you ought to pay and we will consider together with the regulator and industry ways of making you pay.

This is the stuff of satire and cannot be expected to encourage the regulator to enter the field of social protection.

7. Difficulties over affordability are not new. In a report *Paying for Quality*, published a decade ago, the then water regulator examined the affordability of water services to low income consumers amidst anxiety about the cost impact of new obligations contained in EC Directives. For householders residing in areas with high water charges the forecasts for income support claimants were for burdens approaching 10% of income for single parents and 14% for pensioners. The surfacing of the long-standing issue of affordability at the present time may be attributable to its emergence as concern about debt following the abolition of disconnection for non-payment.

8. There are basically two approaches to affordability questions. One is to continue the Ofwat declared policy of cost-reflective charging, “. . . a customer's bill should, in general terms, reflect the costs which that customer imposes on the water and sewerage systems . . .”, and then devise schemes of income support or tariff adjustment to deal with affordability. The other basic approach is to meet affordability head-on and treat the water industry as better suited to some variant of tax revenue funding. We presently have the relic of the latter approach in the three-quarters of English and Welsh householders who pay by the rateable value link to a now redundant arrangement for local taxation. Elsewhere in the UK, Northern Ireland has for the moment wholly tax-based industry funding; Scotland links charges with householders' council tax valuation. For different reasons in those two countries the arrangements are currently the subject of review and dissatisfaction respectively. With the burden of water charges in England and Wales in relation to income of some consumers already exceeding the average charge in relation to income by a factor of ten or more, the Committee may wish to recommend that Government consider whether it remains desirable—as hitherto since English and Welsh water privatisation—to rely so fully on the cost-reflective approach to funding the industry. The question is undoubtedly complex, but the array of available “levers” to satisfy the requirements of sustainable development is large. One such, which is emerging at the present time, is the Office of the Deputy Prime Minister's review of local government funding. A re-casting of the tax base for local government funding may offer a full or partial answer to a search for a water industry funding arrangement that is affordable for householders, and the Committee may wish to consider whether the ODPM review might usefully include that consideration.

9. Witnesses to the EFRA Select Committee's enquiry into water pricing mused about the possibility of the cost of environmental obligations being met out of general taxation, and the collective nature of the benefits of environmental protection gives this suggestion force. We are aware that the supporters of cost-reflective charging consider full cost recovery desirable. Nevertheless, it is our understanding that Article 9 of the Water Framework Directive (Recovery of costs for water services) is not inflexible, and if it agrees that the limits of cost reflective charging for water have now been reached, relaxation of the full cost recovery principle may be something the Committee would wish to consider.

*February 2004*

---

## APPENDIX 9

### Memorandum from Mr Sean Creighton

#### THE THREAT OF WATER PRICE RISES FROM APRIL 2005

##### INTRODUCTION

1. I am submitting this memorandum as an individual, drawing on my experience with water and environmental issues derived from my work as an administrative, development, project and research worker for a range of voluntary organisations over the years, including Secretary of Public Utilities Access Forum (1991–2000), individual member of the Forum since 2000, and organiser of the Towards a Water Saving Trust Conference in 1997.

2. I welcome the inquiry because it provides an opportunity for a considered view about what “sustainability” means in the context of water customers paying for environmental improvements through their charges, rather than those improvements being paid for out of taxation or investment borrowing.

3. In this submission I raise issues about affordability, the sewerage system, water conservation and water resources strategies. On the issue of affordability and sewerage system costs my written evidence to the House of Commons Committee on Environmental, Food and Rural Affairs inquiry into Water Pricing is relevant (published in its report).

---

## SUSTAINABLE DEVELOPMENT

4. “Sustainable development” is supposed to be about meeting three objectives at the same time:
  - social progress which recognises the needs of everyone;
  - effective protection of the environment, and;
  - prudent use of natural resources.
5. Its guiding principles and approaches are:
  - Putting people at the centre.
  - Taking a long term perspective.
  - Taking account of costs and benefits.
  - Creating an open and supportive economic system.
  - Combating poverty and social exclusion.
  - Respecting environmental limits.
  - The precautionary principle.
  - Using scientific knowledge.
  - Transparency, information participation and access to justice.
  - Making the polluter pay.

6. In its November 2000 report “Water Prices and the Environment” the Committee considered that the 1999 Periodic Review provided “a satisfactory outcome for the environment but there is no room for complacency as we face new, future quality obligations and uncertain water resource constraints.” (Paragraph 142) However, at the same time it recommended that “the Director General of Ofwat should be directly accountable for ensuring that Ofwat makes a positive contribution to the Government’s sustainability agenda.” (Para 220). Ofwat’s reluctance to robustly address the “affordability” of water charges issue suggests its failure to understand what “sustainability is about”.

## AFFORDABILITY

7. From April 2005 it is anticipated that water charges will increase substantially as a result of the current Periodic Review of Water Charging by the regulator Ofwat. The House of Commons Environment, Food and Rural Affairs Committee report on Water Pricing (December 2003) has already expressed concern about “affordability”. The Public Utilities Access Forum is addressing aspects of this issue in its submission to the Environmental Audit Committee. In terms of the principles and approaches to “sustainable development” price increases that increase the cost of water, water poverty, and increase the stress in the financial management of people’s lives, cannot be consistent with the “putting people at the centre” and “combating poverty and social exclusion” aspects of sustainable development.

8. The issue of “affordability” is therefore central to the issue of finding a “sustainable development” solution to how to fund environmental improvements.

## SEWERAGE SYSTEM

9. In its 2000 report the Environmental Audit Committee said that it was not satisfied “that Ofwat’s “no deterioration” approach to the maintenance and renewal of underground assets (sewers and water mains) is a logical or acceptable means of assessing the amount of investment which water companies need to meet these requirements. The Committee believes that this approach has amounted to intellectual neglect of this important problem.” (Paragraph 208) The public concern expressed a few months ago about the state of the sewerage system suggests that there has been no substantial improvement.

10. In my evidence to the House of Commons Environment, Food and Rural Affairs Committee I expressed concern that the failure to adequately maintain the sewerage system could aggravate environmental pollution. I suggested that there does not appear to be adequate information in the public arena about the age, maintenance state of the system, and the projected cost of modernising it, and the resultant effect on price rises and affordability. The Committee did not address the issue.

## WATER CONSERVATION

11. In its 2000 report the Environmental Audit Committee expressed the view that “companies do not have sufficient incentives to promote water efficiency and that there would be merit in investigating the feasibility of setting company-specific targets for domestic water use, once a robust methodology for efficiency measurement has been agreed.” (Paragraph 225)

12. Metering is seen by Ofwat, the Environment Agency and the Government as a major instrument to encourage people to reduce water consumption. The Public Utilities Access Forum challenged this approach in its evidence to the House of Commons Environment Committee Water Conservation & Supply Inquiry

in 1996 (Minutes of Evidence and Appendices p 80–95). It argued that it was not cost-effective, was unlikely to achieve major reductions in water usage without risk to public health, and that an alternative approach should be a comprehensive programme to detect and repair leaks, and measures to encourage the fitting of more water efficient equipment.

13. In its 2000 report the Environmental Audit Committee accepted that “As metering becomes more widespread, there will be an increasing price incentive to be water-efficient and clear pricing signals will be needed. (Paragraph 128) For many low income households and those requiring high water usage, because they have children or special medical needs, the price signal can be a reduction in water consumption to lower than is needed to maintain personal health, and to enable children’s water play. This will be especially true for those renting water inefficient homes and whose income level prevents them buying the most water efficient equipment.

14. The House of Commons Environment Committee Water Conservation & Supply Inquiry in 1996 Committee concluded:

“Whilst a case may exist for metering water on conservation grounds, there are clearly others issues to be considered and it is far from proven that it is either a cost-effective or an equitable way to reduce demand. A combination of other measures, if pursued imaginatively and energetically, will suffice to reduce demand to levels which, with good management and proper regulation, water companies should be able to meet in the foreseeable future.” (paragraph 164)

15. In June 1997 the Public Utilities Access Forum published a research report by John Thackray, a water industry expert who had been an adviser to the Environment Committee Water Conservation & Supply Inquiry in 1966. The research was funded by Joseph Rowntree Foundation as “Paying for household water services”, a summary of which is still on the Foundation website: [www.jrf.org.uk](http://www.jrf.org.uk).

16. Thackray reviewed the problems with the then (and continuing) rateable value based element of water charging, and reviewed potential charging options. He concluded:

- “Water-metering is not an economically viable alternative. Only one in 10 homes are fitted with meters and no more than 50% are forecast to be metered by the middle of the next century.”
- “Existing metered tariffs discriminate against low-income households who need above average amounts of domestic water, including those with young children or older people with incontinence problems or other disabilities requiring intensive water-use.”

17. The economic and sustainability case for metering is still unproven. The recently published research referred to in the February 2004 issue of the Environment Agency’s *Demand Management Bulletin* in an item headed “Impact of metering explained” suggests that the average effect of metering on consumption is about 9% (variation 2–14%) depending on the volumetric charge; savings are predicted to be c.2% a month relative to what households used when unmeasured. The study used information through consumption meters from 6,611 households July 1996 to December 2001. It is almost impossible for interested individuals like myself and small organisations to assess the validity of this study given that it costs £200 to purchase. Any evidence submitted to the Committee based on the study will need to be subject to robust analysis so that Committee members may make considered judgements as to whether it provides the basis that justifies the continued emphasis on metering.

18. The same issue of *Demand Management Bulletin* reports a growing lobby for using the powers to compulsorily meter areas because of water scarcity. Folkestone & Dover Water propose to apply for “water scarcity status” by 2009, while the Environment Agency suggests the company should do it earlier. In its “Security of Supply, Leakage and the Efficient Use of Water 2003–2003” Report Ofwat says that “water scarce area status should be given serious consideration”.

19. Notwithstanding short-term savings from metering, the population in the South East will continue to grow and pricing mechanisms cannot drive down consumption inexorably, particularly since households will buy more water as their incomes rise and they take advantage of efficiency savings. So metering therefore cannot be a substitute for developing more water resources.

20. Could it be that Folkestone & Dover has been failing to adequately develop new water resources? Or could it be that the small water only companies are no longer viable to manage their resource needs, and should be absorbed into the neighbouring areas controlled by water and sewerage companies which have the capacity to move water resources around their wider area and spread the costs of developing new water resources across a wider customer base thereby keeping prices down.

#### WATER RESOURCE STRATEGIES

21. Back in December 1996 the House of Commons Environment Committee recommended that:

“If increasing demands for water are to be managed and the environment and existing users protected, it is essential that a long-term strategy for water resources is in place.” (paragraph 319)

22. It suggested that such a strategy must address, “both on a national and regional basis for each water company area:

- what are the present demands for water

- what is the amount of water available to meet these demands
- what would be the future demand for water
- an identification of all the options available to meet the future demands for water (from demand management to new resource development, with the emphasis on the former)
- a strategic environmental assessment to be undertaken of all the options identified above to manage future demands.”

23. Given the relatively new announcements about house building targets, especially in the South-East, it is doubtful that there are up-to-date strategies. Their creation should be central to the last phase of the Periodic Review process and made available for public debate.

#### CONCLUSION

24. At the heart of the Water Pricing review are the concerns about the provision of water as a basic need, and about what environmental improvements are needed and how they should be paid for. At the moment it seems as if the solutions to these concerns are being driven by virtually unaccountable Regulatory agencies and commercial companies without taking into account serious alternative approaches. The likely outcome on current evidence is that the solutions will not be genuinely sustainable. In a context of rising energy prices, and concerns about the future levels of Council Tax increases, rising water charges that contribute to greater affordability problems, and which do not provide visible basic system improvements and environmental benefits, will fuel public discontent. The Committee’s inquiry may be the last opportunity to argue that real “sustainable development” principles should be applied in the final stages of the Periodic Review process.

*February 2004*

---

## APPENDIX 10

### Memorandum from WaterVoice

WaterVoice has statutory duties to represent the interests of customers of the water and sewerage companies in England and Wales. WaterVoice operates through nine regional committees in England and a committee for Wales.

The 10 committee chairmen form the national WaterVoice Council. The WaterVoice Council and its sub-groups deal with issues at national and European level.

#### BACKGROUND

1. In November 2004, Ofwat will set water companies’ price limits for the five years from 1 April 2005. This will be the third price review conducted by Ofwat since the water industry in England and Wales was privatised in 1989.

2. Ofwat is conducting the 2004 review in an open and transparent manner. This is exemplified by the consultation process it has adopted and by the approach taken to market research where the key stakeholders, including WaterVoice and Ofwat, have worked together to commission research into customers’ views. The first stage of that research was published in August 2002<sup>1</sup> with the second stage published in December 2003<sup>2</sup>.

3. WaterVoice benefits from a close working relationship with Ofwat. We have also developed positive working relationships with DEFRA, the Drinking Water Inspectorate, the Environment Agency, English Nature and Water UK meeting with them and sharing information. For our part we have published a series of briefing notes at key stages of the price review to keep customers informed of the main issues.

#### WATER COMPANIES’ PROPOSALS FOR 2005–10

4. In August 2003 water companies submitted their draft business plans to Ofwat. Of the £19.9 billion capital programme outlined in the companies’ preferred strategies the main drivers are:

Environmental improvements	£4.6 billion
Drinking water quality	£2.3 billion
Asset maintenance	
—sewerage	£4.5 billion
—water	4.5 billion
Security of supply	£2.8 billion
Service improvements (including sewer flooding)	£1.2 billion

5. We suspect that several companies may have overstated both the need for additional environmental schemes and its associated expenditure, and may have done the same on the drinking water quality

programme. However, we are also aware of some omissions. Most companies have not included the costs of compliance with new designations under the Freshwater Fish Directive within their business plans. DEFRA has estimated the water industry's share of the cost of compliance at £800 million over the five years to 2010<sup>3</sup>. Furthermore, the prospect of designation of the North Sea, North East Irish Sea and the Solent, among other water bodies, as sensitive waters under the Urban Waste Water Treatment Directive has the potential of at least doubling the proposed environment programme.

6. In their draft business plans companies proposed:

- an average 31% real terms increase in the average household bill, taking it from £234 in 2004–05 to £306 in 2009–10;
- real terms price increases over five years ranging up to 70% in the case of United Utilities whose bills are projected to rise from £243 in 2004–05 to £416 in 2009–10;
- first year (2005–06) real terms price increases of up to 24%;
- average first year real terms price increases of around 13% (£14) for water and 11% (£14) for sewerage.

7. The size of the proposed increases are difficult to relate to estimates made by the Environment Agency, the Countryside Council for Wales and English Nature in "A good deal for water" (September 2003)<sup>4</sup> where they assert that the programme of environmental improvement "*will contribute a modest portion of the household bill for water and sewerage, no more, on average than a fizzy drink in the weekly shopping for each household.*" We think the impact on customers in their bills has been down played if not under estimated.

8. The companies are due to submit their final business plans to Ofwat in April 2004. The plans will take account of Ministers' principal guidance to Ofwat; this has been delayed and has still to be published. There is a high probability that the projected price rises in final plans will exceed those set out in the draft plans. WaterVoice will examine the final plans, as we did the draft plans, to identify the key issues for customers. We will inform the Government, Ofwat and other regulators of our views and publish a summary of the representations that we make. Our views on the draft business plans were published in a WaterVoice Briefing Note<sup>5</sup>.

#### ENVIRONMENTAL ACHIEVEMENTS 2000–05

9. The Environment Agency is the main environment regulator of the water industry in England and Wales with a remit to safeguard rivers, estuaries, inland waters, coastal waters and ground waters from pollution and other damage. Its evidence to this inquiry will no doubt focus on what has been achieved (and what more needs to be done).

10. From a customer perspective we would emphasise that over the past five years water companies have continued to take action to reduce any adverse impact of their activities on the environment. At the 1999 price review Ofwat allowed companies £5.5 billion for environmental improvements (plus almost £0.5 billion for related capital maintenance activity<sup>6</sup>). This investment has been funded entirely through customers' bills. There has been no contribution from government grants or European subsidies. As a direct result of this investment nearly 99% of bathing waters now meet mandatory standards<sup>7</sup> and 95% of rivers are of good or fair biological quality and 94% have good or fair chemical quality<sup>8</sup>.

11. This improved environmental performance has been achieved through the upgrading of sewage treatment works to meet tighter standards for the discharge of effluents and the decommissioning or upgrading of over 2,000 unsatisfactory storm water overflows; a further 2,200 are scheduled for completion in the final two years of this AMP period<sup>9</sup>. This reduction in pollution of the environment by the water industry was recognised by the Environment, Food and Rural Affairs (EFRA) Select Committee in the report of its inquiry into the Water Framework Directive (March 2003)<sup>10</sup>, when it concluded that agriculture was now the biggest polluter of the water environment.

#### THE ENVIRONMENT PROGRAMME 2005–10

##### *The customer dimension*

12. As part of the price review process the key stakeholders jointly commissioned research into customers' views. The first tranche of research was conducted in August 2002<sup>1</sup> and showed some support for work to maintain the quality of rivers and protect important areas of wildlife and plants. But there was also strong support for tackling sewer flooding and improving the taste and smell of tap water. The research did not detail any specific outputs or costs but did ask customers how much they would be prepared to pay to ensure their priorities were realised. While most customers were willing to make an additional contribution to fund improvement programmes no more than 27% were prepared to pay up to £2 per year, 31% between £2 and £5 per year, and only one in eight were willing to pay more than £5 per year.

13. In the second stage of customer research conducted by MVA in autumn 2003<sup>2</sup> customers were presented with a set of detailed proposals based on information contained in their local company's draft business plan. With this information available customers' priorities focused on the essential core aspects of

water and sewerage delivery—drinking water quality, security of supply, and maintenance of the water and sewerage infrastructure, including prevention of sewer flooding. Two of the service areas with least support from customers relate to the environment, ie “managing the effect of water company activities on the water quality of rivers, wetlands and coastal areas” and “managing the amount of water taken from the environment to supply customers.”

#### *Asset maintenance*

14. At its simplest water companies are engaged in the collection, treatment and distribution of water and the collection, treatment and discharge of wastewater. If continuity of these essential services to customers is to be preserved it is vital that water companies avoid a backlog of maintenance activity on their water and sewerage networks.

15. Inadequate maintenance of water and sewerage networks can also have an environmental impact. For example, a failure to repair and upgrade the water distribution system could lead to an increase in leakage rates and a rise in the incidence and frequency of mains bursts. To make up for this loss of potable water, companies tend to increase their level of abstraction. Similarly, failure to maintain or improve the sewerage network is likely to lead to an increase in sewer blockages and collapses with the result that properties experience internal flooding while local watercourses become polluted by sewage flows.

16. WaterVoice, therefore, believes it essential that the effects of under investment in asset maintenance that characterised previous price reviews should be addressed at this review. This approach will clearly benefit customers but it will also benefit the environment through better leakage control, a reduction in mains bursts, addressing deterioration in treatment works performance, and a reduction in sewer flooding. Tackling sewer flooding is a WaterVoice priority for this review. In the Initial Ministers’ Guidance to Ofwat<sup>11</sup> (January 2003) the Government also recognised that “*the public rightly see sewer flooding as something that should be tackled.*”

#### *Striking the right balance—Environmental improvement*

17. WaterVoice supports further environmental improvements that represent value for money, but the scale and pace of the overall programme should be affordable to the customers who will pay for them. We support the principles behind the Agency’s cost benefit analysis and have made what we believe to be a constructive contribution to the development of its benefit assessment guidance.

18. We are however, concerned that only schemes designated as ‘choices to be made’ were subject to cost benefit analysis. We believe that schemes of a statutory nature should have been subject to the same rigorous analysis. We would expect the same degree of scrutiny to be undertaken before the Government signs up to a new EU Directive. This is a role, we suggest, that the Environmental Audit Committee itself might undertake. Undue haste in implementation may result in customers paying for inappropriate and costly schemes. Rather than rush to implement the provisions of various EU Directives, where the cost of doing so are not so clear-cut, several companies have suggested that they undertake studies to determine the optimum approach. WaterVoice supports this approach.

19. We recognise the concerns that have been expressed about the risk of EU infraction proceedings from missing deadlines for delivery of statutory obligations. We do not dispute that such obligations must be met. It is a question of how they are met. We believe there are sound reasons for adopting a more cautious and considered approach to implementing the provisions of various EU Directives. There are two specific benefits from following such an approach.

20. Firstly it is likely to deliver projects at lower cost. One example from the 1999 price review illustrates this well—Wessex Water’s proposals to alleviate low flow rivers in the Wessex region. We raised questions about the value for money of the proposed £105 million investment which would have resulted in a permanent increase of £11 a year on customers’ bills. Ofwat did not allow funding and asked the company to consider more cost effective answers to the low flow problem. Following reassessment an alternative solution was found costing a fraction of the £105 million originally proposed with minimal effect on customers’ bills. In view of this it is vital that companies should explore all options and detail what alternatives have been considered to help demonstrate that the investment to be paid for by their customers clearly represents value for money.

21. Secondly a more cautious approach could allow companies and the quality regulators to ensure that agreed programmes meet rather than conflict with the principles underlying the Water Framework Directive, thereby avoiding abortive or wasteful expenditure. The timeframes of the 2004 price review and implementation of the Water Framework Directive do not match. It is not unreasonable, therefore, to expect some flexibility in the delivery dates of those aspects of the environmental programme where it can be shown that a more cost effective and better solution for the environment can be found through a phased approach.

22. It is crucial that the Agency engages with water companies and their customers (and with other agencies) in developing a holistic approach to managing the water environment. It is questionable for example for the Agency to insist that a company install a phosphate removal process if it does not tackle

the issue of diffuse pollution in that locality at the same time. This is especially pertinent if action taken by the company alone would not improve the status of the watercourse. Similarly, it seems inappropriate for a water company to take no or limited action to reduce leakage from a local distribution system while at the same time arguing for retention of its full licence to abstract from a depleted source that feeds that leaky network.

#### *Security of supply*

23. Water resources in the drier east and south east of England have come under increasing stress in recent years as a result of rises in household numbers and per capita water consumption. The Government's proposals to allow a significant number of new houses to be built in the Thames Gateway and the Stansted-Cambridge corridor exacerbate an already difficult resource problem. Companies in these areas are therefore seeking to improve their resources position by extending existing or building new reservoirs to meet projected shortfalls. Yet these projects may be compromised by the desire of the Environment Agency and English Nature to reduce or terminate abstraction licences. Proposals to reduce Portsmouth's licensed abstraction could have affected 75% of the company's deployable output. Similar reductions in Bournemouth & West Hampshire's abstractions on the Lower Hampshire Avon (which account for 75% of total available output at peak periods) have also been proposed.

24. WaterVoice accepts that a balance has to be struck between customers' needs for water and the possible adverse impact on wildlife. However, we are not convinced that the quality regulators have explored all available options with the water companies concerned. The last price review amply demonstrated that a willingness to think laterally could deliver similar results for lower cost.

25. In its current consultation on the review of water abstraction charging<sup>12</sup> the Agency appears to see the price review and water customers as the means to fund the compensation it will be required to pay abstractors for the reduction or termination of any abstraction licences. Not only is the Agency proposing that water customers should pay the estimated £436 million for the loss of water companies' abstraction licences to protect rivers and wetlands but that they should also contribute to compensation estimated at £309 million for other abstractors. This is the antithesis of the "polluter pays" principle. This also reinforces our view that if new schemes are to be implemented as part of the environmental programme each scheme must deliver maximum value for money.

#### ADEQUACY OF DEFRA GUIDANCE

26. In her "Initial Guidance to the Director General of Water Services" (January 2003)<sup>11</sup> the Secretary of State wrote: "*It is people who matter, whether paying their water bills or enjoying the benefit of clean water through the tap and in the environment, and our policies must strike the right balance in their interests.*" In our briefing note on the Initial Guidance we endorsed that statement and also commented on the seven key messages contained in the document.

27. We broadly welcomed the Government's statement on sustainable development but questioned how this equated with recent trends in under-investment in asset maintenance (paragraphs 15 and 16 refer) and the Government's sanctioning of proposals for substantial housing growth in south east England (paragraph 23 refers).

28. The Government's views on investment priorities, particularly those relating to asset maintenance and sewer flooding were similarly welcomed. And we endorsed the Government's challenge to quality regulators and water companies to ensure that "*the means of implementation are fully explored and that this includes examining the cost effectiveness of any schemes in addition to their effectiveness in delivering the required environmental changes.*"

29. WaterVoice welcomed the Government's statement that "*appraisal of measures should include an assessment of costs and benefits in order to show that a measure is clearly worth doing on the basis that the outcome including wider benefits, justify the costs*". But it soon became apparent that the statutory schemes that constitute the bulk of the environmental programme would not be subject to any cost benefit analysis.

30. We also welcomed the Government's call for regulators and companies to liaise closely to identify schemes "*where it is appropriate to take the future requirements of the Water Framework Directive into account*". One example of where this has worked well is in the Northumbria region where the company, the quality regulators, and WaterVoice, have worked together to determine an environmental programme that takes a wider and longer term view of what is needed to deliver sustainable outcomes. The result is a proposal that will deliver the requirements of the price review at what those involved consider to be a reasonable cost to customers.

31. Although the Government states that "*policies affecting water price limits must take account of the need for essential water services to be affordable*", we have seen scant evidence that all parties have taken this message on board. Whereas the Drinking Water Inspectorate has recently taken steps to refine its advice, and thereby reduce the scale of the drinking water programme, our discussions with companies and the

Agency suggest that the environmental programme is set to grow ever larger. Instead of a £4.6 billion programme outlined in companies' draft business plans we estimate that environmental schemes could cost as much as £5.5 billion.

#### AFFORDABILITY

32. In deciding the scale of the environment programme it is important to remember that it is water customers, not taxpayers, who meet the costs through their water and sewerage bills. Capital investment related to the environment programme already accounts for around one-third of the average household sewerage bill (the range is 24% for Northumbrian to 45% for South West). Extension of the programme will increase bills. The above inflation increases proposed by companies in their draft business plans are very worrying for customers, in particular those on low incomes.

33. The House of Commons EFRA Select Committee recognised in its 'Water Pricing' report (December 2003)<sup>13</sup> that the "*question of how great an increase in water and sewerage bills customers are willing to pay and can afford is a crucial one.*" The Committee said that "*the difficulties some customers face in paying their water bills are a matter of great concern.*"

34. We agree with those views. But affordability is also a real issue now. A good example of this is in the South West which has an above average population of pensionable age and, in Cornwall, the lowest level of average earnings across England. In the South West the average water and sewerage bill has more than doubled from £147 in 1989–90 to £342 in 2003–04, largely to fund the company's Clean Sweep programme. Water and sewerage charges in the peninsula are now currently on a par with the average standard gas bill from British Gas and around 50% higher than the standard domestic electricity bill<sup>14</sup>.

35. The recent WaterVoice/Ofwat Paying for Water research<sup>15</sup> identified that some customers struggle to pay their current water bills, juggling them with other debts. If water bills rise these problems will grow and payment of bills will become less manageable for many more customers.

36. Outstanding revenue and the cost of recovering that revenue will rise. Ofwat figures show that at the end of 2002–03 charging year long-term debt levels (bills outstanding for 12 months or more) stood at £434 million<sup>16</sup>. The companies cannot yet identify how much of this is attributable to customers who do not pay their bills because they cannot afford to pay them rather than because they choose not to pay them. Better data is needed to help understand the scale of the issue but this will not, by itself, solve the problem.

37. We contend that the Government must take responsibility for finding solutions. Water debt has political and social dimensions. It is not appropriate that the water companies, as private enterprises, should assess customers' individual circumstances and ability to pay their water bills, or to move away from cost reflective charging principles.

38. The EFRA Select Committee recommended that "*People suffering from serious difficulty in paying their bills should be helped through the benefits and tax credits system. The Government should review the way in which poorer households are helped with their water and sewerage charges. It should ensure that mechanisms to help people to pay their water bills take account of the regional variation in bills.*"

39. Extension of the vulnerable groups scheme or social tariffs will not address the issue. Rather it would create more cross subsidies within the tariff basket and not generate any new money. The vulnerable groups scheme has not been effective; it has poor take up and is not an efficient way to provide financial support to people with low incomes. We believe that the scheme costs more to administer than it provides in financial help.

40. We think that part of any solution must involve finding new money and alternative sources of finance to help those customers on low incomes who are least able to pay their water bills. The Government needs to provide this through the wider social security system and tax credit system. There are a number of ways in which this could be achieved. We have offered to work with the Government to examine the issues and identify solutions.

#### CONCLUSION

41. Customers know that they have to pay for reliable and good quality water and sewerage services, and are prepared to contribute to the costs of improving and protecting the water environment. But price increases of the magnitude seen in water companies' preferred strategies risk being counter-productive by turning customers against the industry, against the environment and against the Government, and resulting in a further increase in debt and financial hardship.

42. WaterVoice therefore calls upon all parties to look for a balanced outcome by being pragmatic about what can be delivered, realistic about what can be afforded, and focusing on outcomes rather than outputs. In doing so all parties will contribute to the achievement of sustainable development and help to meet the Government's objectives for the water industry:

- a secure supply of water of a quality safe for drinking;

- the use of water resources and sewerage services in a way that respects the environment; and
- the furtherance of social and economic policies.

February 2004

#### REFERENCES

- <sup>1</sup> The 2004 Periodic Review : Research into Customers' Views; MORI; (August 2002).
- <sup>2</sup> Customer Research 2003 : Periodic Review; MVA; (December 2003).
- <sup>3</sup> Regulatory Impact Assessment: New Designations under the Freshwater Fish Directive (78/659/EEC); DEFRA; (December 2003).
- <sup>4</sup> A good deal for water; Environment Agency, the Consumer Council for Water for Wales, English Nature; (September 2003).
- <sup>5</sup> WaterVoice's views on Water Companies Draft Business Plans; WaterVoice; (December 2003).
- <sup>6</sup> Future water and sewerage charges 2000–05 : Final Determinations; Ofwat; (November 1999).
- <sup>7</sup> Bathing Water Quality : Annual Report 2002; European Commission; (June 2003).
- <sup>8</sup> River Quality : General Quality Assessment; Environment Agency; (September 2003).
- <sup>9</sup> Progress with completing the National Environment Programme 2000–05; Ofwat & EA; (January 2004).
- <sup>10</sup> The Water Framework Directive Fourth Report; House of Commons EFRA Select Committee; (March 2003).
- <sup>11</sup> Initial guidance from the Secretary of State to the Director General of Water Services : DEFRA (January 2003).
- <sup>12</sup> Review of the water abstraction charges scheme; Environment Agency; (January 2004).
- <sup>13</sup> Water Pricing; House of Commons EFRA Select Committee; (December 2003).
- <sup>14</sup> Domestic electricity and gas prices; Ofgem; (September 2002).
- <sup>15</sup> Paying for Water Customer Research by Accent Marketing and Research; WaterVoice and Ofwat; (September 2003).
- <sup>16</sup> RD32/03; Ofwat; (September 2003).

---

#### APPENDIX 11

##### **Letter to the Clerk of the Committee from Richard Ackroyd, Director of Regulation and Investment, Yorkshire Water**

I am writing to you in response to the notice published on your website on 5 February. We wish to respond to two of the Committee's specific interests:

- The extent of the environmental achievements delivered as a result of the 1999 periodic review;
- What should be the key components of the environmental programme allowed for in Ofwat's price limits.

#### EXTENT OF ENVIRONMENTAL ACHIEVEMENTS DELIVERED TO DATE

We recognise that a sustainable water and sewerage business is dependent on environmentally sustainable operations. We therefore remain committed, to integrating environmental best practice, continuous improvement in environmental performance, and driving environmental and customer value throughout our activities, contractors and supply chain.

With this in mind, and as a result of the 1999 periodic review, we have invested almost £1 million a day in reducing our impact on the environment and improving our service to customers. Our rivers and bathing waters are cleaner now than at any time since the industrial revolution.

Given the substantial improvements to the environment already delivered by the water industry, cost benefit analysis shows that further investment may be subject to the law of diminishing returns. It is likely that investment by other sectors impacting on watercourses may provide better value for money environmental improvements. The Environment Agency has estimated that the cost of all environmental damage from water related activities is between £1.2 and £2.6 billion per annum (equivalent to a capitalised value of £15–33 billion over 25 years), approximately half of which is attributed, by the Environment Agency, to the activities of water companies.<sup>17</sup> The EA further estimate the benefits of the PR04 investment programme across England and Wales at between £0.3 and £0.9 billion per annum (£4.5 to 11 billion). These figures do not compare favourably with the costs of the PR04 environmental programme which would have to be paid by water company customers, broadly estimated at £12.7 billion over AMP4 if Reference Plan B were supported. It should be noted that Reference Plan B is roughly double Reference Plan A.

---

<sup>17</sup> Economic Appraisal and Assessment of the Benefits in the PR04 Environment Programme, Findings of an Environment Agency seminar, January 2003.

---

## FUTURE ENVIRONMENTAL PROGRAMMES

Yorkshire Water's PR04 Draft Business Plan, both the Company Preferred Plan and Reference Plan A, which already provided for substantial environmental quality enhancements costing circa £250 million. These are largely to ensure compliance with legal obligations and are summarised in the attached annex. The overall impact on customer bills of the environmental, drinking water quality and other cost drivers, such as changes in taxation, provided for in the Draft Business Plan was 3.6% pa increases for five years ie bills increasing by almost 20% by 2010. However there are some further issues where Government is required to make judgements and choices.

### 1. *Freshwater Fish Directive*

Since our Draft Business Plan was submitted, the Environment Agency have confirmed that a number of new additional investment requirements associated with the Freshwater Fisheries Directive (FFD) will now also need to be delivered in AMP4. I am concerned that the new FFD designations at many locations will require investment which is disproportionately high in relation to the environmental benefits. As an example, I would like to draw to your attention the case of Huddersfield STW. Huddersfield is only one of several medium-sized towns in Yorkshire. The STW there serves a population equivalent of approximately 350,000. We have recently improved Huddersfield STW very substantially by constructing three additional treatment plants between 1995 and 2000, at a total cost of over £50 million, in order to comply with the Urban Waste Water Treatment Directive (UWWTD). The key consent parameter driving further investment at this site is ammonia and Huddersfield already achieves the very high standard of 8 mg/l of ammonia on a 95%ile basis and the River Colne already supports an active coarse fishery. The 75% designation under FFD will require circa a further £20 million of investment in new treatment processes in order to make a relatively small improvement in the quality of the continuous discharge to meet a 5 mg/l ammonia consent. It is unlikely there will be any visible improvement in the river as a result. We regard this investment as highly questionable in terms of value for money.

As noted above, our Draft Business Plan indicated that water and sewerage charges would need to rise by 3.6% pa. above inflation for five years before any allowance is made for the cost of compliance with the Freshwater Fish Directive or other new obligations. Once an allowance for the cost of the new FFD designations is made then prices would need to rise by an additional 1% per annum for five years.

### 2. *Humber Estuary Designation*

With regard to the outstanding issue of whether the Humber Estuary should or should not be designated as a sensitive water under the Urban Waste Water Treatment Directive (UWWTD) in consequence of the reasoned opinion issued against the UK in March 2001. The company has over the past three years been supporting Defra in making its case against the reasoned opinion issued against the UK as outlined in the Commission's COM (2001)685\*1, dated 21 November 2001. This reasoned opinion asserted that the Humber Estuary should have been designated as a Sensitive Area (Nutrients) under the terms of the UWWTD. This matter is currently unresolved. If this matter goes against the UK, additional nutrient removal investment of circa £600 million (adding a further 10% to customer's bills) will be required at our waste water treatment works, with further investments required at those of Severn Trent and Anglian Water. The nature of the investment required to meet FFD requirements is entirely different from that required to reduce nutrient levels in our waste water discharges, as would be required by a Sensitive Area designation. Again to implement the FFD investment requirements before we fully understand the outcome of the Sensitive Area issue could lead to abortive investments being made, or for premature nutrient friendly solutions to be provided during this period, at additional cost to our customers of circa £40 million.

## AFFORDABILITY

We are also concerned about the socio economic impact of the environmental improvements we may be asked to make in terms of the impact on our customers, many of whom are on low incomes. Given the background of rising costs elsewhere eg council tax, energy costs etc, we believe that many of our customers will simply be unable to afford the increases in water prices that further environmental improvements would drive.

We have undertaken a substantial piece of research canvassing our customers' willingness to pay for current and future levels of service, including environmental improvements. This work has been described as "state of the art" and "setting the standard for other studies to emulate" by leading international experts. Our results show that maintenance of current standards is accorded high priority and that, whilst significant willingness to pay for further environmental improvements exists, the benefits are outweighed by the costs of the requisite investments.

In addition to the question of value for money of further investment in Freshwater Fisheries initiatives, it is vital that we are able to structure and phase our investment programme in order to minimise the risks of making abortive and wasteful investments, thereby ensuring the most cost effective achievement of environmental benefits. The requirements of the Freshwater Fish Directive are likely to lead to wasted

investment, if tighter standards are subsequently imposed after 2009 by the Water Framework Directive (WFD) or if the Humber Estuary is designated as a sensitive water under the Urban Wastewater Treatment Directive.

We put forward an alternative proposition to Defra at the end of last year, to phase compliance with FFD over a longer period of time, requiring full compliance by the end of 2012 rather than 2010. The advantages of such a longer timescale can be summarised as follows:

- It minimises the risk of abortive investment as it allows time to see the effect of other factors improving river quality and allows time for clarification of improvements required by other legal requirements.
- It reduces the impact on customer bills.
- The phasing we have proposed ensures that the sites with greater certainty and greatest benefit are addressed first ensuring that over two-thirds of the sites are improved and FFD compliance at those sites is achieved prior to identification of the requirements of the WFD in 2009.

In summary, we believe that the AMP4 program should be limited to those investments required by law, phased over an appropriate and affordable timescale, with any further investments challenged on the grounds of costs vs. benefits, and affordability. Similarly, investments should be spread over AMP4 and AMP5, and only made where they do not risk being abortive due to pending legislation.

Our reason for this view is twofold. Firstly benefits cannot be shown to exceed costs for most further environmental improvements and secondly we doubt the ability of many customers to afford the consequent water bills.

We would urge your Committee to consider the proposed investment program in light of the very considerable achievements of the water industry to date, and excellent value we have offered to both the environment and our customers. Further environmental improvements, should be provided for only where justified by robust cost/benefit analysis and the value they offer to customers can very clearly be demonstrated.

Please do not hesitate to contact me should you wish to discuss any of the points I have raised.

March 2004

#### Annex

	Company Preferred Plan £m		Reference Plan A £m	
	Capex	Opex*	Capex	Opex*
AMP3 overhang (infra)	43	0.0	43	0.0
AMP3 overhang (non-infra excl WID)	27	4.9	27	4.9
UWWTD (excl U1 o'hang & U5b)	15	0.3	15	0.3
Intermittent discharges	106	0.4	106	0.4
Disposal of sewage sludge	12	0.3	12	0.3
Bathing Waters Directive	<1	0.0	<1	0.0
Chemicals	0	0.0	0	0.0
Dangerous Substances Directive	0	0.0	0	0.0
Infiltration	0	0.0	5	0.0
First Time Sewerage	<1	0.0	<1	0.0
Freshwater Fisheries Directive	11	0.3	11	0.3
Groundwater Directive	20	0.3	21	0.3
Nature Conservation	<1	0.0	8	0.1
River Quality Objectives	0	0.0	0	0.0
Waste Incineration Directive	9	0.1	9	0.1
Water Framework Directive	1	0.0	1	0.0
<b>Total</b>	<b>244</b>	<b>6.6</b>	<b>252</b>	<b>6.4</b>

## APPENDIX 12

### Further supplementary evidence from The Environment Agency

#### INTRODUCTION

1. This note provides a response to additional question raised by the Environmental Audit Committee on the Environment Agency's evidence to the Inquiry into Water: The Periodic Review and the Environment Programme. It explains the process by which water companies, Ofwat and other stakeholders were involved in the development and application of the Agency's cost benefit assessment methodology.

This information provides supplementary information to Annex B of the Agency's Memorandum of Evidence (see Ev 7).

#### HOW THE AGENCY DEVELOPED THE COST BENEFIT ASSESSMENT METHODS

2. The development of the Agency's methodology for assessing benefits and its application was undertaken in consultation with key stakeholders in the 2004 Periodic Review Process.

3. The Regulators Group (chaired by Defra) established a working group, the Appraisal Group, to manage the development and application of the economic appraisal methods that would be used by the Agency for the environment programme. The Appraisal Group was chaired by Defra, and included the Welsh Assembly Government, Agency, Ofwat, English Nature and DWI.

4. In order to develop the cost benefit methods, the Agency established a project steering group to manage the contracts with consultant economists to develop the methodology. The steering group included representatives from Ofwat, Defra, English Nature and the Agency and two experts to peer review the work (a leading academic economist and a water company economist, the latter acting as an expert but not representing the industry).

5. The Agency held two workshops for stakeholders during the development of the methodology. The first workshop was undertaken before work on the methodology was complete, to seek views of stakeholders on the Agency's approach.<sup>6</sup> Participants included representatives of the organisations on the project steering group, together with water economists from academia, consultant water economists, Water UK, representatives from water companies, WaterVoice and RSPB. One of the issues raised by the water industry at this workshop was that the Agency should do more to take account of the costs to the environment of schemes, for example carbon dioxide emissions from additional sewage treatment. In response, the Agency developed a methodology to allow companies to make this assessment to be set against environmental benefits. However, only one water company carried out the assessment. The workshop also suggested the need for an in-depth review of the available techniques for monetary valuation.

6. The Agency then held a second workshop before it finalised its methodology for assessing benefits. This two-day workshop reviewed the monetary valuations used in the benefits assessment methodology.<sup>7</sup> The workshop identified the main limitations of the available valuations and determined how to overcome them in deriving appropriate valuations to use for the benefits assessments for PR04. Participants in this workshop included most of the leading academics and researchers and representatives of Ofwat, Water UK and WaterVoice. As a result of the workshop, the Agency made the agreed revisions to the methodology, and published the revised guidance.

7. The Agency completed benefits assessments using the revised methodology. Ofwat provided data on costs from companies' draft business plans. We provided the full results to Ofwat, Defra, water companies, and WaterVoice. A number of companies queried the results of the assessment, to which we responded, and where appropriate amended the results.

8. The process described above explains why the Agency is confident that it has developed and applied a sound, peer-reviewed methodology, which represent the best currently available techniques to assess the benefits of environmental improvements for the 2004 Periodic Review. The work has been done in full consultation with all key stakeholders in the Periodic Review. Throughout the process we have worked closely with Defra's economists to ensure that the methodology and information provided would be in a form which Ministers would expect in making their decisions. Indeed, the Secretary of State's Principal Guidance<sup>8</sup> welcomed the appraisal work undertaken to inform her decisions.

*March 2004*

<sup>6</sup> Report available on our web site [http://www.environment-agency.gov.uk/business/444304/444643/425378/425401/425411/563114/?lang=\\_\\_e](http://www.environment-agency.gov.uk/business/444304/444643/425378/425401/425411/563114/?lang=__e).

<sup>7</sup> Environment Agency (2003) Review of Non-use Values for Water Quality and Water Resources and Values for Bathing Water Improvements. Report of an Expert Workshop in Peterborough, May 2003.

<sup>8</sup> Principal guidance from the Secretary of State to the Director General of Water Services, 2004 periodic review of water price limits. Defra, March 2004.