



House of Commons
Environment, Food and Rural
Affairs Committee

**Water Pricing:
follow-up**

Nineteenth Report of Session 2003–04

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

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Environment, Food and Rural Affairs Committee

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Committee staff

The current staff of the Committee are Matthew Hamlyn (Clerk), Fiona Mclean (Second Clerk), Jonathan Little and Dr Antonia James (Committee Specialists), Marek Kubala (Inquiry Manager), Louise Combs and Jim Lawford (Committee Assistants) and Anne Woolhouse (Secretary).

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Summary

The 2004 review of water prices is an important process for water companies, their customers and other stakeholders, as it will determine water bills until 2010 and hence, to a large extent, what the companies can be expected to achieve during that period. At the time of publication of this report, Ofwat has not yet announced the final determination of price limits, so we have not commented in detail on the determination. Nevertheless, this is a good opportunity to examine the conduct of the review and identify some issues that Ofwat and its stakeholders should examine in the evaluation of the review process planned for early 2005.

A key issue for stakeholders is the transparency of the review process. Customers must be able to see what they are paying for and why. We commented in an earlier report that the early stages of the review process were more transparent than in previous rounds, which we welcomed. However, as the review has entered its final stage, this transparency has become somewhat clouded. It is not yet clear what customers can expect the water companies to provide. We hope that this uncertainty will be resolved on publication of the final determination, but we recommend that Government examine the process, both to check that the final determination adequately reflects the statutory requirements placed on companies and to identify ways that 'horse trading' can be reduced in future rounds.

We repeat our earlier recommendation that Government must do more to address the causes of water pollution and flooding and that, where these are not the responsibility of water companies, water customers should not pay for the solutions. Similarly, the problems that water companies face due to climate change may need to be addressed in other ways.

The Government must address the growing difficulties being faced by people on low incomes in paying their water bills, particularly in regions with the highest bills. It will not be enough to adjust payment mechanisms; the underlying difficulty in meeting the cost must be tackled.

Finally, the Government must examine the long term risks, including climate change, faced by the water industry and identify means of managing them.

1 Introduction

1. The Director General of Water Services reviews the limits on prices that water and sewerage companies may charge their customers every five years. The current price review began in October 2002 and Ofwat expects to announce the final determination of price limits on 2 December 2004.¹

2. This Committee first looked into the current price review during its early stages and published its report, *Water Pricing*, in December 2003.² The Environmental Audit Committee held an inquiry into the environmental programme of this price review. It published its report, *Water: the periodic review 2004 and the environmental programme*, in April 2004.³

3. We decided to take a second look at this price round towards the end of the process. Our terms of reference were:

to gauge the reaction of stakeholders to the draft price limits, and to an extent also to assess how the Periodic Review has been conducted, particularly looking at how it has taken – or should take – into account long-term planning for climate change and environmental improvements.

4. We received written evidence from 17 organisations and took oral evidence from Ofwat, the Department for Environment, Food and Rural Affairs, Water UK, WaterVoice and the Environment Agency in October and November 2004. We are most grateful to all those who gave evidence and assisted us in other ways.

5. Our inquiry was conducted before the publication of Ofwat's final determination of price limits. Therefore, we are not in a position to comment on the final determination. Our aims in this report are to update the conclusions of our first report in the light of the way in which the later stages of the price review were conducted and to comment on some general principles. In this report we examine:

- a) the conduct of the review;
- b) the provisions in the draft determination to tackle sewer flooding;
- c) the problem of affordability; and
- d) the way long-term issues and investment are accounted for in the five year price review cycle.

We intend our report to inform debate about the final determinations and feed into the evaluation of the review process that Ofwat plans to conduct early in 2005.

¹ Q62

² Environment, Food and Rural Affairs Committee, First Report of Session 2003-04, HC 121

³ Environmental Audit Committee, Fourth Report of Session 2003-04, HC416

2 The conduct of this review

6. The price review process is clearly a crucial one for water companies and their customers, but it is also a very important time for the environmental and quality regulators. The Environment Agency explained that it represented the “biggest single environmental programme”.⁴ The significance of the process therefore means that the way in which the review is seen to be conducted is very important if all the stakeholders involved are to trust the regulator and accept his decisions.

7. In both of our inquiries we therefore paid particular attention to the conduct of the review and especially to the questions of its transparency and the extent of ‘horse-trading’, the process whereby companies tend to overbid and the regulator tends to undercut, both of which had been criticised in previous reviews.

Transparency

8. At the beginning of this price review, Ofwat stated that it aimed to conduct the review in a transparent way.⁵ In both this and our previous inquiry into this review we asked to what extent Ofwat had succeeded in this aim. In our previous report, we commented on two significant improvements to the transparency of the process, both of which were welcomed by all stakeholders: the introduction of draft business plans in which companies set out what improvements and maintenance they intend to carry out in the next five years and their estimates of the costs of those projects; and the joint customer research that was conducted by the major stakeholders in the early stages of the review. We concluded that, overall, the initial stages of the review had been carried out in a more transparent way than in previous reviews.⁶ However, some areas of contention have emerged in the later stages. These centre on the nature and extent of information placed in the public domain and the way that costs have been presented. There have also been some comments about the blurring of roles in environmental decision-making.

9. Water UK, representing the UK’s statutory water and wastewater operators, told us that the reasoning behind the regulator’s draft determination was not clear.⁷ Environmental and consumers’ groups said that, at the draft determination stage, too little detail was given on individual projects in the quality programme for customers and other stakeholders to make informed judgements about company plans or Ofwat’s determination of price limits.⁸ There were also complaints about the disparity between the information made public by different companies, which again makes any comparison of companies’ performance or the reasons behind their price rises more difficult to make.⁹

10. In response, Ofwat stated that it and the water companies published “considerably more detail than was published in the past”, and cited independent comments that the review process was “significantly more transparent” than before. However, Ofwat also

⁴ Q204

⁵ Ofwat. *Setting price limits for 2005–10: framework and approach*, October 2002

⁶ Environment, Food and Rural Affairs Committee, First Report of Session 2003-04, HC 121, paras 10-14

⁷ Ev 44 [Water UK], para 2.1

⁸ Ev 107 [RSPB], para 13

⁹ Ev 92 [Environment Agency], para 28; Q 211

noted that there is “a delicate balance to be struck between complete exposure of all information provided and respecting necessary commercial confidentiality.” For companies to expose all the information contained in business plans on, for instance, revenues, costs, quality enhancements and service improvements “could compromise their position in competitive markets”. Ofwat also consider it would be prejudicial to customers’ bills, and to the delivery of the improvement programme, to expose the costs of individual schemes in companies’ business plans.¹⁰

11. We are disappointed that Ofwat felt it could not be clearer about which maintenance and improvement programmes were allowed for in its draft determination of price limits. We hope that this is resolved in its final determination of price limits, in order that customers and other stakeholders may have the clearest possible understanding of what they can expect water companies to deliver. If Ofwat chooses not to present this information, it should write to us explaining its decision.

12. WaterVoice, which represents water and sewerage customers, has criticised what it sees as a lack of transparency in the way that Ofwat has presented the likely increases in bills, arguing that it is difficult for most customers to understand the information given to them.¹¹ WaterVoice says that Ofwat generally presents headline figures in terms of the change in the average bill, which takes into account both metered and unmetered customers and Ofwat’s estimate of the number of customers likely to switch to a metered supply during the relevant period. In company-specific information, Ofwat also presents figures for “typical” bills, which refer to the amount that an unmetered customer living in a house of average rateable value would pay, or that paid by a metered customer using an average amount of water.¹²

13. WaterVoice would prefer Ofwat “to present bill figures based on a range of rateable values in terms of unmeasured bills and based on consumption for different households for measured bills”.¹³ WaterVoice set out examples of what it views as a more readily understood format in its evidence to this inquiry.¹⁴ **We recommend that Ofwat considers WaterVoice’s suggestions for clearer ways to explain to customers the impact of changes in price limits during its evaluation of this price review.**

14. There has also been criticism of the way in which the reasons behind the likely price increases have been presented. Both the Environment Agency and environmental groups argued that too much emphasis has been placed on the cost of environmental improvement – in effect, the “blame” for the price rises has been laid at the environment’s door.¹⁵ Part of this perception may arise from the way in which Ofwat presents the ‘drivers’ for price increases, in which it separates out the increases due to improvement programmes and the decreases due to improvements in efficiency.¹⁶ Environmental improvements appear as a cost; efficiencies as a reduction in cost. Another contributing factor is that some schemes classified as “environmental” may have wider benefits. It is no

¹⁰ Ev 23 [Ofwat]

¹¹ Q169 ff

¹² Q173

¹³ Ev 80 [WaterVoice], para 3

¹⁴ Ev 82 [WaterVoice], annexes B and C

¹⁵ Ev 91 [Environment Agency], para 26, Ev 107 [Royal Society for the Protection of Birds], para 13

¹⁶ See evidence from United Utilities, Ev 57, Table 1, for an example of the ‘drivers’.

longer the case, as it was in the early days of privatisation, that most programmes can readily be classified as environmental or non-environmental. Many of the programmes put in place to meet the requirements of environmental legislation also provide other benefits. Spending on a new storm water holding tank in Manchester, which United Utilities told us was driven by the Freshwater Fish Directive¹⁷, would be of general benefit to the people of Manchester, but the cost would be attributed to the ‘environment’ column. Ofwat insists that it is not its intention to downplay the importance of the environment programme, but there does appear to be some confusion in the way the cost of the environment programme is presented.

15. The controversy over the cost of the environment programme risks giving the impression to customers that water bills are a source of investment for environmental work, albeit vital work, that it would otherwise be difficult to fund. There is no perfect way of presenting information about these costs, but Ofwat should consider how information can be presented to give customers the most accurate possible picture of the costs of and reasons for the environment programme and how they contribute to the overall bill. The Government should also consider making a statement at the start of the process stating in clear terms details of the environmental legislation which the water companies will have to comply with over the five-year period of the pricing review.

16. Whatever the arguments about the way information is presented, there is a more fundamental point to be considered about the funding of solutions to environmental problems. In our previous report, we supported the application of the ‘polluter pays’ principle to water and sewerage services, but with the important proviso that not all problems are caused by the water company alone.¹⁸ Therefore funding will in some cases need to be found other than from water bills. **We are particularly disappointed that the Government has been slow to address the problems of diffuse water pollution and flooding caused by urban run off and that as a result the costs of these problems fall on water customers. The Government should consider whether charging via water bills is the most equitable way of funding the effects of these environmental challenges as well as the impact of climate change. The Government should make clear, at the earliest opportunity, its plans for solving these problems.**

The respective roles of Ofwat, the quality regulators and Defra

17. The roles of the government, quality regulators, Ofwat and the companies themselves in the price review process appear at first to be quite distinct. The Secretary of State for the Environment, Food and Rural Affairs, with advice from the quality regulators, sets out what water and sewerage companies are expected to deliver in terms of quality of service and protection of the environment. The companies estimate what it will cost them to meet these standards. Ofwat makes a judgement about whether those cost estimates are reasonable and, in the light of that judgement and its view of the other ways in which companies can raise finance, determines how much the companies may charge their customers. The price review allows for this process to go through more than one iteration,

¹⁷ Q 137 [United Utilities]

¹⁸ HC (2003-04) 121, paras 31-32

in order that each party can refine their views and cost estimates in the light of fresh information.

18. The regulator has a duty to ensure that prices are no higher than they need to be and is free to query the costs put forward by companies. In some cases, where the regulator has judged that the companies' costs are too high, he has asked them to find other ways of achieving the same ends. The Environment Agency argued that, in choosing which costs of environmental projects to allow for in the draft determination and which to exclude or to delay until further information is available, Ofwat has in effect assumed the role more properly taken by the Secretary of State of taking environmental decisions.¹⁹ The Agency has said that, regardless of which plans Ofwat allows for in its final determination, it will

issue permits requiring the improvements to water companies' assets to be delivered by 2010 whether or not companies consider them to be funded.²⁰

19. As the price review system stands, it is not for Ofwat to determine the content of the environmental and quality improvement programmes. We are concerned that, if the final determination does not fund statutory requirements, those companies will apply for further increases in their price limits before the next review. This would undermine the value of the price review process. We recommend that the Government examine closely how the regulator has responded to its guidance and to what extent statutory schemes have been allowed for in the price limits.

'Horse trading'

20. A key factor of this round was the halving by the Regulator of the opening price increase proposals put forward by the companies. Such a response, in what we accept is an iterative process, leaves the process open to accusations of 'horse trading'. As such it appears that companies overstate their likely costs, knowing that Ofwat will later attempt to reduce prices. In contrast, Ofwat sets prices lower than the level companies say is necessary, knowing that companies will have overstated their costs. In this price round, the price limits identified as necessary in companies' business plans were on average halved by Ofwat. Water UK argues that this is in part due to clarification of which programmes were necessary and of the cost of those programmes during the course of the review, but some companies remain dissatisfied with Ofwat's decisions.²¹ The Environment Agency told us that in such an important process a degree of disagreement and an element of bargaining were only to be expected.²²

21. We accept that an economic regulator for an inherently monopolistic industry like the water industry can never be a perfect surrogate for market competition. However we are concerned that the bidding process seems to result in such stark differences of opinion over costs, value for money and the scope for efficiency savings that the regulator, in his draft determinations at least, halved the bid set out by the companies. We recommend that the Government re-examine the methodology of the bidding

¹⁹ Q203

²⁰ Ev 88 [Environment Agency], summary and para 12

²¹ Qq126-130

²² Q204

process to identify the reasons for the striking differences between the companies' and the regulator's positions.

3 Sewer flooding

22. The timing of our inquiry has meant that we have seen only the draft determination of price limits. The final determination may be very different. Nevertheless, there are some features of the draft determination which, if reflected in the final determination, will cause some stakeholders concern. For customers, one of the main areas of concern is the scope that Ofwat has allowed companies to tackle sewer flooding. At present, 0.04% of households – approximately 20,000 – are described as being “at risk” of sewer flooding, which means they face a one in ten year likelihood of experiencing sewer flooding. The problem is not evenly spread throughout the country, but instead is often clustered on certain areas.²³ This is consistent with the Office of Science and Technology's 2002 Foresight report on flood and coastal defence, which we noted in our recent report on Climate Change, Water Security and Flooding. The OST report concluded that, in some areas, the limits of sewer capacity are already being reached and that sewers will need to be upgraded to be able to cope with storms and sudden flood conditions.²⁴

23. In the joint customer research conducted at the start of the review, the reduction of sewer flooding was identified as a key priority for customers. However, reducing the risk of sewer flooding at some properties can be very expensive and Ofwat has set a cap of £120,000 per property on the expenditure that companies can include in their business plans. Ofwat says this will still allow companies to halve the number of properties at risk of sewer flooding and that companies may still tackle the more expensive properties if they can present an adequate cost-benefit analysis of the case for doing so.²⁵

24. Water companies and WaterVoice have expressed disappointment that the backlog of properties at risk of sewer flooding will still not be cleared if the final determination closely reflects the draft.²⁶ **We accept that it may not be possible to address every property at risk of sewer flooding, but we are concerned that the problem appears to linger on from price review to price review, leaving a backlog of properties waiting to be addressed. This is of particular concern given the likelihood of increased risk of sewer flooding identified in the Office of Science and Technology's Foresight report on flood risk and climate change. We recommend that companies prioritise action in those areas at highest risk and that, in examining the cost-benefit ratio of plans presented by the companies, Ofwat consider the distress and inconvenience of those affected as well as economic damage.**

²³ Qq 43-47 [Ofwat]

²⁴ Environment, Food and Rural Affairs Committee, Sixteenth Report of Session 2003—04, *Climate change, water security and flooding*, HC 558, para 33; www.foresight.gov.uk/fcd.html

²⁵ Qq 37, 45 [Ofwat]

²⁶ Q136 [Water UK], Y4 [WaterVoice], paras 35-37

4 Affordability

25. In our first inquiry into this price review we were told that between two and four million householders could not afford their water charges.²⁷ Water bills will increase in this price round: the draft determination would mean an increase in the average household bill of £34 from £249 in 2004-05 to £283 by 2009-10, a real terms increase of 13%.²⁸ This average increase masks much greater increases in some regions. WaterVoice told us that a “radical approach” was needed to address the growing problem of meeting the cost of water bills and increasing customer debt.²⁹ It said:

it is time for the Government to act to provide financial assistance through the benefits and tax credits system to help those customers on fixed and low incomes who are least able to pay their water bills.³⁰

26. There is no separate social security payment to those on low incomes to help them pay for their water and sewerage charges. Instead, people who receive social security benefits are expected to budget to meet their expenses out of the single payment. The consumer groups WaterVoice and the National Consumer Council told us that a problem with this approach is that there is no provision in the benefits system to reflect the wide regional variation in water bills.³¹ Thus, the proportion of an individual’s benefit payment that is spent on water and sewerage charges varies across the country. People on low incomes in areas with high charges can therefore face acute problems. The Government’s own figure for affordability of water is that less than 3% of income should be spent on water charges.³² But WaterVoice argued that, based on the draft determination, by 2010 pensioners in the South West would be paying almost 11% of their disposable income on water and sewerage charges.³³ Ofwat argues that this is because, as a significant number of customers in the South West are expected to exercise their right to switch to a meter in order to reduce their bills, this raises the overall average bill. But because those who switch will reduce their own bills, those who do not switch, or have already switched, will see an increase above the average increase in bills. Ofwat concludes that average water bills would increase by 17% over the period to 2010, which compares with WaterVoice’s forecast that typical measured bills in the South West would increase by 29% and typical unmeasured bills by 35%.³⁴

27. The consumer groups also expressed disappointment that the Department for Work and Pensions (DWP) says that it cannot provide a breakdown of social security payments showing how much allowance is made for the cost of water and sewerage, nor how increases in those costs are taken into account.³⁵ We asked the DWP for more

²⁷ Environment, Food and Rural Affairs Committee First Report of Session 2003–04, *Water Pricing*, HC121, Ev 77 (Public Utilities Access Forum)

²⁸ Ev 2 [Ofwat], para 9

²⁹ Ev 70 [WaterVoice], para 23

³⁰ Ev 70 [WaterVoice], para 21

³¹ Qq 179–181 [WaterVoice], Y 15 [National Consumer Council] p.2

³² Defra, *Quality of life counts—update 2004*, indicator Q3 water affordability <http://www.sustainable-development.gov.uk/indicators/national/index.htm>

³³ Ev 70 [WaterVoice], para 19

³⁴ Ev 25 [Ofwat]

³⁵ Qq 182-183

information about uprating. DWP explained that social security payments are uprated each year in line with the ‘Rossi’ index, which is the Retail Price Index (RPI) less the costs of housing. This is the index which most clearly reflects the cost of living increases for Income Support recipients, since housing costs, such as rent or mortgage interest, are separately met through other social security payments.³⁶ The Office for National Statistics also provided us with information explaining the details of the weighting accorded to the “Water and other charges” element of the RPI and the Rossi index. This element has a weighting of 1.3% in the Rossi index.³⁷

28. The Government accepts that the cost of water and sewerage charges is a significant problem for some people on low incomes, particularly those living in regions where those charges are highest. It has taken action on two fronts. It has identified a group of particularly vulnerable customers who need additional help with their water charges. To qualify for this help, a household must have a water meter, be in receipt of an income-related benefit, and contain either a large family, or a person who has special water needs because of a medical condition.³⁸ The Water Industry Charges (Vulnerable Groups) Regulations allow for a cap to be set on such people’s bills. The regulations have been criticised for having too narrow a definition of vulnerable groups and for not reaching all those who are eligible. The regulations are under review and the Government expects to publish a report on the subject shortly.

29. In addition, it is conducting a cross-Government review of the ways in which low income groups are helped to pay. However, WaterVoice told us that the review had so far taken rather a narrow view of the options available for helping those on low incomes with their water bills and that the possibility of offering further help through the benefits and tax credits system has effectively been dismissed.³⁹ If this proves to be the case, WaterVoice told us that it would be necessary to consider meeting the costs of programmes for the wider public benefit, such as those associated with cleaning up bathing waters or protecting special environmental areas, through general taxation.⁴⁰ At present, it seems that the Government is reluctant to consider either option.

30. The Government does appear more prepared to consider ways of helping people to budget for their water bills.⁴¹ For example, for people who receive fortnightly benefit payments, it may be easier to pay a fortnightly, rather than a monthly, water bill. Increasing the number of people who can opt to have the cost of their water bill deducted from their benefit before it is paid to them – so called third party deduction – may also help people to budget. At present third party deductions are only offered to those whose payments are already in arrears.

³⁶ Ev 121 [Department for Work and Pensions]

³⁷ Ev 121 [ONS] The weight for “Water and other charges” within the overall RPI is derived ultimately from the ONS’s Expenditure and Food Survey. The weight for water and other charges in the Rossi index is calculated thus: Weight for “Water and other charges in RPI” / (total RPI weight less combined weight of those housing costs excluded from Rossi) = $11 / (1000 - 39 - 47 - 43 - 38) = 11 / 833 = 13$ parts per thousand, or 1.3 per cent.

³⁸ HC (2003-04)121, para 38

³⁹ Ev 70 [WaterVoice], para 21-24

⁴⁰ Ev 71 [WaterVoice], para 26

⁴¹ For example, see Q 75 [Defra]

31. As we said above, the Government should consider ways of meeting the costs of some improvements to the aquatic environment other than through water bills. However, the problem of affordability does not arise just from environmental costs and addressing the way the environmental programme is paid for would not in itself be enough to solve the problem of affordability. **We await with interest the review of the Water Industry Charges (Vulnerable Groups) Regulations and the cross-Government review of the ways in which low-income groups are helped with their water bills. However, we wish to make clear that we believe that many people on low incomes will have spent too great a proportion of their income on water. Adjusting the mechanisms for making payments would benefit some customers and would be welcome as an interim measure. But the Government should also consult on ways to reduce the charges paid by the poorest and on ways that the assistance offered to those on low incomes can reflect the great regional differences in water bills.**

5 Long-term issues

32. Ofwat intends to evaluate its approach to this price review with its stakeholders in the New Year. It will publish the results of the evaluation and says that the findings will inform its planning of the next price review in 2009. One of the issues that it will consider is whether the five year review cycle is the right length. Ofwat told us that there was a balance to be struck between the need to take account of the long-term investment required and the uncertainties in costs that are apparent even in a five year cycle.⁴²

33. In our first report we expressed concern about the ability of the five year price review system to allow for long-term investment, particularly that needed to meet the challenges of climate change and the requirements of the Water Framework Directive.⁴³ Water companies are required to make 25 year resource plans and this is one way in which long term issues can be considered.⁴⁴ **We are still concerned that the five year cycle will tend to delay expenditure until the problems become urgent. We recommend that Ofwat, the water companies and the Government use the opportunity of Ofwat's evaluation of the price review process to assess the long-term risks and challenges that the water industry faces and report back to us on how coping with these risks will be funded.**

⁴² Q1

⁴³ HC (2003-04)121, para 15

⁴⁴ Q1

Conclusions and recommendations

Transparency of the review process

1. We are disappointed that Ofwat felt it could not be clearer about which maintenance and improvement programmes were allowed for in its draft determination of price limits. We hope that this is resolved in its final determination of price limits, in order that customers and other stakeholders may have the clearest possible understanding of what they can expect water companies to deliver. If Ofwat chooses not to present this information, it should write to us explaining its decision. (Paragraph 11)
2. We recommend that Ofwat considers WaterVoice's suggestions for clearer ways to explain to customers the impact of changes in price limits during its evaluation of this price review. (Paragraph 13)
3. The controversy over the cost of the environment programme risks giving the impression to customers that water bills are a source of investment for environmental work, albeit vital work, that it would otherwise be difficult to fund. There is no perfect way of presenting information about these costs, but Ofwat should consider how information can be presented to give customers the most accurate possible picture of the costs of and reasons for the environment programme and how they contribute to the overall bill. The Government should also consider making a statement at the start of the process stating in clear terms details of the environmental legislation which the water companies will have to comply with over the five-year period of the pricing review. (Paragraph 15)
4. We are particularly disappointed that the Government has been slow to address the problems of diffuse water pollution and flooding caused by urban run off and that as a result the costs of these problems fall on water customers. The Government should consider whether charging via water bills is the most equitable way of funding the effects of these environmental challenges as well as the impact of climate change. The Government should make clear, at the earliest opportunity, its plans for solving these problems. (Paragraph 16)

The respective roles of Ofwat, the quality regulators and Defra

5. As the price review system stands, it is not for Ofwat to determine the content of the environmental and quality improvement programmes. We are concerned that, if the final determination does not fund statutory requirements, those companies will apply for further increases in their price limits before the next review. This would undermine the value of the price review process. We recommend that the Government examine closely how the regulator has responded to its guidance and to what extent statutory schemes have been allowed for in the price limits. (Paragraph 19)

'Horse trading'

6. We accept that an economic regulator for an inherently monopolistic industry like the water industry can never be a perfect surrogate for market competition. However we are concerned that the bidding process seems to result in such stark differences of opinion over costs, value for money and the scope for efficiency savings that the regulator, in his draft determinations at least, halved the bid set out by the companies. We recommend that the Government re-examine the methodology of the bidding process to identify the reasons for the striking differences between the companies' and the regulator's positions. (Paragraph 21)

Sewer flooding

7. We accept that it may not be possible to address every property at risk of sewer flooding, but we are concerned that the problem appears to linger on from price review to price review, leaving a backlog of properties waiting to be addressed. This is of particular concern given the likelihood of increased risk of sewer flooding identified in the Office of Science and Technology's Foresight report on flood risk and climate change. We recommend that companies prioritise action in those areas at highest risk and that, in examining the cost-benefit ratio of plans presented by the companies, Ofwat consider the distress and inconvenience of those affected as well as economic damage. (Paragraph 24)

Affordability

8. We await with interest the review of the Water Industry Charges (Vulnerable Groups) Regulations and the cross-Government review of the ways in which low-income groups are helped with their water bills. However, we wish to make clear that we believe that many people on low incomes will have spent too great a proportion of their income on water. Adjusting the mechanisms for making payments would benefit some customers and would be welcome as an interim measure. But the Government should also consult on ways to reduce the charges paid by the poorest and on ways that the assistance offered to those on low incomes can reflect the great regional differences in water bills. (Paragraph 31)

Long-term issues

9. We are still concerned that the five year cycle will tend to delay expenditure until the problems become urgent. We recommend that Ofwat, the water companies and the Government use the opportunity of Ofwat's evaluation of the price review process to assess the long-term risks and challenges that the water industry faces and report back to us on how coping with these risks will be funded. (Paragraph 33)

Formal minutes

Wednesday 17 November 2004

Members present:

Mr Michael Jack, in the Chair

Mr Colin Breed	Austin Mitchell
David Drew	Joan Ruddock
Patrick Hall	Paddy Tipping
Mr Mark Lazarowicz	Mr Bill Wiggin
Mr David Lepper	

The Committee deliberated.

Draft Report [*Water Pricing: follow-up*], proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 33 read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Eighteenth Report of the Committee to the House.

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

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

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

Ordered, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House.—(*The Chairman*).

Several memoranda were ordered to be reported to the House.

[Adjourned till Wednesday 1 December at Two o'clock.]

Witnesses

Wednesday 20 October 2004

Philip Fletcher, Bill Emery and Fiona Pethick, **Office of Water Services (Ofwat)** Ev 8

Wednesday 27 October 2004

Elliot Morley MP and Richard Bird, **Department for Environment, Food and Rural Affairs** Ev 32

Wednesday 3 November 2004

Roy Pointer, John Sexton and John Roberts, **Water UK** Ev 59

Maurice Terry and Andrea Cook, **WaterVoice** Ev 74

Baroness Barbara Young and Dr Andrew Skinner, **Environment Agency** Ev 93

List of written evidence

Office of Water Services (Ofwat)	Ev 1, 22, 23
Department for Environment, Food and Rural Affairs	Ev 26
Water UK	Ev 44
Anglian Water Services Ltd	Ev 48
Thames Water Utilities Ltd	Ev 51
United Utilities plc	Ev 55, 67
WaterVoice	Ev 68, 80
Environment Agency	Ev 88
Northumbrian Water Ltd	Ev 100
Chartered Institution of Water and Environmental Management (CIWEM)	Ev 103
Royal Society for the Protection of Birds (RSPB)	Ev 105
Institution of Civil Engineers Water Board	Ev 108
Association of British Insurers	Ev 109
English Nature	Ev 114
Pippa Woods	Ev 117
National Consumer Council	Ev 117
Office for National Statistics	Ev 121
Department for Work and Pensions	Ev 121
Unison	Ev 121

List of unprinted written evidence

Additional papers have been received from the following and have been reported to the House but to save printing costs they have not been printed and copies have been placed in the House of Commons library where they may be inspected by members. Other copies are in the Record Office, House of Lords and are available to the public for inspection. Requests for inspection should be addressed to the Record Office, House of Lords, London SW1. (Tel 020 7219 3074) hours of inspection are from 9:30am to 5:00pm on Mondays to Fridays.

WaterVoice appendices A and B.

Reports from the Committee since 2001

Session 2003–04

Eighteenth Report	Dismantling Defunct Ships in the UK	HC 834
Seventeenth Report	Agriculture and EU Enlargement	HC 421
Sixteenth Report	Climate Change, Water Security and Flooding	HC 558
Fifteenth Report	The Departmental Annual Report 2004	HC 707
Fourteenth Report	Sites of Special Scientific Interest (<i>Reply, HC 1255</i>)	HC 475
Thirteenth Report	Bovine TB (<i>Reply, HC 1130</i>)	HC 638
Twelfth Report	Reform of the Sugar Regime (<i>Reply, HC 1129</i>)	HC 550-I
Eleventh Report	GM Planting Regime (<i>Reply, HC 1128</i>)	HC 607
Tenth Report	Marine Environment: Government reply to the Committee's Report	HC 706
Ninth Report	Milk Pricing in the United Kingdom (<i>Reply HC 1036</i>)	HC 335
Eighth Report	Gangmasters (follow up) (<i>Reply, HC 1035</i>)	HC 455
Seventh Report	Implementation of CAP Reform in the UK (<i>Reply, HC 916</i>)	HC 226-I
Sixth Report	Marine Environment (<i>Reply, HC 706</i>)	HC 76
Fifth Report	The Food Standards Agency and Shellfish (<i>Reply, HC 601</i>)	HC 248
Fourth Report	Environmental Directives (<i>Reply, HC 557</i>)	HC 103
Third Report	Caught in the net: Cetacean by-catch of dolphins and porpoises off the UK coast (<i>Reply, HC 540</i>)	HC 88
Second Report	Annual Report of the Committee 2003	HC 225
First Report	Water Pricing (<i>Reply, HC 420</i>)	HC 121

Session 2002–03

Eighteenth Report	Conduct of the GM Public Debate (<i>Reply HC 443 Session 2003-04</i>)	HC 220
Seventeenth Report	Biofuels (<i>Reply, HC 88 Session 2003-04</i>)	
	HC 929-I Sixteenth Report Vets and Veterinary Services	HC 703
Fifteenth Report	New Covent Garden Market: a follow-up (<i>Reply, HC 123 Session 2003-04</i>)	HC 901
Fourteenth Report	Gangmasters (<i>Reply, HC 122 Session 2003-04</i>)	HC 691
Thirteenth Report	Poultry Farming in the United Kingdom (<i>Reply, HC 1219</i>)	HC 79-I
Twelfth Report	The Departmental Annual Report 2003 (<i>Reply, HC 1175</i>)	HC 832
Eleventh Report	Rural Broadband (<i>Reply, HC 1174</i>)	HC 587
Tenth Report	Horticulture Research International (<i>Reply, HC 1086</i>)	HC 873
Ninth Report	The Delivery of Education in Rural Areas (<i>Reply, HC 1085</i>)	HC 467
Eighth Report	The Future of Waste Management (<i>Reply, HC 1084</i>)	HC 385
Seventh Report	Badgers and Bovine TB (<i>Reply, HC 831</i>)	HC 432
Sixth Report	Rural Payments Agency (<i>Reply, HC 830</i>)	HC 382
Fifth Report	The Countryside and Rights of Way Act 2000 (<i>Reply, HC 748</i>)	HC 394
Fourth Report	Water Framework Directive (<i>Reply, HC 749</i>)	HC 130
Third Report	The Mid-term Review of the Common Agricultural Policy (<i>Reply, HC 615</i>)	HC 151
Second Report	Annual Report of the Committee 2002	HC 269
First Report	Reform of the Common Fisheries Policy (<i>Reply, HC 478</i>)	HC 110

Session 2001–02

Tenth Report	The Role of Defra (<i>Reply, HC 340, Session 2002-03</i>)	HC 991
Ninth Report	The Future of UK Agriculture in a Changing World (<i>Reply, HC 384, Session 2002-03</i>)	HC 550
Eighth Report	Hazardous Waste (<i>Reply, HC 1225</i>)	HC 919
Seventh Report	Illegal Meat Imports (<i>Reply, HC 1224</i>)	HC 968
Sixth Report	Departmental Annual Report 2002 (<i>Reply, HC 1223</i>)	HC 969
Fifth Report	Genetically Modified Organisms (<i>Reply, HC 1222</i>)	HC 767
Fourth Report	Disposal of Refrigerators (<i>Reply, HC 1226</i>)	HC 673
Third Report	Radioactive Waste: The Government's Consultation Process (<i>Reply, HC 1221</i>)	HC 407
Second Report	The Countryside Agency (<i>Reply, HC 829</i>)	HC 386
First Report	The Impact of Food and Mouth Disease (<i>Reply, HC 856</i>)	HC 323

Oral evidence

Taken before the Environment, Food and Rural Affairs Committee, Water Pricing Sub-Committee

on Wednesday 20 October 2004

Members present:

Mr Michael Jack, in the Chair

Mr David Drew
Patrick Hall
Mr Mark Lazarowicz

Mr David Lepper
David Taylor
Paddy Tipping

Memorandum submitted by Ofwat

SUMMARY

We published our draft determinations of price limits on 5 August 2004. Our decisions would mean an annual average price limit of 3.2% before inflation. This would lead to an increase over the period to the average household bill of £34 from £249 in 2004–05 to £283 by 2009–10. The price limits and their effect on average bills vary from company to company according to the companies' different circumstances and obligations. Most customers, however, will see an increase in their water and sewerage bills.

In general terms we were content with the strategies companies proposed in their business plans. However following scrutiny and challenge we consider that companies generally overestimated the costs of implementing their plans and underestimated the scope for efficiency.

In arriving at our draft price limits we have reflected the costs the companies face in the year when they are incurred. The price limits are therefore greatest in 2005–06, the first year of the price limit period, reflecting the underlying profile of the changes in costs the companies face.

The draft price limits would allow the companies to reduce significantly the numbers of properties at risk of sewer flooding. Our draft determinations allow for progress by 2010 on 94% of the quality and environmental improvement projects in companies' business plans. In a few cases we have not included some projects because the proposals were not fully specified or were too costly. Following reappraisal some of these projects may meet our criteria for inclusion in our final determinations.

We consider our draft determinations to be soundly based on the information available. We are now working on our final determinations. These will take into account final guidance from Ministers, representations from companies and other stakeholders. We will examine the representations carefully and take account of new information or arguments that may mean changes up or down to our determinations.

The companies, customers and other stakeholders are now making representations on our decisions. In arriving at our final determinations in December we will take account of Ministers' final guidance as well as carefully considering these representations.

We intend to review our approach to this price review with our stakeholders in the New Year. We will publish the results of this and the findings will inform our planning of the next price review in 2009.

THE PRICE REVIEW

1. We have worked hard to carry out this review transparently and efficiently. The companies and others have in general acknowledged that progress has been made on this issue. We have shared our financial model with the companies; consulted on our methodology; companies submitted draft business plans setting out what price limits companies considered they needed prior to delivery of their final business plans.

2. We produced a comprehensive publication setting out our initial decisions and how we arrived at them, "Future water and sewerage charges 2005–10: Draft determinations".¹ We have also provided each company with a supplementary report setting out in detail how we have dealt with their business plans and the assumptions underlying our decisions.

¹ On 9 September we published "Ofwat corrects draft determinations for Thames Water" (Information bulletin 03/04).

3. We are meeting each of the 10 WaterVoice Committees, the WaterVoice Council and the quality regulators during the month of September. These meetings will provide an opportunity to discuss their representations on our draft determinations with us before they submit them. This is followed by meetings with each company, in October, to consider their concerns around the draft determination. In addition, we are receiving written representations from customers and other stakeholders.

4. The price limits we set need to be sufficient to enable each water company to run its business day-to-day and make required improvements to service, environment and drinking water quality while also being no higher than necessary for customers of monopoly businesses. In our judgement our draft determinations met this balance.

5. We expect final guidance from Ministers in September. We will take this and the representations we receive into account when we set final price limits. In considering representations we shall require convincing arguments or new information to justify any change.

6. We welcome the Committee's interest in the price review process and outcomes and we expect the Committee's conclusions following this inquiry to be relevant to our review of the price review and our planning for the 2009 price review. We would also welcome an opportunity to explain our final determinations to the Committee, following their publication in December.

OUR DRAFT DECISIONS

7. Our draft determinations were arrived at after careful scrutiny of each company's business plans. In general terms we were content with the strategies that the companies proposed. We consider that companies have however tended to overestimate the costs of their strategies and to underestimate the scope for further improvements in efficiency.

8. Our draft determinations for the period 2005–10 would mean an annual average increase in price limits of 3.2% before inflation. On average the companies sought annual price increases of 6.2% in their business plans. Annex 1 sets out the price limits for each company. The price limits vary from company to company.

9. The average household bill of £249 in 2004–05 will rise £34 to £283 by 2009–10, a real terms increase of 13%. The main drivers for changes to bills are set out in the table below. The change in bills reflects the additional revenue required by the companies in the next period over that received in the current five-year period. Additional costs arise from the financing of projects that enhance the assets the companies own. These include projects to provide additional water supplies and sewerage services through growth in demand, drinking water quality improvements, improved customer service as well significant new investment in the environment programme. The scope for reduction to bills through future efficiency improvements is identified separately in this table, but in practice it applies to each of the areas of expenditure. Figure 4 of "Future water and sewerage charges 2005–10: Draft determinations" sets out the efficiency assumptions we used in arriving at our draft determinations of price limits.

10. The increases to the average bill for each company are set out in annex 2. Companies' business plans proposed an increase of 29% to average household bills, an increase of about £72 before inflation.

OFWAT'S DRAFT DETERMINATIONS: DRIVERS FOR CHANGE

Average household bill in 2004–05 (£s)		£249
Less	(1) past efficiency savings and out-performance	(4)
	(2) scope for reduction through future efficiency improvements	(17)
Plus	(3) maintaining base services	15
	of which (a) changes in revenue	(6)
	(b) changes in operating costs	9
	(c) changes in capital maintenance	6
	(d) changes in impact of taxation	5
	(e) financing	2
	(4) maintaining security of supplies to all customers	9
	(5) the impact of improvements in services	30
	of which (a) drinking water quality	8
	(b) environmental improvements	20
	(c) service performance	2
Average household bill in 2009–10		£283
Change from 2004–05 to 2009–10		£34

11. Due to the costs the companies face the price limits are greatest in the first year, 2005–06. For the industry as a whole the average price limits would be 7.8% in that year. The scale of the increase then reduces year-by-year for the remaining four years tailing off to 1.2% in 2009–10. The companies’ proposals in their business plans would have led to an average increase of 13.4% in 2005–06.

12. The profile of price limits reflects year-by-year the changes in costs faced by the companies. Our draft determinations only smooth the draft price limits for one company. The rise in 2005–06 for South West would have been higher if we had not followed the company’s proposal in its business plan and spread the price rise more evenly.

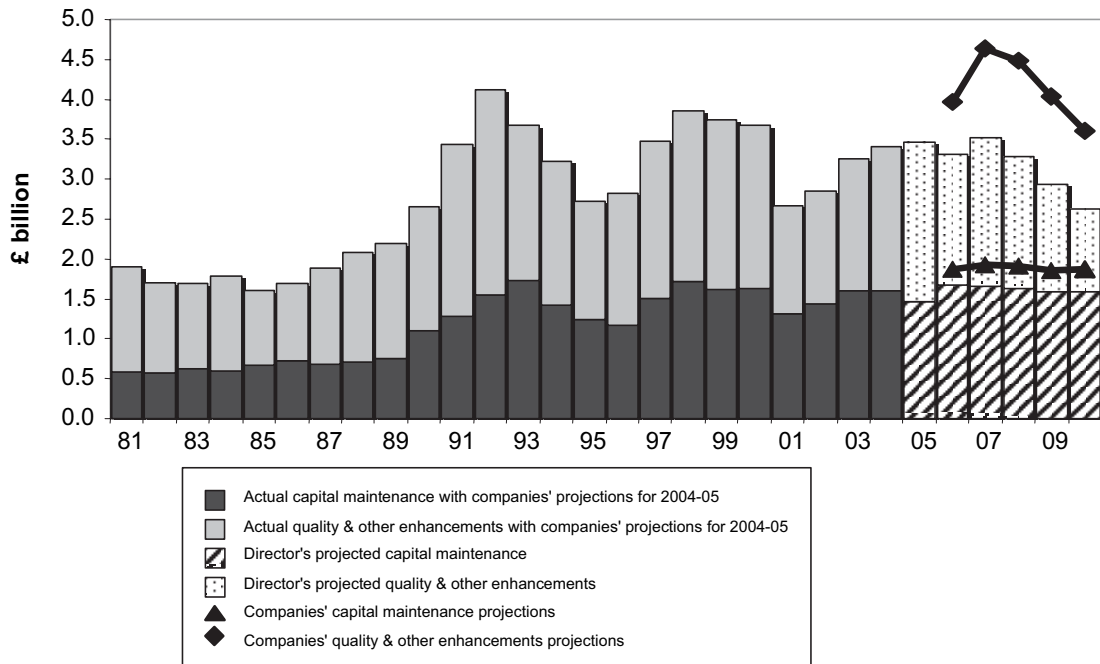
13. We are aware of the effect of price increases on customers who find it difficult to afford water bills. We are contributing to Defra’s review to examine the issue of affordability of water bills and options to help customers who have problems paying their bills. We recognise this is an important issue, and while we cannot set price limits on the basis of affordability we have worked hard to ensure that customers’ bills are no higher than they have to be.

What will the price limits deliver?

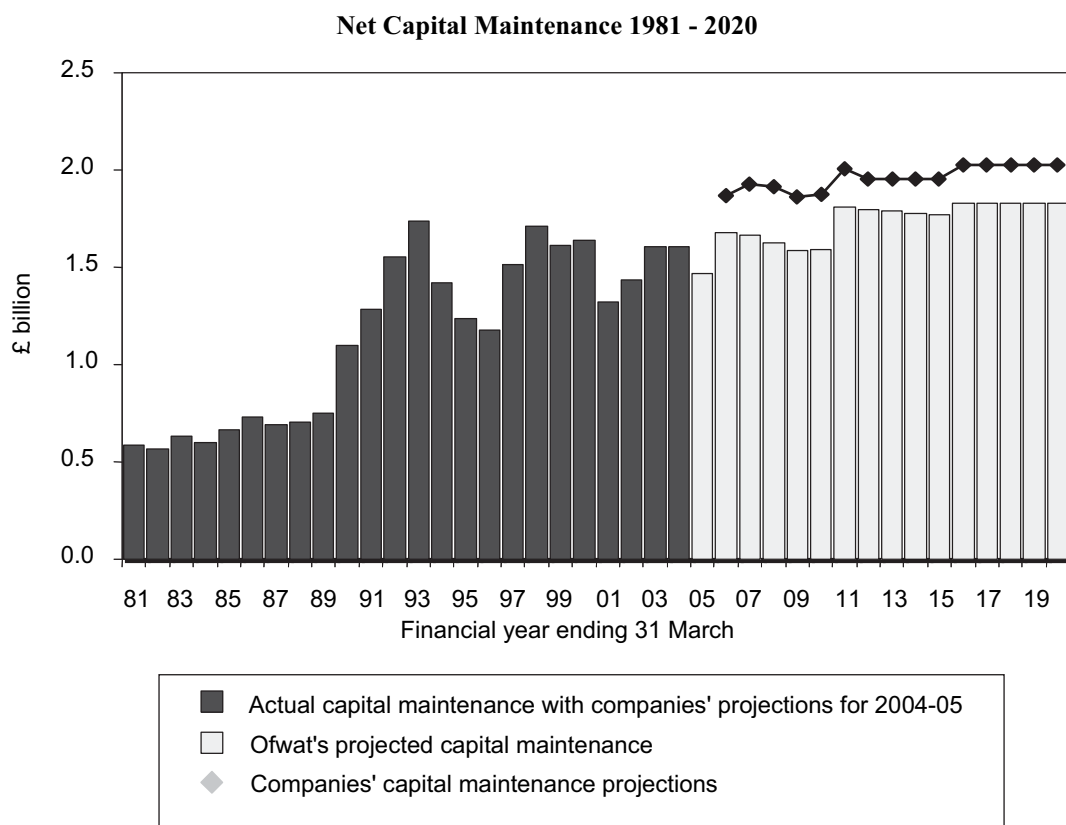
14. The price limits will allow the companies to maintain their existing services to customers. Our draft price limits assume an increase to the industry’s operating costs of 4% due to rising costs faced by the companies including pension and energy costs, tax and the additional running costs of the improvement programme.

15. The table below sets out for comparison the capital investment proposals included in companies’ business plans and the assumptions included in our draft determinations.

**Actual and Projected Net Capital Investment
1981 - 2010**



16. Our draft price limits assume that current services will be maintained. Companies need to continue to sustain the serviceability of their assets over the period 2005–10. Companies will have invested around £7.5 billion on maintaining their assets in 2000–05. We have allowed £8.1 billion in our draft price limits for 2009–10, a 9% increase over companies’ expenditure in 2000–05 and 18% more than we assumed at the 1999 price review. This will allow the companies to undertake more activity to maintain their assets, as shown in the table below.



17. We consider our price limits will allow companies to meet all changes in demand for water and sewerage services from new and existing customers; promote the efficient use of water; and ensure leakage is kept at the economic level. They will also allow the companies to prepare for the impacts of climate change. The capital expenditure assumed in our draft price limits will allow the companies to ensure that the supply of water meets essential demands and the sewerage systems can deal with increased volumes of sewage. This includes upgrading and extending the sewerage systems to reduce the number of properties at risk of regular flooding from overloaded sewers.

18. The draft price limits assume that the industry will invest around £5.1 billion for new quality and environmental expenditure following our challenges to the companies' proposals of £6.9 billion. Our draft determinations include about 94% of the projects included in companies' business plans. We have excluded some projects, either because the proposals were not fully specified or were very costly. However, our price limits assume the companies will undertake work on more than 4,000 of the 4,406 projects they included in their business plans.

19. The guidance provided by Ministers in March 2004 set out the programme of quality and environmental improvements. This was interpreted by the Environment Agency and the DWI who specified or gave technical support for individual schemes. We reviewed the projects included in companies' business plans against our criteria. The overwhelming majority have been included in our draft determinations. Some excluded projects may meet our criteria for inclusion in our final determinations; for example, projects that have been "parked" as further work is needed to specify the activities and costs they involve and to assess their economic viability. There are also mechanisms in place to allow companies to deal with projects that are subsequently identified as needing expenditure in the period 2005–10.

20. Most of the capital expenditure we have allowed to improve service levels relates to sewer flooding. This will resolve 8,200 of known and emerging internal problems and 4,480 of external ones. This will allow companies to deal with around half of currently known internal problems and most of those forecast to emerge during 2005–10. The draft price limits also allow for measures to mitigate the effects of sewer flooding at 4,000 additional properties where a permanent solution cannot be found and 3,700 cases of flooding caused by repeated blockages. By 2010 only 0.02% of households will be at risk of sewer flooding.

21. In their final business plans companies proposed capital expenditure (net of grants and contributions) of £20.7 billion. Our draft determinations assumed capital expenditure of £15.7 billion. The difference arises from changes to the scope of the work we assumed companies needed to do (£2.8 billion); the costs of schemes which were "parked" for further work to be done on specifying activity costs and viability (£1.4 billion); and the more ambitious efficiency targets we set for companies than they set for themselves (£0.8 billion).

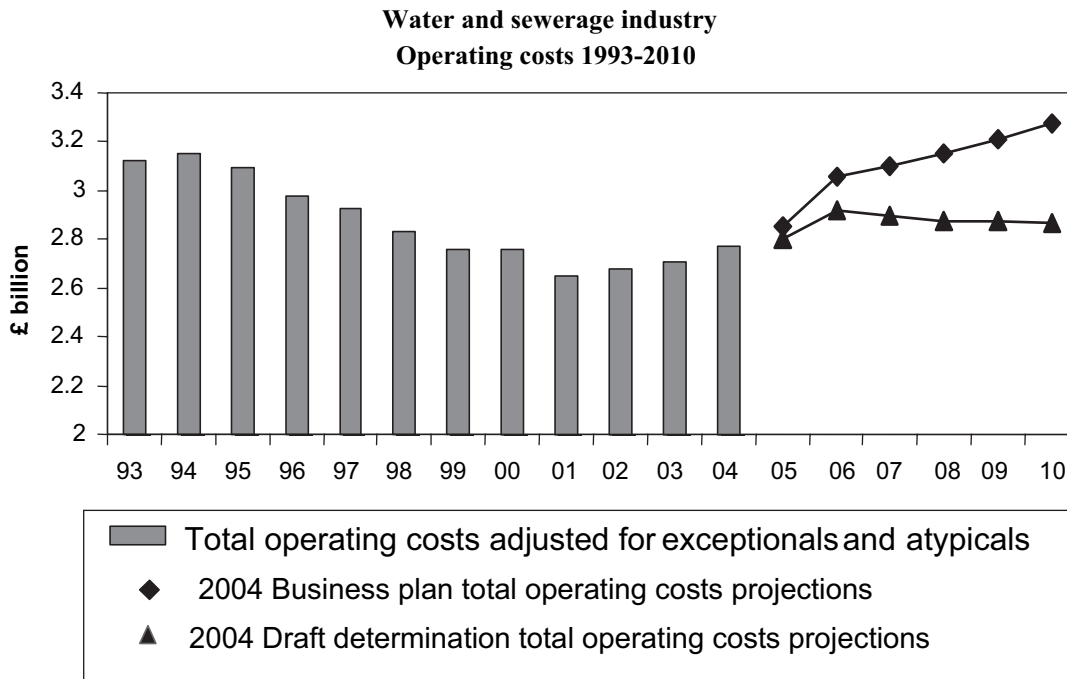
EFFICIENCY SAVINGS AND OUT-PERFORMANCE

22. Each time price limits have been set we have included challenging efficiency assumptions over and above the improvements achieved in the economy as a whole. Each time the industry has subsequently performed better than we assumed. This allows customers to benefit through bills being lower than would otherwise be the case.

23. The industry has continued to out-perform during the current five-year period, although to a lesser extent than previously. Our analysis of the relative efficiency of the companies indicates that there is still considerable variation in performance.

24. We have assessed the scope for continuing efficiency for the water and sewerage services and the potential for less efficient companies to catch-up with the best performing companies over the five-year period. In order to continue to provide incentives to companies to out-perform we have assumed only half the scope for efficiency savings in our draft price limits, the remaining half being potential out-performance for the companies. We have assessed the scope for efficiency by service for operating costs. For capital expenditure we have made different assessments of the scope for efficiency for capital maintenance and capital enhancement expenditure for both the water and sewerage services. At this price review we estimate that past out-performance and future efficiency improvements would reduce the average household bill in 2004–05 to £21 by 2009–10. We estimate that the overall effect of efficiency improvements since privatisation would have reduced bills by around £90.

25. In arriving at our draft assumptions on the scope for efficiency we took account of the studies that we commissioned on the scope for future efficiency as well as those commissioned by the industry and others, including Ofgem. We have updated and refined our analysis of the relative efficiency of each company in its operations, capital maintenance and new capital works using the latest information provided by the companies. We consider our judgements to be soundly based providing demanding efficiency assumptions for the companies as well as incentives to outperform.

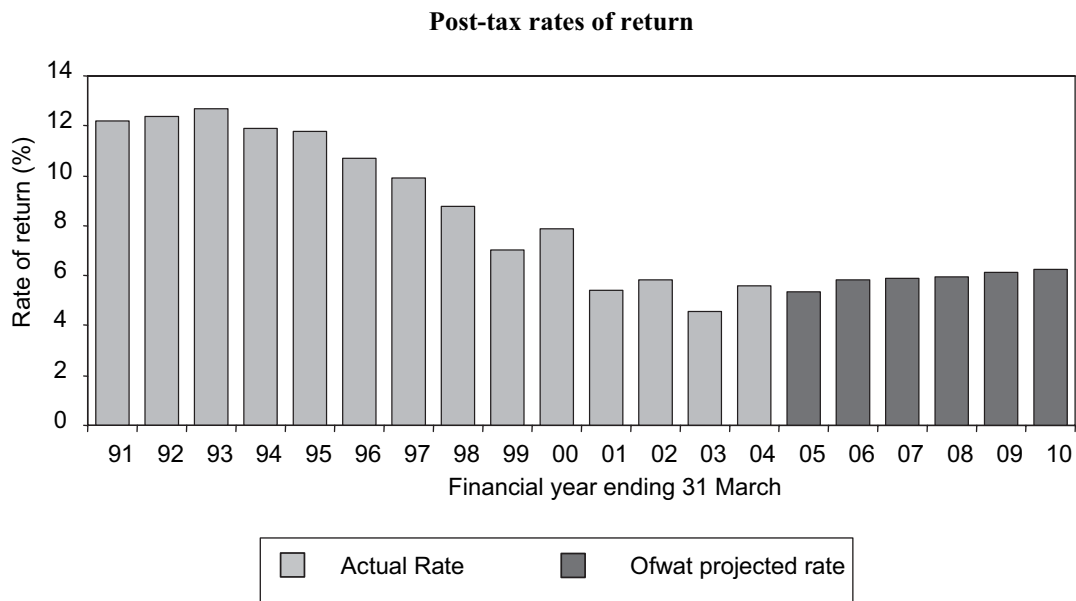


FINANCIAL ISSUES

26. We have a duty to ensure that efficient companies are able to finance their functions. The price limits we set enable companies to earn returns that are at least equal to the cost of capital and be in a position to raise finance on reasonable terms in the capital markets. The continuing large capital programmes that the companies face has made our approach to financeability and the cost of capital critical at this review.

27. The cost of capital is the minimum return investors require if they are to provide capital to a company. It may be viewed as the weighted average of the costs of a company’s debt and equity finance. The cost of capital is applied to the entire capital base of each company. If the cost of capital is set too low then companies may experience difficulties in financing their investment programmes; if too high shareholders may earn windfall returns. Taking all relevant factors into account we have assumed a cost of capital of 5.1% post-tax in real terms in our determinations. We have also allowed a small company premium for the water only companies, ranging from 0.2% to 0.7% depending on the size of the company.

28. A consequence of the major capital investment programmes required of the companies is persistent negative cashflow, which could restrict companies' access to capital markets and increase the cost of capital they face. We believe the draft price limits we have proposed are a balanced outcome which are fair to customers but do not jeopardise the companies' ability to access capital markets and finance their functions. Our draft price limits include around 0.5% in aggregate, for 2007–08 rising to 1% in 2009–10 to allow companies to maintain their financeability. This reflects the constraints on the capital programme in the later years of the period. This is set out in the bar chart below.



THE LONG TERM

29. We have approached this price review, as we have previous reviews, with the objective of ensuring the effective, and financially viable long-term provision of appropriate quality services to customers. At price reviews we must focus on the next five years, but make our decisions within the context of the longer term. We need to take account of uncertainties when looking to the longer term and have in place systems to deal with uncertainties should they arise.

30. Climate change will impact on the provision of water and sewerage services. The frameworks are in place to allow companies to identify and address the impact of climate change as this becomes clearer. At this price review the companies did not seek significant precautionary investment in their business plans for the five-year period. However, climate change was identified as a growing future issue for both the water and sewerage networks. As the impact becomes more certain appropriate strategies can be incorporated into future price reviews. Future price reviews will also take account of the Water Framework Directive and other prospective EU and national legislation.

24 September 2004

Annex 1

Draft Price Limits for 2005–06 to 2009–10

Company	2005–06	2006–07	Annual price limits ¹		2009–10	Average ²
			2007–08	2008–09		
Water and sewerage companies (WaSC)						
Anglian	2.4	−0.6	2.3	1.2	2.1	1.5
Dwr Cymru	13.2	2.4	3.0	2.6	1.5	4.5
Northumbrian	4.3	2.0	1.5	0.0	0.0	1.5
Severn Trent	10.4	4.5	1.3	0.8	0.8	3.5
South West	12.5	8.0	2.8	2.8	2.3	5.6
Southern	7.5	4.1	1.8	5.1	1.7	4.0
Thames	14.2	1.6	0.0	0.1	0.0	3.0
United Utilities	1.8	5.6	4.2	3.5	2.2	3.5
Wessex	7.4	3.9	4.6	3.3	2.0	4.2
Yorkshire	4.7	3.7	2.4	2.8	2.7	3.3
WaSC average (weighted)	7.6	3.3	2.2	1.9	1.4	3.3
Water only companies (WoC)						
Bournemouth and West						
Hampshire	14.4	0.6	1.8	−0.5	−2.4	2.6
Bristol	11.1	2.4	1.5	0.6	−2.2	2.6
Cambridge	9.3	1.0	−0.1	−0.2	−0.7	1.8
Cholderton	5.4	−0.8	0.5	−2.0	−0.1	0.6
Dee Valley	4.3	−1.7	0.2	0.0	−0.2	0.5
Folkestone and Dover	8.5	3.3	2.4	1.4	1.2	3.3
Mid Kent	4.1	0.1	1.4	−0.6	−1.2	0.7
Portsmouth	−3.5	−1.2	0.8	1.3	0.0	−0.5
South East	13.8	2.0	0.8	0.1	−1.3	2.9
South Staffordshire	7.4	2.4	1.2	0.6	0.9	2.5
Sutton and East Surrey	8.8	1.5	0.8	−1.4	−1.6	1.6
Tendring Hundred	−4.3	−1.2	0.5	−0.5	−1.2	−1.4
Three Valleys	14.2	1.3	0.8	−1.0	−0.6	2.8
WoC average (weighted)	10.2	1.3	1.0	−0.2	−0.9	2.2
Draft determination	7.8	3.1	2.1	1.8	1.2	3.2

¹ The price limits for 2005–06 take account of any unused K carried over from previous years. For companies with carry over, the formal adjustment factor (K) set for that year will be lower than the effective price limits shown here.

² The average for the price limits is the geometric average of the annual price limits.

AVERAGE EXPECTED HOUSEHOLD BILLS¹

Company	2004–05		Average annual household bills (£) ² 2009–10		Change		Total	% Change
	Water	Sewerage	Water	Sewerage	Water	Sewerage		
Water and sewerage companies								
Anglian	122	172	137	166	15	–6	9	3%
Hartlepool	94	—	106	—	12	—	12	13%
Dwr Cymru	123	163	147	190	24	27	51	18%
Northumbrian	100	132	107	137	7	5	12	5%
Essex & Suffolk	132	—	143	—	11	—	11	9%
Severn Trent	116	105	130	127	14	22	35	16%
South West	126	231	168	250	42	19	61	17%
Southern	91	168	106	197	15	29	44	17%
Thames	113	98	149	99	36	2	38	18%
United Utilities	133	136	145	170	13	34	47	17%
Wessex	126	151	164	168	38	17	55	20%
Yorkshire	117	126	132	147	16	20	36	15%
WaSC average (weighted)	118	132	138	147	20	15	35	14%
Water only companies								
Bournemouth & W Hampshire	107		119		12		12	11%
Bristol	108		120		12		12	11%
Cambridge	91		98		7		7	8%
Cholderton	147		153		6		6	4%
Dee Valley	107		104		–3		–3	–2%
Folkestone & Dover	143		166		22		22	16%
Mid Kent	131		133		2		2	2%
Portsmouth	77		76		–1		–1	–1%
South East	129		145		16		16	12%
South Staffordshire	91		103		11		11	12%
Sutton & E Surrey	127		136		9		9	7%
Tendring Hundred	162		152		–10		–10	–6%
Three Valleys	118		134		16		16	13%
WoC average (weighted)	113		124		11		11	10%
Draft determination	117	132	136	147	18	15	34	13%

1. This table is quoted in 2004–05 basket year prices all other figures quoted in this document are in 2002–03 financial year average prices unless otherwise stated.
2. The actual impact on customers' household bills will also be governed by companies' approved charges schemes.

Witnesses: Mr Philip Fletcher, Director General, *Dr Bill Emery*, Director Costs and Performance Division and Chief Engineer, and *Ms Fiona Pethick*, Periodic Review Project Manager, Ofwat, examined.

Q1 Chairman: Good afternoon, ladies and gentlemen, and welcome to the first session of our sub-committee hearing into water pricing. Can I just say by way of a piece of housekeeping before I officially welcome our witnesses that a vote is expected shortly. No disrespect to all of those who have just come in if we just rush out. We hope that we can vote and turn around for a short adjournment in about 10 minutes. So, I apologise that we are going to be disrupted. I would like to welcome officially to the Committee Philip Fletcher, the Director General of the Office of Water Services and he is accompanied by Bill Emery, the Director of Costs and Performance Division and the Chief

Engineer—that lot keeps you very busy I am sure—and Fiona Pethick who is the Periodic Review Project Manager. Can I thank you all for coming in at this stage. We are aware obviously that the nearer we came to your final determination, there are some sensitivities, which is why we thought we would rather unusually start with you rather than finish up because we wanted to give you maximum opportunity to talk as freely as you are able to about the exercise in terms of the final determination of water pricing which I gather is scheduled for December. I would just like to open the questioning on this with a general question. We have done a number of inquiries now on issues connected with

20 October 2004 Mr Philip Fletcher, Dr Bill Emery and Ms Fiona Pethick

water security and water flooding and we also looked before at water pricing issues and we did a study on the water framework directive. All the issues raised by the reports that the Committee put out on that indicated that we are dealing with some very long-term and big investment challenges and I would just like to ask whether in general, Mr Fletcher, you consider that the five-year cycle is the right one for these very long-term investment decisions because, in your evidence, you point to a number of these issues, you are cognisant of them and you say that you are trying to take all these into account and then you indicate that the current review is front-end loaded and that the increases are going to go off but, if we then take the forthcoming attractions of all the investment the water companies tell us they are going to have to make to meet water framework directive climate change challenges, what we might see is another one of your roller-coasters where you go up and then you come down and then the prices go up again. Should we not be looking at this over a longer timescale given the length of the timescale of the issues to which I have just referred?

Mr Fletcher: I think inevitably, Chairman, the five years is a compromise. I entirely accept your point that we are dealing with a long-term industry which needs a long-term picture. Our price review is actually running alongside the water resource plans which the companies prepare and which the Environment Agency invigilates them on which look over a 25-year period. So, if you take that into account plus the fact that looking at capital maintenance, another very significant issue, we have actually looked over, going forward, the period up to 2020 and going backwards, because backwards is also important here, another 10–15 years back, because we do seek to ensure that we take account of the longer-term issues. Arguing on the other side of the scale, it has proved quite difficult, even in this review, at this stage, to get an absolutely clear fix on all that the companies are going to need to do over the five years until 2010.

Q2 Chairman: Is that because they do not know?

Mr Fletcher: It is partly because they are not in a position to know. For example, there are still some important issues around the Habitats Directive where it is quite likely that more will come along which ought at least, in a spirit of hope, to be carried out before 2010 to observe all our EU directive responsibilities. So, we are faced with uncertainty and we need provisions in the system to deal with uncertainty even coming up in a five-year period and we need as much stability as possible for the companies given the way in which incentive-based regulation works. So, if they have a solid platform on which to perform to be even more efficient than we are assuming over whatever period it is. Taking account of these long-term environmental periods, at the moment I think five years is about right but we have undertaken that once this review is out of the way, next year, we shall be conducting a separate review on whether the following review from 2010 onwards could extend, as ideally it should, longer

than a five-year period. I actually think there are wider issues here to fit with the Water Framework Directive and so, almost by good fortune, the fit is not at all bad given where we are.

Q3 Chairman: Before I get into more specific questions about your submission, what informs and guides you is the Secretary of State's guidance and I appreciate that it is a very lengthy and detailed document but, having looked at the final guidance text for the periodic review 2004, I note that, in the foreword to that document, the Secretary of State says, "The Government is particularly concerned about the impact of water bills on the least able to pay" and we are going to talk about that in more detail. What I was particularly interested in was when you received this guidance from the Secretary of State, how do you pick out and weigh the various messages that are in there? So, if I said to you, what are the three key things that are in your mind that the Secretary of State has guided you about and what weight do you attach to them, give us a flavour of how the Secretary of State's guidance is used by you in your work.

Mr Fletcher: I look at it always in the context of statute. I have been given by Parliament a job to do and some very specific rules on how to do it. The Secretary of State is very conscious of that and has always made entirely clear, for example, her acknowledgement that the context is that I take the decisions on the price limits because I have that job under the statute. Within that context, I take her guidance as a whole. There are very specific things, perhaps I would put it right at the head of the queue, where the UK Government are in a position to take the decisions that I am not. Most obviously, what are our international obligations and our statutory obligations most often arising through European directives? She is the one who knows what needs to be done and why—and obviously she gets advice on that—and I take a great deal of notice of just what she tells me. I do not want to give the wrong impression, I take a great deal of notice of everything she tells me. She clearly also attaches importance to the bills being no higher than they need to be, but that is the way in which I have to interpret this point: it is, do not be excessively generous to the companies but do your statutory job, Director General, and that statutory job is to enable efficient companies to carry out and finance their functions. That is the primary statutory duty. So, the need to take account of affordability and the least well-off customers, which I take very seriously, has to be in that overall statutory context. Those are probably the two main things that I want to pick up but we do go through all of it. As you say, the first guidance—there were three stages overall—which appeared a little late in March this year was the main bit. This is the tidying up which comes towards the end and, as you will have seen, focuses particularly on those things that Margaret Beckett was not able to settle in March.

Chairman: One of the things in your own evidence that caught my eye was this sentence, "However, following scrutiny and challenge, we consider that companies generally overestimated the costs of

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implementing their plans and underestimated the scope for efficiency.” In information to the Committee, Water UK said that this price review had been conducted in a more transparent way than past reviews but they went on to comment, “There is considerable scope for further improvements in transparency.” If you can see better—and you might like to think about the answer to this whilst we go and vote—what has enabled you to, if you like, in this greater transparency, if you believe it exists, have been able to come to that conclusion? Is it because you now have a better sight of what the companies are up to that you can observe that they may be over-egging the pud?

*The Committee suspended from 2.45 pm to 2.58 pm
for a division in the House*

Q4 Chairman: As we enjoy our water, I think, Mr Fletcher, you reminded us last time that this was the equivalent of 0.067p a litre, not these particular contents but the equivalent if it had come out of the tap, and that number has seared itself into my memory banks.

Mr Fletcher: It is 0.08 pence.

Q5 Chairman: Just before we adjourned, I asked you about over-egging the pud and you were going to provide us with an answer.

Mr Fletcher: Transparency first of all, Chairman, and, yes, I do believe, though I was not here for the last review, and the various stakeholders all seem to say, with some reservations about some aspects, that the whole process both has been more transparent and that this is welcome and there are various ways in which we have sought to achieve that. Being more open with the process, the sharing of papers, the sharing of our financial model and requiring the companies to undertake draft business plans which was an important part of the dialogue, but then, at the end of it all, you point out that Ofwat’s draft conclusions suggest roughly halving the increase in bills that was sought by the companies and how can we do this given all this transparency? We do think that the companies, perhaps naturally, will be overcautious and conservative in their assumptions at the stage of putting proposals to us. It is natural that they should be. They are looking at coming up with proposals which they are confident they can deliver through the five-year period and beyond. We also obviously want to be confident that they can deliver. But we have both less knowledge of the circumstances of the individual company, inevitably, than the management of that company and more knowledge of the wider picture for the industry as a whole and confidence in the instruments that have now been developed over a 15-year period since privatisation and which interact with those of other economic regulators including the basic RPI minus x approach to give us the confidence on behalf of customers and all the other stakeholders to say, “We believe that you will go on being more efficient, that we can set you challenging

targets to achieve that and that you can achieve what needs to be achieved over the five-year period for a good deal less.”

Q6 Chairman: Is that a sort of technical explanation of the horse trading that appears to go on because in fact you are saying that you halve the bills, that says that the water companies set off and said, “What can we get away with?”—and I am sure they would disagree if they were giving evidence and they will have every opportunity to challenge that statement—and they might say, “We know what we can do, so we will throw everything in lock, stock and barrel, notwithstanding what the Secretary of State’s guidance is, because we know that that man Fletcher and his technicians will get busy and they will knock us back to another number and then we will come up with some really cogent arguments and we will meet somewhere in between.”

Mr Fletcher: The best answer of all is to have a competitive market in which customers can take their business elsewhere. That is not possible in this sector, that is why you have a regulator, as you know.

Q7 Chairman: I thought I read in the press at the weekend that there was some person who was making a challenge to—it may have been South West Water and forgive me if I am wrong—be able to use the existing water infrastructure to deliver water from this particular company’s own boreholes into the system and they wanted to challenge the lack of “competition”. You say it is not possible but is it not the case that somebody is looking at that?

Mr Fletcher: Indeed, we are looking at it and we are working again under statute under the provisions of the Water Act passed last year. The particular company in the press at the weekend were Severn Trent and Aqua Resources was the potential competitor. We have just published for consultation a series of proposals worked out in close consultation with others who are involved here including Defra as the custodians of the legislation on how we shall seek to implement the statutory provision for competition for the large business users. To start off with a very restricted category using over 50 megalitres a year, which does mean 2,000-or-so very big customers. Getting the ground plan for that in place is quite complex, putting water into effectively public service systems without causing danger to all those who draw their water off requires quite a careful balancing between the interests of the incumbent determined to preserve the purity of his water and the legitimate interests of the competitor who wants to be able to use that network to supply customers in competition with the same incumbent. That is, if you like, a different part of the story but obviously I accept your point, there is room for competition and it will develop over time but it will be, on all the signs at the moment, a relatively slow process. So, I would say that the regulator is needed at the moment and is likely to be needed for some time to come. Experience, as you know, in other sectors is almost paradoxically that

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you need the regulator to ensure fair play for competition especially in the early stages of the process.

Q8 Chairman: This is all very helpful and Mr Tipping is going to take up the questioning in a minute but I would just like to conclude on this question of transparency. The Environment Agency have commented to the Committee that they believe there is a lack of consistency about the information that is made available in public. I think they are suggesting that more should be made available. There are questions of commercial confidentiality but are you satisfied, as the regulator, that, from the point of view of those looking at what you do, sufficient information is made available on a consistent basis to cover your deliberations?

Mr Fletcher: I do not think that I am satisfied. This is never something on which one can achieve anything like perfection. We will be doing a review early in the new year which will have an independent element and I expect to look into just this sort of issue. I do believe that we have taken the transparency and the publication of documents a long way further on. We do have to balance that, as you indicated, with the legitimate commercial confidentiality concerns of the companies and with the fact that, at the moment, we are at this hybrid stage between the draft and the final determinations. On the specific point from the Environment Agency, I would certainly be expecting to provide significantly more information at the final point to the general public on the schemes which the Environment Agency itself knows about under confidentiality agreements.

Q9 Paddy Tipping: Can I turn to an area that has been contentious in the review which is the environmental programme. In their evidence to us, the Environment Agency suggest that the environmental programme is 20% of the total capital cost. Is that right?

Mr Fletcher: Would it help to turn to page 3 of our evidence which sets out in an endeavour to be helpful—and this is part of the information that we publish generally, it is not new for the Committee—how we believe you move from the £249 average household bill in the current year to £283 at the end of the five-year period and you will see there under item 5 (b), £20 for environmental improvements. This table is very specifically about the drivers for change, so it is about the things that actually alter from the £249 starting point. You will have seen that there are two negative issues, the efficiency gains the companies will have made up to 2005 or up to the new starting point and the scope we assess at the moment for further reductions through future change and those have all been lumped together at the start. But some of them will apply to the environmental element where we are making the assumption that the capital programme for the environmental improvements will be delivered for less than the companies actually ask for.

Q10 Chairman: Could I just query this number. If you are saying that you have a reduction for past efficiency savings and that, over the past five years, they only knocked off £4, that is like saying there is a 2% improvement over the previous year and yet you are saying that the scope in the prospective period is, what, about seven or eight per cent.

Mr Fletcher: This is illustrating how difficult it is to come up, as we intend, with something that is transparent and clear. This is about the drivers for change. So, the £4 is on top of what Ofwat assumed they were going to achieve at the last review, which was significantly more demanding than the assumptions that we are making for the period 2005 to 2010. So, it is just the out-performance. With the environment programme, the asset management programme we tend to talk about in five-year chunks because each of the chunks is a capital investment programme in its own right and is new for that period, requiring new effort under the directors etc. So, that is why the environment programme looks so large at this point. It is not looking at what is already in the base in the £249, it is looking at the things that change it. You can look at it in a completely different way and, if you say, well, what difference, for example, has it made since privatisation in 1989 that we have had to do—and it has been very successful, a large environmental programme for a 15-year period already. If you look then at what customers are paying in their bills, it is on average something probably over 30% because of the cost of supporting the finance, the debt which the companies have borrowed in order to undertake those large capital programmes ever since 1990. So, you can look at it in various different ways. The environmental programme has been very large and will be very large. I am not quarrelling with the fact that it is important that, as long as we do not spend more than we need to, the water companies should, and their customers in funding them should, be spending a significant proportion of their bill on enhancing our environment.

Q11 Paddy Tipping: That is fine and a lot of work is being done talking to customers, some of it survey work and some of it joint work and I think it is quite interesting because customers say to you—this is a cartoon but tell me if it is broadly right—“We are prepared to pay for environmental improvement but we are not prepared to pay an awful lot.” They want it but they do not want to pay for it and that is the reality, is it not?

Mr Fletcher: The thing the customer wants above all is a safe and reliable supply of drinking water. We did a joint survey which was part of the preparations for the review that the Committee examined in a previous session and one of the things that I think the Committee quite liked is the fact that Ofwat, with all the other regulators, with the environmental groups, with customer representatives and with Government, got together and just did one customer survey and that was the clear message. Yes, beyond that, customers in general are prepared to pay more

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for the environment but not a huge amount more and that is an absolutely fair reflection of the general message that was coming back through that survey.

Q12 Paddy Tipping: In the increase in price, the £33 increase, how much of that is for the environmental programme? The EA suggests it is £20. Just looking at the graph to which you have drawn our attention, the table on page 3, that looks to be the case as well.

Mr Fletcher: That is the figure for the driver for change and that is not strictly £20 out of £34, it is better probably if you add in the efficiency, the £21. So, look at it as something like £50.

Q13 Paddy Tipping: Like the Chairman, I read the press and I get the impression from the press—and I do not believe all that I read in the press and maybe you will tell me what the truth is—that water bills are going to go up because of the wicked environment. That is the view that appears to be around in the press. What is the story?

Mr Fletcher: It is not a view that Ofwat seeks to foster. What we want is the bills no higher than they have to be which is why we do go around challenging the companies and challenging all the other stakeholders too and it includes our collegiate relationship with the Environment Agency.

Q14 Paddy Tipping: I am pleased you have mentioned that because, at paragraph 26 of their evidence, the EA say, “We believe that the public and decision makers have been given an unfair impression of the cost burden of environmental improvements on customers.” This is a key stakeholder. This is somebody you talk to a lot and I get the impression that the EA are saying, “Hang on a minute, prices are going up, customers do not like it and it is that wicked Ofwat who are saying, ‘It is all the prime costs of the environment.’” That is the message that is in the ether, as it were.

Mr Fletcher: I suspect the Committee receiving evidence at this moment in the review will have lots of evidence saying that Ofwat has it wrong. Some of them have been kind enough to send it to us but I suspect you have a whole lot more that I have not seen.

Q15 Paddy Tipping: We are very transparent in our dealings!

Mr Fletcher: Absolutely. Frankly, I think that is just what you would expect to see at this stage in the review because all the stakeholders are clearly focused on the thing that matters most to them. Ofwat is there in the middle trying to ensure that the outcome both observes our statutory duties and properly reflects all the pressures on this review including the tension between bills no higher than they have to be and all the things that have to be done. Ofwat is not going around saying that somehow the environment is not worth it. We are recognising, as I said to the Chairman, not least that we have European directives which, as a nation, we have to carry through. We do challenge

environmental schemes where there is no clear output, no clear timetable and no clear price because, when that is the case we cannot do our job.

Q16 Paddy Tipping: Can you give us some examples of schemes like that? Presumably, you have looked at all the schemes that have been put up by water companies, you have crawled all over them and there are a number of schemes just like that where you are saying, “We are not going to get any payback.” Can you let us have some examples?

Mr Fletcher: Yes, certainly, and I will give you one very big one in a minute but I will come to that. We set out in our methodology paper way back last year that we were looking for these clear tests. To put a scheme into price limits, we have to have clarity about what the customers are going to get in the long run from the scheme and when and how much it is going to cost. Otherwise, we cannot hold the companies to account by just giving them money and you cannot be sure in the end what will happen to it all. A lot of the environmental programme is being firmed up over really quite a short period. It goes back to this tension on whether it is better to have a five-year period or a longer period. Several of the proposals which were initially put forward by the Environment Agency either they themselves pruned them down or they pruned them down in discussion with Government because, at the end of the day, there was no conviction that it was absolutely needed for statutory purposes and the amount that is down to non-statutory discretionary purposes is actually quite small in all of this. Even where it is a statutory purpose, the ways you skin the cat may vary considerably from case to case and, to give you my first example, when we saw the companies’ final business plans, we were taken aback by the sheer cost of some of the very large improvements to sewage treatment works necessary to deliver outputs under the Freshwater Fish Directive: big ones in Yorkshire, big ones in the Midlands and in various other places. These often mean building absolutely huge holding tanks, I mean really giant ones, several football pitches, just to hold the storm water up, so that it does not discharge straight through the sewage works with diluted sewage into the river in periods of storm. As a result of our questioning of these schemes which we parked, we use the term, meaning they are not yet in price limits but they may come in, or some of them, to the final limits. We and the Environment Agency and the companies have all been looking at them and already a lot of further thinking is going on and, in some cases, I think in the light of that overall cost challenge, there will be a consensus that it is sensible to do more monitoring, more assessment, before you decide that a scheme, which on its own may cost £100 million or more, is really needed to protect the freshwater fish down the river. The giant scheme I would offer you is the one just outside the window or just up the road, it is the tideway under the Thames where, potentially, we are looking at a scheme costing billions of pounds, at the moment the figure is somewhere under £2 billion but I should be very surprised if it finishes up like that, which could not be completed until getting on for

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2020 anyway, but which amounts to almost a mini Channel Tunnel, a tunnel with a bore as big as Crossrail going 22 miles down the Thames in difficult ground conditions. We all know that the Thames is not perfect and the sewers discharging into it can cause really nasty episodes in periods of storm—eg at the beginning of August—but is this the best way of dealing with the problem? I am glad to say that, in the end, that is a problem on ministers' desks and, in her final guidance, Mrs Beckett has said, "Well, not yet. Let us see whether there are ameliorative measures that could deal with that."

Q17 Paddy Tipping: Can I take you back to the initial point that I was making. Bills are going to go up £33 roughly and the accusation is that £20 of that is for the environmental programme. Just tell me again what your view is on that in order that I am very clear about it.

Mr Fletcher: Twenty pounds is the figure for the implementation of those parts of the environmental programme that we took into the price limits before applying the efficiency assumptions. So, again, it is an interim figure. I believe it is a fair reflection of the change factor on these bills that the environment programme represents. If we were not talking about improvements—and this is not just improvements on the environment side, there is drinking water and sewer flooding improvements as well—we would not be talking about significant increases in bills as we are because the efficiency gains would largely offset the other things that need to be done.

Q18 Paddy Tipping: You told us earlier on—and I think this is a truth—that a lot of these issues are driven by European legislation. You are a pretty careful regulator; you look at all kinds of things. Presumably, you have been looking at different European countries and saying, "How much are prices going up there?" How far is that driven by European legislation? Are the price bands broadly in comparison or is the accusation that is always around but that I do not actually think is true that we gold-plate things here in the UK? What is your view on that?

Mr Fletcher: On the two wings of that, we do try and compare with Europe and with other countries across the globe because we want to see how we are doing as a system. We find it astonishingly difficult. Very few water bills in our fellow European countries are actually totally unsubsidised as the bills in England and Wales are. In Ireland of course, nobody pays a water bill. That creates a real problem for comparisons and there is a lot of subsidy and cross-subsidy of one sort or another from the taxpayer which reduces the transparency comparisons. So far as we are able to do it—and I have drawn here on some work that was done for the European Commission—where there is lack of subsidy, then we are broadly in the right sort of ballpark or probably rather better than most. I am sorry to put it so crudely and, if the Committee would like a note, I shall be happy to try and draw it out.

Q19 Paddy Tipping: I think that would be helpful and if you could reference that with—

Mr Fletcher: I will certainly reference it but I am afraid that I have to warn you that it is not satisfactory information just because it is so difficult to put it all together. The second part of your question was, how is the rest of Europe doing and it is certainly true that, partly as a consequence of the investments which water customers have supported since 1990, we have largely removed from Britain the tag of "Dirty Man of Europe" and that is a legitimate objective outcome of this investment. The European Commission is taking action against a number of Member States on water directives of one sort or another. So, I do not think that we could claim for a minute that the UK is picked on by the European Commission. We are very transparent with our information. When we present the European Commission—this was in the context of competition—with our series of reports—five covering different aspects produced every year for the industry in England and Wales and they are having to cope with some 6,000 entities in Germany alone as opposed to our 22—they fall over themselves at getting this quality of information but, in a sense, that is a key part of our regulation to make things transparent. So, we cannot express sorrow about that. Where I would scratch my head—and this is something that goes way back to when I was a civil servant in the Department of the Environment so I carry part of the blame too—we were also slow in getting real attention on cost benefit issues into the thinking around directives. I do think that the Commission and Members State together have moved on since then, but the fact is that we are now reaping the consequence of not really thinking about the costs alongside the benefits and we are having to pay for them.

Q20 Paddy Tipping: Are you making a slightly broader point about EU regulations that are very good in policy terms and conceptual terms but were not so good in actually looking at the consequences, the practical issues and the costs of those regulations?

Mr Fletcher: We are all very conscious—back to the Chairman's long-term point and other studies which the Committee has made—that the Water Framework Directive is very important and absolutely right in its focus on outcomes. Nonetheless, the crucial issue is, what benefits are going to be there? What is it going to cost? Who is going to pay those costs? Hopefully, learning from the past, we will all of us, certainly including Ofwat, get better at it as we go forward.

Q21 Mr Lepper: The Chairman has mentioned the question of affordability already and you have told us about the costs of the environmental scheme in terms of increases and you will be aware that our earlier report on the review referred to some two to four million householders who cannot afford their water bills already and you acknowledged that in your evidence to us and mentioned the fact that Ofwat is contributing to the Defra review of options

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for helping those who find difficulty in paying their water bills. Could you give us some indication of what you will be contributing to that Defra review. How should the problem of affordability of our water bills be addressed?

Mr Fletcher: Would you mind if I started with your first point, that is affordability itself. Overall, water customers are paying about 1% of their income towards their water bill. So, any bill and any bill going up is very unpopular, I absolutely appreciate that, but it is not a huge proportion and it is a very much smaller proportion than, for example in most of the developing world, customers are paying for water. That said, we entirely accept that, in the very high bill areas—and the most obvious example is South-West England—for least well off customers, we are already seeing bills that are likely to represent a significant proportion of their incomes, in many cases 3% or more, and, subject to the issue around metering which you may want to bring me back—

Q22 Mr Lepper: I was going to in a while, yes.

Mr Fletcher: There is a real tension there. The contribution which Ofwat is making to the Government's review is to be very much part of the expert evidence to that review. We are ourselves a Government, though a non-ministerial, Department. Clearly, it would be duplication for Defra itself to have all of its knowledge. We supply the knowledge we have which includes the work we have done with Water Voice, who are formally at the moment still linked to Ofwat and still part of the same organisation as the customers' representatives and we have done quite a lot of review work on debt issues with the companies, on issues around affordability, on issues of good practice in companies managing debt, keeping it down but paying attention to those customers who find it the most difficult to pay in order that they are properly treated and so on. That has been our main focus in this review so far.

Q23 Mr Lepper: Can we come to this question of metered and unmetered waters. I know that the National Consumer Council says that it is extremely concerned about the difference in charge between metered and non-metered customers. Do you share those concerns? Why is there this difference between metered and non-metered customers?

Mr Fletcher: Seventy-five per cent of us as householders still pay our bills on an unmeasured basis using the rateable value of our houses and this is about the only purpose for which rateable value is still generally used and no one would claim it is a perfect proxy for the use you make of water services, it is a rough and ready, broadly progressive, which is important, form of tax applied in this different category. The measured bills, apart from a standing charge to represent the overall cost that the customer imposes on the company's assets, quite apart from the amount of water used or disposed of, does focus on what the customer is actually using. By definition that it is metered and that means that it is in the interests of very large numbers of customers to switch from rateable value to metering which, under

the 1999 legislation they are free to do at no cost to them individually. The cost falls on customers as a body, the cost of installing the meters and the loss of revenue that then follows because customers have not just moved from, in most cases, a high-ish rateable value perhaps with relatively low use to a measured use on relatively low use still and then some of them on top of that will use less, which is good from a conservation perspective but reduces the revenue. So, that is why you get this mismatch. It is because the characteristics of the customers in the 75% are different from the characteristics of the customers in the 25%.

Q24 Mr Lepper: I am just thinking about these two to four million—and I take your point about the proportion of the household the water bill forms—householders who are already having problems because a switch to metering—and some of those households are fairly large households perhaps—is not necessarily going to be beneficial to them, I would have imagined, and would indeed exacerbate the problems of affordability.

Mr Fletcher: I am afraid you are absolutely right. It is the logical consequence of the legislation passed five years ago that people who can freely transfer to a meter will tend to do it if it is in their financial interest to do so. Therefore, the subsidy which high rateable value low-use customers are at the moment effectively paying to the rest of the body, including the less well-off customers, is disappearing through the transfer and, as it disappears, a greater burden is imposed on those customers who are left in the rateable value category.

Q25 Chairman: I am going to bring David Taylor in in a second, but I just want to ask you a question which arose out of some of your evidence. I wonder if you could give us a little commentary—unfortunately, you did not put numbers on your memorandum—on page 4 where there is a chart showing actual and projected net capital investment. I would be grateful for some explanation. You have in the period from 2004 through to 2010 a chart which shows the directors of the water companies projected capital maintenance and then, on top of that, you have the directors projected quality and other enhancements, which I suppose looks roughly, taken overall, about 50/50 and then a strange little mountainous bit that sits above this projection called “Companies quality and other enhancement projections” which seem to replicate directors projected or are the directors saying something and the companies saying something else? I am a little confused. What am I supposed to derive from that picture?

Mr Fletcher: The companies in aggregate in their final business plans were saying, “The capital expenditure that we need to carry out will cost £20.7 billion over the five-year period.” Ofwat came up with a figure of £15.7 billion. The difference between the two is not simply efficiency. That only accounts for £0.8 billion of the difference. The main differences are first of all this element of parked schemes to which I have already referred in answer

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to Mr Tipping of things that we have not included in price limits yet, £1.4 billion, and £2.8 billion which, in a very broad category, is change of scope and a lot of that means that we have concluded that the proposal as presented to us by the company in its final business plan is not yet clear enough to take into the price limits—it is the point I was making earlier, no clear outputs and no clear timetable—and, in those cases, although the vast majority have an element included in the draft price limits, very often that will be about investigations, relatively small costs, to define the output more precisely.

Q26 Chairman: One of the things that comes out of that explanation is that in a world where the normal competitive forces prevail, companies, in their pricing policies, are acutely aware of what is going on in the marketplace, what the market will bear and what their overall commercial objectives are and they juggle those in finding a competitive price. If they do not get the competitive price, they do not get the goods, so the price comes down, etc, etc. In this case, you are the surrogate for that process and what you have described to us here is about £5 billion and it almost sounds like overbidding. I get that flavour because you have, on a number of occasions in response to questions so far, told us that the companies had schemes which either could be questioned upon analysis because the components of that scheme were not actually required to meet a particular legislative development, a European director or whatever, of the companies were over-ambitious. These companies are answerable at the end of the day to their shareholders, in the main with some of the bigger water companies, some of the private ones are perhaps driven by different parameters but I am just a little concerned and I would be interested in your opinion as to the investment decision-making process within the companies that lead them to accumulate, if you like, almost on a bottom-up basis which says, “We will start from a position of adding in everything that we would like to do” and then leaving it to you to use your knowledge to knock it back because you might argue that either there is something fundamentally wrong about the way that we are trying to implement improvements in water legislation between those the company thinks it needs to do to keep its customers happy and those that it needs to do to fulfil a legislative requirement and therefore I am wondering whether in fact the whole process of dialogue and discussion about what the companies obligations are is somewhat flawed if it leads to the fact of a £5 billion difference between what the companies bid for and what you say they actually need to do.

Mr Fletcher: First, I entirely accept that what we are trying to do is mimicking the way a market would work. An out-performing company will make a greater return for its shareholders or their equivalents and that is the system that is supposed to work. We then claw the gain back after the five-year period for the benefit of customers as a competitive market would in rather shorter order. What is noticeable is that the companies did not all take the

same approach in their final plans. Some of them almost under protest said in their final plans, “We are putting some schemes in which we would really rather not do but we have been told that we ought to put them in for environmental reasons” and some of those have found their way into the category of parked schemes.

Q27 Chairman: Who told them?

Mr Fletcher: Those elements were included in the lists associated with the Secretary of State’s principal guidance.

Q28 Chairman: So, they are looking at what the Secretary of State said and are saying, “This is what Mrs Beckett is telling us to do” and then we have Mrs Beckett’s evidence saying, “I don’t really want these bills to be unaffordable”, but she has already given evidence which has been interpreted by the companies which have pushed up the bids because they thought they were doing the right thing. Do you see what I am getting at about understanding? Is there a flaw—and I am sorry to go off at a slight tangent—in the way that the Secretary of State explains her requirements and the way that the companies are interpreting them because, if you are saying that is driving the pricing bids, then there is something wrong?

Mr Fletcher: We are talking about an iterative process and all of us learn from that iterative process as we go along. So, Mrs Beckett’s final guidance takes here a step on from the principal guidance in certain important respects and all of us, by challenging each other, which can sometimes be quite uncomfortable, I believe will finish up with a much better outcome for the customer and the environment than we started off with a year or two back. You are quite right, if you take a cut/slice at any one point in time, there are these imperfections around because of the artificiality associated with it.

Q29 Chairman: So, almost one could say that the Secretary of State’s first cockshy flushes out the companies into a big bid and then the Secretary of State panics when she adds it all up and says, “My God, I do not think politically the bills are going to be at an acceptable level”, so we do not have more conservative advice coming out to trim back a bit.

Mr Fletcher: I am glad to say that I do not have to speak for ministers and no doubt they will be in front of you to do so, but I do not think it was quite like that. They get advice from experts, notably the Drinking Water Inspector, English Nature and the Environment Agency. There is a process of dialogue involving all of us in what is always a tension, wanting to have the best for the environment and what it will cost and, out of all that, sandpapered by the underlying legislative requirement, will come some sort of final view which, I would hope, is as satisfactory as we will ever get because there will always be dissatisfaction. It is not perfect.

Chairman: Excuse us while we adjourn to rush over and vote and then we will return. I fear it may mean that we have to sadly curtail your evidence because

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we will have effectively lost half-an-hour, but we will do a quick squeeze at the end. We will be back shortly.

The Committee suspended from 3.39 p.m. until 4.00 p.m. for a Division in the House

Chairman: I will invite Mr Taylor to resume our batting.

Q30 David Taylor: Thank you, Chairman. I was late into the session, so if I ask anything which has been covered I know you will stop me or divert the questioning. Mr Fletcher, as to privatisation out of the full circle of stakeholders, the long-suffering taxpayer, the environment, water consumer and the shareholder or shareholders, the shareholders have done pretty well, have they not? Do you think that is something to the credit of Ofwat?

Mr Fletcher: Shareholders have made a return which was very high in the early part of the 1990s and which has been a lot less in the last five years or so. Going back into what is now the historic period, I think it astonished the companies and the other stakeholders how much it was possible to gain in terms of efficiency in the early years after privatisation and therefore, with the hindsight now available to us, the challenge perhaps was not as tight as it might have been in that early period.

Q31 David Taylor: You have got a vested interest in saying that, though, have you not?

Mr Fletcher: I am sorry?

Q32 David Taylor: You have got a vested interest in saying that?

Mr Fletcher: I hope I am just saying it objectively. The issue now is that shareholders and the other financiers of these very big water investments need to have an adequate return if the water companies, who run on negative cashflow, their outgoings, ever since privatisation, have exceeded their incomes, and Ofwat is there in the middle on behalf of customers, replicating, mimicking the markets, to seek to ensure, through its price limits and the rest of its regulatory activities, that companies are only making a significantly higher return than we have assumed here if they are at the same time significantly outperforming the assumptions that we have made. If they do significantly outperform, that is to the benefit of everybody, including customers, because Ofwat, trying to mimic the market, comes in at these five-yearly intervals effectively to cream that excess.

Q33 David Taylor: It is a market failure though, is it not?

Mr Fletcher: It is a market?

Q34 David Taylor: It is a market failure, is it not?

Mr Fletcher: No, it is not. It is a market failure in the sense that it is inherently a market failure. We are talking about something which is as close as you can get to a natural monopoly. Ever since the water wars in the early nineteenth century in London it has not

made sense for the provision of services to most customers to replicate, duplicate, sewers or water mains. Therefore, that is the inherent monopoly bit.

Q35 David Taylor: But the five-year price review mechanism is a dog's breakfast, is it not? It is not adequately providing for the capital investment that is needed in infrastructure. You blame the water companies in terms of inaccuracies and failure to provide, and they blame you and the Government with similar charges. To what extent do you think the price review does allow companies to plan ahead for longer term expenditure, and should you be advising them very strongly where it is deviating so significantly, as this graph shows and as the Chairman mentioned before the two divisions that we have just had?

Mr Fletcher: I would not accept for a moment that it is a dog's breakfast. It is a proper process in which you would expect to see tension. Tension does not equal dog's breakfast. What you would expect to see at the end of it, as you have following previous price reviews, is significant capital expenditure which does not just exist in its own right but produces significant benefits in terms, where it is capital maintenance, of the sustainability, the long-term serviceability of the networks of pipes, sewers and water mains, and the above ground assets, and we are seeing that. We are seeing the same with serviceability. We think the companies need to spend more going forward. You would expect to see an environmental programme that is not just money into the ground that produces very big gains in terms of our environment. It has produced just that. If you look back to 1990 and the state of our rivers, our bathing waters, our coastal waters at that stage and what they are now, huge improvement.

Q36 David Taylor: How about flooding. Have you got time for a very brief example, Chairman? North west Leicestershire is about as far from the sea as you can get, and most of the constituencies are absolutely remote from major water courses, and in recent years we have seen the incidence of flash floods that have affected areas in the Coalville area and elsewhere near East Midland's Airport on quite a regular basis, and Severn Trent, in whose patch we lie, talk about these things being in a once in a 200 year time-frame irrespective of the fact that it is quite clear now that the global warming evidence is with us, climate change is a fact and that they need to invest at a rather greater level and in greater amounts than would normally be the case if this was just to protect against a one in 200-year incident rate. There is something going adrift here, is there not? Who should be carrying the can for this and actually getting a grip of the problems that are affecting areas like my own and, indeed, much worse towns, like Shrewsbury, Worcester, and so on, where flooding has been not unusual over recent decade, but it is hitting ordinary constituencies now. You are saying that the companies are bringing forward projects. Name some that you are aware of, major scale ones,

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that Severn Trent, for instance, have brought forward in recent times to tackle the impact and effects of climate change?

Mr Fletcher: If we are talking about river flooding, that is primarily something which the Environment Agency under government direction is in charge.

Q37 David Taylor: It is not rivers, it is—

Mr Fletcher: I was thinking of your reference to rivers. Where it is a matter of flooding through the sewers which serve, especially in the older areas, usually two purposes: they are both rain water drains and sewers for foul water, and that is at the heart of the problem. When you are building fresh, then it makes sense to separate the two out. The Victorians did not, and from their point of view you can understand why: it was something that cost a lot of money. Complete separation on a retro-fitting basis seldom makes sense. Therefore, it is important that the companies do more to correct for the problem of sewer flooding, and they have put forward in their plans extensive proposals. They have put forward proposals accounting for nearly 1.5 billion in their plans to us. At the moment we have in the draft determinations allowed significantly less than that because we are saying, although it is possible for less than half the cost to deal with over 80% of the problems, in doing that we have provided a sort of top challenge so that those schemes which cost £120,000 per house, which is quite a lot per house—

Q38 David Taylor: We are talking about urban areas.

Mr Fletcher: This is very often, in fact usually, urban areas that sewer flooding occurs; because that is where the sewers are effectively acting as rain water drains.

Q39 David Taylor: I understand what you are saying, and I am sorry to interrupt, but can I direct this question to your chief engineer then, to your left as I look at you? Are the water companies upgrading their assumptions and their projections in terms of rainfall, not just in annual terms, of course, but in terms of the maximum number of heavy storms that there might be and therefore looking at capacity from that perspective? Are they doing that? How much lead-in time is necessary to alter whatever capital works they might have planned over the next three to five years when the assumption needs to be upgraded in that way? What sort of lead in time are we talking about, Dr Emery?

Dr Emery: Most companies are not at this stage in a position when they are upgrading the storm profiles, and so at the moment they are recognising there are a number of instances of intense storms, so they are at an information stage where they are yet to make what design criteria should be for future major investments in the sewerage systems—they are not quite there yet—and that is appropriate because we are not quite certain as to what will the most appropriate design characteristics to assume. Everybody recognises that climate change is happening, but it is a matter of the pace of that and

what is the right response. The lead-in time, which is your question, is, if it does involve a substantial change to the sewerage system and upgrading of the sewerage system, then that is going to be a decade, several decades, of work to do. It is clearly something that the companies—and it is one of the issues we have flagged up in our draft determination document, that in the next period we will be looking to companies to start to get a better handle on this and start to develop long-term plans for the sewerage infrastructure, and that is similar to the kind of findings of the recent NAO report on these matters. I think at the moment there is not sufficient evidence as to which sewers to do first. The focus of the work on the sewerage system is twofold in this next period, and that is to deal with the immediate quality problems associated with problem discharges to the water environment, and that is intermittent discharges from the sewerage system, and to deal with a large number of existing problems on the sewer network created by sewer flooding. Deal with those and you will at the time be looking at what is an appropriate patch to do on that particular sewerage system.

Q40 David Taylor: But as your engineering projections and climatic changes azeotropically approach the reality, it is no consolation to residents in Whitwick, Leicestershire, that they sit between where your projections are and what is actually happening in their area and they are ankle-deep in water in rooms of estates which are quite some distance way from any water courses that have never shown any inclination to act as they have done in recent times. So it is all very convenient and comfortable from the third floor of an office block in the centre of London to be dealing with these sorts of things, but you want to get out on the ground a little bit more.

Dr Emery: Certainly, I have myself been working in the water industry since 1975, so in a sense I have seen this at the sharp end, and I know that Mr Fletcher has been out to see matters at the sharp end of sewer flooding, so we are very conscious of the importance of sorting out sewer flooding. That is why, in this particular draft determination, we have essentially put forward a major programme of work for the companies to do. In essence, we are looking to the companies to solve most of the sewer problems that should be solved in this next five-year period.

Q41 David Taylor: My final question, Chairman. I am sorry to interrupt, Dr Emery, but there are a lot of questions people want to ask. I described the five-year review as a dog's breakfast in terms of its ability to provide sufficient capital funding for the necessary projects and the funds we are projecting in terms of what was necessary. There is also this question of research and development, is there not, that companies need to provide for? Can you describe, one of the team, how the five-year price review cycle does, in fact, allow companies to

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conduct long-term research and development when they are bailing out, if I can use that analogy, other aspects of their operations at a vigorous rate?

Mr Fletcher: The companies should, as part of their base operating expenditure, be carrying out appropriate research to enable them to discharge their functions properly. Customers, in my view, should not normally be coughing up for projects that they ought to be doing as part of their normal business. There is, as you probably know, an industry-wide research body called UKWIR, where the companies, in consultation with Ofwat, the Environment Agency and others, do draw up a programme which is of common interest to the whole industry and which can therefore be financed by the industry on a collective basis, on things like sewer flooding, very much included, on climate change, and a number of other issues; and I think that that is an appropriate way forward. In addition, individual companies will obviously want to undertake their own research, usually applied research, perhaps sometimes to give them a competitive edge, which is fine; it is how the system is meant to work and the customers should not, own the whole, be paying too much towards it. In Mrs Beckett's final guidance to me she has asked that I include provision for what amounts to demonstration projects/research into the interesting and perhaps concerning issue of endocrine disruption for fish, and I am going to have to reach a conclusion on that in setting the final price limits.

David Taylor: So this bogus market has not, is not and never will deal with these sorts of problems. That is the perception that I get, Chairman.

Q42 Paddy Tipping: So this is a big issue. I get lots of complaints about sewers. All my colleagues get complaints about sewers. It appears to be on the increase, but I got the impression that you are a bit complacent about this?

Mr Fletcher: I would not want to leave you with that impression.

Chairman: Can I follow that up: because I had telephone call from, I think it was United Utilities, who told me that in the context of their proposals and your initial determination from their point of view, that they would not be able to complete all their foul-flooding projects; and my view is a bit like Mr Tipping's, that here we are in the twenty-first century. You said at the opening, Mr Fletcher, that people wanted a good, safe, high quality water supply. That is fine for what comes into the house—

David Taylor: Not in the living room!

Q43 Chairman:—but they also want to have a good, safe, guaranteed method of disposing as to what goes out; and they do not want to see it bubbling up in the streets, and yet we do not seem to have nailed all those problems down. Why not?

Mr Fletcher: Because the problems tend to crop up all over the place. I absolutely accept that sewer flooding, especially in your home, is an extremely unpleasant event. As Bill Emery has said, both of us have been out and seen on the ground and talked to customers who have suffered from this, and I know

it is extremely nasty. The fact that it is a very small proportion of householders is no excuse for complacency, but something needs to be done to tackle that proportion. At the moment, I think, and I will correct it in the transcript if it is wrong, it is 0.04% of households are vulnerable.

Q44 David Taylor: Annually?

Mr Fletcher: That is at risk. That is on the at-risk register of one in 10 year events, and that is where I need to check, because I am speaking from—

Q45 Chairman: Mr Fletcher, let me put it to you in this way. If you adopted the same approach that you have just outlined for water in, you would have people saying, "Well, every so often the water goes off and I cannot get the water into my house, and therefore I have a sort of spasmodic and interruptible supply." It would be a phenomenon which, I think, anybody who wants a mains water supply would object to. So why can they not have an equivalent quality universal service of water out?

Mr Fletcher: We do, first, have a series of specific indicators of customer service, one of which is interruptions to supply, which we have been running since privatisation and which is an important contributory factor to the assessment we make of the way in which the companies are doing their job, along with a lot of others. I would suggest the sewer flooding issue is not quite the same. There we are talking about households at risk of a one in 10 year nasty event, and again, I stress, it is a nasty event and merely because it is one in 10 years is no excuse for it. The proposals in the draft determination would, on our judgment, serve to reduce the number of properties on the register by half to 0.02. Again, you may rightly say, "It should not happen to anybody", but this is one of the problems. It can first of all happen for reasons that are nothing to do with the lack of capacity in the sewer—or the one in 30 year, 50 year, 10 year rainfall event; these can be a blockage in the sewer arising from, often, grease and fat which has been poured down, and there people will get flooded. You can either blame the companies for poor maintenance or the customers who poured the grease down.

Q46 David Taylor: 0.02% of 25 million households is about 10,000 households, is it not?

Mr Fletcher: At risk of sewer flooding. So, this is not the number that are affected by it.

Q47 David Taylor: An average of 15 per constituency. So it is a tiny problem?

Mr Fletcher: No, I am not saying it is a tiny problem, because it is a concentrated problem. The Chairman has mentioned the north-west. It is concentrated in London and the north-west, although it affects most constituencies to an extent, and I entirely accept that a great deal of progress needs to be made on this problem in the five-year period we are talking about, that customers collectively should be spending money in their bills to relieve the customers directly

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affected of the problem; the issue is: how much and just how is it judged, which is one of the points that United Utilities have taken up with the Chairman.

Q48 Paddy Tipping: You talked to us earlier on about outputs. You are both keen on outputs?

Mr Fletcher: Yes.

Q49 Paddy Tipping: Let me ask you this. If you come back to us, or your successor comes back to us in five years' time, what is your output going to be on private sewers?

Mr Fletcher: Halving. On sewer flooding, at-risk register, halved; on the draft determinations, halving the risk of sewer flooding.

Q50 Paddy Tipping: What about those people who it is going to cost too much to do: because you were going to tell us about the cap on it a minute ago and we moved on. Remind me about that. Is it a £12,000 cap?

Mr Fletcher: No, £120,000.

Q51 Paddy Tipping: I am not very good on sums!

Mr Fletcher: We definitely do not relate it to the prices of property, because I think that would tend to mean a bias towards solving the problems in the prosperous areas and not solving them in the old inner cities; so we do not relate it, but, nonetheless, that is two-thirds of the average house price at the moment, even after the soaring house prices we have been talking about. So it is a lot of money, but that does not mean it should not be done. What we have said in the draft determinations is that we think where it is that expensive that the companies should still be able to do it—it is their choice which are the highest priority schemes, but there ought to be a cost benefit assessment showing the value of it, and if it does not prove its value, then they should be going for other means, which may include ameliorative measures, not a perfect engineering solution, not something an engineer would be terribly a proud of, but which would significantly reduce the risk of being sewer flooded. We are going on thinking about these issues, because they are not easy, before we get to the final determination.

Q52 Patrick Hall: I would like to follow the line of questioning that was started by Mr Taylor on flooding and investment to deal with flooding, sewers in particular, I think. I see in the evidence from the Environment Agency, under a short section on page nine referring to climate change, and it briefly refers to the expected higher frequency of intensive periods of rainfall; it goes on in paragraph 37 to say, "While the evidence is not sufficient to justify investment now, investigations by companies are needed to look at the implications of climate change, water supply and sewerage systems." I find the first part of that sentence that I have just read out surprising. "The evidence is not sufficient to justify investment now." That is in the Environment Agency's evidence to this Committee. What is Ofwat's view on that statement?

Mr Fletcher: A great deal of the investment assumed in the draft price limits will help towards dealing with the foreseen problems around climate change; sudden or dramatic rainfall events. The work of capital maintenance, which we see as a necessary increase in the level at which the companies have been spending, will help ensure that the systems are better able to cope with the sort of pressure applied on them by sudden rainfall events; but, as Dr Emery was saying, that does not mean at the moment an alteration to the basic assumption that a sewer should be able to cope with a one in thirty year rainstorm. We may need (collectively I am talking here—this is the whole sector and its regulators) to move on from that, as the evidence on climate change becomes clearer and the help from the Met Office, the Hadleigh Centre, begins to be more relevant and directly applicable in terms of where we can expect the problems: because to invest now in a wholesale upgrade, apart from the astonishing disruption it would cause in every street in the land, would not be good value in terms of the level of investment and the outputs associated with that investment. I think that is what the Environment Agency means. There is not at the moment grounds to say just climate change alone means an uplift of maintenance. That evidence may come along. In the meanwhile, we are better off seeing the industry investing in all the things and which will contribute to being better able to deal with climate change.

Q53 Patrick Hall: So there is no question in Ofwat's mind that climate change is a fact?

Mr Fletcher: No; no question.

Q54 Patrick Hall: Therefore does it not follow that it is a good idea to anticipate the effects of climate change by investing up front? Are we saying here . . . This is an industry view. The companies have a view on this. Perhaps I could ask you what you think, the companies' view on this is, but you have an important role. Are we saying that we accept that something is happening but we do not actually know where and when and what it is, except in general terms, therefore we hold back on investment other than repairing problems of the past and dealing with a few other issues? That does not seem to add up to adopting what the Chairman was trying to draw attention to at the beginning of this questioning, a long-term view which will put us all in a strong position rather than almost playing catch-up and complaining about the cost? Surely we have the opportunity now to say things and to do things that will help us in the next few decades?

Mr Fletcher: The cost of the investment in the industry is broadly spread across the generations, because all the generations are going to benefit from them. So our bills now include expenditure, include the financing costs for the investments being undertaken, our children will still be paying for the investment being undertaken over the next five years. So, whilst we should not just be playing catch-up, and I entirely accept that, I do think it is important that the investment that goes in should, going back to my earlier answers to Mr Tipping,

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relate to specific projects with clear outputs, clear prices and clear timetables. We are not wasting our time or being niggardly in the level of investment we are talking about, which is actually closely akin to the much higher level of investment, a big step up, that took place in 1990 on privatisation and has been running fast ever since and is putting quite a strain on the financing costs of the companies because of the negative cashflow issue. So significant further steps up in capital expenditure will not just have a pro rata consequence for bills, it will have a more than pro rata consequences, because it is going to be more difficult, more risky, more costly for the companies to finance it. You may regard that as a bit of a red herring from your point, but it is one of the factors I have to take into account. A lot of the investment that is going in in the coming five years will help on climate change. I mentioned in a somewhat dismissive way investment in fresh-water fish, huge storm water tanks. To the extent they are necessary, that is very directly related to the sort of the effect we expect from climate change, more very heavy downfalls which swamp the existing infrastructure, but this is the problem: we do not know, nobody knows, where those heavy downpours are going to take place. All we can do is seek to spot where the pinch points on the system are now and deal with them, and that is just what the proposals from the companies, our response to them, the inputs from the other regulators, are designed to do, even though they are also meeting the requirements of the various European directives, etcetera.

Q55 Patrick Hall: I have a fear, not necessarily that there is complacency, but perhaps that the very nature of the structure of the industry and the way it is funded is simply unable to step up to meet the challenges of climate change?

Mr Fletcher: I would just note that in the private sector the industry has been better able to invest than it proved to be in the public sector as nationalised industries up to 1989. What, I think, is in little doubt—

Q56 Patrick Hall: We were not talking about climate change in quite the same way?

Mr Fletcher: No, we were talking, though, about the state of the assets; and the level of maintenance of those assets at the end of the 1980s was something that—these assets are long-living—they can last an awfully long time without showing too much signs of breaking down—and I do not want to be alarmist at all, and Bill Emery will correct me on this so that I must not be alarmist, but, nonetheless, it was an unsustainable level of investment in the public sector and is now on a more sustainable level.

Q57 Patrick Hall: That is a slightly different issue, because we were talking about running down the publicly owned industry at the time, but my point was not an implicit philosophical argument about

public ownership or not, it was whether or not the structure of the industry and the way it is funded can meet the challenges of climate change; and by saying we do not have enough evidence, which the industry seems to be saying—I am not blaming you personally or Ofwat—it may be that the industry is unable to meet that challenge, and, if that is the case, then we need to be aware of this, talking about this now so that the partnership that is needed, which will have to be—someone is going to have to pay—is going to have to be talked about up front much sooner, otherwise we will just be, as I say, playing catch-up at the wrong times and people complaining all the time as things get worse.

Mr Fletcher: Could I bring in Dr Emery but make one point first, which is that in the area where the bills are highest and have been all the way through, that is the south-west, a large part of that is the very large environmental programmes as well as capital maintenance which in that area has been financed by the relatively small customer base of that company. If you are seeing signs of strain, that is quite a sensitive place to look, and obviously there does come a point, and I do not think we have got there, when a government needs to think about taxpayer help; and I am not suggesting that for this industry at this moment in time. Can I bring in Dr Emery?

Dr Emery: I think the investment in the industry over the last 15 years demonstrates a capability to invest. There had been huge steps up in the late 1980s and steps up in investment to meet the challenges of each periodic review. If you are looking at what happened, one of the big concerns of this or earlier committees around our last review was on the ability of the companies to maintain the adequacy of their systems. That led us to challenge the industry to develop a common frame of capital maintenance. That was done. It was research done by the industry and has been remarkably successful and implemented in very quick order by the companies and led to an under-pinning, in quite a large sense, of the capital maintenance requirements that were in the business plans. We took the view that there was still some work to do, but the industry has shown a capability when facing the challenge, to do the work, and I suppose where this industry is different when moved on in the last 15 years is it is trying to have a sound information base for decisions in the future such that it does not go ahead and invest inappropriately and unnecessarily; and I think that you should have reasonable confidence in this industry. When the evidence is there, it will respond quickly and appropriately to meet the challenge of climate change and the Water Framework Directive and other aspects. The track-record is there that they will do joint research, they will come up with appropriate means. We put the challenge down that we think that in dealing with and understanding what the implications of climate change are for both water resources and the continuous supply of water to everybody and in terms of a sewerage system, that is something we want to properly address through research information to properly

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inform the next review of price limits. In the meantime, they have a substantial challenge to deliver in terms of the investment programmes to deal with today's problems.

Chairman: I want to draw our questioning to a conclusion, but I would like to just pursue one aspect. You can have a tiny postscript, one question, Mr Tipping, and then we must come to a conclusion.

Q58 Paddy Tipping: My own concern is private sewers. There is nothing in this price frame for private sewers, but the Government increasingly is moving towards a solution. Hopefully there will be an announcement, a long awaited announcement, in the spring. Suppose the sewage undertakers, water undertakers, are given the task, what are you going to do about it? How are you going to fund this?

Mr Fletcher: My hope would be that there would not be an instant transfer of a lot of what are undoubtedly much poorer assets than those currently, in effect, in the public service—those run by the sewerage companies. Clearly there will be a cost associated with putting right what in many cases has been no maintenance at all for decades; and my hope will be that where the current owners of those assets are financially able to do so, where they are corporations, for example, maybe local authorities, that they make appropriate contributions so that water customers are not left holding the can for what could be a very significant additional burden. There is provision in what we have called our “draft change protocol” whereby new burdens that are assumed by the water and the sewerage companies between 2005 and 2010 can look for appropriate financial uplift if they are taking on commensurate new burdens; and private sewers could be one such category.

Q59 Chairman: I want to close. If you want to consider this and write to me about it you can do, but in paragraph 27 of your evidence to us you talk about the 5.1% post tax in real terms cost of capital, which, if you gross that up into pre-tax and real money terms, are you looking at a yield of about seven odd per cent?

Mr Fletcher: Yes. If you look at the pre-tax equity element, it is 7.8%.¹

Q60 Chairman: One of the things that I find unclear is the capital raising mechanisms. It is right that you have a concern to ensure that the companies can raise capital. What I do not know of the companies that are listed in the tables at the end of your evidence is how many of them for each pricing round, given their investment programmes, have to go to the market with various bond, loan or even

equity issue—very few seem to go down the equity route, but there may well be a bond issue—raise indebtedness; in other words, there is a real job to raise new money to go in; and how many of them have got sufficient in terms of their existing profitability to fund out of revenue their investment plans? Obviously from the people who have to go to the market, the rate of return is of very real and immediate importance; for the others it is a different scenario. Perhaps you might just give us a little commentary on that?

Mr Fletcher: I will write to you, Chairman. Can I just offer you a very brief summary now? Negative cash-flow for all the companies, as I indicated, outgoings exceeding incomings, they are variously dependent on bank finance, and the European Investment Bank is a key lender, on debt finance and on equity, though only one company since privatisation has made a rights issue, so it is mostly retained earnings; and this is a crucial issue for the companies and for Ofwat in assessing how high the revenues need to be and therefore customers' bills need to be, is to assess the finance elements around that. Our basic cost of capital is supplemented towards the end of the five-year period, the last two years, by, for the water and sewerage companies, who have generally the biggest programme, a small uplift which varies depending on the circumstances confronting a company, to recognise this stretched financial position in a way that gives confidence, without over-confidence—a point for Mr Taylor—to their investors, lenders, debt-holders.

Q61 David Taylor: One brief addendum, Chairman. It links that very point, and as an accountant I am interested in it. Mr Fletcher has acknowledged that the cost of capital assumption is about 7% of balancing out equity and other form of finance?

Mr Fletcher: By post tax—

David Taylor: Yes. If this was still a publicly owned utility, the cost of capital to the Government would be significantly less than that. You are saying that the difference is justified, I believe, by the extra efficiency in quality that the water industry has brought to all of this. Could you, not now, but in the letter when you are writing to the Chairman, put an appendix which demonstrates what I can say is a touching belief in some sort of coherent financial structure that will convince me?

Q62 Chairman: And, I think, to overlay that, because part of my interest in asking this question, it is one way of measuring whether in fact the rate of return is a reasonable one in the context of the nature of the business where there is no question there will be a permanent demand for the services of the company, therefore the risk element from that stand-point is relatively low, but, on the other hand, there are risks in the business which are beyond the companies' control which can affect the use of their capital; and we have touched on those in the context of legislative risk and of climatic risk. Can I thank you for your patience due to our

¹ The pre-tax equivalent is 7.3% for the weighted average cost of capital, which rises to 7.8% by 2007–08, allowing for an additional element to maintain financeability.

20 October 2004 Mr Philip Fletcher, Dr Bill Emery and Ms Fiona Pethick

interruptions and for coming to see us? It is clearly a complex and, indeed, fascinating matter. There may well be further questions that we want to write to you about, both following this evidence session and, indeed, when we talk to the company. We do accept that the nearer December there may be constraints on what you can say, but, I think, as you will see from our inquiries, we are anxious to

understand clearly the way in which you operate and adjudicate on these matters. Thank you very much indeed for your help and coming to see us today.

Mr Fletcher: Thank you, Chairman. The 2 December is when I will publish the final determinations which take this a step further.

Chairman: Thank you very much.

Supplementary memorandum submitted by Ofwat

At the hearing of the Environment, Food and Rural Affairs Committee on Wednesday 20 October I promised to supply some additional information to the Committee.

I was asked about how water and sewerage bills in England and Wales compare with those in Europe. I said that the costs of water and sewerage services are broadly in line with those countries where water and sewerage bills are not subsidised. There is very limited published information available on this subject. In March 2004 we published “International comparison of water and sewerage service—2001–02 report” which brings together the latest information available on the relative performance of international companies that are directly comparable to those operating in England and Wales. A copy of this report is enclosed. The section on bills (page 49–51) of this report compares domestic and commercial charges.

The Aqualibrium report “Europe Water Management between regulation and competition” (page 330) compares water charges across a range of European companies. The European countries that are most directly comparable include Denmark, Germany, Finland and Sweden, as they base charges on full financial cost recovery. Bills in most other European countries have some element of subsidy. On the basis of the figures included in the Aqualibrium report water charges in Denmark (4.31 euros per cubic metre of water); Germany (3.6 euros) and Finland (2.75 euros) are higher than in England and Wales (1.57 euros). Sweden’s are lower at 1.15 euros per cubic metre.

We are not aware of any data that identifies the extent to which charges in different European countries are driven by European legislation. Environmental taxes, ranging from discharge and extraction charges to specific taxes are levied in most countries, and in some are used to help fund the sewerage network.

You sought a commentary on the post tax cost of capital and the yield. The expenditure associated with large capital programmes means that companies have negative net cash flows each year. Consequently the companies have to raise funds via the capital markets. Our headline weighted average cost of capital (WACC) of 5.1% is calculated on a fully post-tax basis. This is equivalent to a return of 5.81% which is based on a cost of equity of 7.7% and a cost of debt of 4.3% for the water and sewerage companies. This is the return allowed on the companies’ capital base (the regulatory capital value) after allowing sufficient revenue to cover their actual tax bill. The fully post-tax WACC of 5.1% could be presented as a fully pre-tax WACC of 7.3% assuming a marginal tax rate of 30%.

Mr Taylor noted that if the water authorities had remained publicly owned corporations the cost of capital to them would be significantly less than the cost to private sector companies. He questioned whether the difference is justified by the additional efficiencies the companies have made since privatisation. Meaningful comparisons between the relative financial benefits and costs of public and private ownership are not straightforward. The nearest thing to such a comparator is Scottish Water, a public sector nationalised industry. The analogy is not exact. Scottish Water has only recently been formed from the three previous regional water authorities. However, my opposite number the Water Industry Commissioner for Scotland published comparisons in February 2003 indicating that Scottish water and sewerage bills in 2001–02 were 60% higher than would have been the case if they had been operating as efficiently as their English and Welsh counterparts. As a result the average household bill paid in Scotland was about £80 more than should have been necessary.

In terms of the cost of raising finance, the difference between the credit of a public corporation and that of a significant utility company with a credit rating comfortably within the investment grade is around one percent per annum. However, a number of other factors come into this part of the equation. Thus, had the water authorities remained in public ownership the evidence of public funding in the 1970s and 1980s suggests that Governments would have been unwilling to sanction the increase in the Public Sector Borrowing Requirement necessary to deliver the enhanced drinking water and environmental quality programmes required. (The overall level of investment, some £50 billion since privatisation in 1989, is at least double the level of investment over the equivalent previous period.)

The form which privatisation took in 1989 was intended to put pressure on the companies both to deliver better services and to do so more efficiently. Regulation of monopoly utilities was to be combined with the pressure of shareholders and other financial stakeholders, as well as from customers, on the companies to out-perform the regulatory assumptions.

Our regulatory assumptions include challenging requirements for year by year improvements in efficiency that must be met or exceeded for a company to develop.

Outperformance of the regulatory challenge would initially be to the benefit of the shareholders but such benefits are returned to customers at the next review of price limits in the form of lower bills.

At each price review, Ofwat has made efficiency assumptions which require the companies to outperform significantly the level of efficiency achieved by the economy as a whole. The figure in paragraph 24 of our evidence shows the reductions in operating costs the companies have made. At each price review companies have also made capital efficiency savings over and above those assumed in price limits. Overall, the effect of efficiency improvements from 1990–91 to 2004–05 has held the average household bill around £90 below the level it would otherwise have been.

This letter offers only a broad commentary. The five reports which Ofwat publishes each year on aspects of company performance offer much more detailed assessments of levels of efficiency in terms not just of expenditure but of improved service to customers and to the environment at large.

Philip Fletcher

1 November 2004

Further supplementary memorandum submitted by Office of Water Services (Ofwat)

1. *Average and typical bills in the South West*—annex 1 explains that because a significant number of customers in the South West are expected to exercise their right to switch to a meter in order to reduce their bills this raises the overall average bill. But because those who switch will reduce their own bills, those who do not switch, or have already switched will see an increase above the average increase in bills.

2. *Our change protocol*—we set out for consultation alongside our draft determinations a draft change protocol. This set down the principles and outline procedures for water companies to obtain confirmation to any changes to the improvement programme funded in our determination of price limits for the 2005–06 to 2009–10 period. We are currently considering the consultation responses and we will issue a final version alongside our final determinations.

3. *Transparency and confidentiality*—we set out at the start of this review our intention of conducting this review in a transparent way.

At each stage of the process we and the companies have published considerably more detail than was published in the past. However there is a delicate balance to be struck between complete exposure of all information provided and respecting necessary commercial confidentiality. It was for this reason that when companies submitted their draft business plans (August 2003) and final business plans (April 2004) they also provided a public summary. These public summaries were available to their customers and to WaterVoice. A single page executive summary for each company was also placed on our website.

These business plans, as for any commercial organisation, set out forecasts of revenues, costs, investment, efficiency, maintenance, quality enhancements, service improvements and their financial positions. For the companies to expose all this information in the public domain could compromise their position in competitive markets. Although they are monopoly suppliers they still have to compete for finance and for contractors in an open competitive market. It is because they are largely monopoly suppliers that Ofwat needs to act as a proxy for a competitive market to ensure customers pay no more than necessary.

The debate last week and with the Environment Agency (EA) has focussed on one part of the business plan, that is the lists of schemes included in price limits. Lists of schemes were developed between the EA and the Drinking Water Inspectorate (DWI) and the companies. These were scrutinised against our published criteria and we informed the quality regulators and the companies of our draft decisions in August. We saw these lists as work in progress. This detailed information was shared with the quality regulators (EA, DWI and English Nature) and Government departments (Defra, Welsh Assembly Government) on the understanding that it was commercially confidential. This enabled our regulatory colleagues to review the companies' proposals and costs for individual schemes and our provisional views included in draft price limits. We have since received changes both from companies and the quality regulators, which will affect the list of schemes included in our final determinations.

In mid October, the EA published the list of permits it intends to issue to ensure that companies meet their legal requirements. Until this was complete the list was still evolving. We will alongside our final determination indicate which schemes are funded in price limits. Companies can use the change protocol to seek funding for these schemes, as and when the schemes are ready to pass our published criteria.² Companies will publish next April monitoring plans setting out their commitments within the price limits set for the five years 2005–06 to 2009–10.

We consider that it would be prejudicial to customers' bills and the efficient and timely delivery of the improvement programme to expose the individual scheme costs proposed by companies in their business plans.

Finally it may be useful to the Committee to know that other stakeholders have commented publicly that our process for this review is significantly more transparent than in the past. For example:

- Dieter Helm of New College, Oxford, commented in the editorial to the *Utility Journal* for September 2004; “Ofwat has done a thorough job, carefully developing the framework, dealing with the business plans and managing expectations in financial markets. The process has been well planned and professionally executed. The outcome has already been indicated in the draft determinations, which leave plenty of time for fine-tuning and listening to the companies and other stakeholders ahead of final determinations in December 2004” and
- Moody's one of the two key rating agencies commented in their industry outlook for November; “Moody's believes that Ofwat has demonstrated a rigorous and transparent approach. The Regulator has published detailed information explaining the Draft Determinations, supported by a breadth of specialist studies and independent research, which have also been partly commissioned in conjunction with the industry. Ofwat has also shared with the companies the financial model, which it uses to translate the regulatory assumptions into their price limits.

In our opinion, the level of disclosure and clarity not only marks a significant improvement on the previous price review in 1999, but is also unmatched among other UK and European regulators. This is an important factor in our continuing assessment of the UK water sector with one of the lowest business risks among all European rated industries. Ofwat has developed over the years a detailed and sophisticated methodology for the price review. This methodology incorporates the results of an in-depth analysis of companies' operational and financial performance that Ofwat carries out on a regular basis to monitor the sector and operate the system of comparative competition that forms a fundamental component of the regulatory regime. As a result, the water companies are likely to face challenging efficiency targets over the next regulatory period and, most likely, as a constant feature of price reviews.”

We will publish our final determinations on 2 December.

November 2004

Annex 1

TYPICAL MEASURED AND UNMEASURED BILLS

In our draft determination document we presented typical measured and unmeasured bills in addition to average bills. For some companies eg South West the increases in average bills are, significantly less than the increases in typical measured and typical unmeasured bills. All the bill figures are in current prices (using November 2003 RPI).

Average household bills

These are calculated as the total household revenue divided by the number of household properties. This takes into account the changes to all household customer bills—including those who are measured, unmeasured, those who switch from being unmeasured to measured and any growth in customer numbers or water delivered.

² Before we take the costs into account when setting price limits, each scheme proposed must:

- Be required by the quality regulators, and confirmed by Ministers, or be a new obligation under current legislation;
- Deliver a measurable defined output, which is enforceable;
- Have a clearly defined timetable and due date for delivery in line with regulations or other legislation;
- Have defined asset improvements or changes to operational procedures to deliver the output; and
- Have identified costs—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).

Typical measured bills

These are calculated for a customer with average measured consumption in 2002–03, where consumption remains constant each year to 2009–10.

Typical unmeasured bills

These are calculated for a customer with average rateable value in 2002–03, where rateable value remains constant each year to 2009–10.

The typical bill figures illustrate the change in bills, year on year, that customers can expect assuming they remain on the same charging basis and use a similar amount of water. Although, the actual change in bills for individual customers might be much higher or lower than this.

So as WaterVoice set out typical measured bills in the South West increase by 29% while typical unmeasured bills increase by 35%. However, average bills increase by only 17% because during the period (2004–05 to 2009–2010) 113,000 households are expected to switch from unmeasured to measured supplies.

This is probably best explained by thinking of three groups of customers:

- (1) those that remain on measured bills 47%;
- (2) those that are currently on unmeasured bills and do not choose to change to a meter during the period 36%; and
- (3) those that choose to switch during the period.

Currently about 301,000 of South West Water's households are metered. By 2009–10 we anticipate that about 446,000 of households will be metered. We have assumed that 113,000 people will choose to have a meter and 32,000 new households will be built with a meter. The 113,000 customers who switch will do so because they expect to save money.

All this is dependent on the assumed number of households that switch from an unmeasured to measured bill. If the outturn is significantly different from our assumption either the company or we can trigger an interim determination. Part of the reason for the large number of assumed switchers is the rate of increase in bills driven by the continuing improvement programme in the South West and its impact on customers' bills. It is quite conceivable that our estimates of switcher numbers are an understatement and that actual switching rates and therefore impacts on customers who do not switch will be even greater.

The company needs to collect a similar amount of revenue to run its business from its customers whether or not they choose to switch to a meter. Meter optants on average use only a little less water post metering and so place almost the same burden on the company in terms of demand for water, but costs are increased due to installing, maintaining and reading meters and increased costs in billing metered accounts. As the 1999 Water Industry Act requires companies to provide free domestic meters on request, companies do not have control of metering programmes and this has led to significant price increases for both measured and unmeasured bills, without providing a corresponding benefit for all customers. While the cost of the metering policy falls on all measured households as a group the impact of lower bills for measured customers also means any increase in total revenue requirement has a greater impact on all customers. The greater the number of customers choosing to switch the greater the burden.

November 2004

Wednesday 27 October 2004

Members present:

Mr Austin Mitchell, in the chair

Ms Candy Atherton	Diana Organ
Mr Colin Breed	Joan Ruddock
Mr David Drew	Alan Simpson
Patrick Hall	David Taylor
Mr Mark Lazarowicz	Paddy Tipping
Mr David Lepper	

Memorandum submitted by the Department for Environment, Food and Rural Affairs

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1. INTRODUCTION

1.1 The Government's aims for the water industry are to protect public health, safeguard the environment, and to ensure that the water industry continues to provide sewerage and drinking water services and supplies at a price affordable to consumers. A sustainable water industry, well-managed and regulated and with a secure investment base is essential to deliver these objectives.

1.2 Defra has given evidence to previous inquiries on this subject and would refer the Committee to its written evidence to the Environment, Food and Rural Affairs Committee inquiry into water pricing, October 2003¹ and the Government's response².

1.3 Previous Select Committee reports, including those by the Environment Audit Committee in 2000 and 2004, and those referred to above, have helped to inform the ways in which Ofwat, the Environment Agency, the Drinking Water Inspectorate, English Nature and Defra have approached the current review.

¹ House of Commons—Environment, Food and Rural Affairs—First Report.

² House of Commons—Environment, Food and Rural Affairs—Fourth Special Report.

2. HOW THE REVIEW HAS BEEN CONDUCTED

2.1 Responsibilities—*who does what?*

2.1.1 Ofwat, as the independent economic regulator, is solely responsible for setting price limits as part of water companies' terms of appointment. Ofwat designs and leads the Periodic Review process in order to meet its primary statutory function of enabling efficient companies to finance and carry out their statutory duties.

2.1.2 The Government's role is limited to setting the policies within which services must be delivered, and they do not have any role in deciding how companies are funded to carry out their functions. It is however Government's responsibility to inform Ofwat, the independent economic regulator and the companies of policy decisions which need to be taken into account in companies' business plans, and hence in the price determinations that Ofwat set.

2.1.3 The role of the quality regulators (the Environment Agency, English Nature, and the Drinking Water Inspectorate) is to give advice to Ministers, including technical advice, on what their policies on the environment should be. This guidance embraces how environmental policies, supply-demand balance, nature conservation objectives and European standards on drinking water quality shall be met by water companies. The individual quality regulators then work with companies to devise programmes of schemes to meet these objectives. The Agency also advises Ministers on water resources planning issues.

2.1.4 Drinking water quality regulation is the responsibility of the Drinking Water Inspectorate.

2.2 Timetable

2.2.1 Defra has issued three sets of guidance to Ofwat during the course of the current Periodic Review; the Initial Guidance, which was published in January 2003, and the Principal Guidance, which was published in March 2004. Final Guidance was published on 4 October.

2.2.2 Water companies produced their draft business plans, taking account of Initial Guidance, in August 2003. Final business plans were submitted to Ofwat in April 2004, taking account of the Principal Guidance.

2.2.3 Ofwat has recently (on 5 August) published its draft determinations of price limits for consultation. The consultation will close on 13 October 2004. The Director General of Water Services has said that he will publish his final price determinations on 2 December 2004.

2.3 Process

2.3.1 Ofwat devises the process and timetable and sets price limits. In order to discharge this function properly, it needs timely information from all stakeholders and, in particular, from Defra's Secretary of State, in the form of the published Guidance.

2.3.2 In this Review, after discussion with Ofwat, Defra Ministers decided that this should be done in three discrete stages—Initial Guidance in January 2003, Principal Guidance in January 2004 (issued 11 March) and Final Guidance in September 2004 (issued 4 October). This was designed to provide information at three key dates in the overall timetable for the review. The guidance on the Periodic Review may be considered as a subsidiary document to "*Directing the Flow—Priorities for future water policy*", which Defra published in November 2002. The policies set out in the Initial Guidance are specific applications of the principles in "*Directing the Flow*" to the water industry.

2.3.3 Water companies translated these requirements into practical, deliverable measures to meet these objectives on the ground. Companies then submitted business plans including projected costs and revenue. Ofwat will set its price limits on the basis of the relevant information.

2.3.4 Ofwat's role is to scrutinise and evaluate these proposals, having regard to cost-effectiveness and value for money. Ofwat takes customers' interests into account.

2.3.5 The process for ensuring the review takes account of Government policies has functioned as it was designed to do. The publication of three sets of guidance at appropriate stages in the price setting process has enabled Ofwat and water companies to plan and present proposals which are fully informed by Government policies for the environment and drinking water quality. This has also given the quality regulators a good basis for working alongside companies to help develop detailed proposals and provide the appropriate degree of challenge.

2.3.6 Once final price determinations are published by Ofwat in early December, the price setting process will be complete. It is however open to each company to ask Ofwat to refer its decisions to the Competition Commission for re-determination if it does not accept the price limits Ofwat sets.

2.3.7 Ofwat has indicated that it will conduct a review of the price review process. Defra will contribute to that review. Defra will also consider from its perspective, the lessons to be learned and the implications for the future of developments such as the Water Framework Directive. It is still too early to make definitive judgements.

2.4 *How policies are decided*

Meeting legal requirement

2.4.1 Ofwat has a duty to enable water companies' to finance their statutory functions as part of the price-setting process. The Environment Agency and the Drinking Water Inspectorate reviewed final business plans to check that water companies had accurately reflected the environment programme in their final business plans, as required by Principal Guidance. The Environment Agency also reviewed water companies' final water resources plans, and provided a report to Ministers³.

Taking account of costs and benefits

2.4.2 When considering the costs of meeting environmental obligations, full account needs to be taken of the costs and benefits to the water industry and the wider public, having regard to the polluter pays principle. This applies especially to the water and sewerage industry because effluent discharged from sewage treatment works is an important contributor to the cleanliness of rivers and hence to river ecology. Equally, water companies often find they are treating water that has been affected by diffuse pollution inputs. Diffuse pollution from agriculture is a particular problem for drinking water, which requires treatment to remove pesticides and nitrates to meet mandatory EC standards. When considering costs and benefits, it is important that:

- definitions of costs and benefits are wide enough, and cover all relevant groups and policy areas;
- the impacts of new policies—both costs and benefits—on all relevant parts of the population and on business are taken fully into account, including costs to the water industry and to agriculture; and
- sustainable development needs are assessed and fully taken into account.

2.5 *Stakeholder involvement*

Joint Statement

2.5.1 In the joint statement published on 12 August 2003, regulators for the water industry and the Government explained how the price review would work and what decisions would have to be taken, by whom, and by when. It also set out some key questions for contributors to consider. The joint statement was particularly important because it was the first time regulators and Government had publicly explained their involvement in the price review process, at the outset, and sought input from others.

Joint customer research

2.5.2 Joint Customer Research took place in 2002 and 2003. Although there was a broad degree of satisfaction with services provided and a limited willingness to pay for environmental improvements, opinions varied on the amount they were willing to pay and the degree and urgency of any improvements needed. Chapter 8.1 of Ofwat's draft determinations document⁴ summarised the results.

Involvement of other, non-regulatory stakeholders

2.5.3 Ministers and senior officials meet with other stakeholders; environmental, consumer affairs, trade and representative professional bodies. The Government takes the views they express into account in setting policies and in formulating guidance to Ofwat.

3. AFFORDABILITY

3.1 Affordability is a key concern, and this is particularly the case in areas with relatively high price increases proposed and large numbers of low-income households. However, it should be borne in mind that affordability is not an issue which is confined to the Periodic Review. It needs to be considered with a longer-term perspective.

3.2 A cross-Government steering group was set up earlier this year to review the way in which low-income households are helped with their water and sewerage charges. Views from interested parties outside Government were invited. A seminar was held on 18 June 2004 which brought together a range of stakeholders and this was followed by a series of bilateral meetings to examine the issues in more detail. A wide range of viewpoints and ideas have been put forward and the Government is carefully considering all of these. A report is due to be published by the end of the year.

³ Environment Agency—Maintaining Water Supply (July 2004).

⁴ "Future water and sewerage charges 2005–10: Draft determinations".

4. POLICIES FOR 2005–10 AND THE LONGER TERM

4.1 *Planning and continuity for the long term*

4.1.1 The Government is determined that water policy is clearly grounded in the commitment to sustainable development, covering economic, environmental and social aspects. These important principles have been key to the development of the Secretary of State's guidance to the Director General of Water Services in order to inform the Periodic Review process.

4.1.2 Considerably more emphasis is now given to integrating water policies with other Government policies, for example flood management. Defra's Water Directorate now embraces flood management policy alongside other policies for the water environment. The ongoing *Making space for water* consultation on proposals for a new Government strategy for flood and coastal erosion risk management in England considers all types of flood risks, including sewer flooding, and all areas of Government policy together for the first time. The consultation framework emphasises the need for integrated flood management solutions that address the complete economic, social and environmental impacts of flooding, and that work with natural processes and can achieve multiple benefits, for example for water quality, biodiversity or community regeneration. It also emphasises the continued need for resilience and flexibility in the face of potential climate change adaptations and the importance of links with spatial planning policies.

4.1.3 The PR04 guidance given to Ofwat by the Secretary of State aims to integrate different aspects of water policy, including water quality, and water resources insofar as they impact on water company costs between 2005–10. Improvements to the water environment need to be seen more in terms of the broader enhancement of water ecology. This also needs to take account of current work to develop catchment-scale solutions, against the background of the future requirements of the Water Framework Directive and other European legislation.

4.1.4 As a result of this Periodic Review, taken cumulatively with the previous price reviews, there is a proven track record demonstrating continuous progress; year-on-year, there has been a steady momentum in quality improvements since privatisation. The fact that this is the case, despite the different financial climate prevailing in 1999 (PR99) than now (PR04), makes this achievement more striking. It can be seen, therefore, that the technical details of the price-setting process have not been allowed to detract from the delivery of long-term projects. For example:

- *Urban Waste Water Treatment Directive*: as part of price-setting in 1999, intermittent discharges eg combined sewer overflows, which were considered to be operating unsatisfactorily were identified. Between 2000 and 2005, a significant proportion of these (around 4,500) will be improved within the price limits set at that time. The remainder, which have been reassessed to ensure they are still causing problems, and those since found to be unsatisfactory, are proposed for improvement in PR04.
- *Section 19 undertakings on drinking water*, where a 20-year programme will have been delivered between 1990 and 2010.

4.1.5 In 1999, against a background of falling prices, the quality investment programme was costed at £7.4 billion. Resources for investment in PR04 are expected to be very tight because of the concurrent pressures on other areas of the capital programme eg capital maintenance. Ofwat has said that price increases will be kept to a minimum consistent with enabling efficient companies to carry out and finance their functions. However, the quality programme for the five year period 2005–10 currently stands at £5.1 billion. In its draft determinations, Ofwat has assumed less expenditure on drinking water quality and the environment than in 1999, although the overall assumption for capital investment is more than £15 billion.

Water Framework Directive

4.1.6 Water Framework Directive objectives will be a significant driver for action beyond 2009, including water company investment through future Periodic Reviews, as well as action by other key players—especially farmers and others who contribute to diffuse pollution. However, measures to achieve the objectives do not have to be operational until 2012 and, as detailed requirements are still under development, it was not generally appropriate to include specific WFD schemes at this price review. However, Government guidance made clear to water companies the need to ensure that investment decisions taken for PR04 were consistent with the need to implement the Directive in the future (so as to avoid costly additions at a later date).

4.2 *Climate change*

4.2.1 Climate change is potentially a significant issue for the water industry, and will undoubtedly lead to investment in the future, not least to enable the ageing sewerage systems in metropolitan areas to cope with larger volumes of stormwater, and peak rainfall events on a more frequent basis. This requires decision-making and planning now. The water industry, along with other key sectors, needs to take on board current knowledge and seek to develop strategies to identify areas where additional investment may be needed.

4.2.2 In July, the Environment Agency reported to Ministers on the water companies' final water resources plans, which inform the business plans under PR04. The Agency's report indicated that most of the water companies have made an estimate of the impact of climate change. Some believe that the impact is small and that it can be managed within existing plans. Others have shown that it could have a serious effect on the supply-demand balance. The Government expects all companies to continue to refine their plans in line with the Environment Agency's recommendations, and in particular to carry out more detailed analyses to help them understand the scale and scope of the impact of climate change, and thereby to inform their choice of appropriate adaptation measures.

4.3 *Water resources policies*

4.3.1 Government policy in this area was previously explained in the Defra memorandum to the Environment, Food and Rural Affairs Committee's inquiry "Climate Change, Water Security and Flooding" in April. The Committee's report was published on 16 September⁵. The Government is currently considering the recommendations, including those which relate to the Periodic Review processes and water pricing, from this report. The Government will respond to these recommendations in due course.

4.3.2 Essentially, the Government expects all water companies to achieve and maintain a sustainable balance between supply and demand for water; final water resource plans show that all water companies expect to be able to meet their customers' needs in the short term, although some companies need to do more to address security of supply issues. Most companies are forecasting an increase in household demand over the next 25 years.

4.3.3 The Government would like to see demand management measures making a greater contribution to meeting the supply-demand balance, alongside the development of new resources. In the Final Guidance, Ministers have encouraged water companies to include more demand management in their water resources plans.

4.3.4 Where additional water resources are planned, companies need to be able to justify the need for this against other options such as further leakage controls and water efficiency measures.

4.3.5 Most companies are now at their economic level of leakage. The Government expects companies to continue to manage leakage within Ofwat's economic framework and, as appropriate, to exploit opportunities to reduce leakage further. In its draft determination Ofwat provided for a significant increase in investment in the maintenance of underground assets, including water mains, which will assist companies in their longer-term management and improve security of supply.

4.3.6 Water resource planning is also a key feature of Government planning for *sustainable communities*. Significant house building in the south-east will undoubtedly impact on the supply and demand for water. This has generally been factored into water companies' water resource plans, but will need to be updated as further, more detailed information on housing numbers and precise locations becomes available. The Sustainable Buildings Task Group identified a number of steps to improve the water efficiency of new development, including tighter standards in building regulations, which the Government is working to implement. Local authorities will need to ensure that the water companies are kept abreast of evolving development plans.

4.4 *Policies for the environment*

4.4.1 Water quality

4.4.1.1 The Secretary of State's Principal Guidance to the Director General of Water Services, published in March 2004, conveyed her main decisions and policies affecting the Periodic Review. This included a detailed analysis of the environment programme that Ministers wished to see included in Final Business Plans (chapters 4.2 and 6).

4.4.1.2 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 Principal Guidance recognised that compliance with EU and domestic statutory obligations would not offer all the additional discretionary elements and these were left open for Ministers' decisions on the basis of a Regulatory Impact Assessment.

4.4.1.3 The Principal Guidance also took into account other factors such as 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.

4.4.1.4 The environment programme is robust. The Environment Agency, English Nature and Ofwat have collaborated to assess the effectiveness of the companies' proposals in delivering the required environmental improvements and whether the solutions put forward were reasonable.

⁵ http://www.parliament.uk/parliamentary_committees/environment_food_and_rural_affairs/efra_climate_change_and_water.cfm

4.4.1.5 In addition to the appraisal work carried out before Principal Guidance, the Environment Agency and English Nature have undertaken further technical appraisal of some parts of the programme and some high cost schemes have been subject to further scrutiny. The outcome of this process substantially reduced between Initial and Principal Guidance the number of schemes needed to deliver the proposed programme.

4.4.1.6 Ofwat has undertaken extensive analysis of companies' Final Business Plans. This has informed its Draft Determinations which, along with the Regulatory Impact Assessment of the small amount of discretionary schemes will inform the Secretary of State's Final Guidance.

4.4.1.7 In the Final Guidance, published on 4 October 2004, the Secretary of State confirmed the policies that she wishes to go ahead in the light of water companies' Final Business Plans, further advice from the regulators and Ofwat's Draft Determinations.

4.4.2 What will the environment programme deliver?

4.4.2.1 The environment programme will improve and protect the quality of over 2,900 km of rivers in England and 260km² of lakes and coastal waters. This programme builds on previous achievements. Over the last decade the environmental status of our inland and coastal waters has been significantly improved. For example, 65% of monitored river length in England was of "good chemical quality" in 2002, compared with 43% in 1990⁶. Over the same period, compliance with minimum EU bathing water standards has increased from 79% to almost 99%.

4.4.2.2 However, there is no room for complacency. More work is needed to improve the water environment, for example, to improve the condition of water and wetland Sites of Special Scientific Interest (SSSIs) and to meet the requirements of the Water Framework Directive.

4.4.2.3 The present environment 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 drinking water, meeting the required standards, 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 within the constraints imposed by statutory regulations represent good value for money and promote sustainable development.

4.4.3 Nature conservation and habitats objectives

4.4.3.1 The environment programme will contribute to meeting nature conservation drivers such as those associated with the protection of internationally important sites, including Natura 2000 and Ramsar sites, and similarly important national sites, SSSIs. The Environment Agency and English Nature have recommended investigations and schemes to tackle abstractions and discharges which may be adversely affecting those sites. Schemes have also been recommended to tackle abstractions and discharges which may be adversely affecting Biodiversity Action Plan species and habitats.

5. CONCLUSIONS

- Early indications suggest that the process for incorporating Government policies in the current water price review has worked as intended (paragraph 2.3.5).
- Guidance given by the Secretary of State enabled key Government policies to be reflected in water companies' final business plans (paragraph 2.3.5).
- After the process has been completed, Ofwat will consider with Government what lessons need to be learned for the future. It is too early to make definitive judgements (paragraph 2.3.7).
- Affordability is a key Government concern and a cross-Government steering group will report by the end of 2004 (paragraph 3.2).
- Long-term planning has not been hindered by technical details of price setting process (paragraph 4.1.2).
- Climate change has been reflected in water resources plans and hence in the price-setting process. There is room to review analyses and update plans as further/better information becomes available (paragraph 4.2.2).
- Water companies do however need to include more demand management and water efficiency projects in their water resources plans (paragraph 4.3.3).

⁶ The chemical classification system assigns river stretches and canals to one of six chemical quality classes—A (the highest) to F. "Good" equals classes A and B.

- There will be a significant increase, as indicated by draft determinations, in the amount of investment available for maintenance of underground assets, including water mains (paragraph 4.3.5).
- The quality programme for drinking water and the environment confirmed in Government guidance will continue the substantial improvements made in earlier price reviews (paragraph 4.4.2.1).

25 October 2004

Witnesses: **Mr Elliot Morley**, a Member of the House, Minister for Environment and Agri-Environment, and **Mr Richard Bird**, Director of Water, Department for Environment, Food and Rural Affairs, examined.

Q63 Chairman: Welcome, Elliot. It is good to see you, as always. You are a regular visitor and in fact we will probably reserve that place for you permanently down the other end of the table, but it is nice to see you. We want to talk about the final ministerial guidance, which we have got copies of. It seems to be a proclamation of all the virtues because you are expecting them to look after the environmental damage, the effects of global warming, and at the same time keep the water pure and keep the fees down before an Election and after the Election. So you are really proclaiming virtue to the water companies. Now, the question is whether they are going to be able to fulfil those intentions, so let me ask you how this final guidance differs from the original guidance, the two original ones.

Mr Morley: Okay. Thank you, Chairman, and could I first of all say it is very nice to see you in the chair today. I am also joined by Richard Bird, who is the director of the water division in Defra. The point you make is a very pertinent one, Chairman. There is a lot of balancing requirements in relation to water policy and water strategy. You will be aware, of course, that we do have an independent regulator. The independent regulator has the responsibility for examining the companies' business plans. It is the regulator's role to determine the capital programmes and the overall price increases and the regulator is to bring forward his final determinations on 2 December. Our role in relation to Defra is to obviously consult with the regulators that come within the Defra family, and that is the Drinking Water Inspectorate and the Environment Agency. They put to us their quality and environmental programme and that is submitted to the regulator, because of course there are costs with that as well and the regulator also examines that after it has been through very careful examination in Defra, I have to say. So it is gone over in some detail in the same way as the companies' business plans are also gone over in great detail by the regulator. We provide ministerial guidance and the ministerial guidance has not changed very much from the draft guidance to the final guidance. We have put some emphasis on things like sewer flooding, which is a problem, and we are quite keen to see an increase in their capital allowance on sewer flooding. You will appreciate that the ministerial guidance is that, it is guidance. It is up to the regulator. You cannot order the regulator to do this, but the regulator of course takes into account what we have said. Basically, we feel that the environmental quality programme is justified in terms of its costing. There is always this dilemma in relation to keeping prices down, which is

important, but also having good standards of environment and quality, which is also important. My belief is that of course consumers are concerned about prices, but consumers are also concerned about clean rivers, clean coasts and good quality drinking water and that is a very important consideration as well. You will have seen the draft determination of the regulator and I think he has done a good job in terms of trying to balance up these demands and the pressures that are on him. He is recommending considerable reductions in what the companies have been asking for in terms of prices. But he has to be careful, of course, that in terms of seeking those reductions there are the adequate capital programmes in order to have the investment and the maintenance. There were some concerns about the level of maintenance that was allowed, for example in the last five year price round, so of course there is an impact on that. So I do not think we have changed our final guidance very much, apart from just having the emphasis on that and also the fact that we do think one or two of the environmental programmes where there were some questions, shall we say, such as the Endocrine disruptors research, which we think is quite important, some of the upland management programmes, which we also think are quite important. We think that they are justified in terms of the overall package of measures which have been put forward to the regulator.

Q64 Chairman: So no substantial changes between the principal and the final?

Mr Morley: Not really, no.

Q65 Chairman: Okay. You are satisfied with Ofwat's response?

Mr Morley: Yes. I think Ofwat have been reasonable in their response. They did not accept absolutely everything within the environmental programme but some of the schemes that were not accepted were not rejected; the regulator asked for further details, he asked for clarification with the Environment Agency, and my understanding is that the Environment Agency and the regulator have been working very well together in terms of providing that detail. I do not see anything wrong with the regulator asking for clarification if he feels there is a need for that within the programmes, because I want to see that the environment programmes are justified and I believe they can be justified.

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Q66 Paddy Tipping: Could I pick up on two issues you have raised. One was about upland management. The big challenge is the challenge around diffuse pollution. The easy bit in a sense has been done and I would be grateful if you would talk to us a little bit about how you see progress on that and how it fits into the EU Directive. Secondly, you mentioned sewers. Let me just divert from the script a little bit and say there is nothing in this price round for private sewers because you have not defined the policy, and I think you are about a year behind your own timetable. Perhaps you would just say a little bit about private sewers. I think you are going to make an announcement now in the spring. Suppose you were minded to do things on private sewers. How does that link into this price round?

Mr Morley: Okay, and thank you for that helpful extra that you have put in there, Chairman. If I could just deal with the upland measures first of all. I am an enthusiast for a much more integrated approach towards water management in this country as a general principle. I am a great enthusiast for the water framework approach in river basins management and I think that the Ribble Valley pilot is going very well. We do have a lot of challenges. We have the nitrate directive to apply, we have the water framework directive, which is a huge directive which comes in in 2015. You are quite right in what you say. Really we have made enormous progress on end of pipe solutions from industrial pollution, from the water treatment plant sewage works. We have really cleaned up the rivers and the coasts and I think is it something we can be proud of. In many cases the rivers and our coasts are cleaner now than they have been for the last one hundred years because of the effects of the industrial revolution. We have managed to rectify that. But we are moving away from measurement of water simply on chemicals and really I doubt whether we can make a great deal more progress. I think there is a bit more progress that can be made, but we are up in the high nineties in relation to quality standard and things like that. We are moving to measurement by ecological quality, which is much more challenging. We are going to measure things like siltation, the effect on the water table in relation to abstraction, the ecological health of all water courses, lakes, rivers and ground water. That is hugely different and much more challenging. There are also challenges for us in relation to how we reduce agricultural run-off and that will require changes in all sensitive catchments, looking at inputs, fertilizers, pesticides, looking at stocking density, manure storage, manure spreading, and I think that if we have some upland management methods and the two schemes that are put in can be justified in the sense that it can reduce cost to the consumers downstream—because removing nitrates and pesticides costs the average family round about £20 a year, roughly speaking. So there is a cost to consumers in relation to what is happening now and we need to remove those externalities from agriculture and deal with the source of the pollution. So I am a great enthusiast and I think it is the way we need to go in terms of an integrated management. On the issue of private

sewers, this is a very difficult one, so I am going to ask Richard to come in in a moment! But I will tell you where we are with it. We have had the consultation and round about 80% of the respondents felt that the solution to private sewers was for them to be handed over to the water and sewer companies. You can well understand the logic of that. We are in the final stages of our response and I will ask Richard to give you some details on that in a moment. When we have our response it is clear what the preferred solution is basically, Chairman. There is no point beating around the bush on this. Therefore, what we have to think about is how we are going to handle that and how we are going to handle the costs of it. Because it is out of sync with the current five year price review there is not likely to be major finance in this current five year review. That is not to say that we could not maybe make a start in relation to how we approach this, but we would have to think about how we do that. I think, to be honest with the Committee, because of the cost implications it would be easier to phase that change in so that you spread the cost by looking perhaps at the worst first, because there is a lot of private sewers which are not a problem. So you could actually perhaps look at the ones which are causing the problems as a priority and then work it through to the rest of the network. Do you want to comment on that, Richard?

Mr Bird: Well, there is not a great deal to add, Minister. We are aiming to publish a decision paper along with a full regulatory impact assessment as soon as possible next year. Before then we have got to do more work on costs, which is obviously the critical aspect. We are engaging consultants to help us do some more work on this. There is a joint steering group (which includes the water industry, Ofwat, and the Environment Agency as well as ourselves) which is investigating this issue. We have asked W.S. Atkins to do some more research here. So there is ongoing work. As the Minister has said, if action then needs to be taken in terms of additional costs for the water industry that can be picked up as part of the interim price determination process. It does not need necessarily to wait until the next five year round.

Q67 Mr Breed: Minister, thank you for those opening remarks. I think they were most interesting, particularly the last bits about the private sewers. Just going back on the environmental programme itself, I think after privatisation it might have been a major shock but most water charge payers recognised there was a huge capital backlog that had to be cleared and water charges went up substantially. I think the feeling was that after about five or 10 years when all that capital worth has produced real significant improvements, particularly in the quality of the water and such, there would be a period of time when we would then begin to see prices levelling off. We would not see the sharp increases. So the perception has come about, of course, that the environmental costs that are now being incurred are producing these very sharp rises and people are saying, “Well, can we really afford

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these environmental costs and aren't we not in effect almost getting ourselves into the law of diminishing returns in the sense that costs are going up and up to achieve a relatively modest improvement on what we have already achieved. How much has that really been taken into account, bearing in mind that the Environment Agency, and indeed others, have been—I will not say criticised but it has certainly raised the issue of the cost of the environmental programme.

Mr Morley: I understand that point and indeed given the huge input in relation to the capital programme there is a logic that it should decline or flatten out. You have to bear in mind, however, that there has been an awful lot of concentration in relation to cleaning up water treatment in particular and there is still existing infrastructure that does need to be maintained and in some cases to be replaced, and that is part of the capital programme as well. The environment programme is a small part of the overall price increase. Is it about 20% approximately, Richard?

Mr Bird: It depends which way you look at it.

Mr Morley: Well, it depends which way you look at it. So it is 20% the way I look at it, anyway. So it is a small element; it is not the major element in relation to the impact on prices. Although it is true that immediately post-privatisation prices went up sharply—and we are well aware of that and we are also very well aware of the regional differences—I think it is fair to point out to the Committee that because there was a reduction in the last round, if you take the interim price determination and you look at that from 1999 you are actually looking at a 3% price increase since 1999 in relation to water bills (this is on average), which is not unreasonable, although I accept that there are regional differences in relation to the prices.

Q68 Mr Drew: Last week, when we had evidence from Ofwat, they seemed to think that the water companies were placing undue excuse on the environmental cost. Who is right?

Mr Morley: Well, I think it is easy enough to have a look at the breakdown of the figures as a Committee in relation to the environment and quality programme and the other elements of the companies' business plans, and I think if you look at a breakdown of those figures you will find that the environmental quality programme is a small part of it.

Q69 Mr Drew: So given that the water companies are not saying that to us, they are saying that this is a major factor in why prices are going up, what powers through Ofwat or through the Department do you have to at least get the message out to water companies that they have got to clarify what their position is?

Mr Morley: Water companies, I think, have an obligation to clarify it. I would be interested to read the transcript of the evidence, but there was an element, I think, of trying to look for excuses in relation to price rises, although to be fair to the water companies they have not been doing that in recent

times and they have been fairly straightforward about what is their capital programme and what element is in the quality programme. You can argue, and Richard touched upon this, that if you are upgrading your water treatment then there is a potential environmental benefit and you could argue that is an environmental issue. It is not necessarily an environmental issue. You have to do it because of water quality directives and treatment in any case. It is part of the infrastructure investment that we would expect to see. So you can get a bit of a blurring in relation to where the money is going and what it is for, but basically in relation to the programmes which are advocated by the Environment Agency and the DWI you will find that they account for a really very small part of the price increase.

Q70 Ms Atherton: Minister, you mentioned that the average was a 3% rise—

Mr Morley: Nationally, yes.

Q71 Ms Atherton: Nationally. That is the critical word, because they are regional and you did accept that there were regional differences.

Mr Morley: I do accept that.

Q72 Ms Atherton: In the very far south-west of Devon and Cornwall it is significantly more than 3% and some people will be reaching for their pacemakers with anger, and quite rightly so. One of the issues you have mentioned in the past is that the lowest waged area—and Diana is going to do affordability—pays the highest bills, the reason being the length of the pipes, the problems with the environmental programmes, how far the pipes have to go, the sewage pipes, you name it, and the relative small size of the water company serving the population of Devon and Cornwall. You have indicated in television programmes in the West Country—

Mr Morley: Yes. It got me into a bit of trouble actually.

Q73 Ms Atherton: Oh, I am so pleased, because it actually does solve some problems for these regional disparities, which are huge. Have you had further thoughts, in view of the little bit of trouble, and sorted things out?

Mr Morley: Well, the reason why I got into trouble is that these are issues for the regulator and I am very careful not to transgress into the regulator's area. My comments in the interview, following your suggestions actually, also caused a share price increase, which is the first time I have ever had any influence on anything financially really. So I was quite taken aback by that.

Q74 Ms Atherton: Be assured I have no shares in South West Water.

Mr Morley: I absolutely accept that. There is—perhaps difference is too strong a word, but I sometimes worry about the restrictions on mergers. My concern is British-based companies because the regulator is keen to have a separate company so that he can have the price comparator and the regulator

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believes that there is a need for a certain number of separate companies so that he can have the price comparator to ensure better value. I just worry that that works against the opportunity of British companies strengthening their positions both within the UK and also within what is becoming a growing international market in relation to environmental services. So I just worry a bit about that, although I understand the regulator's position and I understand his argument on that.

Chairman: Shall we move on to affordability.

Q75 Diana Organ: As we know, the Government expressed its concern about the price increases and the difficulty of ability to pay for certain consumers and I understand from what you are saying that the independence of the regulator is very important, but surely we cannot go on with the fact that water bills are rising above the rate of inflation each time there is a periodic review and we have the increasing difficulty of how are we going to put into place measures so that those are the least able to pay can meet their bills. I understand that there is a review going on and it hopes to be possibly reporting before the periodic review of April 2005, but in all honesty what can government do and what do you hope to put into place to make it easier for those who are going to find it difficult to pay the hikes in the bills?

Mr Morley: Well, let me be again quite honest with the Committee there. It is limited, what the Government can do, in relation to assisting those people on low incomes with water bills. It does not mean there are not things that we cannot do, and I will outline some of those. We did host a seminar on looking at the whole issue of affordability and we will be producing a report in the very near future on the findings of that, although we do operate within fairly limited parameters on this so I do not want to raise false expectations that there are going to be enormous major statements of policy because that is not likely to happen. I do come back to the point that as you go from 1999 in relation to the growth in people's incomes and the overall growth in prices of 3% nationally then it is not a bad impact and the way that the regulation has evolved in this country (which is designed to protect the needs of the consumer, to ensure that there is adequate investment but not excessive profits, that the companies' business plans are what is needed and no more and to ensure investments in the environment) is that it has evolved into what I think is quite a successful structure. There are many countries internationally who beat a path to our door to have a look at the regulatory framework in the UK because they are very interested in applying it themselves. But there are things we can do. For people who are on meters there is a limit to the absolute maximum price. So if you have vulnerable groups, people who are disabled, people who have chronic illnesses, for example, then there is a cap on the prices that can be applied now in relation to the regulations. We have been talking to the water companies about flexible methods of payment. I am sure we all have constituents who are paid benefits fortnightly, and being able to pay fortnightly and perhaps paying

direct either out of benefits or direct out of bank accounts for many people in terms of budget management is a big advantage to them. A number of companies do have trust funds, which are administered separately, sometimes by a charitable trust. Those trust funds can help out those people who have financial difficulties and vulnerable groups and there is a potential for extending that further. I know that the water companies are also interested in the equivalent of the Energy Saving Trust, whereby you can give support to groups. In fact they are actually looking at reducing water consumption generally, which is an important issue, but the Energy Saving Trust, of course, is designed to help people reduce energy and the water companies themselves are quite interested in a similar structure to help people reduce water use as well. I think that is very good in environmental terms as well as in social terms.

Q76 Diana Organ: Can I just come back on two points. One is that of course, as you said quite rightly from your analysis, it has not been too hard a hit on those people if we look at the rise in earnings. Of course, for those who are on a fixed income, either on benefits or on a pension, they are not beneficiaries of the rise in earnings.

Mr Morley: I would accept that.

Q77 Diana Organ: Those are the most vulnerable groups. So I was hoping for possibly a little more from what government might be able to look at from the outcome of the review to assist those groups. The other is that we have heard from the water companies, particularly last week. Ofwat was saying that of course it is the environmental requirements and standards that are taking up their expenditure. Is there not more that Government can do, since it is Government (often through EU legislation) which is imposing on the water companies extra standards and extra requirements which is costing them money? Is there not something we can do there to meet the bill, because effectively we are asking the consumers to pick up everything that we are imposing and some of those are very vulnerable groups?

Mr Morley: Sure. Well, it is true that a lot of these are water directives from the EU, although they are measures which we strongly support in relation to environmental quality standards and it is an issue of the polluter pays. On the polluter pays, we are moving to a general position in this country that the people who are responsible for the pollution are the ones who pay to clean it up and that, of course, applies to water and sewage companies. I do not know if there is anything I have missed out on the vulnerable groups, Richard, is there?

Mr Bird: No. Just to emphasise, on the vulnerable groups we are looking to see whether there is any way in which the existing arrangements might be extended to include more groups and we are due to come forward with proposals on that very soon.

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Q78 Chairman: Could I just ask when you will make your announcement? I assume it will be before May 2005?

Mr Morley: I think we are looking at weeks, are we not, Richard? Yes.

Q79 Chairman: There will be no return to imprisoning people for—

Mr Morley: No. There are no proposals at all to cut people off, because of the health implications.

Q80 Mr Drew: Just to return to the Water Saving Trust, I have certainly picked that up both from Water UK and one other company. On what basis is such an organisation set up? The Energy Savings Trust obviously receives quite a substantial sum of government money. I do not know if it has got any legislative basis at all, but what I am really asking is what would be needed to get this under way because there is a lot of goodwill but that is not quite the same thing as setting up—

Mr Morley: There is goodwill and I think to get it going the water companies through their trade organisation, Water UK, are prepared to put the money up themselves.

Q81 Diana Organ: Can I come back, Minister? We do have a problem, as you will be aware of, that many consumers do not have a lot of confidence in the bills that they are being issued with by their water companies. As you know, people who live anywhere between Chepstow and the top of the border, in the marshes area, between Welsh Water, Severn Trent and other water companies there have been considerable problems about the billing. Yes, I know, I have written to you about it, about the problem that they have been wrongly billed for a long time and they were not on the computer. There is an issue here about the bill coming through the letterbox and people saying, “Well, they don’t even know who I am, where I am, where I get my sewage taken away to and who is dealing with it and where I get my water from.” There is a lack of confidence amongst many consumers, and Candy Atherton’s area has similar experiences with lack of confidence, and yet those very areas are going to be some of the areas that are going to have the highest increases in their water bills.

Mr Morley: I think it is a very difficult one because I know the case in question and it is a very unfortunate one, shall we say, in relation to which water company had the responsibility of the billing. There are cases of that where you get an overlap of boundary. It is not so common. Until our boundaries changed I had one community where the boundary ran through the middle of the village and half the village was in Severn Trent and half the village was in Anglian and the water prices were different, because they are different, and the sewage prices were different. Of course, that is not the kind of thing that leads to a harmonious relationship, basically. So I understand that, although I think that is a fairly narrow problem where you are on the periphery of water companies.

Q82 Diana Organ: Ten thousand people it affected.

Mr Morley: Oh! That is a broader problem than I thought, actually.

Q83 Diana Organ: Not all in the Forest of Dean; it is all the way through the marshes.

Mr Morley: Right. I think the case that you uncovered is certainly the largest of its kind that I am aware of.

Q84 Mr Lepper: Can we just focus for a moment or two on the price review process itself. You will be aware, Minister, that in our first report on water pricing earlier this year we said we were concerned about the inability of the existing process to take proper account of long-term planning on issues such as climate change, research and development into those issues. Ofwat is about to review the process with a view, presumably, to informing what might happen next time, in 2009. Could you just clarify for us to what extent you or the Department expect to be involved in that evaluation by Ofwat?

Mr Morley: We will be involved in the evaluation there. Ofwat will look at the system and of course it is likely they will make a report to Defra within that. I should say that all water companies are obliged to have a twenty-five year plan in relation to water resource and management, so they have to look ahead for the next twenty-five years in relation to the kind of demands that are going to be made for water and they have to plan ahead because, of course, there is a need to ensure that there is security of water supply. That means that water companies are obliged to take into account the effects of climatic change because there are some severe potential long-term effects of that. They are obliged to look at long-term plans in relation to housing development, for example, and increasing demands that could be made upon water. So they have that obligation at the present time. I think the regulator will be looking at the five year review process and how it works. As a general principle, all I would say is that the way that we have developed the water sector in the UK is that it is a long-term industry that requires long-term investment. It is within a very, very tight regulatory framework and I do not think it is unreasonable to have as much long-term planning as you possibly can.

Q85 Mr Lepper: It is great that there is that long-term view that the industry is encouraged to take, but on the other hand that planning still gets chopped up into five year segments, inevitably, in terms of the money that is likely to be available to carry forward those plans. Of course the current pattern of those reviews always tends to coincide with a General Election within a few months or so of the decisions being taken and the inevitable balancing act between long-term issues dealing with climate change, the context now of the water framework directive as well that we have to operate within, the needs of the environment and the sorts of issues that Diana and Candy have dealt with about

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the pressures of pricing on their constituents in particular and for all our constituents always come into this. Is there another way of dealing with this?

Mr Morley: There may be, and I think that is part of what the regulator is looking at. All I would say to you, Chairman, is that I have an open mind on these approaches and I recognise that there is a need for long-term investment, long-term planning, and sometimes in relation to some of the bill problems the longer you can spread the investment then the lower the impact there is on consumers and I am very much in favour of that as well.

Q86 Mr Lepper: I wonder if I could just carry on with this issue about the water framework directive. Again, we have had RSPB saying to us that this price review does not deal with plans for the water framework directive effectively, that it is storing up additional problems for perhaps the next two price reviews. Any thoughts on that?

Mr Morley: Well, I do not really accept that. We have until 2015 to implement the water framework directive. We will not even get the definitions of what is classified as good ecological status until 2006. We will not even get the definitions until then, so there are not huge spending implications in this price round. But a lot of the work that will be done, for example work on the nitrate-vulnerable zones in terms of meeting the nitrate directive, in terms of meeting the drinking water directive, in terms of meeting the ground water directive, and some of the ways that we are shaping the upland management schemes, the agri-environment schemes, will all contribute, Chairman, to the outcomes of the water framework directive. So it is not as if nothing is going to be done in the next five years. An awful lot is going to be done in the next five years in terms of meeting those requirements.

Q87 Mr Lepper: So RSPB are being perhaps a little bit over-concerned, a little bit alarmist?

Mr Morley: I think they are quite keen on seeing as much money up front as they can possible argue for, and I do not blame them for that, but I think the right balance has been struck in relation to the required investment.

Mr Lepper: Thank you.

Q88 David Taylor: Just to pick up one or two loose ends. I think David has covered the longer term issues fairly well. Would you accept that politicians in general, the Environment Agency, the water industry in general, and perhaps Ofwat have been slow to accept that climate change is in fact a reality and not some theory which may or may not fit the facts of climatic change over the last few years, and if you did accept it that the forward plans for capital expenditure over a very long period (you have talked about 25 year plans a few minutes ago) have started to climb almost in parallel with the acceptance that we are talking about serious sums of money here? We have had evidence and there are suggestions that the water industry have tried to respond in an appropriate way but they felt the downward pressure of Ofwat, who felt the downward pressure,

presumably, of politicians. So the twenty-five year mechanism is translated, as David said a moment or two ago, into five year lumps. Is it really the right way to respond to things when just a year or two ago certain patterns of climatic activity were described perhaps by experts as just one in two hundred years and now that has been revised very rapidly indeed, and capital expenditure has got to come in parallel with that?

Mr Morley: That is absolutely right, but there is certainly no government that is taking climate change more seriously than this one, in terms not only of giving a lead internationally but also in looking at adaptations in relation to climate and the long-term implications that there are for our economy and for our country. The water companies also accept that, which is why we do have the twenty-five year plans, but we are seeing some changes in relation to potential pressure because of the climate. Thames Water, for example, are going ahead with the desalination plants. In some ways that is a pilot scheme and that is designed to deal with pressures in the summer basically, where you can get low flows and water shortages, and there may well have to be further investment in terms of ensuring that our water supply is secured. That is also, I might say, on the other side of the coin, allied with the targets which the regulator sets for leakage, for example. There have been considerable improvements on leakage nationally by the water companies, but there are still one or two companies who have to do a lot more on that. We also need to raise awareness about water being an important resource. The Water Bill, for example, in terms of abstraction changes and controls, is also part of implementing a more sustainable approach towards water with an eye on the range of pressures that there are on water resources in this country, and of course climate is one of them and that is built into the approach.

Q89 David Taylor: Is it possible for the law of diminishing returns to apply to investment to prevent and reduce leakage in much the same way as you yourself said there was in relation to quality? At what point do you acknowledge that we have come about as far as we economically can do and that resources would be better applied in other areas?

Mr Morley: That is right. There is what is called the economic level of leakages and that is a level of leakage which is at a certain low level where it is not cost-effective to try and spend large sums of money to get that lower. Some companies are probably at their economic level, but not all.

Q90 David Taylor: Which ones would you say were not?

Mr Morley: Thames is not at its economic level of leakage.

Q91 David Taylor: Severn Trent?

Mr Morley: Severn Trent have actually changed their calculations, which makes their leakage look a lot worse. They may be right, actually. If they are right, then they will not be at their economic level.

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Q92 David Taylor: Finally, Anglian, where the border runs straight through Leicestershire, between Anglian and Severn Trent?

Mr Morley: I think Anglian has got quite a good record on this, has it not, Richard?

Mr Bird: I think so. I think the Committee will have an opportunity to ask them next week about that specifically, but certainly I think Thames rather stands out here.

Mr Morley: To be fair to Thames, they have some real problems in relation to London clays. They have problems in relation to it. It is enormously difficult digging up roads in London, as I am sure London Members will be aware, so I have some sympathy with Thames. However, they still could do better and we do expect to see them do better.

David Taylor: Thank you.

Q93 Chairman: There is almost an element of fudge-ability and fiddle-ability in these loss estimates, is there not?

Mr Morley: Yes. There are always, shall we say, different ways of interpreting figures, Chairman!

Q94 Alan Simpson: I am just wondering whether this five year price review helps us to address longer term issues about climate change or whether it hinders us, because it seems to me that what we have set up is an impossible contradiction between the water companies required to plan on a twenty-five year water resource management basis and Ofwat squeezing them on the five year price review process. It just seems that this is a no win process for the environment. We put pressure on the companies. They say that they want to do things. We ask whether they have got the resources and they say, "Well, it's all very well, but there's a hole in my bucket, dear Eliza." We are in real danger of just spinning round on this in ways that pretend that we have an agenda that relates to long-term climate change when we do not.

Mr Morley: Yes. The twenty-five year plans help, obviously, because the companies are obliged to look quite a way ahead. We have also had programmes like the Foresight Programme with the Office of Science and Technology, but that is looking at flooding and coastal defences. There is a bit of a read-across in relation to it. It is water management. Yes, I accept your point that it is clearly better to have longer term planning, and that also includes longer term price planning, because it is such a tightly regulated industry. It is almost part of the state apparatus, even though it is privately funded. It is a very strange hybrid link that has developed over the years. Now, in that respect perhaps we should just accept that the water sector is always going to be tightly regulated and to look at the advantages of that, which is that you can have long-term planning with stable returns in relation to investment. That is the big advantage of water companies. It is capital intensive but it is a nice, steady, safe return for investors. So there is a *quid pro quo* in this. I have no objection to looking at it in the longer term and I would be very interested in the regulator's views on this and once the price review is

out of the way we will have more time to talk about things like that. Of course the regulator, quite understandably, has been very much focused on the current reviews and the work that he and his staff have to do, along actually with our own water division, I have to say, as well. Also, as a general principle, I do not think it is desirable for consumers to see prices go up and down and up again. I just do not think that is desirable. I would much rather see a steady, nice smooth approach in terms of long-term investment in relation to water.

Q95 Alan Simpson: But is not the price review almost the antithesis of what you were saying about the polluter pays principle, because the price review is about the consumer paying?

Mr Morley: But the job of the regulator is to apportion that cost in a fair way. Yes, there is a cost to consumers and there are no two ways about that, but the companies themselves are expected to raise part of that cost through borrowing and through equity, and the regulator seeks to ensure that that balance is struck.

Q96 Alan Simpson: But I do not think that that in any way engages with the question of the polluter pays. Whether companies raise money through equities or through long-term loans, it is a mechanism for meeting obligations; it is not about requiring the polluter to pay. The Department today has come out with, or slipped out an announcement that it has just agreed to a 7.5% increase in carbon emissions from the April figures.

Mr Morley: The DTI modelling has demonstrated that we were short of about 7.5%, not—

Q97 Alan Simpson: My understanding was the DTI are lobbying rather than modelling—

Mr Morley: I think we are straying a bit here, Chairman, but that is not our interpretation at all. I am very happy to talk to Alan afterwards about it.

Q98 Alan Simpson: The issue here is how the industry and how us as a government give the industry a remit to address long-term climate change.

Mr Morley: Yes.

Q99 Alan Simpson: You have made reference to the role of the Energy Saving Trust and it is an important one in energy issues. However, the role of EST has to be seen in the context of us as a government having made a commitment to completely eradicate fuel poverty by 2016.

Mr Morley: Yes, and on target to do so.

Q100 Alan Simpson: Well, we might come back and discuss that one because I do not think we are. The fact is that that remit was defined by central government policy.

Mr Morley: Yes.

Q101 Alan Simpson: It was not sort of behind the scenes negotiations between the regulator and the industry, it was the Government setting clear

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obligations which industry then had to meet. If that is what we are saying is happening in relation to water, we have to be much more prescriptive and interventionist to give the industry a role. You talked about the industry having an interest in reducing water consumption and water back flow and sewage problems, but there is no intervention that you are contemplating or that is incorporated in a price review that would do things like give new planning powers to local authorities to require water recycling schemes to be built into all developments or, as they have in some American cities, a requirement that all new buildings (office buildings and developments) have to have their own reservoirs built into that as a provision to counter soak-away. All of those interventionist costs to deal with the polluter responsibilities are actually absent in our framework. We just have a price mechanism that is picked up by consumers.

Mr Morley: Well, I say that it is not entirely picked up by consumers because the price is spread in relation to what the companies have to do in terms of their borrowing requirements and their equity requirements, but it is a good point, I think, that you are making. We can approach some of these issues in terms of grey water systems and water use through building regulations, for example, and I am very keen to do so.

Q102 Alan Simpson: Except every time we try and do that other departments say no.

Mr Morley: Well, we did set up the Better Building task force group and that of course was a joint programme between ourselves and Defra, ODPM and DTI. They have come out with some very helpful suggestions, one of which is new building standards designed to cut water consumption in a new-build home by between 25 and 30% and we are planning to go ahead with those changes and to introduce new building regulations. Indeed, there is more we can do in relation to commercial development, in terms of new development, sustainable open drainage, for example, rainwater catchment. I think it is certainly a fair point to say that there is more that we can do. It does not have to be through the price review process. There are other mechanisms that we can use on this, not least, incidentally, in terms of public buildings, the contractual obligations that we can put in in terms of a policy of sustainable production and consumption. All these are areas that we are taking forward at the present time.

Q103 Alan Simpson: My final point on this is just to say that if we want the water industry to play an active and constructive part in those deliberations we must also reflect on the changes that have to be built into the remit of the regulator that allow for that to be taken on board, because there is a tension which is reflected in the perspective of the regulator that says this is a price issue.

Mr Morley: Yes. However, under the changes that the regulator will go through (which were brought in in the Water Bill under the new office of the regulator where there will be a board, for example), in the

Water Bill there is a duty to take into account sustainability within that duty, and indeed defining what that means is going to be an issue but very much along the lines of what you are saying.

Patrick Hall: Minister, I would like to pursue a little bit the issues raised by colleagues about long-term planning. At the oral evidence session that this Committee had with Ofwat last week I asked a question referring to the Environment Agency's written evidence to this Committee and on page 9, paragraph 37 of that evidence there is a sentence which reads: "While the evidence is not sufficient to justify investment now, investigations by companies are needed to look at the implications of climate change on water supply and sewerage systems." I asked a question saying that I found the first part of that sentence rather surprising. The answer from the Director-General was certainly not to deny climate change—

Chairman: I thought we might finish the course. If we can come back in 10 minutes' time, we will resume. Thank you very much.

The Committee suspended from 4.47 pm to 4.58 pm for a division in the House.

Chairman: I will resume because we are quorate. Patrick, perhaps you could just give us your question again.

Q104 Patrick Hall: I was referring to a question last week drawn from the Environment Agency's evidence and I read a sentence referring to the evidence for climate change. In fact the evidence started "While the evidence is not sufficient to justify investment now" and I think I just said that the Director-General of Ofwat did not deny that climate change exists in general terms. What he did say, and I think I am being fair, was that there was no need to engineer now changes in event frequency assumptions, and Mr Fletcher used the example of a sewer needing to cope with a one in thirty year rainstorm. That is the traditional assumption that is applied and it is still being applied.

Mr Morley: That is right.

Q105 Patrick Hall: He said that evidence on climate change needed to be clearer before investing in a wholesale upgrade, which would be expensive, and therefore that is beyond the scope of the five year price review that we are looking at. Of course, Minister, it would be expensive to do these things, but surely it will be even more expensive if we do not do those things, if we do not prepare for the future?

Mr Morley: I agree.

Q106 Patrick Hall: Do you think there is a danger of either complacency in the whole system in not planning ahead, or could it be that the very structure of the industry, regulation and funding severely limits its ability to prepare for climate change? I am not questioning the integrity of individuals. The Government is certainly very cognisant of the need

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to prepare for climate change, but it is all very well building this into a long-term 25 year plan, but if little strategic attention has been applied to this in terms of five year investment plans then what does it mean? We are heading towards problems. Could I ask you, Minister, whether or not you think there is a case here for very seriously looking at the way these things are going to be actually addressed in practice?

Mr Morley: No, I do think there is a case and I think you can argue that five year timescales are difficult in relation to the financial planning. I think it is fair to say that the regulator, I guess, will be looking at the capacity that we have in the UK at the present time, particularly in water supply security, which is in reasonably good shape, particularly in the north and the west, although of course if you take London, the south-east and the Anglian region there is no room for complacency in relation to water demand and average rainfall in those areas. It is also the case that we do have to take into account that weather patterns do appear to be changing. There is no certainty yet because you need a number of years to actually identify a pattern, but it does appear that we are seeing drier summers generally (although not this summer, I have to say) and we are seeing wetter winters. We are also seeing a greater incidence of intense downpours in comparatively small areas, and we saw that in Boscastle, of course, in August. That was an extreme. But we are seeing examples of that and therefore there are implications for sewer flooding, which is why extra attention is being given to sewer flooding, partly because there is an investment need and partly because of the increased incidence of sewer flooding, which I know the regulator is aware of and is sympathetic in relation to the investment priorities. So you are seeing that measure in itself. But in terms of longer term water security we are not in a situation of desperate water shortages, nor in some parts of the country do we have any ground for complacency and it is likely that we will have to build these in the future in relation to both dealing with potential sewer flooding and also water resource management. I would say that generally when you are building new systems in they are much better in relation to their capacity, their design, and indeed how long they last compared to older systems.

Q107 Patrick Hall: Could I just press a little more on your personal view. It seems easy to say, "Yes, we accept that there is such a thing as climate change," but at the same time we are saying, "But there isn't sufficient detailed evidence to actually do something about it." If that is the position then we will not do anything about it until it is too late, as it were, or at least until it is much more expensive with all sorts of associated inconvenience and disruption, which has economic effects anyway. Surely it is not wise to wait for 101% proof on an issue such as this and therefore a judgment has to be made, and I guess that needs to come from Government, for it to take the lead in this. Okay, we do not get 101% proof, but there is sufficient evidence. We must build this into our plans because it is in our long-term interests to do so.

Mr Morley: You are absolutely right and there are research projects under way. I will perhaps ask Richard to expand on that, not least because I cannot read without my glasses, Chairman!

Mr Bird: Just to say that in the same paragraph in the Environment Agency's memorandum they do refer to a new research project with the UK water industry research programme to ensure climate change is adequately considered in the next review. So I think that is exactly the process that you have in mind in terms of turning more general considerations for climate into specifics for water companies. So this is very much on the agenda as an issue.

Q108 Patrick Hall: So we can look to detailed evidence of that in five years' time?

Mr Morley: We can. Well, yes, it is possible that in the next round there may have to be an element—

Q109 Chairman: We will be here in five years' time!

Mr Morley: There may have to be an element of building in investment because of the effects of climatic change.

Q110 Mr Breed: If I could just talk about the sewer flooding and flooding generally, looking at the sort of rural areas and with your other hat on in the Department, if you like. What work is actually being done in respect of the management of agricultural land and land generally in rural areas as a really potential contributory help to try to alleviate some of these flash flooding incidents in a way in which agriculture is actually undertaken? Of course, we have the added disbenefit of run-off, which takes a lot of soil with it as well, which actually gums up all sorts of other sewers and everything else.

Mr Morley: It does.

Q111 Mr Breed: What work is being done to try and, I suppose, compensate farmers (if that is the right thing) or to encourage them to farm in a different way, which may not be as perfect economically as they may wish but actually would have the benefit of absorbing water when it falls out of the sky and stop the run-off and everything else?

Mr Morley: Well, there is a lot of interest in agriculture in relation to farming and using land as part of water management and there are some very interesting Welsh studies about the role of forestry and water absorption, which certainly in some of the figures I have seen suggests that the role of trees in certain circumstances, in certain soils, has a much greater effect on water control than was previously thought and those are issues that of course we are looking at in Defra because we have a range of objectives in terms of water management and biodiversity, recreation, environment, agriculture, forestry. As I mentioned earlier on, I am very keen to have a much more holistic approach to all these objectives. The other issue is in relation to soil management. We do have codes of good agricultural practice and we have a code dedicated to soil management, because how you manage soil does have a bearing on the rate of run-off. For example,

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heavy machinery can compact soils. The way you plough and ploughing with contours can decrease run-off, the kind of crops in relation to the areas, of course, and also in terms of the time for green cover and brown cover. All these things do have a bearing on water run-off and there are codes of good practice that farmers can follow. In some cases, particularly in relation to controlling chemical run-off, there may be a role for putting certain land into agri-environment schemes as part of managing that.

Q112 Joan Ruddock: I do say to the Minister, of course, that it is also a huge problem in urban areas—not the run-off from our gardens but certainly the sewer flooding in London—and Ofwat needs to really understand that the science, I think, and all analyses are showing that there is a greater increase of these incidents and that global warming is perhaps happening faster than had been earlier anticipated. You have just got to look at the number of times the Thames Barrier has had to be raised. It is very, very significant in terms of the impact of climate change.

Mr Morley: That is right, yes.

Q113 Joan Ruddock: I wanted to ask something quite different. We have talked now a lot about environmental improvements. I was a bit struck earlier on in one of the answers you gave that there was perhaps some confusion in how an environmental improvement was described and accounted for in terms of the price reviews. It seems to me that that confusion ought, in everybody's interest, to be done away with if it is possible and that there ought to be greater transparency, not least because we may find that we have to have more and more environmental improvements because of things like climate change. Is it not possible for there to be an agreed set of criteria between the Department, Ofwat and water companies as to what does constitute strictly an environmental improvement? For example, if the improvements are directly related to a European directive on the environment then that would be very obvious. Is there scope for that? Can it be done? If it could, I believe it should be done.

Mr Morley: Sure. I think there is perhaps more work we can do in terms of ensuring transparency in relation to what programme is for what outcome and the costing of that. There is a point, and I am very grateful for the opportunity to clarify, in relation to the environmental programme and that is that our environmental and quality programme (which is what we advocate from Defra) is in two parts. One part is what we have to do in relation to the mandatory obligations that are upon us, mainly in meeting European directives. Now, we have no choice about this because it is an obligation that we have to meet. The other part is what is called the discretionary environmental programmes, which are programmes which we would like to see. The Endocrine research work, for example, is in the discretionary programme. The upland programme is in the discretionary programme. But that

discretionary environmental programme, the non-mandatory part, is tiny, Chairman. I think you have a figure for that, Richard, do you not, for what accounts for the discretionary element?

Mr Bird: Yes. A pound of the total.

Mr Morley: Per year. A pound a year.

Q114 Chairman: Is it possible to give the bills in a form whereby the consumer knows what increase is due to what and what they can blame on Europe?

Mr Morley: I have opened an unfortunate box there, Chairman. Theoretically, yes, although there would be a cost to that if you broke it down in great detail on the bills, and of course I do not think any of us want to add additional costs to the consumers' bills. But certainly in relation to having the information available and sub-divided in relation to what is for the environment, what is capital, what is driven by European directives and what is discretionary, I am sure that can be done on a national basis and have website accessibility.

Q115 Chairman: On a national basis or a company basis?

Mr Morley: I think it could be done on a company basis, could it not, Richard?

Q116 Joan Ruddock: It ought to be done on a company basis.

Mr Morley: Yes. I think it might be to a certain extent.

Mr Bird: I think the companies will have the information. No doubt there is a bit of a judgment sometimes about which particular category it falls into.

Chairman: Yes. It would be useful to have it more identified and published.

Q117 Alan Simpson: Minister, we are in a situation where the Environment Agency is re-drawing its maps about the areas and properties likely to be affected by severe weather conditions and flooding. The Met Office are just revising their advice to us about the incidence of severe weather conditions and the flooding that will follow from that, yet we have a dispute between the water companies and the regulator about what they see as the capping of the cost per property that the regulator is willing to allow for making provision for sewer flooding. How do we get out of that, because in practical terms MPs are confronted by constituents who face not an arbitrary issue about whether it is likely to happen but what they do when it has happened and what we are doing in policy terms about things that now appear to be happening not just on a regular annual basis but irregular periods within each year? We do not appear to have an effective intervention strategy that addresses current crises, let alone a strategy that addresses them in the longer term.

Mr Morley: Yes, although it is not quite as rigid as I think it has been presented in relation to the guidelines from the regulator. He believes that cost-effective spend on sewer upgrades and repairs should be less than £120,000 per property. Now, I know that in areas like the north-west, where there is a

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sewer flooding problem, you get houses which are very much on the borderline about whether or not in some cases the cost of the upgrade may be more than the property. I understand that is a problem, but I have talked to the regulator about this and I know that the regulator is sensitive to the very points that you make and he is aware that there may well be cases where there could be justification for sewer upgrades and work to deal with sewer flooding that may go over that figure. His view is that that is a matter for the water company to make that case. But it is not a hard and fast figure. It is not a situation where you cannot go one penny over that level and it very much depends on the circumstances. I thought he was taking a reasonable attitude towards that.

Q118 Alan Simpson: Is this an issue, though, that we can leave to be resolved between the regulator and the water companies?

Mr Morley: Well, in relation to the system that we have and the way that the price setting and the capital programme is at arm's length—and I think there is a good argument for that because we had the point that it is unfortunate that the price review comes up very close to a General Election—of course it causes anxiety in relation to price impact but it needs to be done in relation to meeting those three objectives (the needs of the consumer, the needs of the companies and the needs of the environment) and that is what it must be driven by. Now, the companies can make their case to the regulator. The companies can even in some cases go for an interim determination if there are unexpected costs which fall on them and they believe they have a case to take to the regulator. If the companies do have unexpected costs there are mechanisms whereby the spending that they have in this five year period can be taken into account in the adjustments and the business plans in the following five year period. There is a number of mechanisms that the regulator can discuss with the companies in terms of meeting particular problems. So it is not as rigid as it has sometimes been presented and I think if the companies feel that there is a particular problem—and I know that there are in certain parts of the country and I know that there are in the north-west—then there is action that can be taken. I must make that absolutely clear.

Q119 Alan Simpson: The reason I asked about whether we can just leave this to be resolved between the regulator and the water companies is that our own discussions need to be set in the context of the fact that there is either none or next to no other country in Europe where water services are entirely subsidised in the way they are in England and Wales. In Ireland people pay no water bills at all. The question that I am trying to interject here is, if we just leave this as a dialogue between the regulator and the water companies everyone else gets off scot-free. I think there is a whole series of other players who ought to be brought into this in terms of how we address a real and current problem. I mentioned earlier soak-aways. There are cities and countries

around the world where it is now part of the planning obligations for all new developments that they have to contain reservoirs underneath them and that compensates for the soak-away land that development takes away. That is not something that could be resolved between the water companies and the regulator. We have to have more interventionist planning powers and duties that are put on the shoulders of developers. You know as well as anyone else that the building industry in the past has said, "Oh, no, Minister, you can't do this because it will increase the cost of the developments."

Mr Morley: That is right.

Q120 Alan Simpson: But everyone else is picking up the cost in terms of the incapacity of the current sewage and drainage system to deal with the consequences of previous developments that had no environmental obligations put on their shoulders to begin with. So it is a question of how we intervene, who else has a duty to intervene and in what ways as part of resolving this issue.

Mr Morley: Sure. We do not have to leave those kinds of strategic decisions to the regulator and the companies. I mentioned the review of planning conditions which is currently under way, which applies to both private and commercial property. We can also deal with that in relation to planning law. I think that we could have some really good examples of sustainable development and design in some of the big new housing developments like Thames Gateway, for example. We could actually stipulate those and that is a strategic decision which comes from Government, through Government strategy, Government policy, through ODPM and through Defra. We can do that without necessarily leaving it simply for the regulator and the companies.

Q121 Alan Simpson: Is this the lead that you are taking as the Minister on behalf of the Government in terms of a national risk minimisation strategy?

Mr Morley: On Thames Gateway, for example, we have a joint Cabinet Committee, MISC22, which includes representatives of Defra, DTI, ODPM and other government departments and that is looking at the big new developments, and of course Defra has a big input in relation to the sustainable agenda, and there is considerable support for that, I might say. So there is a cross-Government approach in relation to this agenda.

Q122 Alan Simpson: I think that is excellent and I do not want to knock that at all. I would just point out that there are one or two of us who do not live in the Thames Gateway and what I was asking was about a national strategy about risk minimisation.

Mr Morley: The building standards will be national and they will apply on a national basis.

Q123 Alan Simpson: I am not sure that is the same as a national strategy, but if it is a step towards it then I would welcome that, but I think we ought to have a national strategy on something that in whatever ways it manifests itself is a national problem.

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Mr Morley: Sure. The reason why I focused on the Thames Gateway—and that also includes the Milton Keynes development and other large developments—is that it is much easier when you have large new-build developments to build in some quite innovative and radical ideas from the very beginning. It is much harder to retro-fit a lot of these issues, but even in terms of small-scale new-build you can still build in rainwater catchment systems. You can even have grey water flushing systems, for example. It depends on the sophistication how much it adds to the cost of the house but it will be recovered. An argument that I firmly adhere to is that I think the cost of some of these changes will be very modest and I think it will be more than recovered in relation to the savings in relation to water and energy over the lifetime of the building.

Q124 Chairman: Just one final question. To what extent will the draft determination deal with the problem of sewer flooding?

Mr Morley: In the draft determination there were additional resources made available in business company plans for additional work on dealing with sewer flooding. The companies, of course, do comment on the draft determination and I know that one or two of them feel that there is an issue of a need for more resources in relation to their own sewer flooding problems. They are free, of course, to make that pitch to the regulator and the regulator will decide whether or not there is a need for an adjustment in the final price determination. Those decisions, of course, are a matter for the regulator, you will appreciate.

Q125 Chairman: Thank you very much. As usual, you have been very obliging to the Committee and given us comprehensive and effective answers. I have to say that if we have to face rises in prices of water bills, or indeed any other utility, there is no other Minister I would rather bring me that bad news!

Mr Morley: Thank you for that reassurance, Chairman.

Wednesday 3 November 2004

Members present:

Mr Michael Jack, in the Chair

Mr Colin Breed	Diana Organ
Mr David Drew	Joan Ruddock
Mr Mark Lazarowicz	Alan Simpson
Mr David Lepper	Paddy Tipping
Mr Austin Mitchell	

Memorandum submitted by Water UK

1. EXECUTIVE SUMMARY

1.1 This evidence from Water UK provides an overview of company reactions to the draft determinations. It also considers affordability, and longer term issues relating to price reviews. It draws on the views of our member companies and our work with stakeholder groups.

1.2 Companies are concerned about the overall draft determination package and will be discussing further with Ofwat the changes necessary to ensure planned outputs relating to service delivery and environmental improvements are properly financed. Very serious consideration needs to be given now to the major customer issue of flooding from sewers. This cannot wait for a further five years for review.

1.3 The affordability of price increases is a matter of concern, even though water and sewerage bills are low relative to other utility bills or council tax. We think that government is currently “tinkering at the edges” and needs to put in place reforms that would make a real difference. This should include adequate support for customers, administered alongside existing Council Tax Benefits, and changes in the application of data to assist the water companies in a similar way to energy companies, enabling them to focus support on those less able to pay.

1.4 We are keen to see more long-term thinking underpinning price reviews. Some exists for water resource planning and is emerging for some capital maintenance planning, but not for the quality programme or for sewerage systems. When the price review is complete we think government and others should work together to produce a quantitative assessment and review of likely developments over the next 15 years. This will enable companies to plan service and quality improvements cost effectively within the certainty of a longer planning horizon.

1.5 Given the pressures on the industry we believe that the prospect is of continuing price increases into the indefinite future. This raises wider issues of financeability in the longer term as companies continue to be cash negative. It also strengthens the need to address fully the question of affordability and raises the issue of what should be paid for from water customers’ bills in the future.

2. BACKGROUND

2.1 This price review has been conducted in a more transparent way than past reviews, but there is considerable scope to further improve transparency. In framing its draft determinations Ofwat has attempted to address investors’ concerns, and has moved in the right direction in considering the importance of adequate capital maintenance in securing essential service to customers. But there is more to do.

2.2 Ofwat has also shared information using its financial model, and has based its assessments on companies’ final business plans—which in turn are based on full consultation with regional and local stakeholders.

2.3 The draft determinations are still only drafts, more discussions between companies and Ofwat are currently under way—and the views of wider stakeholders have not yet been fully taken into account.

3. FINAL MINISTERIAL GUIDANCE

3.1 Water UK has not yet seen the guidance, which is to be published at the end of September. However the effect of the guidance could be to raise capex by up to £1 billion according to Table 27 of the Ofwat report, raising prices further. We will comment further if necessary when the guidance has appeared.

3.2 Defra will be publishing a detailed regulatory impact assessment for discretionary schemes, costing of the order of £200 million—roughly £1 on bills—but not for the main statutory quality programme costing £5–6 billion. We think that there should be a regulatory impact assessment for the full programme.

4. ISSUES OF CONCERN TO COMPANIES

4.1 The main concerns are:

- Efficiency targets that are unfounded and unrealistic.
- Disallowed expenditures and “hidden” efficiencies.
- Too much risk transfer, inadequate handling of uncertainties.
- Disallowed outputs.
- Inadequate allowance for capital maintenance.
- Cutbacks in capital expenditure.
- The cost of capital is under estimated.
- Developer contributions are over estimated.

4.2 Companies have reviewed the overall package and have concluded that the overall package is unsustainable.

5. EFFICIENCY TARGETS

5.1 Ofwat has set efficiency targets that assume that the available scope for efficiency is of the order of 3%–4% pa beyond that of the economy as a whole. This goes well beyond the available evidence presented in consultants’ reports prepared both for Ofwat and Water UK.

5.2 In price reviews the devil is in the detail. Ofwat have imposed further “hidden” efficiencies on companies by disallowing certain unavoidable cost increases. Costs disallowed include: 50% of pension contributions required to remove deficits in funds; expected increases in taxes and charges; expected increases in Environment Agency charges [even though these normally increase beyond inflation]; bad debt increases [even though with rising bills more people are likely to find it difficult to pay], landfill tax increases [even though the Treasury has already announced increases of at least £3 per tonne per year] and increases in business rates for the sewerage service [even though rates valuations for utilities have risen more than for any other sector of the economy].

6. RISK TRANSFER

6.1 Companies face significant risks over the next five years. Some of these are normal commercial risks and reflected in allowed returns. Others reflect decisions by government [including new directives from the European Union, or tax changes that disproportionately affect the industry]. These are dealt with by interim price determinations or “logging up or down”—allowance at the next price review.

6.2 The draft determinations significantly increase regulatory risk. Companies are concerned that too much risk has been shifted to companies and their shareholders.

6.3 Outputs are open-ended and expose companies to the risk of over-spending. But the penalty for over-spending is that the company bears the full cost in perpetuity, in contrast to under-spending, the benefit of which is shared between customers (80%) and companies (20%).

6.4 Tax uncertainties are regarded by Ofwat as “normal commercial risks”. Financeability has been judged by Ofwat on the basis of their optimistic view of costs and revenues after reductions for efficiency and other adjustments, and not on the basis of downside assumptions. In practice there is a high probability that financeability will deteriorate, and almost any significant adverse cost change will compromise company ratios. In the longer run this will jeopardise customer interests by raising the cost of funds.

6.5 Exceptionally, Ofwat has introduced a mechanism designed to limit exposure to the risk of unfunded investment to 10% of company turnover judged separately for each service. This has occurred as a direct result of one company’s experience during this period which has resulted in unremunerated investment of £240 million after the application of the mechanism.

6.6 Companies will be looking carefully at the degree of risk they are now exposed to, taking into account the likely downside risk.

7. INADEQUATE HANDLING OF UNCERTAINTIES

7.1 Unavoidable changes possible before 2010 not properly taken into account by Ofwat include:

- corporation tax reform; reduced capital allowances.
- business rates; increases above inflation in the uniform business rate stemming from the ODPM balance of funding review.
- Environment Agency abstraction charges; these are under review at present. Water UK has written to Defra asking if government is prepared to commit to increase base charges by no more than inflation but no answer has been received yet.

7.2 Over and above these possible cost changes there are lots of uncertainties that could lead to further price changes before 2010. These include new EU directives on bathing water and priority substances, the Water Framework Directive—already part of UK law with measures to be put in place as early as 2012, but not dealt with in this price review, the review of discharge consents to ensure compliance with the Habitats directive and other UK law, odour reduction and adoption of private sewers.

8. DISALLOWED OUTPUTS

8.1 In our previous evidence to the Committee in 2004 we emphasised that companies had put considerable effort into preparing draft business plans in consultation with their regional and local stakeholders. This work continued into final plans. Nevertheless Ofwat has halved price limits set out in final business plans in part by removing service improvements for customers that are well supported, worthwhile and relatively inexpensive, eg for sewer flooding and discolouration of water supplies. We hope that Ofwat will take full account of stakeholder views when finalising outputs required of companies.

9. CAPITAL EXPENDITURE

9.1 Total capital expenditure is significantly lower than in final plans by about £6 billion, at £15.7 billion rather than £21.5 billion. Ofwat has achieved this partly by removing certain schemes altogether, “parking” about £1 billion of quality expenditure, and by applying high efficiency targets.

9.2 For capital maintenance Ofwat has applied a banding system that disallows extra investment to secure the infrastructure if, in the eyes of Ofwat, the business case is unsatisfactory. The adjustments made by Ofwat are arbitrary and have not been well justified.

9.3 Water UK is concerned that these efficiency targets and cutbacks go too far. A number of companies have had to overspend on capital maintenance in the current five-year period. This reflects the under-funding at the last price review and must not be replicated in this review. In particular, unfunded sewer maintenance will have particularly adverse customer and environmental impacts.

10. ALLOWED RETURNS AND COST OF CAPITAL

10.1 Ofwat has allowed returns on the regulatory value of the companies of 5.1%, slightly higher than the floor previously indicated. In addition it has made “financeability adjustments” which increase returns—to ensure that the debt investors and rating agencies remain satisfied that the capital programme is adequately financed.

10.2 However all water and sewerage companies receive such adjustments by 2010 which implies that Ofwat has underestimated the cost of capital. One consequence is that the small company premium is effectively reduced or eliminated. It is not clear that companies are adequately financed to cope with further pressures before and after 2010.

11 DEVELOPER CONTRIBUTIONS

11.1 About £1 billion of capex has been removed by shifting capital expenditure from “growth” to “new development”, and by assuming that companies can collect more revenue from developers of new housing estates. The expenditure that can be allocated to “new development” is tightly defined in business planning guidance from Ofwat—and by the law on requisitioning of new assets by developers—and Ofwat appears to have ignored its own guidance and the legal restrictions. Furthermore the Water Act 2003 has changed the rules on how much can be collected from developers and companies expect to collect less not more revenue.

12. AFFORDABILITY

12.1 Affordability and the problems around household debt are very real issues for the water industry and its customers.

12.2 Efra’s last report on Water Pricing 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”. Water UK agrees.

12.3 In their report on the Periodic Review and the Environmental Programme the Environmental Audit Committee strongly supported that recommendation.

12.4 Information recently published by Ofwat shows that household water debt has fallen marginally since the previous year—the 2003–04 figures for revenue outstanding up to four years is £779 million; it was £782 million in 2002–03. This may reflect the slight increase in expenditure by the companies on revenue collection last year. However revenue outstanding is still 14% greater than the level in 1998–99 when

legislation removed the threat of disconnection. But for the Periodic Review, Ofwat has assumed there will be no increase in household debt over the next five years. The industry believes that price increases, at Draft Determinations levels, could lead to a step change increase in household debt levels.

12.5 Water UK held a Think Tank on Debt, Charging and Social Impacts in May. We have summarised the thinking and outputs from this in the attached report [Annex 1—not printed]. The report also lists the range of measure companies offer to help those less able to pay their bills.

12.6 Research commissioned by WaterVoice and Ofwat and referred to by the Environmental Audit Committee noted that the customers sampled did not realise they could not be disconnected. They concluded that the ban on disconnections had not led to rising debt levels but that water companies needed to improve their billing and debt management systems. This joint research was however purely qualitative and surveyed a very small number of customers. In fact, more recent research carried out by the same organisation revealed that most of the customers questioned did know that they could not be disconnected.

12.7 Other research by CreditScorer (a respected Leeds University based credit benchmarking organisation) has shown a clear increase in household water debt from 1998–99 the year when the ban on disconnection came into force. It was generally the threat of disconnection rather than the action that led to payment of debt. The CreditScorer report went on to say, “given regulatory constraints and the effects of scale the water industry is generally adopting good practice in collection and recovery of debt”. It also concluded that the industry record on debt management is comparable with the gas and electricity sectors across several key performance indicators.

12.8 The industry is not looking for a return to disconnection but it is asking government for changes to the way customer data can be shared and used to address the disadvantaged position the industry was placed in with the removal of the threat of disconnection and the change in data protection legislation. This would enable the industry to tackle the calculating and determined debtors (some of whom are in the higher socio-economic groups) more effectively and efficiently, and to provide more appropriate services to those with genuine payment difficulties eg advising of extended payment plans, the WaterDirect option and providing charitable trust referrals.

12.9 Water UK recently submitted two papers to Defra. The first of these outlined how we thought adequate support for water charges, administered alongside existing Council Tax Benefit could address water affordability. The second outlined how improvements in data availability (and changes to how data protection legislation is implemented) could assist the industry recovering unpaid charges and reduce the debt burden on all paying customers.

12.10 The Minister recently responded in the Westminster Hall debate on the Water Industry (Price Review) that financial support and the benefits system is a matter for the Department for Work and Pensions. We accept that the current notional provision for water charges within income-related Job Seekers Allowance and Income support would have to be taken into consideration and incorporated in any revised benefit package. The existence of this current provision will limit the cost of changing to a more appropriate and more focused benefit arrangement.

12.11 However whilst some commentators have remarked on the erosion of the element in existing benefits, we have not been able to ascertain from DWP what the actual provision for water charges is. This is a hurdle that seems to preclude any move to a new tax credit or benefit system. We believe the Committee should pursue this question.

12.12 The energy sector still has the right to install budget payment units that can “self-disconnect” and were outlawed for water. The energy sector can also insist on special terms for “bad” credit risks or deposits and requires personal identification details of the customer supplied. Despite this, or perhaps because of this, and to meet its social inclusion policy the Government pays out £2.4 billion in winter fuel payments plus energy efficiency grants to address the issue of fuel poverty. We believe it is right and timely that the Government considers water affordability in a similar way and makes provision within the tax credits and benefits system for greater support to those who struggle or cannot afford to pay their water bills.

12.13 Defra held a seminar on water affordability for relevant stakeholders in June. Defra’s focus then was solely on looking at ways of developing the good practices amongst the water companies. All the stakeholders present at the Defra seminar strongly voiced concern that such “tinkering at the edges” would not address the real problem of water affordability.

12.14 Following a subsequent bilateral meeting we believe Defra is now considering longer-term measures to address affordability over the next AMP period rather than concentrating simply on incremental changes for April 2005. However we await the Ministerial Guidance for further information.

13. LONG TERM PLANNING

13.1 The Committee recommended in its 2003 report [paragraph 15] that Government and others should examine together ways of taking into account long-term issues for the water industry.

13.2 Defra published its “Directing the Flow” document in November 2002. This set out broad objectives primarily in qualitative terms. Once the price review is complete we think government and others should work together to produce a quantitative assessment and review of likely developments over the next 15 years.

13.3 This should consider the likely increases arising from interim price determinations before 2010—as noted earlier these could be significant.

13.4 Ofwat has started this process by providing in its draft determinations document a forward look at likely trends in capital maintenance spending. But we only have a five-year assessment of the quality programme and other cost drivers. In contrast in Scotland, the Quality and Standards III report published in July 2004 takes a 10-year view of likely trends.

13.5 One result of this is that the financeability of projected capital expenditure beyond 2010 has not been reviewed systematically. Ofwat modelling assumes the quality programme is zero beyond 2010 and that their financeability adjustments used in price setting are essentially temporary. However with the substantial extra capital spending expected for example to meet the requirements of the Water Framework Directive—not dealt with in this price review—financeability may be an issue for the medium term.

13.6 In its report on sewerage and sewer flooding in July 2004, the Public Accounts Committee recommended that Ofwat should require companies to prepare long-term sewerage resource plans. This recommendation needs to be considered further after the price review is complete.

13.7 Clearly there are many uncertainties. It is important, nevertheless to be aware of orders of magnitude, and also to take a rounded view of the likely impacts of all the pressures affecting the industry—including the Water Framework Directive, which has not been addressed properly in the 2004 price review, and climate change, which needs a clearly defined national strategy for companies to work within when planning water resources and for flooding incidents resulting from more intense storms.

13.8 We think such a study would show that there are many pressures for price increases well beyond those already allowed in draft determinations for the current price review. Because of this it is important to establish a shared understanding of orders of magnitude. It would also be important to consider if there are opportunities to mitigate the impact on water customers, for example, by controlling pollution at source [in the case of diffuse pollution say] or a more systematic application of the polluter pays principle—to which little more than lip service is paid at present.

24 September 2004

Memorandum submitted by Anglian Water

INTRODUCTION

1. We understand the aim is to gauge the reaction of stakeholders to the draft price limits, and to an extent also to assess how the Periodic Review has been conducted, particularly looking at how it has taken—or should take—into account long-term planning for climate change and environmental improvements.

2. This evidence provides a summary of Anglian Water's reaction to the draft price limits and discusses the issues raised by the Committee.

SUMMARY

3. Our overall view of the draft price limits is that the company faces a high probability that it will fail to maintain services to customers and will not be able to finance the business at a reasonable cost. The result will be higher bills for customers in the long term.

4. Although the Periodic Review 2004 process has been conducted in a more transparent manner than was the case in 1999, there are still a significant number of instances where Ofwat has not applied its methodologies in a transparent or consistent way or where decisions have been made that are not supported by the evidence. There are also significant examples of Ofwat having taken a short-term view of investment requirements, in particular in respect of capital maintenance investment requirements and in addressing sewer-flooding problems.

5. The areas where Ofwat has either departed from due process or where its determination is not supported by the evidence include:

- Financeability and risk.
- Efficiency.
- Capital maintenance investment.
- Metering.
- Sewer flooding.

6. As a growth region, Anglian Water has an imperative to reinforce its network and upgrade its water resources. We believe Ofwat is far too optimistic in its assessment of the potential to recover these costs from new customers.

7. Adequate consideration has been given to the impact of climate change on water resources, during AMP4, given current knowledge. The position on wastewater is less satisfactory. All parties need to work together to build our understanding in order to inform AMP5 plans.

8. These issues are discussed below.

FINANCEABILITY AND RISK

9. Ofwat assesses the ability of companies to raise finance at a reasonable cost by checking that their determinations should result in minimum financial ratios that are consistent with an investment grade credit rating. In carrying out this test Ofwat has used financial ratios that are at the very minimum of what is acceptable. No allowance is made for normal business variability in cash flows.

10. Ofwat does not appear to have carried out any risk or sensitivity analysis to assess whether companies have a reasonable prospect of meeting minimum financial ratios. Anglian Water's risk analysis indicates a 99% probability of ratios being breached based on the draft determination and Ofwat's assessment of a "normal" level of gearing.

EFFICIENCY

11. Ofwat has proposed an overall scope for efficiency in the water sector of circa 3% per annum. This assessment is either above, or at the top end of, the scope identified by economic consultants, carrying out studies commissioned by Ofwat. In making its assessment Ofwat appears to be assuming that water companies will continue to improve productivity at a faster rate than the economy as a whole because of the effects of privatisation, even though by 2010 it will be 20 years after privatisation.

12. When taking account of other likely costs that Ofwat has not allowed in setting prices (eg redundancy costs, landfill tax, bad debts) the effective efficiency rate required is double Ofwat's headline rate.

13. A reasonable central estimate of the overall scope for efficiency is 1.4% p.a. based on evidence of the scope for efficiency in manufacturing.

14. Ofwat has not reflected previous Competition Commission decisions in respect of:

- (a) The weight to be placed on the two alternative methods for assessing comparative efficiency.
- (b) The speed with which companies can improve efficiency in enhancement investment.

15. In respect of (a) the Competition Commission placed a weighting of 75:25 on the most favourable assessment to take account of uncertainties in the robustness of any methodology whereas Ofwat has assumed an equal weighting. In respect of (b) Ofwat has assumed that companies can become more efficient and move to within 75% of the benchmark company from day 1 of the new period whereas the Competition Commission phased the improvement required over three years.

CAPITAL MAINTENANCE INVESTMENT

16. Ofwat has reduced proposed capital maintenance investment, based on a banding adjustment introduced subsequent to submitting final business plans and without consultation. Ofwat has also been inconsistent in its assessment of the quality of a company's capital maintenance proposals between draft and final business plans.

METERING

17. Ofwat has reduced the forecast number of meter optants for Anglian Water, the driest region in the country, below the current level of optants being experienced. The alternative model used by Ofwat to forecast the number of meter optants is not robust. As Europe Economics, the author of Ofwat's models, concludes the models "... have undesirably large unexplained variation in them".

18. The potential consequences of reducing the metering forecasts include:

- The company discouraging customers opting for a meter (thereby missing an opportunity for demand management);
- Price instability as a result of an Interim Determination of price limits being triggered part way through the period;
- Financial instability, with companies breaching key financial ratios.

SEWER FLOODING

19. Ofwat has applied a simple cost cap in assessing the eligibility of companies' sewer flooding proposals. The draft determination takes no account of evidence on the severity and frequency of sewer flooding in assessing the level of investment to be allowed to alleviate flooding incidents. The imposition of an arbitrary cost cap does not take account of the benefits of solving individual problems. Customers are left with severe

and frequent sewer flooding that will not be resolved for many years. In the case of Anglian Water the funding of a further £23 million investment in sewer flooding alleviation schemes, to address the most severe and urgent cases, would increase the average bill by only 27 pence by 2009–10.

IMPLICATIONS FOR THE LONG RUN

20. We believe Ofwat's approach to the above issues will lead to adverse consequences in the long run, namely higher investment or higher cost of capital or both. Ultimately, these effects will be reflected in higher prices for customers.

ENVIRONMENTAL IMPROVEMENTS AND CLIMATE CHANGE

21. We turn now to your specific questions regarding environmental improvements and long term planning for climate change.

WATER RESOURCES PLANNING

22. We submitted details of our proposals in our Water Resources Plan (WRP04) to the Environment Agency (EA) that has subsequently been reported to ministers. We were disappointed at the response from the EA that concentrated on technical detail rather than strategic planning, but hope to work with them as they produce their strategies for 2006. Our supply-demand balance investment for the Periodic Review is based on the full utilisation of existing assets eg by the extension of treatment works at Rutland Water to use the full potential of the reservoir and the transfer of limited surpluses to meet forecast deficits. We anticipate the need for larger scale investment to meet planned economic growth and the reduction in the availability of water arising from climate change and environmental concerns. As discussed in more detail below, we believe Ofwat is far too optimistic regarding the extent to which these system reinforcement costs can be recovered from new customers.

ENVIRONMENTAL IMPROVEMENTS—WATER SERVICE

23. The draft determination limited the Water Resources Environment Programme to investigations only. In the longer term the Habitats Directive and the Water Framework Directive (WFD) will require environmental improvements during AMP4 which are unfunded. Indeed there appears to be a lack of long-term consideration of the implications of the WFD, which is being deferred to AMP5.

24. The issues above were addressed in the Water Resources Plan submitted to the EA in parallel with the final business plan to Ofwat. We were disappointed at the lack of co-ordination between the information requirements from the two regulators and the outcomes, particularly with the Water Resources Environment Programme referred to above.

CLIMATE CHANGE

25. The water industry is one of the leading industries in including the impact of climate change in their future plans and has invested in a number of joint research studies with experts and through Ukcip (UK Climate Change Impacts Programme). On balance we have taken the impact as far as we can based on the current knowledge base but there needs to be a concerted effort during AMP4 for Defra, regulators and researchers to make this a more definitive exercise in preparation for AMP5. The impact of climate change on water companies carrying out their functions could be substantial both in terms of its impact on assets and activities.

26. The current situation is set out below.

27. In terms of activities the major impact considered is the impact on water supplies and demands. Water companies were advised both by the EA and Ofwat guidelines to take this into account utilising previous studies. Where there was a degree of uncertainty then companies could allow for climate change in headroom ie the margin of additional supply capacity above demand. Ofwat would not allow specific investment on the back of climate change unless rigorous analysis had been undertaken. Overall the approach was reasonable and an element of allowance has been made in future plans. This needs to be firmed up during AMP4 and an allowance has been made in future Water Resource investigations.

28. However, on the wastewater side, where climate change can impact on wastewater volumes and in particular flood events, climate change has not been adequately taken into account. It is believed that this is a result of some uncertainty as to the impact of climate change on flood events (surface and groundwater flooding) which has given rise to the regulators not being in a position to support funding for enhancement of assets. It is considered that Defra should give a lead in clarifying which of the various flood impact analyses should be taken as standard (eg Flood Estimation Hand Book vs. Flood Studies Hand Book) for planning purposes through the Centre of Ecology and Hydrology (CEH) and the British Geological Survey (BGS) during AMP4.

29. As regards the impact of climate change on assets and their performance, no account has been taken of climate change. Again this is due primarily to the uncertainty of the impact eg the structural impact of increased intensity of rainfall on the overloading of sewers and groundwater flooding on the water mains network and leakage.

30. Although the impact of climate change on biodiversity has been explored by a number of Ukcip supported studies, the impact of climate change on the preservation of wetlands and other water dependent environments has not been considered. Here the concern is that we may be attempting to conserve now what, in the future due to climate change, could be impossible to conserve.

FUNDING AND LONG TERM INVESTMENT

31. The two examples above illustrate that there is a need also to review how these are funded and the necessity for long term planning.

32. The current rounds of five yearly AMPs do not facilitate long term planning and encourage a “shorttermism” approach. As such the long term consequences of climate change and environmental enhancement, in particular those that need to be addressed by the Water Framework Directive, are not being adequately addressed and continue to be deferred, building up funding problems for the future.

33. This also raises the issue of who should pay for these longer-term issues and their consequences. In the case of the Anglian region we have significant growth proposed, as a consequence of the ODPM’s Sustainable Housing Initiative, but also a significant number of wetlands that need to be protected. In addition the impact of climate change will progressively reduce our water resources in the future. As a consequence of this we need to transfer water over large distances from areas of surplus to areas of potential development. This has been accepted by Ofwat and the EA for AMP4. Except where the costs can be directly attributed to new development the costs need to be funded by the generality of customers.

27 September 2004

Memorandum submitted by Thames Water

EXECUTIVE SUMMARY

The Director-General’s Draft Determination of water company prices from 2005–10 was published on 5 August 2004. It makes only very limited allowance for the impacts or risks presented by climate change. Thames Water supports the overall assessment of the Draft Determination submitted to the Committee by Water UK but we have a number of significant company specific concerns. These include:

- The allowances for investment in, and the outputs associated with, water supply security (including leakage).
- The maintenance of underground infrastructure assets.
- The alleviation of property flooding from sewers and odour problems at some sewage treatment works.

These substantive issues are included in our formal Representations on the Draft Determination to the Director-General.

1. INTRODUCTION

Thames Water Utilities Ltd (TWUL) is the Appointed Business of RWE Thames Water, providing water and sewerage services to over 13 million people in London and the Thames valley. The majority of demand for our services is from the population of London, but we also serve the major population centres of Guildford, Reading, Oxford, Swindon and the surrounding areas.

2. BACKGROUND

TWUL has faced three major issues in the current price period (AMP3; 1999–2000 to 2004–05), which are relevant in the context of both this price review and climate change. These are:

- Controlling leakage, particularly in the old water mains in central London. Half the mains in London are over 100 years old, 30% are over 150 years old and TWUL has consistently had the lowest rate of mains replacement of all companies. This situation has arisen partly as a result of the assessments of remaining pipe life made in 1989 and partly because Thames has not had a drinking water quality driven programme to replace mains in London,

In the AMP3 period the rate of outbreak of leaks has exceeded any reasonable expectation at the last price review in 1999. This has occurred as a result of the co-location of the oldest mains with some of the most aggressive soils in the country (corrosive and subject to movement with changes

in moisture content) and a run of exceptional weather patterns since the year 2000. Significantly, this period has seen the wettest autumn/winter in 300 years (2000–01) and the third longest hot dry spell on record (summer 2003).

Although levels had reduced by about 30% from AMP2 into AMP3, leakage has subsequently increased dramatically during such climatic events. It is now taking considerable time, effort and increasing resources to hold and then return leakage to previous levels, more so than that which delivered the original reductions, as a result of the underlying asset issues.

- *Demand for water* from our customers has increased over the same period, again outstripping that forecast at the last price review, as a result of additional growth in both population and number of households.

These two issues have stretched our ability to keep our customers in supply, particularly under peak demand conditions experienced during the summer of 2003. Dealing with them has required very substantial additional investment in leakage control, pipe replacement and new water resources and treatment.

- *Property flooding from sewers* has been a major customer issue for those customers affected. Despite our investment since 1989 some sewers in our area suffer from hydraulic overloading during heavy rainfall. As a result about 45,000 properties were at risk of internal flooding with sewage under such circumstances as at 31 March 2004. More are at risk under exceptional rainfall. New cases of properties at risk occur each year. These are either properties that are newly flooded, principally as a result of greater flows from more intense, local rainfall or increased impervious areas as a result of development infill; or previously unreported properties, discovered as result of specific studies for alleviation schemes.

Although not a large absolute number (4,500 is approx 0.09% of all properties) this problem is appalling for those who suffer and is an unacceptable situation, which we have planned to remedy or at least ameliorate for all but the most difficult and expensive cases in our Strategic Business Plan.

London and some other areas are unusual in that they have combined sewer systems where foul sewage and rainfall mix. These have historically been accepted as part of normal sewerage system design. As a result there exist a number of combined sewer overflows which discharge potentially large volumes of very dilute but untreated sewage onto land or into water courses. Such events, of which the discharges to the Tidal Thames on 3 August were a particularly severe example, are permitted by legal consents but they now make up the majority of pollution incidents associated with our assets that are of concern to the Environment Agency. The patterns of such discharges may be expected to change under climate change scenarios.

3. TWUL REACTION TO THE DRAFT DETERMINATION

Thames Water supports the overall assessment of the Draft Determination submitted to the Committee by Water UK but we have a number of significant company specific concerns. It is necessary to understand the aims, objectives and something of the content of our Strategic Business Plan (SBP) in order to understand these concerns. We have not included any specific aspect of the Environmental Enhancement programme here, as it is relatively modest. The exception is the proposal to mitigate the effects of heavy rainfall on the Thames Tideway, which may require very substantial investment but is currently under consideration by Ministers. There are however environmental issues with other programmes which may need to be considered, for example the impact of continuing high leakage levels, or the risk of pollution from sewerage escaping from sewers as a result of inadequately funded maintenance.

3.1 *The priorities in our Strategic Business Plan*

Our SBP is designed to enable the company to meet and finance its obligations. The key priorities are:

- To address the critical issues of balancing supply and demand (including reducing leakage) and nuisance arising from foul flooding and sewage treatment works odour.
- To increase the availability of water resources and treatment capacity for both water and wastewater so that continuity of service is maintained in future years.
- To maintain and replace key assets that are in a condition to present a risk to serviceability to customers.
- To implement specific, legally required quality and environmental improvements, or those where the environmental benefit has been clearly demonstrated to be appropriate to the cost by the quality regulator.

These priorities have been determined from assessments of our operations, our assets and the views of our customers, as expressed through the national, joint survey, company-specific market research and by the Ofwat WaterVoice-Thames Customer Services Committee.

The following section sets out the key components of the plan where we have the most concerns and briefly describes our reaction to the determination in each area.

3.2 *Supply/demand and leakage*

The water industry needs to plan for the long-term. Many of our assets such as storage reservoirs and underground infrastructure will be in place for over a 100 years. Our long-term water resource plans have a time horizon of 25 or 30 years, but the existence of our five-year regulatory planning cycles make strategic planning difficult. The quinquennial price review process in England and Wales tends to focus on short-term deliverables and hence immediate financial imperatives tend to preclude or defer more strategic considerations.

The current PR04 process is the first one explicitly to allow some recognition of climate change in company strategic business plans. The Government is promoting the precautionary approach with respect to climate change, but consistent guidance and support from both Government and regulators has been limited. Ofwat does not allow contingencies in company plans. Without the support and commitment of Government to allow funding of long-term forward planning, or the provision of adequate recourse mechanisms, the ability of water companies to deliver their statutory duties could be compromised.

Some provision for climate change, in line with the most recent CCDeW views, was included within demand forecasts for water supply which underpin TWUL's plan. Broadly speaking, even with further demand management, decreased rainfall and higher temperatures, coupled with wetter winters, particularly in the South East, will require more resource development. As a consequence more upstream reservoir storage will be required to capture high winter flows, help regulate river flows and to cope with increased demand and irrigation.

A robust strategy, addressing both supply and demand-side measures has been developed to improve water supply security in London and then maintain it thereafter across the entire supply area. It includes:

- A programme of approx 1,400 km of network upgrade—water mains network improvement, targeted at the leakiest areas, which includes wholesale network redesign and pipes replacement, including meters, communication pipes etc.
- A continuation of proactive detection and repair of leaks and repair of reported leaks and leaks from customers' supply pipes.
- Further customer metering, including metering on change of ownership in trial areas.
- Enhanced water efficiency campaigning.
- Delivery of new resources, including the preparation required for a planning inquiry for a large storage reservoir in Oxfordshire.

The Draft Determination includes partial elements of this package which, together, no longer form a coherent strategy. The size and scope of the network improvement programme, trunk mains leakage work, selective metering and enhanced water efficiency have been curtailed. The planned public inquiry for the reservoir has been effectively moved into AMP5, delaying its construction and hence its use by at least two years, beyond 2020.

As a result the Draft Determination will not provide supply security in London in either the short or long term. Leakage will also continue to be a major issue.

3.3 *Infrastructure maintenance*

A new approach to the assessment of capital maintenance investment has been developed by Ofwat and the industry since the last price review—the “common framework”. This sensibly attempts to understand future investment needs, rather than simply repeating historic trends, minus further efficiency reductions. Our plan seeks to demonstrate increased maintenance need and hence expenditure and measurable activity on the water distribution and sewerage systems, substantially so for some types of asset. These increases reflect the Ofwat assessments, with which we agree, that the serviceability of our water mains is deteriorating (eg numbers of bursts are increasing) and that of our sewers is “marginal” (eg numbers of sewer collapses are increasing).

The Draft Determination has effectively imposed substantial cuts in these programmes of work by disallowing much of the investment within price limits. As a result we will be unable, for example, to reduce the number of burst water mains to the levels suggested. Despite an increase in funding allowed over AMP3 we will also have little or no investment available to proactively invest in our sewerage network. All the funding allowed will be required to react to problems as they occur. Furthermore, this is an area where it is difficult to assess the implications of climate change (although our AMP3 experience with water mains could

be seen as a strong indicator) and so there is no explicit allowance within the Draft Determination. We are also seeing increasing incidents of pollution from our wastewater network that are, in part, related to investment needs. These are likely to worsen under climate change scenarios.

As a result the Determination does not adequately address the needs of the company's underground infrastructure. Serviceability to our customers will not be maintained. The general public will continue to experience levels of disruption due to burst water mains and other infrastructure failures that are higher than they need be.

3.4 Flooding from sewers

Thames Water has the largest number of properties at risk of sewer flooding of any company as a result of our size and the high proportion of combined sewers. The SBP proposes a comprehensive balanced programme of investment that takes account of the costs and benefits of projects to alleviate flooding. It is consistent with the expressed wishes of our customer base, including their willingness to pay, as ascertained by market research. It is supported by the local Ofwat WaterVoice Committee.

The Draft Determination is mixed in its response. On the one hand it requires us to invest in projects to reduce the register of properties at risk to a lower level than we had planned. On the other hand, for the purposes of cost-benefit justification for investment, it assumes a cost-cap (an upper limit on a cost per property basis) that is low, relative to house prices in the area, because it is based on a national benchmark. This reduces the number of properties we proposed to resolve by 28% and will leave many properties that have flooded several times without a solution. It also assumes that future additions to the list of properties at risk of flooding will be lower than we believe, again based on national averages. Our own assessment, based on the average of the last nine years (including the very wet year of 2000–01), is that nearly three times this number of properties will become at risk. This does not make any explicit allowance for the effects of climate change.

The Draft Determination leaves many properties without a solution to an existing, often severe flooding problem. It also considerably underestimates the likely scale and cost of future flooding issues. Unnecessarily large numbers of customers will be left at risk as a result.

3.5 Odour from sewage treatment works

Encroachment of housing around sewage treatment works (STW) and reduced public tolerance has led to an increase in the number of complaints about odour in recent years. Maintenance and improved site management are insufficient to reduce odour at some sites to levels now considered to be acceptable to local residents and the local authority. Water companies are now subject to statutory nuisance orders from the local authority following recent clarification of the legal position in the Appeal Court.

Our SBP included odour investment at Mogden STW, our second largest works serving the equivalent of 1.4m population, located next to Twickenham Rugby Ground in west London. Despite investment in this period and audited operating improvement this works receives the most complaints and is the subject of a current Statutory Nuisance Order (SNO). Our plan includes staged investment, starting with the most malodorous elements, including the specific process stage cited in the SNO.

The Draft Determination accepts the case for Mogden, but only allows a relatively small percentage of the required investment in prices, even less after a large efficiency challenge. Further investment might be allowed in future prices, but only after it has been made and has been justified via a change procedure proposed by Ofwat. No allowance is made for solutions at other sites.

The allowed investment will not result in the reduction in odour expected by the local residents and local authority and will be unacceptable to them. It will not address the SNO issue, nor is there any allowance for investment at other similar odorous sites. The change procedure is designed for uncertain items, but these are certain.

4. CONCLUSIONS

We are very disappointed that the Draft Determination does not adequately address the needs of our customers or the infrastructure upon which our service to them depends. In some areas there are significant shortcomings. We continue to follow the process prescribed by the Regulator and have made our formal detailed Representations accordingly. Discussions continue. We hope that there is sufficient recognition of the issues to reach a more acceptable outcome at the Final Determination in December. We will also continue to work informally with the Regulator to that end, to the degree that the process allows.

24 September 2004

THE LIKELY IMPACTS OF CLIMATE CHANGE ON THE WATER INDUSTRY

We have mentioned impacts of climate change, where relevant to our concerns with the Draft Determination, in our submission to the Committee. This annex briefly picks up other issues arising from Climate Change. These have been extensively and more generally described elsewhere but may include:

- Changes in customer demand for water.
- Added uncertainties and risk associated with water resource demand forecasts.
- Changes in raw water quality and availability.
- The adequacy of existing water treatment design and network capacity.
- The design, operation and capacity of wastewater collecting systems.
- The impact of treated sewage effluent on the receiving river quality.

Climate change is also likely to affect industrial use, agricultural practice, irrigation, frequency and severity of non-sewer flooding and access for recreation, all of which will impact directly or indirectly on company delivery standards.

WASTE WATER SERVICE

The design standards of our existing sewerage systems do not take climate change into account. Forecast wetter winters and more frequent extreme wet weather events are likely to exceed the current hydraulic capacity of parts of the network leading to more local flooding. Enhancing sewer design as well as improving CSO performance in order to meet the demands placed upon them in the future will be very expensive.

ENVIRONMENTAL IMPACTS

In winter increased flooding and soil moisture content will lead to greater infiltration and more dilute sewage. Conversely drier summers and higher temperatures will affect STW performance. Treatment works may therefore be faced with sub-optimal conditions, both in summer and winter for very different reasons. Similar factors may cause septicity and odour problems in the network. Despite the improvements in river water quality since privatisation, reduced dilution in low flow rivers may effectively require a further tightening of already stringent effluent standards, resulting in additional costs for customers.

The industry also has statutory duties with respect to conservation, access and recreation. Currently in England and Wales the industry must have due regard for the 75 SPAs and 177cSAC protected sites which are water dependent. The advent of climate changes suggests a shifting of climate belts northwards through the country, which may render efforts to protect southern chalk streams, for example, redundant. Even a small increase in annual average temperatures could lead to a loss of protected species in designated sites over the next few decades.

The water industry is also very aware of its own impact on global warming. We are of necessity highly energy intensive, although great efforts have been made to become more energy efficient and reduce our associated greenhouse gas emissions.

There is a real danger that these gains will be eroded because of the need for ever-tighter treatment standards. At many sewage treatment works where tighter discharge consents are likely to be required, the potential options for achieving them are increasingly limited to hard engineering/package plant retrofits and high associated capital costs due to operational space constraints. The downside of these solutions options is that they are very energy intensive with the attendant increase in emissions. In addition, there could also be a further financial impact on the industry and its customers as a consequence of emissions trading if we have to offset our emissions by purchasing emission large numbers of additional credits on the open market.

It is unclear how the current regulatory framework will deal with these challenges in the context of the Water Framework Directive.

24 September 2004

Memorandum submitted by United Utilities Water plc

1. The Committee's further enquiry into Ofwat's 2004 periodic review of water price limits is timely and welcome. The period between publication of Ofwat's draft determination (DD) on 5 August and its final determination (FD) in early December represents the final opportunity for stakeholders to comment on and influence the outcome of the review. United Utilities' (UU) memorandum to the Committee sets out our principal comments on Ofwat's DD and also discusses how the review has dealt with a number of the issues that the Committee identified in the enquiry it conducted into the periodic review last year.

EXECUTIVE SUMMARY

2. Ofwat's DD acknowledges what has been apparent since companies submitted draft business plans last Summer—that water prices will need to rise from 2005 to 2010.

3. This reflects the fact that the period of significant company out-performance of the regulator's expectations is now over. This feature of the regulatory regime is not, however, reflected in Ofwat's DD. The regulator's approach to future efficiency fails to follow a well-founded, evidence-based approach.

4. Taking together the effect of Ofwat's assumptions on the scope for future efficiency and their treatment of increased costs, our water business is required to make annual operating cost reductions in excess of 3% as a result of Ofwat's DD. Cost reductions on this scale are unrealistic some 15 years after privatisation and inconsistent with the evidence that Ofwat has assembled on the subject.

5. The Committee's last report drew attention to the importance of ensuring that the cost of capital allowed in price limits is not set so low as to damage companies' access to capital markets.

6. From the start Ofwat has set an objective for this review to halt the declining credit quality that has been a characteristic of the water industry since privatisation. We are concerned, however, that Ofwat may have failed to deliver on its objective of stable credit quality for the industry. We are also disappointed that Ofwat has made no serious attempt to assess the longer-term financial position of companies.

7. Customers and their representatives have welcomed the DD's significant reductions in price limits compared to companies' final business plans. Nevertheless, the DD, as discussed above, makes clear that prices will rise in the period from 2005. For some customers this will mean that difficulties in paying their current water bills will not ease and may become greater.

8. For those customers who have genuine difficulty in paying their bills, we are establishing a charitable trust, which will assist customers with payment of water and other utility bills. The trust will operate independently of United Utilities but with our contributing some £15 million over the next five years.

9. In practice, water companies cannot solve the problem of chronic indebtedness on their own. The tax and benefit system will remain the principal means by which customers receive support. We are, therefore, disappointed that the government seems to have set a very limited objective for its promised review of water affordability and that it has not, as yet, come forward with revisions to the Vulnerable Customer Regulations.

10. Ofwat's proposals for sewer flooding are a significant disappointment to companies, Watervoice, and local MPs. The Regulator's imposition of an arbitrary £120,000 cap on the cost of alleviation at each property will mean that the balanced prioritisation system that we had developed for our sewer flooding programme will be replaced by a crude cost per property assessment.

11. Reinstatement of United Utilities' submitted sewer flooding programme would add only £1.25 to customer's bills on average by 2009–10. We believe that customers will see this as good value for money.

12. The DD makes clear that there are likely to be significant additional costs faced by companies in the period, which will not be factored into price limits in December. In this environment it is vital that the adjustment mechanisms available to deal with these changes are robust and adequate to the task.

13. The first of these adjustment mechanisms is the "Change Protocol", which Ofwat has published to describe how potential changes in companies' obligations will be dealt with. As yet, there is a lack of agreement between Ofwat and the Environment Agency over whether changes need go through the processes described in the Protocol.

14. Once changes are agreed and identified, they are handled in price limits through logging-up or interim determination (IDOK). The IDOK mechanism needs reform to deal with the potential financial consequences of very significant new capital expenditure requirements in AMP4.

THE NEED FOR PRICE RISES

15. Ofwat's DD acknowledges that water prices will need to rise from 2005 to 2010. The reasons for this can be summarised in the table below, which compares the drivers of bills at the time of the 1999 FD with the bill drivers evident from the DD just published.

Table 1
DRIVERS OF THE CHANGE IN BILLS

<i>% Change In Average Household Bill</i>	<i>1999 Final Determinations</i>	<i>2004 Draft Determinations</i>
Past Efficiency Improvements	- 14	- 2
Future Efficiency Improvements	- 10	- 7
Maintaining Base Services	—	6
Maintaining The Balance Between Supply And Demand	< 1	4
Improvements In Drinking Water Quality	4	3
Improvements In Environmental Quality	8	8
Improvements In Service Performance	< 1	1
Total	- 12	13

16. The table shows that in 1999, as now, there were upward pressures on prices from the drinking water and environmental quality programmes, which would have added 12% to household bills but for a more than offsetting reduction from companies' past and expected future efficiency improvements of 24%, thus leading to an overall outcome of a 12% reduction in bills. By contrast the 2004 DD shows that upward pressures on prices total 22% and can be offset by only 9% of savings from past and future efficiency improvements.

17. Most striking is the fact that past efficiency improvements, which accounted for a reduction in bills of 14% in 1999, can deliver a reduction of only 2% in 2004. This reflects the fact that the period of significant company out-performance of the regulator's expectations, is now over. Ofwat's DD shows that:

- companies have over-spent Ofwat's capital maintenance assumptions by 8%;
- companies are now incurring operating costs that are higher than expected when price limits were last set;
- nine companies have experienced over-runs on their capital programme in AMP4; and
- industry aggregate returns are below the level assumed by the regulator in 1999.

18. These features of the regulatory regime do not, however, appear to be reflected in Ofwat's DD. As the table above shows, the scope for future efficiency improvements contributes a reduction of 7% in bills in the 2004 DD, only a little lower than the 10% assumed in 1999.

THE INDUSTRY'S SCOPE FOR EFFICIENCY IMPROVEMENT

19. Ofwat's proposed price limits assume that companies can, on average, reduce operating costs by a little over 3% per year. Ofwat has only assumed a proportion of these potential cost reductions in its DD, leaving a proportion for potential company out-performance—the so called “carrot and stick” approach. In our view, however, Ofwat's proposals are, in practice, “all stick and no carrot”.

20. This water price review has on the whole been characterised by a high degree of professionalism in Ofwat, far greater transparency in the DD and, for the most part, detailed reasoning behind the conclusions the regulator has reached. By contrast, the regulator's approach to future efficiency fails to follow a well-founded, evidence-based approach. The regulator has commissioned a number of studies from economic consultants to inform decisions on the scope for efficiency improvement from 2005. Those studies, and the equivalent carried out for Ofgem, are summarised in the table below.

Table 2
PERIODIC REVIEW EFFICIENCY STUDIES

<i>Study</i>	<i>Water Opex (% pa)</i>	<i>Sewerage Opex (% pa)</i>
London Economics for Ofwat (November 2003)		
— Top-Down Approach	0.1% to 1.3%	0.1% to 1.3%
— Component-Based Approach	< 2.9%*	- 0.1% to 1.9%
Europe Economics for Ofwat (November 2003)		
— No Privatisation Effect (central point)	1.3%	1.8%
— Including Privatisation Effect (central point)	2.7%	3.5%
Stone and Webster (May 2004)**	1.7% to 1.9%	1.7% to 1.9%
CEPA for Ofgem (November 2003)	1.3% to 2.0%	1.3% to 2.0%
Studies Central Point Average	1.84%	1.73%
Ofwat Base (pre “carrot”/“stick” adjustment)	2.6%	3.9%
Ofwat Enhancement (pre “carrot”/“stick” adjustment)	3.0%	4.45%

21. Any reasonable assessment of the evidence from those studies would conclude that there is significant uncertainty around the extent to which the industry can reduce costs after 2005, and that a central estimate higher than 2% per annum cannot be justified.

22. The full efficiency requirement on companies is a function not just of the assumptions the regulator makes about reductions possible on companies' current cost base but also of how the Regulator treats likely future cost pressures. In this review the three most significant cost pressures recognised are pensions, rates, and power with pensions the most significant of these.

23. Ofwat's approach to pensions has been to allow in full increased contributions that companies have made in 2003–04 but only a proportion of any contributions companies are making, or forecast to make, after that date. Ofwat's argument for this approach is based, in part, on a comparison of the position of the water sector with companies operating in a competitive business environment. This comparison is flawed for several reasons.

24. First, the social and economic outcome for employees of companies operating in a competitive business environment has been far from ideal. It is, therefore, questionable whether it is in the public interest for Ofwat to rely upon such a comparison.

25. Second, an analogy with competitive markets is of only limited relevance to a price-capped regulated sector, such as the water industry. The water regulator has a primary duty to ensure that companies are able to finance their functions, and it is not clear that price limits based upon a comparison with competitive, non regulated markets are relevant to that duty.

26. The relatively low cost of capital used in water price limits is justified on the grounds that companies face low business risk. That low business risk arises from the resetting of price limits periodically, which is able to take account of changes in company circumstances. Not to allow a genuine cost increase, such as enhanced pensions contributions, conflicts with the assumption regarding the risk faced by companies.

27. Taking together the effect of Ofwat's assumptions on the scope for future efficiency and their treatment of increased costs in the period, we estimate that our water business is required to make annual operating cost reductions in excess of 3% as a result of Ofwat's DD. Cost reductions on this scale are unrealistic some 15 years after privatisation and inconsistent with the evidence that Ofwat has assembled on the subject.

FINANCING COMPANIES' INVESTMENT PROGRAMMES

28. The Committee's last report drew attention to the importance of ensuring that the cost of capital allowed in price limits is not set so low as to damage companies' access to capital markets.

29. Companies and investors have welcomed the fact that Ofwat committed last autumn to setting a cost of capital at this review no lower than that used in 1999 and in the DD the cost of capital has been set slightly higher than that figure. What ultimately matters to investors, however, is not the cost of capital but the returns they can expect to achieve through the price review period. This reflects the cost of capital assumed by the Regulator, companies' ability to achieve the Regulator's assumptions on costs, and the approach the Regulator takes to ensuring that companies remain of good credit quality.

30. From the start Ofwat has set an objective for this review to halt the declining credit quality that has been a characteristic of the water industry since privatisation: "We will ensure that cash-flow and other financial indicators remain robust and stable, so that efficient companies can continue to finance their functions" (para 1.52 of Ofwat's March 2003 on the framework and approach for the review).

31. We are concerned, however, that Ofwat may have failed to deliver on its objective of stable credit quality for the industry. The threshold financial indicators the Regulator has used to assess this DD are significantly lower than most companies presently achieve. In addition, the Regulator has made substantial adjustment to companies' opening balance sheet position to assess financability; in practice, companies' actual financial position is likely to be somewhat worse than the Regulator assumes.

32. We are also disappointed that Ofwat had made no serious attempt to assess the longer-term financial position of companies. Ofwat's assessment of the AMP5 period is predicated on no enhancement expenditure after AMP4. This gives no reliable indication of whether companies will enter the next decade in a sustainable financial position.

AFFORDABILITY AND CUSTOMER PRIORITIES

33. Unsurprisingly, customers and their representatives have welcomed the DD's significant reductions in price limits compared to companies' final business plans. Nevertheless, the DD, as discussed above, makes clear that prices will rise in the period from 2005. For some customers this will mean that difficulties in paying their current water bills will not ease and may become greater.

34. Problems of affordability are likely to be specific to particular regions of the country, and particular groups of customers. The North West is characterised by high levels of income deprivation compared with the national average. For those customers who have genuine difficulty in paying their bills, we are

establishing a charitable trust, which will assist customers with payment of water and other utility bills. The trust will operate independently of United Utilities but with our contributing some £15 million over the next five years.

35. In practice, water companies cannot solve the problem of chronic indebtedness on their own. We are, therefore, disappointed that the government seems to have set a very limited objective for its promised review of water affordability.

36. Whilst our customers' primary concern is the water bill they face, there are customer service improvements that command widespread support.

37. Ofwat's proposals for sewer flooding are a significant disappointment to companies, Watervoice, and local MPs. The Regulator's imposition of an arbitrary £120,000 cap on the cost of alleviation at each property will mean that the balanced prioritisation system that we had developed for our sewer flooding programme will be replaced by a crude cost per property assessment.

38. Cost benefit analysis has a significant role to play in evaluating areas of discretionary spend. We do not, however, accept that the alleviation of sewer flooding affecting customers' properties once in ten years or more frequently should be seen as a discretionary "nice to have". The limits on the applicability of cost benefit analysis were highlighted in the report commissioned for the National Audit Office's enquiry into sewer flooding from Professor David Pierce, who said, "In general, the use of CBA is likely to be confined to cases where risks are less frequent. Properties at risk of relatively frequent flood events (eg two or more events in 10 years) are likely to be regarded as priorities which demand action that will not necessarily be informed by CBA".

39. We share his view and note that reinstatement of United Utilities' submitted sewer flooding programme would add only £1.25 to customer's bills on average by 2009–10. We believe that customers will see this as good value for money.

40. We are also disappointed by the Regulator's approach to the problem of odour from wastewater treatment works. We submitted a focussed, staged investment programme in our business plan, which would have made progress on odour problems at seventeen sites out of our total of 600+ wastewater treatment works. Ofwat's proposed funding in the DD would, at best, allow us to deal only with the top seven sites and leave us with no resource to address problems that might emerge in the period.

DEALING WITH CHANGES DURING AMP4

41. The DD makes clear that there are likely to be significant additional costs faced by companies in the AMP4 period, which will not be factored into price limits in December. These include operating and capital expenditure increases arising as a result of changes in Government policy. In addition, Ofwat has estimated that further quality requirements to the tune of £2 billion are possible. Interim Determinations (IDOKs) are therefore likely to be as prevalent, if not more prevalent, than they have been in AMP3. In this environment it is vital that the adjustment mechanisms available to deal with these changes are robust and adequate to the task.

42. The first of these adjustment mechanisms is the "Change Protocol", which Ofwat has published to describe how potential changes in companies' obligations will be dealt with. As yet, there is a lack of agreement between Ofwat and the Environment Agency over whether changes need go through the processes described in the Protocol.

43. Once changes are agreed and identified, they are handled in price limits through logging-up or interim determination (IDOK). United Utilities' IDOK of 2003 exposed potential anomalies in the workings of IDOKs. We are pleased that Ofwat has agreed to examine these issues once the periodic review is concluded. But we also consider that the IDOK mechanism needs reform to deal with the potential financial consequences of very significant new capital expenditure requirements in AMP4.

24 September 2004

Witnesses: **Mr Roy Pointer**, Chairman Water UK and Chief Executive, Anglian Water Services Ltd, **Mr John Sexton**, Managing Director, Thames Water Utilities Ltd, and **Mr John Roberts**, Chief Executive, United Utilities plc, Water UK, examined.

Q126 Chairman: Good afternoon, ladies and gentlemen. My apologies for the slightly late start. I am afraid that the Committee had some other pressing business which took a little longer than we had anticipated. Our first witnesses are from Water UK: Mr Ray Pointer, the Chairman of the organisation and the Chief Executive of Anglian Water Services, Mr John Sexton, the Managing Director of Thames Water and Mr John Roberts,

the Chief Executive of United Utilities. I will declare an interest: I am a customer of Thames when I am down here and United Utilities deliver my water when I am in the north west and I am sorry, Anglian, you do not get a look in on this one! There we are, at least I have representatives of the water suppliers which service the Jack household. Can I just ask you this on behalf of the industry which you represent. You all sat down and you made a very careful

3 November 2004 Mr Roy Pointer, Mr John Sexton and Mr John Roberts

assessment of what you wanted out of this price review; you did all your sums; you put these things in; you did not exaggerate for one moment the amount of money you needed by way of price rises; and you took into account all the environmental requirements, service improvement and responses to the consumer. Then, along comes the Regulator and chops you in half! Do you really think this is a very sensible way in which to conduct an exercise that determines the price of one of the most precious and fundamental things that human beings require to be both delivered and in a polluted form taken away because either you did not get it right and did not understand what the Regulator wanted or the Regulator listened to what the Secretary of State said by way of advice and put the guillotine in and really made it look like an exercise in horse trading? Mr Pointer?

Mr Pointer: Good afternoon, Chairman. I will start the answer to that question. First of all, what we are looking at here is a process; it is around two-and-a-half years long from the start of the process to the final determination which we expect in early December. As part of that process, Ofwat consult in the initial stages on the methodology that they will use to carry out the review and a very important change this time around was the introduction of a draft business planning stage. We found this very advantageous because, for the first time, very early in the process—and the early point is significant for later—we had the opportunity to consult widely with stakeholders and just test the temperature of what people's expectations were, whether they were regulators, quality regulators, customer groups or whatever, and put forward plans which were comprehensive and would be clearly subject to consultation and indeed subject to refinement, particularly in respect of ministerial guidance that was coming and is still coming down the track on quality improvements that the nation required.

Q127 Chairman: You have not actually answered my question because the question I put to you was this. You went through this exacting process. You have just described one of the significant differences in the way that this current review was organised than the previous one. You are all very used to producing business plans/ investment plans because that is what makes your businesses tick. You put all this in and you did all this work and, at the end of two-and-a-half years of careful analysis, the Regulator comes along and chops in half your proposals. What I am asking is, as a spectator to this great game, it looks like it is an exercise in horse trading. Would you have argued at the beginning that you got your numbers right?

Mr Pointer: I would argue that we, as companies, got our numbers right for the scenarios at that time and there were, as you may recall, a number of scenarios produced to enable customers and other stakeholders to weigh the costs and benefits of the programmes as they would come forward. We are two-and-a-half years out, a lot of uncertainty is

around in terms of what requirements might be in some level of granularity, what they might cost and how they might be brought forward.

Q128 Chairman: Can you just explain what “granularity” is? I would not like to have that in my water!

Mr Pointer: A level of precision on individual items either by quantum in terms of what was to be built or what it might cost and how it might be constructed. So, if you think of all the uncertainties at that time, I think it was—and I come back to it—a very good process to set in train where, very early in the process, stakeholders from a wide variety of sources could see what might be possible, when it might be constructed and what it might do and cost.

Q129 Chairman: Mr Sexton, would you like to add to this?

Mr Sexton: I would and if I could speak from Thames Water rather than necessarily for Water UK and other companies. We are extremely disappointed by the position we reached with the draft determination at the beginning of August. We did think that we had put together a well-constructed plan that actually did reflect what our customers wanted, what politicians wanted, what customer organisations wanted and what we knew we needed to deliver the business, and Ofwat have reduced very substantially the outputs that they require us to deliver. We were surprised by that. As far as the process goes, I hope very much that Ofwat have listened to our representations—and I know representations from third parties on a similar theme—and we are still hoping that, early December, we will get a final determination from Ofwat that better reflects the needs of our business.

Q130 Chairman: Come on, Mr Roberts. Could we have the North-West perspective on this?

Mr Roberts: Certainly and, thank you, Chairman. In our case, there has been a reduction of about £900 million from the final plans that we submitted to the draft determination. Eight hundred million of that is schemes that have been taken out by the Regulator and I would very much reiterate what Roy Pointer is saying, we have two things that are moving here: what are we being asked to do and how much will it cost? The requirements that are laid on us in terms of the outputs that we have to deliver move from between one business plan submission and another, partly driven by what either the Regulator sees or partly driven by ministerial guidance. In our case, £800 million of the £900 million difference are outputs that the Regulator either said, “You should not do at all” or the majority of these are ones where he is saying, “I am not convinced that these are the right solutions or represent value for money. I need to take them away and look at them in more detail over a longer time period. So, let us just park them to one side for the time being. They may come back later on in the programme in later years.” That is the position as it stands at the moment.

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Q131 Paddy Tipping: I would like to share Mr Sexton's unhappiness with him. You get a final determination in December and you may still be unhappy. Just remind me because I am not exactly sure of the process. Suppose that you want to take the Regulator on. Your route is pretty complicated and, dare I say, hazardous. Just take us through what happens.

Mr Sexton: The process is to appeal to the Competition Commission. We have two months to decide whether or not we wish it to be referred to the Competition Commission and, in so doing, the Competition Commission effectively redo the determination in full. They will not take a single item and look at the item, they will look at the whole package. So, there is a process which, if not too many companies go, the intent of the Competition Commission would be to complete in six months. So, by the summer, we should have a final review. The only appeal route subsequent to that would be a judicial review if we felt they had not conducted themselves appropriately, which is obviously extremely unlikely.

Q132 Paddy Tipping: And I think I am right in saying that nobody has ever been to the Competition Commission.

Mr Sexton: Some companies have been; each time, one or two companies have been. So far, it has been the smaller companies. You mentioned the hazardous nature. Clearly, it is a huge commitment. It is something that, if you go to, you have to do well on. Most senior people in the company are going to be committed to that. It takes resources and I think we would all prefer to be going on running the business and delivering the challenges that we have. Inevitably, that decision will be a hard one to make but I do not think any company is going to back away from it if it is what is needed.

Q133 Paddy Tipping: Is that a warning to the Regulator?

Mr Sexton: It is just a statement of what I believe.

Q134 Chairman: You said at the beginning that you had had a series of different scenarios put to you. Mr Roberts, do these changing scenarios suggest that they could be the best part of £1 billion out in terms of where you started off and then the subsequent adjustments to different scenarios?

Mr Roberts: I do not think that necessarily we were seeing at the beginning of the process that there was £1 billion that could be taken out if we were to price up all that we thought we were being asked to do. What the Regulator has done is removed a substantial number of quality outputs from the programme and he says that he wants to look at them in more detail and, in his words, "park them" and he may well then decide, I assume, that they in fact do represent value for money and they will come back into the programme at some later date. That is quite possible. What we were doing when we put in our final business plan was attempting to evaluate the outputs that we were being asked to deliver over the five-year period as we understood them and we

have to respond to the requests that were made to us by the quality regulators as to what they need to see in terms of improved performance and that is what we were pricing to do.

Q135 Mr Mitchell: I am still not convinced. What you are saying is different in all three cases. Mr Pointer says that the requirements are clarified within the bill that you asked for, Mr Sexton is saying that you asked for what is absolutely necessary and it is what you want and you are upset that it has been cut back; and Mr Roberts is saying that it represents your estimation of the requirement that the Government impose on you. There must be an element of auction in it, must there not? It is a game. You put in for the maximum knowing that the Regulator will want to show virility by cutting it. So, there must be an element of that kind of auction game in it, surely. You cannot all be virtuous with strict adherence to requirements.

Mr Pointer: Can I just remind you of the point I made earlier, that you are at a very early stage in the process. Remember, at this time, national customer research was going on and that is another facet this time around where, instead of customer research being done variously by the various stakeholders, this time the industry got together with the regulators and Ofwat and made sure that there was one set of customer research going on. So, there are a number of moving parts going all the time and this will change and did change the components of the plans as they came forward. In addition to a base plan which the company has put in, Ofwat also requested that we put some alternative plans, so-called scenarios A and B, to play some tunes on this. So, there was definitely a way in which I think the industry with Ofwat was trying to get a picture where you could see what might be possible and where eventually people want the whole thing to end up.

Q136 Mr Mitchell: But that is saying that the game is still going on. Let us be specific. What were the most important proposed customer improvements that were cut out?

Mr Pointer: In my own case—and colleagues will comment from their own company—there was a strong willingness and desire from WaterVoice, the customer representative body, that sewer flooding should be eradicated once and for all, that we are now in the 21st century and, however you deal with this, it is totally unsatisfactory that people should be experiencing flood from the sewers—flooding is a wider issue we know—and we had a strong level of support which I believe is still there that sewer flooding should be eliminated completely. In fact, in the current stage of the process—and of course it is, as you say, an ongoing process—Ofwat have put in a price cap per property of some £120,000 above which schemes would be excluded. So, there is an example where we believe we have a strong mandate from customers that this could be sorted once and for all but the Regulator is taking a view and saying, "No, at £120,000, that is rather too much." From our perspective, we would rather take an approach

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which talks about costs and benefits and one needs to try and make some judgment about the economic costs versus the economic benefit of solving some of these problems. So, whereas my own company has come at it from a sense of a strong customer mandate and a cost-benefit approach, what we are confronted with from the Regulator is a list of schemes with a ceiling per property of £120,000.

Q137 Mr Mitchell: What about the other two?

Mr Roberts: Perhaps I can give an example in a different direction. I mentioned that the big difference between what we asked for and what we have so far been given in the draft determination is about £900 million of which £800 million relates to quality improvements. If I give you one example of a very big scheme, that was £100 million to create a huge storm water holding tank in Manchester to stop storm water spilling into the Manchester ship canal. That was driven by the Fresh Water Fish Directive. Ministerial guidance tells us that is mandatory, there is no option. In their draft determination, Ofwat has said that they are not necessarily convinced that this is value for money. So, they want to remove that from our investment programme and they want to conduct investigations into the quality of the Manchester ship canal to decide whether this is good value for money and I think that is an example of the kind of examination they want to do. The other point I would mention is of course what we have not brought to the Committee's attention and that is that our investment programmes are subject to independent scrutiny by an independent third party, the Independent Reporter, who reports to Ofwat on whether what we are proposing is sensible and is value for money and, in all cases, we normally get that approval. So, it is not as if we just put these numbers together, hand them across to Ofwat and that is it, it is independently certified.

Mr Sexton: I share first of all Mr Pointer's point about sewer flooding. That was the clearest message we had from customers that needed to be resolved and from politicians, I must say, and that was the area we are most surprised that was significantly cut back by Ofwat. We had two other major issues that we wanted dealing with: one is the very, very high leakage rates which we have in London which we have managed to avoid being a major capital issue at the moment because we have kept people in supply but, with a huge increase in population forecast for London, there are no other major water resources that we can produce readily, we have to tackle leakage. The last determination gave very, very little funding and what funding there was was for dealing with leaks, finding them and repairing them, but the system in London is very old with half the pipes over 100 years old and they need replacing. We strongly believe that that is the right thing to do but we have had our programme on pipe replacement cut back quite substantially. We believe that is an environmental issue. It is actually essential that we get those pipes dealt with. The third issue for customers is odour where we have the one example of our Mogden works which has a lot of odour and

we have had huge customer issues; we have had the minister visit and we had had local MPs up in arms about the situation. We put a programme in to deal with it and about 80% of that was removed by Ofwat. So, there are three areas where I believe we have a very strong mandate but, so far at the draft stage, we have not had support from Ofwat to solve these problems.

Q138 Mr Mitchell: Is the proportion overall that about half the bills have been cut back?

Mr Sexton: It is that order of magnitude, yes.

Q139 Mr Mitchell: Is that the same for all companies?

Mr Pointer: Broadly speaking, yes. It varies but that is a very good average.

Q140 Mr Mitchell: What do you see as the long-term impact of these cutbacks on the kind of service you are going to provide and on customers' bills? Are they saving money now to increase bills later?

Mr Pointer: It may be good to go on to some of the longer-term issues because I think that, in the short term, there is this issue about how we work in five-yearly chunks at the moment and the question has to be asked, what is the right length of programme? On the one hand, you want a level of certainty. Customers must know where bills are going for this work and therefore one is weighing up certainty. On the other hand, there is an investment programme which will deal with the short-term issues. However, we have to have in our mind all the time the longer-term issues of climate change and the Water Framework Directive, which are very, very big issues and the sense we have is that, once this periodic review is out of the way, it will be good for the industry and other stakeholders to sit down and look at the water industry in a longer-term planning framework. One should not sound alarm bells at this stage but, particularly with the Water Framework Directive which is known where tremendous improvements have to be made to the water environment, not all of which can be delivered through the water industry because most of this will relate to diffuse components, diffuse pollution and so on. So, there is a longer-term issue and that will need to be confronted as we get past the periodic review. I used the analogy with some of these things that, if you think about the maintenance of the infrastructure, which is still far and away the biggest element, maintenance is always a very, very important thing to do and, if you think of maintaining a car, the easier way to maintain the car is regularly in accordance with its needs rather than waiting until the wheels fall off or the brakes fail and then doing it in one fell swoop. We have made great strides in the industry, again working with Ofwat and working with the quality regulators, on developing better methodologies to deal with this very difficult topic because we are talking about very long-life assets and what is the right level of capital maintenance to be put on them. We have made great

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strides in these five years and that has been recognised by Ofwat and been recognised by other stakeholders but there is more to be done.

Q141 Alan Simpson: I think most of our constituents would agree that the most important outputs to be allowed (sic) would be the outputs of sewage back on to their streets, but I am intrigued about the difference in perceptions about your submission between yourselves and Ofwat: your claims that your proposals were well supported, worthwhile and relatively inexpensive and the response from Ofwat that they were not fully specified or were very costly. Has the independent reporter commented on this disparity and, if they have not, how do we explain and understand the disparity?

Mr Pointer: I think, very much as John Roberts said earlier, all of these schemes/all of our capital investment is reviewed by an independent reporter completely separate from the company. The issue with the sewer flooding is that they will vary in their location and the benefits that they will provide and, very often, the sewer flooding cases will be in heavily built-up urban areas where they will be extremely expensive to cure and where it is often quite difficult to estimate the exact amount of work that will be required. So, one can get sewer flooding which occurs in an urban area that will be of a completely different nature and type to that which would occur in a rural area.

Q142 Alan Simpson: But what you have just said is significantly different from what you wrote. I understand if you are saying to me that some of these schemes are going to be expensive but that is not what you were claiming in your submission; you were claiming that they were relatively inexpensive. I think it will be helpful to know whether the disagreement between yourselves and Ofwat is in terms of the worthwhile nature of that remedial work or disagreements about the basis upon which it has been costed.

Mr Pointer: The difference is essentially the worthwhileness of the scheme as it has been put forward: what does it deliver for the cost involved? So, it is the cost to benefit ratio rather than an absolute scheme cost and inexpensive in that context can refer to inexpensive in terms of the benefits to costs.

Mr Sexton: I think there are these two different categories: one is about output and we have given examples of those and I have for the Thames case, but there is also a difference in view about how much a scheme should cost and both those features are part of our process. I suppose the good thing about the process we have with the draft determination from Ofwat is that it does at least enable the companies to understand where their case has been accepted and where there are differences and then the process whereby we can make representations as well as third parties. The reporters that we have talked about also can look and focus on those areas of difference and, in some cases, it may be that we have not explained what we want to do well enough

and therefore there is another chance to make sure that, before a final decision is made, it is actually on good grounds.

Q143 Alan Simpson: One of the criticisms of the industry has been that, in the years following privatisation, what you are keenest on is dividend outputs rather than eliminating sewage outputs. What would you do if, rather than having this capped £120,000 per property as a fixed figure, the Regulator said, "Fine, you can go ahead with your schemes but the only allowable figure as far as water pricing will be concerned is the £120,000. By all means do it, but that is something you ought to be doing before you start to pay dividends out of the industry"?

Mr Roberts: I think you have to view the financing of the industry as a whole and what we are trying to do in the way we put together the financing of the industry is to keep our cost of financing as low as we possibly can in aggregate. Part of that is having shareholders having equity because, in part, there is a risk in the business, part of it is having debt and raising money from the debt market, and the residual is through prices and we try to keep the part that relates to prices as low as we can. If we diminish the dividend-paying capacity of the industry, then it is conceivable that that, as a source of finance, would go away and, if that went away, ultimately it would increase the overall cost of financing the industry. So, I think you have to look at that as a package as a whole and try to achieve a balance for the overall funding of our capital programme. We do have some discretionary schemes that we can do out of savings that we make through efficiency and we have done that in United Utilities in the current AMP 3 programme where we have made efficiency savings in one area and we have used that money in another area to improve performance. So, it has not automatically gone to shareholders. The point I would make is that, in the longer term, we have to finance very substantial investment programmes and therefore we have to make sure that we can access properly all the relevant sources of finance to the business.

Q144 Alan Simpson: I am aware of that; I just wanted to know whether you have done any comparisons about the savings that could be gained in terms of the internal costs of capital as opposed to the external costs of capital and I think that was one of the issues that came up earlier in our discussions with the Regulator as well.

Mr Roberts: We have made efficiency savings and, as I have said, where appropriate, we have redirected those savings to do other things for the benefit of the consumer.

Q145 Chairman: When you first started out on this process and you took, if you like, the first scenario, did the rate of return on the capital that you have invested in the business vary? In other words, did it start at a number that was bigger at the beginning than that at which it has ended up? Obviously what you have told us is that the amount of new capital

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that you are going to have to deploy has, by definition, been reducing over time. So, you do not need, by definition, to get as much money to service the debt. Did the capital return come down over time?

Mr Pointer: A number of research studies were undertaken at the time as to what should be the appropriate cost of capital to be used in the industry and both the Regulator and the industry went forward with research at that time and obviously rates do change over time and that has been the history that we have seen in this periodic review.

Q146 Chairman: I am sorry, I may not have made myself clear, Mr Pointer. At the beginning of this process, you were making a return to the investors in your business, whether it be on any kind of debt financing or in terms of equity investors, of whatever the yield was and you would have looked very carefully at any of the programmes you have put forward to ensure that your yield remained competitive to attract, if necessary, new investment into the business. The question I asked was, in the context of those yield returns, did they vary as you reconstructed your bid in the light of different scenarios?

Mr Pointer: Not significantly because the returns made for us are based on the rate of return on an asset-base value. So, as the asset base changes, then that will change simply because of the investment programme going forward and, as the investment programme is changed, then that would bring about that difference.

Q147 Paddy Tipping: Mr Roberts, you have been back to the market, have you not?

Mr Roberts: Yes.

Q148 Paddy Tipping: Just explain what you did.

Mr Roberts: We looked at what we thought was going to be our capital requirement for AMP 4 and, compared with a lot of the other water companies, we still have a significant part of our programme which is new investment which we would regard as slightly more risky than maintenance and therefore more appropriately financed by equity rather than by debt. We took a view that to maintain a credit rating that would enable us to access all markets, we would need to keep the ratio of debt to the total value of the business gearing to around about 55%. Taking into account the likely scale of the investment programme, we decided that we would need to raise about £1 billion of funds from our shareholders in order that we still have the right sort of credit rating and the right sort of gearing and we could still access that market for the balance. So, we went to the market in June of last year and we raised £500 million and we will raise another £500 million in June of next year and that will all be injected into the regulated business. That, hopefully, will overall keep our credit rating at a reasonable level and that in turn will mean that our overall cost of funding will be cut back.

Q149 Chairman: How did you manage to make the right statements in terms of the stock market and raising the money without knowing what the final determination was going to be?

Mr Roberts: We basically explained to the market that we had a view of where we thought it would lie and, within those broad estimates, what the real impact on gearing would be. We also made reference to the Regulator's duty to ensure that we can finance our activities and, taken together, would mean that we should be able to earn a reasonable rate of return on our new investment and that would enable us to get the rights issue away.

Chairman: Ladies and gentlemen, we are going to have to adjourn the Committee because some colleagues want to go and vote on these matters. I am going to suggest to the members of the Committee that, as there may be a series of votes, it may be more sensible to adjourn for 30 minutes in order that we can allow the voting process to be completed rather than us rushing backwards and forwards. So, can I apologise to our current and future witnesses but these are matters, as I say, beyond our control. If the process of voting ceases earlier, we will come back earlier.

The Committee suspended from 4.53 pm to 5.23 pm for a division in the House

Chairman: One of our members has a very important point that they want to raise and I want to move to that but Mr Tipping wants to ask a question in a few minutes about rates of return but, in deference to Ms Ruddock, would you like to put your question.

Q150 Joan Ruddock: I wanted to turn in general to the issue of efficiency savings and I think Mr Roberts has already touched on that point. If I may first of all ask of Thames Water, Mr Sexton said that the programme which the company wanted to undertake on leakages had been rejected. As a London Member, this is of immense concern and is a very, very big issue for us. The company, we know from Government ministers, is not actually meeting its targets, nowhere near meeting its targets, on leakages. So, what is it that Ofwat is requiring of you in order that you can do what the Government ask you to do?

Mr Sexton: I think I need to be clear that they have not rejected pipe replacement out of hand. There are two issues: one is rate of travel, how fast can we make progress with pipe replacement, and we have put forward an ambitious programme trying to get leakage off the agenda and to do a substantial amount in the next ten years. Ofwat have taken a view that less should be done and they have also taken a very hard view, in my view, of the unit costs that that work could be done for and therefore have allowed a financial sum that it is not far off half the amount that we are actually paying today having gone to competitive tender for that work. So, if you take both into account, if we were managed by a cash sum, then they would be putting huge reductions in the programme, but they are not saying, "You do not have to hit leakage targets", they are not saying, "Pipe replacement is the wrong thing", I think strategy, 100% agreement, so its rate

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of travel and cost of achieving is where our differences are but I hope very much that, with the extra information that we have given to Ofwat, they are going to move their position substantially by early December.

Q151 Joan Ruddock: If they did not, would you meet Government targets?

Mr Sexton: If we were left with the draft determination, I am confident that we could not.

Q152 Joan Ruddock: You could not?

Mr Sexton: No.

Q153 Joan Ruddock: Even with efficiency savings?

Mr Sexton: We simply cannot reduce by half the amount that we are spending on the streets today. We have every incentive to get lowest possible rates. The pipe replacements we have been doing for the last year have been totally at shareholders' expense, there has been no customer money in at all, and we have had every incentive to do that as efficiently as we could. We have put forward an efficiency saving because, as we do more of it, we will get better at it. We are not saying there is no scope for more efficiency but I am absolutely clear that I cannot deliver it for the amount that Ofwat have assumed in their draft determination.

Q154 Joan Ruddock: If I may just deal with the more general points about the efficiency savings, I think the suggestion has been made by the companies that Ofwat regard the scope for efficiency savings from water companies to be vastly greater than is required of the economy in general and that, I think the quote is, it goes well beyond the available evidence. On what basis do you believe that Ofwat has gone beyond the available evidence in setting the efficiency targets?

Mr Pointer: Can I start and John Roberts may add to what I am going to say. There has been a lot of study of efficiency that is available in the industry, studies by both Ofwat and the companies variously and through Water UK, and that is well documented and has been shared with Ofwat and with the industry and the fact is that the efficiency targets that have been taken in the draft determinations are almost double the available research that we have. No one is sitting here and we will not be sitting here and saying, "There is no scope for efficiency in these businesses", of course there always is, but necessarily there were major efficiency achievements achieved immediately post-privatisation, lots of costs came out of the business and one is on a downward curve, one is never sure exactly where you are on that downward curve but necessarily, with the passage of time, the distance from the privatisation effect which was quite marked earlier on, there will not be the scope, in our judgment, still to come out. That does not mean to say that the companies will not be striving for efficiency, they clearly will because it is an incentive-based regime and efficiencies are good for the companies in the short term and good for the customer in the longer term because it will revolve into charges.

Q155 Joan Ruddock: Can somebody say what the realistic target might be in your view.

Mr Roberts: We have offered one% improvement in efficiency. Ofwat themselves have undertaken or had undertaken on their behalf a number of studies which would lead you to believe at best there is one-and-a-half to two% maximum. In fact, what they have said is that they have adopted a carrot and stick approach by building in a certain level of efficiency, that is the stick, and then leaving us, if you like, the opportunity to out-perform that and that is the carrot, but they have assumed such a high level of implicit efficiency to start with that it becomes all stick and there is absolutely no carrot at all. It is a little odd because they have done this in a very systematic way and, in most other parts of their analysis where they have done systematic work, they have followed through the consequences of that. In this case, they have come up with a number which is at variance with the analysis they have had done for them and we cannot understand why.

Q156 Joan Ruddock: If you had your corporate way on this with the realistic targets that you would want to put into place, what would be the effect on customers' bills?

Mr Roberts: I think I would have to have notice of that one. You would have to work it through in detail. Perhaps we could come back to you on that. I would not like to just give you an off the top of the head response to that.

Mr Pointer: We could also share the various analyses that have been done for both Ofwat and ourselves, so you could see the pattern and where that sits with the targets taken in the draft determination.

Q157 Paddy Tipping: Mr Roberts, before the break, the bells were ringing and I maybe did not pick up entirely what you were telling us. I think you said you had had an equity of £500 million in July of last year and there is another issue to be made . . .

Mr Roberts: In June of next year, 2005.

Q158 Paddy Tipping: You have all been talking to us about the efficiency squeeze and I think you just told us that it was all stick and no carrot. Why will investors come to you? You raise £500 million, you have another issue coming. What kind of people is it? Is it existing shareholders or increasing the share—?

Mr Roberts: It is a combination.

Q159 Paddy Tipping: Make a sell to me!

Mr Roberts: At the moment, we have a business that is relatively low risk; we have a regulator who has a legal statutory obligation that he must enable us to finance our statutory functions; we have a methodology paper from the Regulator that he published in March 2003 that states very clearly that he would look to financeability as being one of his key criteria. Taking all those together, what we have is a relatively low-risk business which does not earn huge returns but earns steady returns. There are investors out there, pension funds, unit trusts, who

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are looking for reliable, regularly, steady returns. This is the kind of investment that would give them those returns.

Q160 Paddy Tipping: But the other companies are not doing that. You are the only one that is doing it.
Mr Roberts: That is right.

Q161 Paddy Tipping: Why is that?

Mr Roberts: I think that is because we, compared to the other companies, have a larger component of new build in our capital programme and new build brings with it inherently more risk than there is in maintenance—with maintenance, you can take a view on it, you can defer a little, you can manage more easily, it is lower risk—and that level of higher risk is a risk which is better borne by shareholders than by debt funders.

Q162 Mr Drew: If we can look forward to Ofwat's future review, what we have learned so far is that there is a degree of saying, as regards as the price increases, "It wasn't me, gov, it was the other lot who did it." How can we actually move this review forward in order that we can get some greater degree of clarity for the real reasons for price increases and are you optimistic that Ofwat are capable of getting that greater degree of clarity?

Mr Pointer: I think there is a tremendous opportunity—I alluded to it earlier—as we get past this periodic review to look at the future, the challenges that are coming to the industry and the nation—I mentioned global warming and I mentioned the Water Framework Directive—and to see what changes can be made to the process and procedure going forward. I think that the industry would welcome an independent review of the whole way in which water periodic reviews are done.

Q163 Mr Drew: Are you suggesting that Ofwat is that independent reviewer or should it be someone besides Ofwat?

Mr Pointer: I think there is a compelling case to say, "No, we will take it away from all of the stakeholders", Ofwat being one of the stakeholders, and saying, "Let's stand back or get up to 35,000 feet and look at it in the whole" because it is now 15 years in, we have had three reviews or whatever and it is time to take stock and say, "Does it meet the needs going forward with the very different scenarios that we will be looking at as compared with what they were when the industry was privatised?" The fact is that the mechanisms and the reviews have delivered. The industry has delivered what it set out to deliver post-privatisation but now we are 15 years in and, frankly, I believe at the time of privatisation one might have expected that the degree of quality investment and enhancement investment by now might have subsided but, as we do look forward, it is likely that there will be a continuing need for further investment and therefore it seems to me to be an opportune time to look at the process *in toto*. Philip Fletcher has already told us—and he may have mentioned it to the Committee—that he will be

carrying out his own review in which there will be an independent component, but it may be good to stand right back out of the process completely.

Q164 Chairman: When we had the Regulator before us, he agreed with the proposition that he is the surrogate for competition. That is his job. If you were businesses in enterprises other than the ones that you are in selling in the marketplace where there could be four, five or ten companies in the North West, Anglia or Thames, delivering water, then you would have to achieve a commercial balance between your statutory obligations, your legislative requirements, European and national, and what your customers might be able to afford to pay taking into account what the competition is putting forward and I just wonder, Mr Pointer, in light of your last comment saying that the Regulator may have to look at all of this again, you are all business people of the world and understand that there is a limit to what customers can pay. Do you actually think that this process, which you said has gone through four or five different scenarios and ended up with the price increase being halved, massive capital reductions and key customer programmes being slashed, is a very clever way of determining the prices? Should you not be allowed to put forward a proposition and then have it picked over by the Regulator without all this guidance?

Mr Pointer: I think, in fairness, in the earlier reviews, it was very much that way: a company coming forward and Ofwat taking a view. What the process has developed to in the most recent review is far more dialogue with stakeholders, far more engagement with stakeholders and there are pluses and minuses to that. On the one hand, if you do consult with stakeholders, stakeholders are going to have a view and how can you accommodate that in the review but at least it opens the whole process up and is a very, very transparent process going forward.

Q165 Chairman: If I can now just deal with a couple of final questions. First of all, transparency. In some of the evidence we have had, there has been a lot of talk about, "We cannot talk to you about it because it is commercially confidential." What are these super-commercially confidential areas you cannot talk about when Mr Roberts, in putting out his appeal for funds, will have had to have been very open to potential investors about risks and returns and activities and expenditures bearing in mind that none of you are actually at the moment in competition with each other because Thames cannot take over North West's customers and vice-versa unless you buy each other out? I struggle to find what was so confidential that you could not put it into the public domain. Can you help me?

Mr Pointer: To say there is no opportunity for competition is not correct. There is opportunity for limited competition. It is not as much as one might expect in other industries but certainly big industrial demands and so on, industrial customers, can go forward with a competitive supply at the moment, so that is there around the edges. The fact is that we are

3 November 2004 Mr Roy Pointer, Mr John Sexton and Mr John Roberts

and some companies are listed on the London Stock Exchange and there are requirements that they would have to observe in making public statements and we are in a process which is very much in the Regulator's hands at this stage. We make our submissions and it is then down to Philip Fletcher and the Ofwat team to come up with their final determinations which, as I said, we expect in earlier December.

Q166 Chairman: My final question to you is this. A great deal of the discussion we have had latterly has been about the lack of the current five-year programme to take into account the very long-term investment requirements associated with things like the Water Framework Directive. Given that and other environmental legislation, given the burdens and uncertainties of climate change—and we discussed this in our *Water Security and Flooding* report with you—do you think we are coming to a time when it is right to expect the normal commercial relationship between you as the supplier of water services and the customers to individually, company by company, bear the costs of these very big factors, some of which are utterly beyond your control and which are beyond the customers' control but which are world, in the case of climate change, problems? Do we have to look at a different way of paying for impact on water services of issues like climate change?

Mr Pointer: I alluded to and I gave an example earlier with the Water Framework Directive where I think you have a live example that is coming towards us at the moment. Where as much of the water improvements that have been delivered over the last 15 years have been quite clearly levelled at our doorstep, we have been able to make those improvements, they are the so-called end of pipe improvements. As we look forward, the improvements that will be required under the Water Framework Directive will require other stakeholders to contribute to the solutions and the way in which that will be done is still subject to debate and discussion and through Water UK, through the companies, we would be very happy to contribute to find ways in which that can best be done.

Q167 Mr Lepper: Just on that issue of dealing with the Water Framework Directive, we heard from the RSPB in their submission that they felt that the price

review structure as it is at the moment does not allow for effective planning to deal with that and that we are storing up problems for the future if we do not look at it much more long term. The Minister said to us last week—he seemed to be rather more sanguine—that we have until 2015 to implement the Water Framework Directive and that we will not even get the definitions of what is classified as good ecological status until 2006. He seemed to feel that we can be rather more relaxed. So, RSPB on the one hand, the Minister on the other, are you somewhere in between or a little to one side or not?

Mr Pointer: I think there are some very difficult questions that the framework directive poses and, certainly from the industry's perspective, the sooner we engage with other stakeholders, including RPSB and all the other environmentalists, the better and surely we will come to a solution where the nation will have to pay and the question is, is it the nation through its tax system or other systems or should it be through the water bills?

Q168 Mr Mitchell: It is clear that you have to do things caused by various decisions not of your making in the sense that you have environmental improvements, you have European directives to fulfil and you also have customer improvements. Is it possible to state in the company accounts or in the individual bill that the consumer gets what is due to what? In other words, you are now being faced with an increase £X for the wretched European Union or to make the water purer, to stop leakage or whatever.

Mr Pointer: There has been limited progress in that respect and certainly when the determination comes through and the stages we have gone through thus far, there has been a reasonable level of analysis on what components of the increase in the bill are levied at which particular component of improvement. There is perhaps more work to be done in that area but, at the global scale and certainly with the material and brochures that go with the bills, some attempt is made to say what proportionately goes where but it is not a precise science.

Chairman: Gentlemen, thank you very much. I am sorry that our session was slightly disrupted by voting. Thank you for your patience and forbearance. Thank you also for your offer of response in writing to one or two other of the issues that we have raised.

Supplementary memorandum submitted by United Utilities Water plc

At the 3 November evidence session, the committee asked United Utilities to recalculate its draft determination price limit using the efficiency assumptions as forecast by the company.

We have taken the efficiency assumptions for operating and capital expenditure as communicated to Ofwat in the April 2004 final business plan submission, inserted them into Ofwat's draft determination financial model scenario and revised the price limit K factor to produce a financial projection profile consistent with that outlined in the draft determination.

The overall effect on price limits would be to increase the average K factor to 4.1% per annum as compared to the 3.5% as determined by Ofwat. This reinforces the points we made in our evidence to the committee that most of the gap between our proposed K factor of 7.8% and Ofwat's draft determination of 3.5% is due to reduced outputs rather than differences in efficiency assumptions.

12 November 2004

Memorandum submitted by WaterVoice

INTRODUCTION

1. 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 in Wales. The ten committee chairmen form the national WaterVoice Council.

2. Our evidence sets out our:

- role in the 2004 price review;
- reaction to Final Business Plans;
- reaction to the draft price limits on behalf of customers in terms of the:
 - (a) average household bill compared to typical measured and unmeasured bills;
 - (b) bill profile;
 - (c) affordability of the bill; and
 - (d) improvements allowed.

OUR ROLE IN THE 2004 PRICE REVIEW

3. WaterVoice has sought to make sure that customers are treated as key stakeholders, their views heard and taken into account by Ofwat, the quality regulators and the Government at each critical stage of the process. Our aim has been to influence the outcome, with water and sewerage bills set at a price that is acceptable, affordable and represents value for money.

4. We have issued a series of briefing notes (listed in Appendix A [not printed]) setting out what we have said on behalf of customers during the price review.

OUR REACTION TO FINAL BUSINESS PLANS

5. When the companies submitted their Final Business Plans in April 2004 we expressed concern about the proposals to increase the average household bill by £70 (29%) before inflation over the next five years. We regarded proposed price increases on this scale as being neither affordable to some customers nor acceptable to many. Given the very significant regional variations in the proposed increases we believed this would result in thousands more customers falling into debt for the first time and exacerbate the rising level of customer debt in the water industry. To make matters worse for customers the increases proposed for the first year, 2005–06, were on average around half that for the full five-year period.

6. In June 2004 we published an open letter (copy at Appendix B [not printed]) in which we called on both Ofwat and Government, as a matter of priority, to cut proposed increases in bills by at least one-third on average. In addition we pressed (among other things) for smoother price profiles over the five-year period.

REACTION TO DRAFT PRICE LIMITS

7. On the surface Ofwat's Draft Determinations published on 5 August appear to deliver better news than we had anticipated for customers. The proposed average increases of £34 (13%) in household bills (before inflation) are less than half the amount proposed by the companies in their Final Business Plans and meet the challenge posed in our open letter. But the devil is in the detail and it is perhaps more a case that Ofwat has managed expectations.

Average household bill compared to typical measured and unmeasured bill

8. Use of the average household bill masks some stark variations in the amounts that customers, in particular those who remain on an unmeasured tariff, will pay in reality. Even allowing for the significant variations in bill levels across England and Wales there are some worrying differences between measured and unmeasured bill figures within the companies themselves. This is because of the way the tariff basket works and assumptions made about the numbers of customers who will switch to a meter and their consumption levels.

9. The most dramatic are in the South West where the average bill figures show a £61 (17%) increase from £357 in 2004–05 to £418 in 2009–10. In money rather than percentage terms this is double the average industry figure. In terms of unmeasured and measured figures Ofwat has referred to typical bills. This makes comparison with the impact on average household bills difficult. Nevertheless, it is clear that most customers who remain on the unmeasured tariff will see their bills increase in monetary and percentage terms by a greater amount than those customers whose bill is based on the measured tariff. In the case of the South West (Table 1 below) the typical unmeasured bill will rise by £155 (35%) whereas the typical measured bill will increase by £80 (29%).

Table 1

WATER CHARGES IN THE SOUTH WEST 2004–05 to 2009–10

<i>South West Water</i>	<i>2004–05</i>	<i>2005–06</i>	<i>2006–07</i>	<i>2007–08</i>	<i>2008–09</i>	<i>2009–10</i>	<i>Increase</i>	
	£	£	£	£	£	£	£	%
Average annual household bill	357	386	407	410	415	418	61	17
Typical measured bill	273	308	336	343	348	353	80	29
Typical unmeasured bill	442	491	526	547	573	597	155	35

Note: Typical measured bill relates to a customer with average consumption in 2004–05 whose consumption remains constant each year to 2009–10.

Typical unmeasured bill relates to a customer with an average rateable value in 2004–05 who remains on the unmeasured tariff through to 2009–10.

10. This pattern occurs to differing degrees across other companies as illustrated in the graph at Appendix C.

Bill profile

11. Ofwat’s proposal to allow higher price increases in 2005–06 than in the years that follow will have serious implications for customers, especially those on low and fixed incomes who will find it more difficult to budget for and manage to pay higher water bills. Although Ofwat acknowledges that research shows that customers strongly support price stability rather than stepped increases in bills it has chosen to adopt a principle that the profile of bills should follow the companies’ costs. This means that draft price limits can rise one year, fall the following year only to rise again the year after. The impact of inflation will, for all but two companies, offset this effect. Nevertheless, we are concerned that negative price limits within the context of rising water charges overall undermine the message that water is a valuable resource that should be used efficiently.

12. We accept that the companies may have a build-up of costs in 2005–06 and to a lesser extent in 2006–07. But we question whether Ofwat has been sufficiently robust in scrutinising the companies’ claims that they are restricted from managing with a smoother profile because of a need to maintain financial ratios to meet covenants or other agreements with lenders. Ofwat appears to have given greater weight to the companies’ claims of pressures from the financial markets than to customers’ preferences for steady price increases.

13. Ofwat argues that a smoothed change in price limits and bills would mean that bills would be higher at the end of the five year period compared with a front-end loaded profile. However, if this does not add significantly to bills in 2009–10 then we believe customers would accept this as a reasonable trade-off in order to ensure a smoother profile. In the case of South West Water Ofwat has met the company’s request to spread the price rise more evenly.

14. Customers are not alone in stating that they prefer steady price increases to step changes. The Government, in its Principal Guidance to the Director General of Water Services, said, “As the Initial Guidance stated, any sudden large change in customer bills, from whatever cause, has detrimental social and economic effects that may be as serious as a high level of charges”.

15. We are also worried that with so many uncertainties not accounted for in draft price limits companies will apply to Ofwat through the interim determination route for upward adjustments to their new price limits in due course. Interim determinations may become commonplace from 2006–07 onwards. This will erode customers’ confidence in a price setting process that should be sustainable over a five-year period but may not hold for more than two or three years.

Affordability

Impact of the Price Limits

16. Ofwat has said that it cannot set price limits on the basis of affordability but has worked hard to ensure customers' bills are no higher than they have to be. Ofwat seeks to justify affordability of the proposed level of bills in this price review by stating that "overall by 2009 customers would be paying only around 3% more on average, in real terms, than they were paying in 1999." In our view this is an argument that does not reflect what happens in the real world. Depending upon their financial circumstances customers manage their household budgets from day to day, week to week or month to month. They may compare bills year on year but they will not look back to what they were paying five years ago. Our own research "Paying for Water" (jointly commissioned with Ofwat) identified that customers struggle to pay their bills, juggling them with other debts—in customers' own words "robbing Peter to pay Paul." And given the current record levels of general household debt and upward movement of other essential household bills customers are more likely to worry about immediate changes in their household budgets than be concerned about what they were paying at some date in the past.

17. The higher increase in the first year 2005–06 will be worse for customers in the South West where bills are the highest, there is an above average population of pensionable age and, in Cornwall, the lowest level of average earnings across England.

18. Affordability is a real issue now. In the South West the average water and sewerage bill in 2004–05 at £357 represents 6.5% of the disposable income of a single pensioner receiving Pension Credit. By 2009–10 the situation will be even more exaggerated with the average water and sewerage charge for single pensioners projected to account for 7.6% of disposable income based on current income levels. The graph at Appendix D illustrates the picture across England and Wales. For single people in receipt of Job Seekers' Allowance the situation will be worse as the level of this benefit is lower than Pension Credit.

19. Pensioners in the South West who currently receive a typical unmeasured bill of £442 pay 8% of their disposable income to their water company. If they do not switch to a metered supply by 2010 their water and sewerage charges will represent almost 11% of their disposable income. Expenditure at this level runs counter to the Government's own sustainable development indicator (Q3) for measuring affordability for water at 3% of income.

20. It is clear that many more customers will struggle to pay their bills resulting in a further rise in the level of outstanding revenue in the water industry. This currently stands at £893 million, of which £527 million is over 12 months old. There will also be mounting pressure on the household budget as energy bills rise. British Gas has announced that the average household gas bill will rise by £48 per year (12%) in the coming year. In addition electricity bills will rise by £22 per year (9%). Mortgage interest rates have been rising steadily. And there are indications that further substantial Council Tax rises are likely. We expect Ofwat's assumptions for bad debt provision for the water industry to have been set in the context of rising bills in other sectors.

Government Review

21. It is time for the Government to act to provide financial assistance through the benefits and tax credits system to help those customers on fixed and low incomes who are least able to pay their water bills. Both the EFRA Committee (in December 2003) and the Environmental Audit Committee (in March 2004) recommended that people suffering from serious difficulty in paying their bills should be helped in this way. In response the Government said that Defra would lead a cross-Government review of the way in which lower income households are helped with their water and sewerage charges.

22. Our involvement in the review suggests that use of the benefits and tax credits system will be rejected as an option as the Government believes that this would complicate the systems and increase administration costs. Instead a range of other measures have been proposed. In our view they will "tinker at the margins" and do nothing to reflect the regional differences in charges or address affordability in any meaningful way. This is simply unacceptable. It runs counter to the recommendations of two Parliamentary Select Committees and the views of all the stakeholders who attended a Defra seminar to debate the issues on 18 June 2004. In Scotland and Northern Ireland solutions are currently being developed to tackle this issue.

23. Adopting a radical approach may be difficult but sometimes it is necessary to be innovative to effect change that will make a real difference. Help with water bills should be provided as an automatic right alongside other qualifying benefits through the social security system. This could be in the form of an individual allowance for water and sewerage charges included in the qualifying benefit, the issue of a voucher or passport on entitlement to a qualifying benefit or the introduction of a water charges benefit (akin to council tax or housing benefit). It could be provided to measured and unmeasured customers alike and remove the need for the ineffective Vulnerable Groups Regulations.

24. This will require a shift in policy and acknowledgement by the Government of responsibility for the affordability of water as an essential service and as a social issue. Demonstration of commitment to such a change would complement its social exclusion and anti-poverty agenda and highlight the importance of

water as essential for life and health consistent with the decision to ban the disconnection of domestic water supplies. It would, of course, require new resources but the Government already provides substantial funding to the energy sector, and pensioners in particular, to help combat fuel poverty.

25. For 2004–05 the Department for Work and Pensions estimates its benefits expenditure on winter fuel payments will total £1,957 million with an extra £502 million in one-off payments to those over 70 years of age. That is almost £2.5 billion in one year alone to meet an objective to combat fuel poverty but these payments are made regardless of the income of the individuals who receive them. In addition further funding is provided to support energy efficiency measures in the home designed to help reduce fuel bills.

General Taxation as an Alternative

26. Alternatively the Government should consider seriously the use of general taxation instead of water and sewerage bills to fund the wider public benefit associated with bathing waters, special environmental areas or other national assets. Capital investment related to the environment programme accounts for around one-third of the average household sewerage bill with a range from 24% in Northumbria to 45% in the South West. The EFRA Committee in its most recent report “Climate Change, Water Security and Flooding” concluded that there is an argument for meeting the cost of environmental improvements to the aquatic environment, for protection from environmental hazards and mitigating the impact of climate change on water resources through central Government expenditure rather than through water bills. Having determined the outputs of the price review in terms of the environment and drinking water quality programme through Minister’s Guidance, the Government must accept responsibility for the social consequences

IMPROVEMENTS ALLOWED

27. Ofwat has said that all essential services will be safeguarded. Following the transparency that characterised the earlier stages of the price review process we are finding it difficult to distinguish what schemes and projects listed in the companies’ Final Business Plans have been included in Draft Determinations, or to understand the rationale for some of Ofwat’s assumptions. Some of our requests to Ofwat for this information have been turned down.

28. We have identified a number of issues for clarification:

Capital Maintenance

29. Companies need adequate funding to maintain the serviceability of their water and sewerage networks. In their final business plans companies sought £9.4 billion to address the effects of under-investment in asset maintenance at previous price reviews and pre-privatisation. Ofwat’s draft price limits allow £8.1 billion expenditure over the five-year period. From our discussions with the companies we are surprised at the extent of the cuts in the ongoing maintenance of the water distribution system. The latest figures published by Ofwat show there were over 170 mains bursts per 1,000 km over the past six years. Research undertaken by UKWIR suggests that 20% of mains bursts lead to discolouration incidents. Media interest in this, and in the associated issue of leakage, is growing. Customers are increasingly becoming intolerant of disruptions—however minor—to their water supply, and are supportive of companies taking action to improve the reliability of the distribution system.

Drinking Water Quality Improvements

30. WaterVoice is generally supportive of Ofwat’s assumptions for the drinking water quality programme as most of the investment proposed by the companies with the support of a pragmatic approach by the Drinking Water Inspectorate has been funded. We are, however, pressing Government and Ofwat to allow funding for schemes that will reduce the risk of discolouration of supplies. Whether this is funded via the quality programme or through capital maintenance is a matter for Ofwat, but we believe that these schemes should be funded.

Environmental Programme

31. We support environmental improvements that give value for money but question whether in view of what has been achieved to date, the same rate of expenditure is appropriate for 2005–10.

32. While we welcome Ofwat’s proposal to exclude quality improvement schemes that were not fully specified or were very costly (and therefore require reconsideration), we are unsure what exactly has been excluded.

33. It is vitally important that all schemes included in price limits represent value for money. Ofwat’s request for reappraisal is in line with WaterVoice representations. We called on them to identify all high-cost, low-benefit environmental improvements and remove them from the programme to allow more time

to examine lower cost options and the need for the improvements at all in the context of the proposed level of overall price rises. It is also vital that the polluter pays principle is applied appropriately, particularly in the case of diffuse pollution. It does not make sense for the companies to take action to clean up and customers to meet the bill when others are contributing to the problem; for example there is little or no action by the farming community to change its practices in the use of nitrates.

34. What concerns us now is that pressure will mount for all the “parked” schemes to be reinstated in Final Determinations. There is too short a time scale between Draft and Final Determinations to reappraise each of the projects and schemes excluded.

Sewer Flooding

35. Prevention of flooding from sewers is one of customers’ top priorities. Ofwat has cut companies’ bids from £1,470 million to £681 million by imposing a 22% cut on their proposals to alleviate internal flooding risk, reducing external flooding schemes by 41% through the application of what we regard as an arbitrary £120,000 per property ceiling on schemes.

36. Despite Ofwat’s statement that it does not want companies to deal merely with those problems that have the cheapest solutions, the price cap is likely to have that effect. This is extremely disappointing as the companies with WaterVoice support have invested a considerable amount of time and effort in developing systems that sought to prioritise alleviation schemes according to the frequency and severity of previous flooding incidents at individual properties or in public areas. And although Ofwat will allow companies to log up expensive schemes that are subsequently justified through cost benefit analysis we question whether companies will be prepared to wait until the next price review for reimbursement of money spent. We have suggested to Ofwat that raising the ceiling to £150,000 would allow a significant number of additional problems to be tackled without adding greatly to bills.

37. While Ofwat’s acceptance and funding for measures to reduce the risk of flooding from sewers and provide some protection for 4,000 properties it is, in our view, not enough. We do, however, acknowledge Ofwat’s view that companies could do more to identify whether some problems requiring a high cost engineering solution could be addressed through low cost ameliorative action. We will continue to discuss with companies how best to tackle this most unpleasant of service failures.

Security of Supply

38. We would not wish to see the companies’ duty to supply water to customers compromised by the environmental regulators’ desire to reduce or terminate companies’ abstraction licences. Decisions must strike the right balance and allow the companies to take a sustainable approach to water resource management to cope with growth particularly from new developments in areas where water resources are already under stress.

CONCLUSION

39. In reaching decisions on Final Determinations WaterVoice expects Ofwat to give full consideration to the representations it has received from customers alongside those received from the companies and other stakeholders.

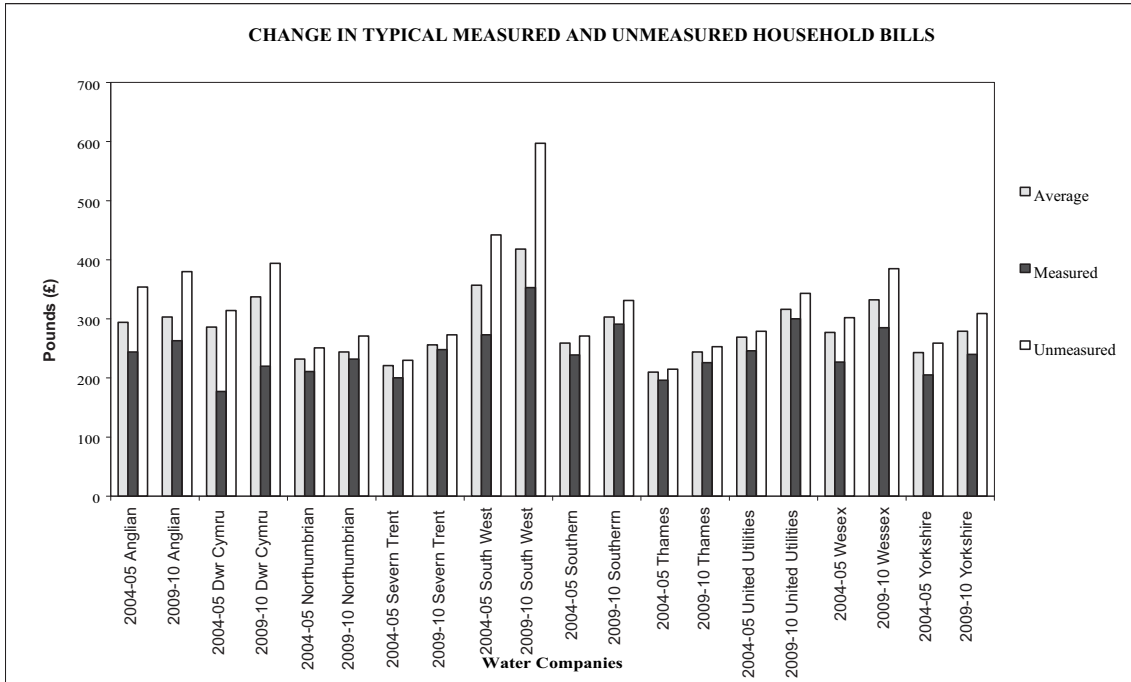
40. We wish to see a balanced outcome to the price review and pragmatic approach by Ofwat about what can be delivered with a focus on outcomes and a realistic approach to what customers can afford. Such an approach would contribute to the achievement of sustainable development and help to meet the Government’s 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.

41. In the words of the Secretary of State in her foreword to the Initial Guidance it is important to remember that:

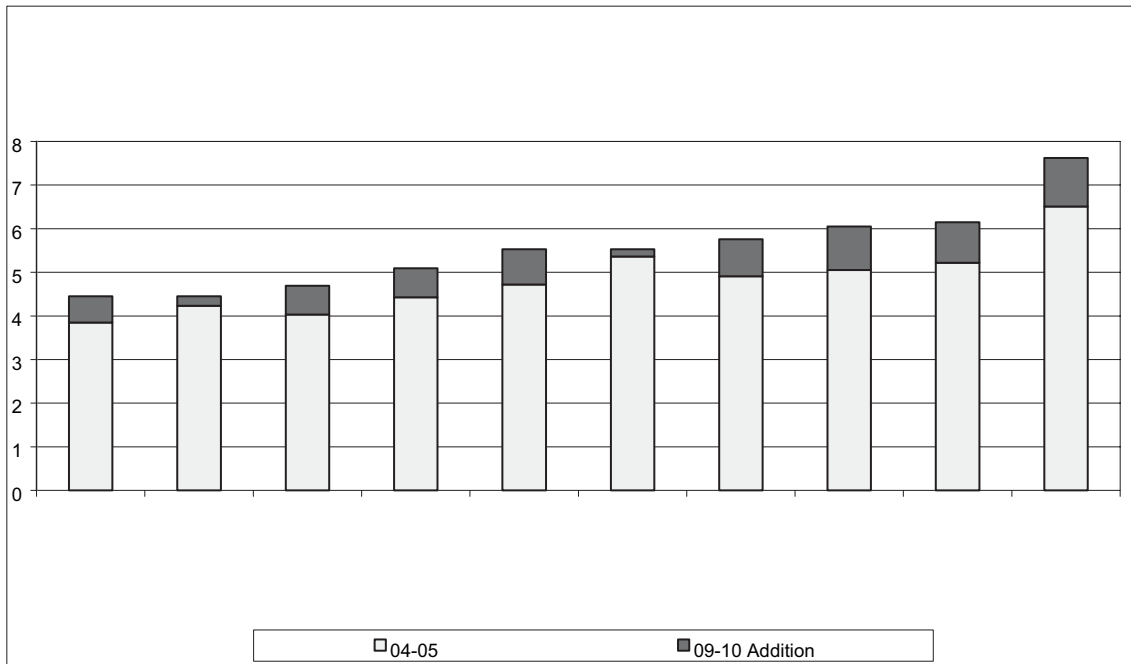
“It is people who matter, whether paying their water bills or enjoying the benefits of clean water through the tap and in the environment, and our policies must strike the right balance in their interests.”

APPENDIX C



APPENDIX D

Average water charges in England & Wales 2004-05 to 2009-10 (as per draft determinations) as % of Single Pension Credit



Witnesses: **Mr Maurice Terry**, Chairman, WaterVoice Council and Chairman WaterVoice North West, and **Ms Andrea Cook**, Chairman, WaterVoice Northumbria, examined.

Q169 Chairman: You are extremely welcome. May I thank you for your written evidence to the Committee. As MP for the Fylde, can I thank you, Mr Terry, for the way you have helped me with the odd constituency query, which I have written to you about. That is much appreciated. You appear today in your capacity as the Chairman of WaterVoice and the Chairman of WaterVoice in the North-West. You are accompanied by Andrea Cook, who is the Chairman of WaterVoice Northumbria. We are delighted to see you. Let me start by asking you for your overall impressions about the way in which this particular review has been conducted.

Mr Terry: From a customer perspective, I certainly think it has been much better than the last review. Let me say that right from the outset. Initially, it has been done in a very transparent way with that as the declared objective of Ofwat. The real thing that has been a distinct improvement is that at all stages in the process all the stakeholders have been involved and have participated in the discussions, and that is something which did not occur at the previous review. As WaterVoice, we have had particularly effective discussions with, for example, the Drinking Water Inspectorate, and we have been very close to them. We have had very useful discussions throughout the process with the Environment Agency in trying to understand their perspective and share our perspective with them. I think, from that perspective, it has been much improved. Also, we work very closely with the industry. One of the things right at the very beginning that we did this time, which I think was very significant on behalf of customers, was to undertake two pieces of market research conducted right at the outset, if you like to try and set the scenario for customers and for customer issues. I think that worked very well. We are perhaps a little less comfortable with the process at the draft determination stage, which was in August. There were two particular areas. There is a lot in the draft determinations. What we have had to do as committees is to try to unwrap that and uncover whether the issues that customers told us about directly and in the market research had been addressed. We found that quite difficult. In many cases we could not get that information from Ofwat and we relied on the company to do it. We have got there, and we have made representations to Ofwat about the fact that we thought at this last stage there was a little less transparency than there had been at the earlier stage. That is one thing about the draft determination. The other area—and I will ask Andrea Cook to say a word or two about this—is about the way the numbers have been presented.

Ms Cook: Chairman, one of issues that we have had to look at is the extent to which customers understand the information that they are provided with. In the majority of instances Ofwat refers to average figures. Sometimes it is quite difficult to be an average person. The 17% that is quoted by Ofwat as being an average bill can, for example, be 29% as an increase for metered customers in the south-west of the country and 35% for unmeasured customers. That is quite a distance away from what is regarded

as an average figure. It is a question of us wanting there to be perhaps more information provided to customers when it comes to final determinations.

Q170 Chairman: May I just stop you there because you said you had difficulty with the figures. In table 1 of your evidence, just explain to me, and I can understand the difference between the point you were just making a second ago about the typical measured bill and the typical unmeasured bill, if this average annual household bill is a national figure.

Mr Terry: The number there is a regional figure. That is the average for the region.

Q171 Chairman: I see how you have worked it out. If typically measured is going up by plus 29 and typically unmeasured is going up by plus 35, how can the overall average increase be 17?

Ms Cook: This is the point that we are making. We have given you these figures. We have done the calculations based on what a typically measured bill is relating to a customer with average consumption where consumption remains constant. We have provided this variance, if you like, between a typical measured bill and a typical unmeasured bill but the information that Ofwat provides when it gives the draft determinations within the regions, through its press releases, is this figure of 17%. Understandably, customers in the region look at this figure of 17%, and say, “That does not relate to my bill”.

Q172 Chairman: Does that include industrial users as well as ordinary users?

Mr Terry: No, that would be the household bills.

Q173 Chairman: You are telling us that Ofwat are saying that in the south-west, in the example you have chosen, their projected increase over the five years is 17 and, depending on whether you are measured or unmeasured, it varies between 29 and 35 by your calculation?

Mr Terry: The way you express it is a little confusing. I think we are just highlighting the actual point that we are trying to make that the way the data is presented is confusing. The average bill, which is, if you like, the total revenue from household customers divided by the total number of households, rises by 17%. There is no doubt about that. An average hides a number of impacts. You are able to look at the so-called typical bill, which is the average consumption and the average rateable value, and that is the sort of discrepancy which we find customers have some difficulty in understanding. We just raise it as an issue about the clarity of the output.

Q174 Chairman: I must admit I am still a bit lost but I take the point.

Mr Terry: I have to say, Chairman, that it is not an easy concept and we struggled with it as well, but I am assured by the calculators that these numbers are actually right. This is the way they are presented. What we are interested in really is: what is the customer actually going to see?

3 November 2004 Mr Maurice Terry and Ms Andrea Cook

Q175 Chairman: Before we move on to questions of affordability, you were talking about the surveys that you have done. In your evidence you identify improvements: capital maintenance, drinking water quality, environmental programmes, sewer flooding and security of supply. Those are the key areas which I have assumed you think need attention.

Mr Terry: Yes.

Q176 Chairman: We have just heard evidence, and you were sitting in so you heard it yourself, from the water companies, which said that they have now found that some of these key issues, like sewer flooding, they will not be able to do. Thames will not be able to stop the water bubbling up through the road. Their argument is that the determination is going to be too tough. You argue that these things that I have just read out are key issues for the consumer. If the consumer is to be made happy and if the consumer is not to pay too much, what, in your judgment, has to go into the proposals so that everybody can have their cake and eat it in this particular case? Something has to give here. The company says it has to do all these things. You are saying it is too expensive but you have identified a wish list. The companies are then saying, "Some of the things on that wish list which are top of the customer priority tree we cannot do".

Mr Terry: We actually do not believe that some of the customer priorities are that expensive. If I could just come to sewer flooding—

Q177 Chairman: Ofwat does because Ofwat has chopped out sewer flooding—£900 million.

Mr Terry: Ofwat has chopped out sewer flooding. The £900 million to which United Utilities was referring was the total investment package: new build, new quality improvement, investment, and so on. Part of that was sewer flooding. If we look at sewer flooding, what we said, based on our assessment of what customers thought was important, was that the backlog, about 10,000 properties in round figures, ought to be dealt with in the next periodic review. Let us get the backlog out of the way and then let us try and make sure that on an ongoing basis we can deal with newly arising properties as they arise and deal with them out of maintenance. That is the approach which we advocated. We are disappointed that Ofwat has not accepted that as a target output. It is not for us to say whether the cost associated with it is fair; that is a job for Ofwat. We are disappointed. We have not got a national figure. I have looked at the numbers in the north-west with United Utilities, which they have shared with me. I would say that the cost of achieving the total programme they want to achieve is something which customers would be prepared to bear, even if it would mean a slight increase over and above their current draft determinations, but an increase at a level based on what customers have said is important to them and what they should be prepared to bear. There are other things as well. They majored, for example but not necessarily in the north-west region, on issues around colour and taste of drinking water, again things which are important

to customers, which we believe need to be rigorously examined but do not necessarily cost a lot of money. I can understand why Ofwat believes they need to challenge them. In our view, cutting the output is the wrong way to go for those particular items.

Q178 Mr Drew: Can I be very clear that your calculations are, as we say, for today's sewer problems and that the proposals that have yet to come through, which you are just about to be consulted on as to much more widespread adoption of private sewers, would be additional sums required on top of that. Have you done any calculations of what those additional sums are?

Mr Terry: No, we have not any calculations. The adoption of private sewers we believe is probably the direction in which we should go. We do, however, have a little bit of a caveat around that which says: would you please cost that and say what it is going to cost the rest of the customer base before embracing it. We do not know what that number is. Intuitively we believe it is the right way to go. Before jumping into new sewer problems, it would be useful if we could get some measure of what this is costing. Therefore, I think that it would be useful if there were some independently undertaken study, market research, to say what customers are prepared to pay for and also a piece of market research that asks: what is this actually going to cost?

Q179 Ms Organ: In the earlier answer to the Chairman we talked about the increase in the bill. We were told at the first inquiry that we did into price reviews that between two million and four million householders were having difficulty and could not afford their water charges. We have just talked about the average increase, but what that really means for people in the south-west on an unmetered or metered situation is that there can be an increase of between 29 and 35%. What evidence do you have that this draft determination would mean a substantial number, or maybe not, of people who are faced with the difficulty of paying their bills, and particularly those on fixed incomes and on low incomes? Obviously there is going to be a regional pattern to that. What evidence do you have about that and what should be done about it? What can the companies do?

Mr Terry: Can I ask Andrea Cook to say a word about that. Andrea has been leading the thinking process in WaterVoice around the whole issue of customer debt and affordability. I would like to defer to her because she is our in-house expert on that.

Ms Cook: May I say, first, that WaterVoice really appreciates the fact that the Efra Committee has taken an interest in affordability. It thinks it would be fair to say it is only as a result of your recommendations that in fact a review into that subject matter has been taking place within government. We do feel that your considerations have given it some impetus. Perhaps I can pick up on some of the points that you were making about context. First, you are quite right that the figure of between two million and four million is

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approximately the sort of number that we would be looking at that would be affected by issues of affordability. Certainly there are 2.2 million recipients of income support and there are 2.5 million recipients of pension credits. Whilst you cannot necessarily say that all of those people will have problems, they are certainly all at risk. You can add to that number of 4.7 million those people who are working, who have families and who might also still be on a low income. That is the part of the population that is at risk. There is a general perception that water bills represent about one% of average income for all consumers. You highlighted in your question the fact that people on a low, fixed income are obviously in a slightly different situation. We are very mindful of the fact that for that type of person within the population their bills will be a substantially higher percentage of their outgoings. In terms of the south-west, can I give you some illustrations? The average water and sewerage bill of £357 in 2004–05 represents 6.5% of disposable income for a single pensioner on pension credit. By 2009–10, that becomes 7.6%. If you are a measured customer, it is 8% of disposable income. If you are an unmeasured customer, it is 11%. The difference between one% for most of the population and 11% for some is obviously very wide. We can provide you with more detailed information about some of these statistics and calculations to assist you. I can add into that the wider economic context, the fact that we are in a situation where we have increases in mortgage rates and council tax, and we have heard announcements this week about further higher increases for energy prices, for gas and electricity. Water bills need to be seen against that background. It is quite clear that if there are already people who cannot afford to pay their bills, the prospect of higher prices in all of those areas is likely to push people over the edge. If you then take into account that outstanding revenue in the water industry stands at £893 million, and that is without any further increases in bills. As that represents about a four% levy on those people who pay their water bills, then we clearly do have a very considerable problem. I hope you will forgive me for providing that by way of an introduction. That is the background against which Defra have been looking at the question of affordability. I would like to say that I think Defra has approached this positively and constructively, as it has convened meetings with stakeholders both collectively and individually. It has also had an across-government steering group, which I think has created limitations for itself. It has started from the premise of the people in that group looking at their own territories and from the concept that not everything is up for change. In this particular area, we are looking at something whereby government needs to make radical decisions rather than just tinkering at the edges. It really needs to recognise that economic and environmental decisions have social consequences. In this area, the social consequence is an inability to pay for water. It does require something really fundamental to change.

Q180 Ms Organ: Thank you. We would be grateful for the further illustration and information that you have?

Ms Cook: Would it help if I said what sort of change we are considering?

Q181 Ms Organ: That is what I was going to ask you. You have just said that Defra has this attitude. It is a real problem, and it is a particular difficult problem in certain regions and with certain groups of people. When you are talking about people having to give eight% of their disposable income for their water, the price rise coming forward is a big issue for them. We have a real problem with that. You said that you wanted the Defra group to think about radical decisions. I would go on to ask you: what would you want to see and what can the companies do as well because they have to bear some responsibility in this, do they not?

Ms Cook: I think everyone has to bear responsibility, and that includes consumers. Consumers have to recognise that they have bills that need to be paid and play their part where they can when it comes to prioritisation of their debts. I think companies can do more in relation to providing more flexible payment arrangements. A lot of people who are on low incomes are paid on a fortnightly basis and would feel much happier if they could make weekly payment arrangements rather than having to make larger payments that they find difficult to manage. It would be fundamentally more helpful if third-party deductions, otherwise known as Water Direct, could be seen as a fundamental part of the payment system rather than a system of last resort because some people actually like assistance with managing their money. They feel that they are having a burden taken away from them if the Government is providing that type of support. It is not intervention; it is actual support. Our overall conclusion is that this really needs to be dealt with through the tax and benefit system and through improvements in terms of social security and that that would either be through some sort of individual allowance for water and sewerage charges in terms of their qualifying benefit—and the parallel with that would be mortgage interest—or some sort of voucher or entitlement that could provide a percentage discount against a bill. The advantage with some of these things is that you can at least take account of any regional discrepancies. If you gave people a 25% discount on their water bill because they were in receipt of a qualifying benefit, that would take account of the fact that the percentage reduction in areas where bills are higher would be higher than in areas where bills were lower. So there would be the opportunity to try and spread it and make the adjustments according to some of the regional variations. I have to say that one of the biggest stumbling blocks for us in addressing this issue has been the inability to identify the amount that is allowed for water and sewerage charges when it comes to people being able to claim benefit. There used to be a system whereby the amount of money for water and sewerage was very clearly identified. We no longer have that information available to us. Again, we have made some calculations and best estimates that we can let you have, but I think

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anything that this committee can do to encourage more openness about the sorts of figures that are allowed would be of great benefit.

Mr Terry: May I add to that? I think there is a need to start thinking outside the box on this. I suppose our criticism of the process up until this particular point in time is that it has been very much, as Andrea has said, tinkering at the edges. It is our view that it has to be more fundamental than that. It does not affect everybody, but it does affect a relatively large number of vulnerable groups on low and fixed incomes across the country. It is most severe in the south-west because of the nature of the prices there, and I can see Mr Breed agreeing. It is equally severe in many of the inner city areas, particularly, for example, in Mr Jack's region of the north-west, the inner city areas of Manchester and Liverpool. It is a problem. It does not affect the whole of the customer base. It reflects a relatively small part but it does need tackling, in our judgement.

Q182 Alan Simpson: I wanted to come back on this theme with Andrea. In a different guise, Andrea, you have done a lot of work that influenced Government's thinking in relation to fuel policy. One of the critical things there was to develop this concept of, in a sense, a fuel poverty benchmark, the proportion of a household income that went on paying fuel bills. That would constitute being in fuel poverty. Have you yet done similar work with WaterVoice in being able to give us a benchmark figure? When we move around the percentages of disposable income people are paying in their water price, do you have a benchmark figure that we may use as a reference point for saying that beyond this threshold people start to be in water poverty? Is that a concept that you have considered?

Ms Cook: WaterVoice has not itself done anything on that benchmark but the figure that is generally regarded as being the appropriate level, based on what Defra itself uses in its sustainability indicators, is three% of income, which compares with, the last time I was acquainted with it, 10% in relation to fuel poverty. I would want to make the point that we do look at this more as an issue of affordability rather than water poverty because some of the read-acrosses are not the same as they are in relation to the fuel sector. There are a lot of different factors. In terms of fuel poverty, you can actually tackle that by improving the energy efficiency in buildings, and you still have the ability to disconnect. In the water industry, it is very much to do with the income of the household. What we need to have here is a recognition that the average householder receiving support from the Department of Work and Pensions needs to know what they receive for water and sewerage, and we need to have the ability to look at that and see whether it is consistent with current levels of bills. That is the bit of the equation that is missed out. I think there are some parallels with fuel poverty. The three% figure can be a benchmark. This really is an issue about trying, first of all, to get clarity and, secondly, to make sure that the amount

of money that is provided both keeps pace with inflation and is consistent with levels of increases in bills as well.

Q183 Chairman: You said something very interesting, that there was a period in the past where you could identify by different types of benefit how water and sewerage was accounted for and that subsequently it has become much more difficult to extract that information. You do not need to answer the question now but could you drop us a note? One of the things I am sure colleagues would want us to do is contact the Department of Work and Pensions to see if they can shine some light into these opaque areas.¹

Ms Cook: I think that would be incredibly helpful to consumers.

Mr Terry: Chairman, I would not say that the numbers that we have given you are precise. They are indicative numbers, the best that we are able to estimate.

Q184 Chairman: What I want to know very simply is: by "benefit", when did you lose sight of the ability to identify the elements within either the uprating formula or the benefit itself where you could say: that is how water was treated?

Ms Cook: In 1988. I am old enough to remember it!

Chairman: Please drop me a line on that.

Q185 Mr Breed: Without wishing to sound alarmist, I think when this issue hits many people in the south-west we may see just the same amount of protests about water charges as we have seen against council tax. I hope that the Government might recognise that it ought to tackle this before it gets to that stage. Whenever we raise this sort of issue with Government, they always say, "Of course, the money has to come from somewhere. It is all very well. We would like to do it". Is it not true that in fact part of this rise is to pay for increased business tax, which the water companies are going to have to pay because of tax treatment? In fact, the Government is actually going to get, according to this document, £5 of this rise per household and that is to do with increased business tax and corporation tax? Of course, the tax treatment up to next April has been different. Now they have to come into line with others. I do not want to go into that so much. Suffice to say there is a lot of additional revenue which is going to be made available to the Government and thus this particular pot could well provide at least some of the potential for that. Has anybody done any very rough calculations as to roughly what is likely to be the increase in revenue available to the Government in corporation tax from the water companies and thus make this additional pot of money at least a potential source to provide some of the benefits that you have outlined?

Ms Cook: I will let my colleague deal with the specifics of the business tax. May I pick up on your point about consumer reaction to council tax and other things that they find distressing or frustrating?

¹ Ev 121

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If there is the political will to do something, then money can be found. One only has to look at winter fuel payments and the fact that we are paying £2 billion in the present year to provide one-off payments to people over the age of 70, and general payments to people who receive money to help them with their winter heating allowances, to recognise that if there is the political groundswell of support for something, you can make it happen. These payments are made regardless of income and indeed regardless of residence. I am aware that some payments have been made in places like Guadeloupe and Martinique, even though people are out of the country, simply and solely because they are people who are on pensionable income. If you are able to do things of that nature because the political will is there, equally you are able to do it in terms of affordability, but you have, first and foremost, to recognise that this is a major social issue and, as water bills rise, it can only get worse.

Q186 Ms Organ: I hope you are not really advocating that as well as the winter fuel payments and the council tax help we are now going to have a water payment rate? I hear what you say, which is that the political will was there to solve the problem.
Ms Cook: No, I am not. We have not gone that route. We have said: make this income-specific; relate it to people's circumstances. We are looking for a moderate approach. We are not looking for a gold-plated service, but we are very definitely recognising that there are people here who quite clearly have an inability, not an unwillingness, to pay.

Q187 Paddy Tipping: Can I press you on one or two interesting points you made? You were talking about the working group in which Defra were the heroes of the piece but that there were some departments who were protecting their own territory. Will you name some names? Presumably the Department of Work and Pensions is on your list, and maybe the Treasury as well. Is that right?
Ms Cook: I think it would be fair to say that all members of that working group, and we were not a member of it, have their own interests to represent and arguably protect. Yes, I think it is fair to say that the Treasury has a responsibility to try to ensure that there are not increases in public expenditure. The Department and Work and Pensions is not looking for complications, they are not looking for extra work, and this has to be seen in the context of a financial inclusion agenda, but it also has to be seen in the context of needing to be quite brave when it comes to making the right decisions that will solve this problem. Not only is this potentially embarrassing; it is potentially heartbreaking for people who cannot pay their bills.

Q188 Paddy Tipping: You name two departments. Are there any more on the list?

Ms Cook: Ofwat was also a member of that group. I am not aware of anyone else.

Q189 Paddy Tipping: You were going back to 1988 when we had a basket of goods approach to benefits. That is very old-fashioned now because poverty is seen in relative terms. Suppose I was from the wicked DWP and I was saying to you, "Forget it, we are not going to go your route at all. It is too difficult. There are practical problems and, by the way, let me ask you this question directly: why should we, as taxpayers, pay for the failure of the regulator? It is up to the regulator to take into account affordability issues. Why should we let the water companies get away with it and then pay public money through the benefits system?"

Ms Cook: I think there are two points there. First of all, Government sets the overall strategic framework in which issues of affordability and social justice are addressed; it is the water industry and the regulator that have the responsibility for doing that, although one would expect the regulator to be mindful of the impact of his decisions on people who have an inability to pay their water bills. The second point in relation to the DWP is: it is all well and good to say that time has moved on and that that basket approach does not apply, provided the overall amount of money that you are paying people is sufficient to be able to cope with the fact that their water bills have increased during that period. We estimate, and again these are figures that the Chairman has requested, that by 2009-10, the shortfall in relation to those payments through the DWP will be about £530.16 million. In that respect, we have tried to do our homework. Clearly there is something that is inconsistent there that needs to be looked at.

Q190 Paddy Tipping: there is a problem here. Let us just suppose that the Government says, "We are not going to tackle this through the benefit and tax credit system. That is a no-no". What is your solution then?

Ms Cook: I think there is a range of other options that you can use to try to moderate such a significant and growing problem, but one has to be realistic and recognise you are not going to produce a solution unless you are more comprehensive in your approach. We can certainly come up with other suggestions in terms of flexible payment methods and doing things through the billing system, working with the companies, et cetera, but it is not going to make the problem go away.

Q191 Paddy Tipping: That is the limit of your suggestions?

Ms Cook: I do not regard that as being limited.

Q192 Paddy Tipping: You have a flexible payment and doing things to the billing system, and what was the third?

Ms Cook: It is working with the companies on payments methods and how they might be administered, with the assistance of the DWP.

Q193 Paddy Tipping: But that is a limited range, is it not?

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Mr Terry: At the moment, that is probably the extent to which we have looked at it. One of the dangers is that the problem is not self-correcting. It is self-billing because if there is an increase in the level of debt, funding of that debt then falls on the rest of the customer base which pays relatively more. There are various numbers being floated around, but I think I am right in saying that at this particular point in time the average customer across the country pays 8 a year to service both bad debt and cost of debt collection. If debt were to rise as a result of some of the issues that we have been identifying, that number is likely to rise. It is not self-correcting; it is a vicious circle, I am afraid. We think there has to be a way out of it. As an organisation, we have never suggested that bills should be set and the environmental programme and the quality programme in total should be set at the level that the least well off can afford to pay. That is not the way you go about it. You set the programme, as Andrea was saying, based on the best balance, but for those people who cannot afford to pay the resulting bill, it is our belief, and we believe it is your belief as well from one of your earlier investigations, and incidentally from the Environmental Audit Committee report, that there is some support needed for that type of customer.

Q194 Mr Lazarowicz: You said in your written evidence to the Committee that customers would much rather have steady price increases than what you describe as the stepped price increases proposed in the draft determination. Could you tell the Committee what your assessment of the likely impact on customers of a stepped approach to pricing would be? Does your preference for a smooth price increase result in a different price at the end of the five-year round?

Mr Terry: I think there are two questions there. The first question is: why are we concerned? If you look at a total average price increase—unfortunately I am going back to averages again—I think more than half of the customers will see something like 50% of that next year. In the first year of the price review, there is going to be a big step change. That concerns us. We think that one-off impact certainly will have an impact in terms of affordability, and perhaps, as Mr Breed was saying, even in terms of customers' willingness to pay it. That bothers us. There is a big step change in prospect in April next year.

Q195 Mr Mitchell: If there is an election in May, it should also bother the Government.

Mr Terry: I am sure that is a point you will make to Ministers. The other research is perhaps indicative research. It came out of the combined customer research which all stakeholders did at the beginning of the periodic review as well. They said they would rather see steady rises in bills rather than the peaks and troughs that we have seen in the past. It is quite interesting that if you actually look at something like the cost of insurance, you know that customers in paying their car insurance often prefer to pay it monthly, even understanding that at the end of the year it will have cost them more to pay it monthly

than if they had paid it in a slug up-front. There is perhaps a customer willingness to accept the fact that if you can smooth it then that gives you better ability to budget and perhaps they will even accept that there may be slightly higher prices at the end. It is quite interesting that in one company in the south-west in particular Ofwat actually acceded to the request of the company to smooth the profile of the bills. That has not happened in other companies.

Q196 Mr Lazarowicz: Does that mean there will be a different price result at the end of the process?

Mr Terry: I am not able to answer that directly to you. Indicatively, it would mean that because of the current prices in the south-west, and because of the prospective increase in prices, the companies said to Ofwat, "We would prefer a smoothing, even though it generates some problems for us in terms of financiality as a company and also potentially higher bills at the end".

Q197 Mr Lazarowicz: On another aspect on the position of the price profile between the reviews, you have also expressed the fear that because of the uncertainties in the current review, companies will be seeking interim determinations in a couple of years' time in the second part of this decade. How widespread do you think that approach might be taken by the companies?

Mr Terry: It is very difficult to predict forward. Could I perhaps give you some indication, Mr Chairman? We have identified 15 areas of potential uncertainty in the draft determination. Numerous schemes are currently parked. All of these things individually might be quite small but, when you start to agglomerate them, they may well go past the trigger point for interim determinations. Because of these uncertainties—and we can understand why certain of the things have been excluded but that still introduces uncertainty—we think there is potential for interim determinations. Just as an example, in the last periodic review, which is currently ending, there were 11 interim determinations. Ten companies applied, one company applied twice, so there were actually 11 interim determinations. It was a relatively benign period for the industry with, in general at the start of the process, prices falling. That suggests, we believe, that there is an inherent uncertainty. To another extent it really undermines some of the confidence which customers are likely to have in the regulatory process. They will say, "We thought prices were fixed for five years". I understand why in certain cases Ofwat cannot do it, but again we do not believe it is in the interests of customers to have this continuing uncertainty as to what is going to happen over their bills.

Q198 Mr Mitchell: There has been a bit of a mess over metering because the first fine careless rapture indicated that everybody would be metered eventually. It seems to have stalled now, and because the people who have metered have done so because they are going to get lower bills, and they are probably dirty, well off people in big houses who have installed meters, their bills are going to increase

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less than the bills of the people who have not metered. The National Consumer Council is concerned about that.

Mr Terry: As are we.

Q199 Mr Mitchell: What steps should Ofwat take to address that disparity? What can be done about it?

Mr Terry: I think there are two points here. Firstly, as an organisation, WaterVoice is looking at its policy currently on metering. We are about to pronounce on that very shortly. I think we accept that a move to further metering is both desirable and probably necessary. It is desirable because you can eventually get fairer tariffs. It is also desirable because it will put a value on water and the resource of water itself. The problem arises because of the way the tariff basket is structured. We are fast coming to the situation where you need to look at other approaches. You are exactly right, Mr Mitchell: you switch largely to a meter because you think your bills are going to be cheaper. The shortfall in revenue which the company now faces is picked up at present by the rest of the customer base. We can understand why that has happened but we think that needs to be looked at. We are going to try to do a little bit of work around that to see if we can address it. At the end of the day, it is probably going to have to be up to an organisation like Ofwat with their resources to look at alternative approaches to it to prevent this, if you like, divergence of charges within the tariff basket, which blatantly is not fair.

Q200 Mr Lepper: Could you give us some idea, if you have the information, about what proportion of customers are metered and are there big variations across the region?

Mr Terry: Yes, there are very big variations across the region. The highest metering level is in the Anglian region. We should have asked Mr Pointer.

Ms Cook: It is approximately 75% of customers nationally who are still on an unmeasured supply but it does vary from area to area. I am being told it is 54% in the Anglian area. If you take an area like Northumbria, it is more along the lines of 11 or 12%. There is quite a considerable variation but it is about 25% of customers on average who are metered.

Q201 Chairman: Can we know who the benefactor in the audience is who provided us with this singular piece of information, for the record? I am told it is the Head of Communications at Anglian Water.

Mr Terry: I do not actually have the number for Anglia but I do have the number for WaterVoice Eastern and it is slightly different to that figure. There are a number of other companies around 50%.

Q202 Chairman: Thank you very much indeed for your very useful evidence and for your written communications. One or two other points came up. No doubt you will drop us a line.

Mr Terry: Mr Chairman, briefly, do you want us to send those metering numbers?

Chairman: We would like them. Thank you.

Supplementary memorandum submitted by WaterVoice

PRESENTATION OF BILL INFORMATION

At paragraphs 8–10 of our Memorandum of Evidence (23 September 2004) we highlighted the difficulties in comparing average household bills with typical measured and unmeasured household bills.

1. Ofwat uses the average household bill as the headline figure to present the impact of price limits in the Executive Summary to its Draft Determinations document and in all its press notices.

2. In contrast typical bill figures are used only in the company specific pages (alongside average bills figures) and in the detailed explanation section of the Draft Determination document.

3. WaterVoice believes that customers find it difficult to relate the average figure to their individual circumstances. We think it would be more meaningful for Ofwat to present bill figures based on a range of rateable values in terms of unmeasured bills and based on consumption for different households for measured bills as follows:

- (a) In the company specific pages (51 to 99 in Draft Determination document) as average household bill, average unmeasured bill and average measured bill. See Annex A for a proposed layout. There would be a cross-reference to more detailed bill impact information further on in the Final Determination document.
- (b) In the section on the profile of price limits and bill (section 9 in Draft Determination document) we suggest that Ofwat replace the current Table D “Charges” in typical unmeasured and measured bills with tables that show bill impact on:
 - Unmeasured household—properties with rateable values of £100, £200, £300, £400.
 - Measured household—comprising one person (where annual water consumption is 60m³), two people (110m³), three people (160m³), four people (200m³).

See Annexes B and C for a proposed layout.

4. This would allow customers to understand how the price limits will affect the bills they pay. For example, a single householder with a meter, or someone living in an unmeasured household with a rateable value of £400, could relate to information that matches their circumstances rather than rely on the average figure quoted. WaterVoice has asked Ofwat to consider this approach in presenting the Final Determinations.

AFFORDABILITY—IMPACT OF THE PRICE LIMITS

At paragraphs 16–20 of our Memorandum of Evidence we set out the impact of price limits on customers and payment of bills.

5. The DWP Statistical Summary details the number of recipients of different benefits. In terms of means tested benefits to people who are unemployed and to pensioner, the DWP statistical summary for September 2004 shows:

- Income Support (aged under 60)—2.2 million recipients.
- Pension Credit/Minimum Income Guarantee (aged over 60) —2.5 million recipients.

6. These customers are at risk of experiencing difficulty in paying their water and sewerage bills now and this will increase in April 2005 when bills rise. In addition there will be families in receipt of Family Credit and others on low earnings who will be at risk.

7. Research shows that when faced with a number of bills or outstanding debts customers pay other bills before water bills as other creditors chase payment more frequently and rigorously than the water companies, and in the case of all other utilities have available the sanction of disconnection.

AFFORDABILITY—AMOUNT ALLOWED FOR WATER AND SEWERAGE CHARGES IN BENEFITS

8. Prior to 1988 water and sewerage charges were added into Supplementary Benefit as a separate identifiable item and based on the actual charge payable.

9. Since the introduction of Income Support in 1988 it has been impossible to identify how much DWP has included within the personal allowance of this benefit for water and sewerage charges.

10. DWP state that when Income Support was introduced an amount for water and sewerage charges was included in the personal allowance and this amount has been index linked since then.

11. In 1988–89 the average household water and sewerage bill was £108 (in nominal terms). In 1990–91 (following privatisation of the water industry the average household bill was £135 (in nominal terms). In 2004–05 the bill is £249.

12. If a figure of £108 was incorporated into the personal allowance in 1988 (to represent the level of charges at that time) and this has been used as the base figure for index linking increases in water and sewerage charges the current personal allowance of any means tested benefits cannot reflect the current bill level of £249. In the intervening period a shortfall has developed.

13. Some commentators estimate that the amount in the personal allowance for water and sewerage represents 60% of the current bill of £249, this is equivalent to £149.40 leaving a shortfall of £99.40 per benefit recipient. For Income Support and Pension Credit recipients the shortfall is in the region of £467 million (£99.40 × 4.7 million).

14. This assessment is based on the average bill in 2004–05 across England and Wales. The figures for individual water company areas will vary.

AFFORDABILITY—GOVERNMENT REVIEW—OPTIONS FOR CHANGE

At paragraphs 21–25 of our Memorandum of Evidence we set out our views on how the Government review should tackle affordability.

15. We have submitted a paper to the Cross-Government Steering Group responsible for the Government review outlining ways in which the social security system could be modified to provide help with water bills. A copy of the paper is attached at Annex D.

16. Each of the options proposed in the paper would address the regional variations in bills and would remove the need for the ineffective Vulnerable Groups regulations.

WATER DIRECT

17. Water Direct is a third party deduction from Income Support. It is a payment facility available to benefit recipients who are in arrears with payment of water and sewerage charges. DWP deduct a weekly amount equivalent to the recipient's annual bill plus £2.85 towards outstanding arrears. Once the arrears have been cleared Water Direct ceases.

18. WaterVoice (and other stakeholders) consider the scheme to be limited in its operation. Research shows that customers are generally unaware of the existence of the scheme and would welcome greater flexibility—for example to allow Water Direct on commencement of a benefit claim (irrespective of whether in arrears) or to continue when arrears have been cleared.

19. While extension of Water Direct will not address affordability by reducing the amount of an individual's bill it would help to prevent a build up of debt for an individual.

METERING

20. Details of the proportion of water and sewerage customers taking metered supplies in 2003–04 and 2004–05 are shown in Tables 18 and 19 of the Ofwat structure and charges 2004–05 Tariff Report.

21. Details of the projected number of customers who will pay by meter by 2009–10 are given at Annex E. 5 November 2004

Annex A

EXAMPLE OF HOW BILL IMPACTS DATA COULD BE PRESENTED IN FINAL DETERMINATION DOCUMENT

Water and Sewerage Company

Price limits (%)	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10	Increase to 2009–10	
							£	%
Ofwat's final determination								
Ofwat's draft determination								
Company's business plan								
Effect on average annual household bills of final determination (£)								
Average bill (water)								
Average bill (sewerage)								
Average bill (total)								
Average unmeasured bill (w)								
Average unmeasured bill (s)								
Average measured bill (w)								
Average measured bill (s)								

Annex B

EXAMPLE OF HOW BILL IMPACTS DATA COULD BE PRESENTED IN FINAL DETERMINATION DOCUMENT

Table xx Change in unmeasured household bills (£)

Company	£100 Rateable Value				£200 Rateable Value			
	2004–05	2005–06	2009–10	Change	2004–05	2005–06	2009–10	Change
	£	£	£	%	£	£	£	%
Water and sewerage companies								
Anglian								
Dwr Cymru								
Northumbrian								
Severn Trent								
South West								
Southern								
Thames								
United Utilities								
Wessex								
Yorkshire								
WaSC average (weighted)								

Table xx	Change in unmeasured household bills (£)
Water only companies	
Bournemouth & WH	
Bristol	
Cambridge	
Dee Valley	
Essex & Suffolk	
Folkestone & Dover	
Hartlepool (1)	
Mid Kent	
Portsmouth	
South East	
South Staffs	
Sutton & E Surrey	
Tendring Hundred	
Three Valleys	
WoC average (weighted)	
Industry average (weighted)	

NOTES

- Hartlepool operate a fixed charge for all unmeasured customers. Changes to unmeasured bills in Hartlepool is shown in the £200 RV columns
- Unmeasured bill = fixed charge + (rateable value of property × rateable value charge)
- % change relates to bill increase between 2004–05 and 2009–10

Annex C

EXAMPLE OF HOW BILL IMPACTS DATA COULD BE PRESENTED IN FINAL DETERMINATION DOCUMENT

Table mm	Change in measured household bills (£)							
Company	1 person household				2 person household			
	2004–05	2005–06	2009–10	Change	2004–05	2005–06	2009–10	Change
	£	£	£	%	£	£	£	%
Water and sewerage companies								
Anglian								
Dwr Cymru								
Northumbrian								
Severn Trent								
South West								
Southern								
Thames								
United Utilities								
Wessex								
Yorkshire								
WaSC average (weighted)								
Water only companies								
Bournemouth & WH								
Bristol								
Cambridge								
Dee Valley								
Essex & Suffolk								
Folkestone & Dover								
Hartlepool								
Mid Kent								
Portsmouth								
South East								
South Staffs								
Sutton & E Surrey								
Tendring Hundred								
Three Valleys								
WoC average (weighted)								
Industry average (weighted)								

NOTES

- Measured bill = fixed charge + (consumption × volumetric charge)
- 1 person household based on annual consumption of 60m³; 2 person household of 110m³; 3 person household of 160m³; 4 person household of 200m³
- % change relates to bill increase between 2004–05 and 2009–10

WAYS IN WHICH THE SOCIAL SECURITY SYSTEM COULD BE MODIFIED TO PROVIDE HELP WITH WATER BILLS

Each of the three options in this paper needs to be set in the context of a strategic framework that accepts the case for radical change to provide help through the benefits and tax credits system to customers who have difficulty paying their water and sewerage bills.

Policy changes in this area would complement the Government's social exclusion and anti-poverty agenda. It would highlight the importance of water as essential for life and health consistent with the Government's decision to ban the disconnection of water and would treat this utility bill on a par with housing costs.

A change in policy would acknowledge Government responsibility for the affordability of an essential service as a social issue. A commitment to provide targeted help through the benefits/tax credit system would be seen by vulnerable water and sewerage customers as an automatic entitlement alongside other qualifying benefits.

The introduction of more significant and targeted assistance would also mirror the support which is available to low-income and other vulnerable households who have difficulty in paying their fuel bills: all pensioner households receive winter fuel payments; access to 100% grants for improvements in energy efficiency, to reduce fuel bills and increase comfort and warmth, is also linked to eligibility for benefits and tax credits. The level of support in this area from Government is substantial.

Once there is acceptance of the principle that the process for providing help needs to change decisions will need to be taken on the extent of the assistance to be provided ie reimbursement of the customer's current weekly water and sewerage charge or only a proportion; assistance provided to all customers irrespective of whether they are metered or not. [Note: The existing Vulnerable Group Scheme provides for a capped charge for metered customers satisfying conditions on the number of children or use of water due to a medical condition and is funded through cross subsidies in the tariff basket by water customers.]

Reimbursement of the full charge for all customers in receipt of qualifying benefits would be the most effective way of meeting the Government's objective to help make water bills more affordable to those who have difficulty meeting the cost. This would also meet the EFRA and Environmental Audit Committee recommendations and match stakeholders' expectations for a more effective system to deliver help to those most in need.

This would move financial assistance away from the Vulnerable Groups Regulations (which would become obsolete) to a Water Charges Benefit contained within the benefits/tax credit system. Instead of making an additional claim to a private water company customers would receive help as an automatic entitlement when they receive the qualifying benefit. It would avoid cross subsidies in the tariff basket and placing additional costs on other water customers.

1. INDIVIDUAL ALLOWANCE FOR WATER AND SEWERAGE CHARGES INCLUDED IN QUALIFYING BENEFIT EG INCOME SUPPORT, TAX CREDITS

Changes required

- (i) identify notional amounts allowed for water and sewerage in the personal allowance of qualifying benefits for normal day to day living expenses;
- (ii) remove the element for water and sewerage charges from the personal allowance;
- (iii) add to the qualifying benefit assessment a new allowance equivalent to the current amount for water and sewerage charges payable by the individual customer (as happens for other housing costs such as mortgage interest). This mirrors the assistance provided under the former Supplementary Benefit scheme and is designed to reflect the differing amounts payable in water and sewerage charges across England and Wales; and
- (iv) pay the amount for water and sewerage charges direct to the relevant water company (in the same way that mortgage interest is paid by DWP to the bank or building society).

Water Direct—third party deduction for arrears only would need to continue but administration could be tied into payment above.

Advantages

- meets EFRA and Environmental Audit Committee recommendations to provide support through the benefits and tax credit system and takes account of regional variation in bills;
- demonstrates Government ownership of social responsibility and commitment to provide help to people on low incomes through the benefits and tax credit system;
- recognises the importance of water as essential for life and health;

-
- customers claim as an automatic entitlement alongside qualifying benefit—one stop shop for claim for help and less stigma attached;
 - simple to administer;
 - help could be available to all customers (measured and unmeasured) who qualify on low income grounds;
 - prevents build up of water debt;
 - no additional cross subsidies in tariff basket or additional costs to other water customers;
 - removes the need for Vulnerable Groups Regulations (regarded as ineffective);
 - long term viability and transparent; and
 - potential savings on administration of Water Direct.

Likely difficulties

- Government funding required to make up difference between notional amounts allowed for water and sewerage charges and actual charges paid by individual customers—HMT/DWP resistance.
- Reassessment of personal allowance—DWP/HMT resistance.
- Some additional administration by DWP.

2. VOUCHER/PASSPORT ISSUED ON ENTITLEMENT TO QUALIFYING BENEFIT

Changes required

Qualifying benefit personal allowance (for normal day to day expenses) includes an element for water and sewerage charges—would need to identify and remove to avoid duplication of payment. Voucher/passport would cover customer's current amount for water and sewerage charges.

DWP to issue voucher/passport for water and sewerage charges to customer/relevant water company on entitlement to qualifying benefit (as happens for Council Tax).

Water Direct—third party deduction for arrears only would need to continue.

Advantages

- meets EFRA and Environmental Audit Committee recommendations to provide support through the benefits and tax credit system and takes account of regional variation in bills;
- demonstrates Government ownership of social responsibility and commitment to provide help to people on low incomes through the benefits and tax credit system;
- recognises the importance of water as essential for life and health;
- customers claim as an automatic entitlement alongside qualifying benefit—one stop shop for claim for help and less stigma attached;
- simple to administer;
- help could be available to all customers (measured and unmeasured) who qualify on low income grounds;
- prevents build up of water debt;
- no additional cross subsidies in tariff basket or additional costs to other water customers;
- removes the need for Vulnerable Groups Regulations (regarded as ineffective);
- long term viability and transparent; and
- potential savings on administration of Water Direct.

Likely difficulties

- Government funding required to reimburse water companies for voucher/passported charges—DWP/HMT resistance.
- Reassessment of personal allowance—DWP/HMT resistance.
- Some additional administration by DWP.
- Some additional administration by water companies to claim recovery from Government (but offset against savings in debt recovery costs).

3. WATER CHARGES BENEFIT (AKIN TO COUNCIL TAX BENEFIT)

Changes required

Treat water and sewerage charges as a housing cost akin to Council Tax.

Local authorities to extend Council Tax benefit applications to cover water and sewerage charges through a water charges benefit (promoted by Water UK).

Basic living allowances for Council Tax benefit includes a notional amount for water and sewerage charges—need to identify and remove to avoid duplication of payment.

Local authorities issue certificate to water and sewerage companies who claim reimbursement from Government.

Water Direct—third party deductions for arrears only would need to continue.

Advantages

- could be operated in conjunction with 2 above. For those who do not qualify for income support etc. (Council Tax relief is available to wider audience);
- meets EFRA and Environmental Audit Committee recommendations to provide support through the benefits and tax credit system and takes account of regional variation in bills;
- demonstrates Government ownership of social responsibility and commitment to provide help to people on low incomes through the benefits and tax credit system;
- recognises the importance of water as essential for life and health;
- customers claim as a right alongside Council Tax benefit—less stigma attached;
- help could be available to all customers (measured and unmeasured) who qualify on low income grounds;
- no additional cross subsidies in the tariff basket;
- removes the need for the Vulnerable Groups Regulations (regarded as ineffective);
- prevents build up of water debt;
- long term viability and transparent; and
- potential savings on administration of Water Direct.

Likely difficulties

- Government funding required to reimburse water companies for charges covered by water charges benefit entitlement alongside Council Tax benefit—HMT resistance.
- Reassessment of personal allowance—HMT/local authorities resistance.
- Increased administration by local authorities—likely to resist.
- Some additional administration by water companies to claim recovery from Government (but offset against savings in debt recovery costs).

WaterVoice Secretariat

August 2004

PR04: DRAFT DETERMINATION (DD)

Household metering activity

Co.	<i>Ofwat's Optional Metering Assumptions</i>					<i>Compa- nies' FBP</i>	<i>Selective Metering</i>		<i>% metered at end of AMP4</i>	
	<i>2005-06</i>	<i>2006-07</i>	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>		<i>DD</i>	<i>FBP</i>	<i>DD</i>	<i>FBP</i>
ANG	19,887	36,158	51,546	65,478	77,980	127,429	0	—	62	65
WSH	24,670	48,540	71,630	93,980	115,600	115,600	2,500	2,000	32	32
NNE	16,200	32,400	48,500	63,500	78,500	78,500	0	—	21	21
SVT	22,524	45,040	66,742	87,623	108,693	125,100	0	8,700	31	32
SRN	10,758	21,159	31,216	40,944	50,356	50,356	62,968	62,968	43	43
SRN	10,758	21,159	31,216	40,944	50,356	50,356	62,968	62,968	43	43
SWT	27,676	52,044	74,063	94,273	112,823	108,650	0	—	66	66
TMS	10,990	23,445	36,584	49,814	62,770	64,218	49,282	57,175	27	27
U UW	40,065	77,623	116,361	157,098	200,659	201,726	750	375	27	28
WSX	9,000	18,000	27,000	36,000	45,000	45,000	1,980	1,940	45	45
YKY	21,069	43,432	66,145	89,046	111,102	120,000	0	—	35	35
BWH	2,040	3,990	5,840	7,580	9,220	8,000	17,860	17,700	55	55
BRL	4,377	8,403	12,030	15,375	18,511	18,511	2,000	—	30	30
CAM	1,150	1,996	2,737	3,371	3,900	7,248	75	55	59	62
DVW	1,971	3,860	5,703	7,489	9,156	10,360	0	—	43	45
ESK	7,000	13,400	19,500	25,800	31,700	31,700	37,839	35,700	47	47
FLK	1,168	2,184	3,071	3,847	4,528	4,528	12,174	12,849	65	66
MKT	3,029	5,961	8,795	11,531	14,170	14,500	5,630	5,500	40	40
MSE	3,500	7,000	10,500	14,000	17,500	17,500	13,750	13,750	38	37
PRT	1,535	3,201	4,968	6,959	9,014	10,700	750	750	12	12
SES	1,500	3,000	4,500	6,000	7,500	7,500	5,000	5,000	26	26
SST	3,242	6,484	9,726	12,968	16,210	13,211	250	250	21	22
THD	985	1,932	2,843	3,720	4,563	4,560	0	—	68	68
TVN	14,488	28,214	41,457	53,896	65,624	92,500	135,176	108,300	44	43
Totals	248,824	487,466	721,457	950,292	1,175,079	1,277,397	347,984	333,012	36	36

- Notes:
1. Optional metering figures taken from Annex A in companies' Draft Determination letters (4 August 2004). These are cumulative.
 2. Selective metering figures taken from Table 1 in companies' Draft Determination letters (4 August 2004).
 3. Final Business Plan (FBP) totals derived from Table D5 in companies' FBPs.

Memorandum submitted by the Environment Agency

SUMMARY

- Periodic reviews of the water industry have enabled England and Wales to meet EU and domestic legal obligations. The clean up of rivers and bathing waters has provided benefits for regeneration, recreation, tourism and nature conservation. Notwithstanding the environmental successes, it is timely to look at this periodic review process, in the context of the future challenges the industry faces. In our evidence we have focussed on the lessons learned and what may need to be done for the future.
- The environment programme for the current review, proposed by the Agency in conjunction with English Nature (EN) and the Countryside Council for Wales (CCW), has been scrutinised rigorously and transparently through technical and economic analysis. It will continue the process of bringing significant economic, social and environmental benefits, as well as ensuring the country and water companies meet their legal obligations.
- Ofwat's draft determinations have confirmed that there was scope to challenge the costs proposed by water companies in their draft and final business plans for delivering the environment programme. This is in line with every previous price review and is what we predicted in evidence to the Committee's 2003 inquiry into Water Pricing.
- We are disappointed that the draft determinations have excluded some of the schemes we proposed, which are required to meet the environmental obligations and policies required by the Government's principal guidance on the 2004 Periodic Review. The Agency will issue permits requiring the improvements to water companies' assets to be delivered by 2010 whether or not companies consider them to be funded.
- Further, Ofwat's proposed Change Protocol for AMP4 appears to invite companies to challenge the funded environment programme, and provides insufficient flexibility for changing commitments between periodic reviews, without recourse to lengthy appeals processes. We believe the approach will disadvantage the environment.
- We are also disappointed in the way Ofwat has presented the impact of environmental improvements on the overall increase in bills. The environment programme they propose is only 20% of the capital programme, but Ofwat have presented their estimate such that it contributes £20 of the proposed £33 rise in customers' average household bills.
- We believe that demand management should play a bigger part in meeting companies supply demand balance. However, the present funding system and the draft determinations fail to encourage companies to follow this approach.
- The draft determinations focus on the next five years. We need a strategic approach to sewerage that matches that for water resources. This will help ensure that the water companies' infrastructure can contribute to environmental improvements and cope with increased growth, climate change and allow better planning in the context of the Water Framework Directive's requirements and priorities.
- While we recognise that there are issues of commercial confidentiality, in future reviews we believe that more information could be placed in the public domain, more consistently. We believe this will be necessary to assess the water industry's future contribution to delivery of Water Framework Directive requirements and to meet the requirements of the Water Act 2003.
- Given the long term challenges that face the water industry we recommend that Government reviews those elements of directing the flow that relate to the water industry to strengthen the requirement for longer term planning framework for the industry.

1. INTRODUCTION

1. A clean environment and good water supplies are vital to our health, quality of life and economic well-being. 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 regeneration, recreation, tourism, and nature conservation. Notwithstanding the environmental successes of the water industry, it is timely to look at this periodic review, in the context of the future challenges the industry faces. Water companies must continue to meet existing and new laws and standards, and to meet the future needs of all water users in a sustainable way. In our evidence we have focussed on the lessons learned and what may need to be done for the future.

2. River quality has improved significantly since 1990, but one in 19 are still in "poor" or "bad" condition. Further work to improve the environment is still needed, for example over half of rivers in England and Wales have high levels of phosphorus.¹

¹ 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.

3. The Agency, jointly with EN and the CCW, proposed a programme of environmental improvements supported by an assessment of the costs and benefits. The scope, costs and benefits of the programme have been carefully scrutinised. This included the recent inquiry by the Environmental Audit Committee.² Virtually the whole of the environment programme required by the Secretary of State's Principal Guidance³ is required is to meet minimum legal obligations.

4. Water companies have submitted long-term water resources plans to the Agency. These set out how companies plan to provide sufficient water while protecting and enhancing the environment. The plans were part of the companies' business plans sent to Ofwat. Drafts were submitted in August 2003 and final plans in April 2004.

5. The Secretary of State also gave guidance on the supply-demand balance. This outlined her expectations for companies to control leakage and manage water demand, taking account of possible impacts from climate change.

6. We estimate that the environment programme required by the Principal Guidance will bring benefits to England and Wales equivalent to £3.1 to £5.6 billion over the next 25 years. This is equivalent to £10 to £18 per household per year. These benefits include the value to current and future generations of improvements to recreation and fishing. They include reductions in illness (for example, stomach upsets) from improvements to bathing waters, and reductions in the risks of damage to ecosystems and natural habitats. They do not include any benefits which improved water quality brings for inward investment and regeneration.

7. The views of customers have also been sought as part of the 2004 Periodic Review. Market research⁴ showed that nationally for the environment, 87% of bill payers believe it important to maintain current services; over 70% think it important to improve them. Nationally, more people were "definitely" or "probably" willing to pay for improvements to a range of services and enhancements than are not.

2. DRAFT DETERMINATIONS

8. Ofwat published draft determinations on 5 August 2004. These set challenging price limits, requiring companies to deliver an improved service while ensuring household water bills do not rise too steeply.

The Environment Programme

9. Just 20% (£3.2 billion) of the £15.7 billion capital programme assumed by Ofwat is for the environment programme. £8.1 billion is for maintaining the assets and £2.1 billion for supporting the supply demand balance. We have worked with Ofwat to scrutinise the companies' final business plans, and as a result the costs of the environment programme have come down as we expected. We are continuing to provide advice to Ofwat in preparation for the final price determination in December.

10. We are pleased that most of the statutory and discretionary programme has been funded, including investigations into how to stop sewage effluent causing sex changes in fish. Also included are improvements to sewage works along the Thames Tideway.

11. As required by Principal Guidance we have kept the programme under review and have made some changes to proposals for a small number of schemes. However, we are concerned about a number of the schemes that Ofwat does not propose to fund, which include those to:

- Enable bathing waters in the South West and on the Fylde Coast to meet minimum EU standards;
- Meet minimum standards of the Freshwater Fish Directive in the Manchester Ship Canal, the River Tame in Birmingham; the River Aire in Yorkshire from the effects of pollution from storm sewage discharges;
- Control sewage debris from storm sewage discharges Penrith, thereby meeting the requirements of the Urban Waste Water Treatment Directive.

Nor has provision been made by Thames Water or Ofwat for work on a long-term solution to the deficiencies of London's Victorian sewerage system, the effects of which were so strikingly demonstrated by the pollution of the Thames Tideway on 4 August 2004. However, the exact detail of how Ofwat have dealt with schemes in the environment programme in draft determinations is confidential to Ofwat and companies but have been shared with the Agency under a confidentiality agreement.

² House of Commons Environmental Audit Committee. Water: The Periodic Review 2004 and the Environmental Programme. HC416.

³ Principal guidance from the Secretary of State to the Director General of Water Services. 2004 periodic review of water price limits. Defra, March 2004.

⁴ Commissioned jointly by officials from Defra, Welsh Assembly Government, Ofwat, WaterVoice, the Environment Agency, English Nature, the Drinking Water Inspectorate, Water UK and the Wildlife and Countryside Link.

12. If Ofwat do not fund companies to deliver these schemes the Agency will issue permits requiring the improvements to ensure that companies meet their legal obligations. This will lead to uncertainty for companies, and lengthy appeals for additional funding through Ofwat's Change Protocol (see paragraphs 14 and 15).

13. Lack of funding for statutory schemes will increase the risk of infractions by the European Commission. In September, the Agency took the first step to implementing the Water Framework Directive, which will require a high level of partnership between regulators and water and land managers. We are very concerned that we will enter this new phase of management of the water environment with a number of case by case appeals about permits and funding.

Change Protocol

14. With draft determinations Ofwat have set out their proposals for a change protocol, which is how companies will seek funding for changes to their programmes between price reviews. There may be good reasons for changes between reviews, such as investigations to clarify the actions required to meet a statutory deadline that applies between reviews, or to meet new obligations. A number of basic principles have been accepted by Government in setting the current environment programme, that is where action is required for statutory purposes, it has to be done, while ensuring that the most cost-effective solution is found. Where there is a choice then cost-benefit analysis is required, carried out in accordance with good practice as set out by Treasury. These are not the principles set out in the Change Protocol.

15. We understand the need to provide stability for customers and certainty for companies. However, we are concerned that as proposed the document would appear to invite companies to challenge the funded environment programme, using criteria that are significantly different to the Government's approach to the periodic review. Further that the document allows insufficient flexibility for changing commitments without recourse to a lengthy appeals process.

Supply Demand Balance

16. We published our advice to Ministers on companies' final water resources plans in July 2004.²⁵ Ofwat has assumed in its price limits that companies can meet demand from 2005 to 2010, in a way that is consistent with delivering their water resources plans. We expect companies to implement the appropriate actions in their plans. Ofwat's draft determinations provide only a summary so stakeholders cannot be certain whether all parts of the water resources plans, which are designed to secure water supplies for customers, are funded. Lack of funding does not remove from companies their duty to provide adequate security of supply to their customers and carry out work to ensure long-term security of supply. We expect companies to follow their water resources plans.

3. TAKING ACCOUNT OF FUTURE ENVIRONMENTAL PRESSURES

Water Resources

17. Companies plan to meet increased demand from both household and non-household customers in their water resources plans. We believe that the plans underestimate the role that demand management can play over the next 25 years to meet the twin track approach to supply demand balance. We want to see new developments at the forefront of good practice for water efficiency and demand management and we expect to see appropriate funding provided. This is of particular importance for the major housing developments proposed for the south east of England. We believe that funding should be provided for water companies to investigate properly the options for meeting and managing demand as well as developing new resources. Without proper studies and trials into the savings that can be achieved through water efficiency we risk companies' plans becoming even more dominated by resource development that may in the longer term, prove to be inflexible, expensive and unnecessary.

18. Most companies made an estimate of the effect of climate change on their water resources plans. Some believe the impact can be managed within existing plans. Others have suggested that it could have a serious effect. These companies must carry out more detailed analyses over the next few years. It is not clear whether the studies of climate change have been funded in the draft determinations.

19. Water resources schemes needed to protect the environment were included within companies' supply demand balances where the actions required of the companies were clearly defined. This enabled integrated and cost-effective solutions to be developed by companies to meet both environmental requirements and increased demand. Only a small number of schemes, which have clearly defined actions, are included in the draft determinations. As more clarity becomes available once investigations are complete and the environmental requirements known, companies may need to revise all or part of their water resources plans,

⁵ Environment Agency. Maintaining water supply. July 2004.

during the 2005 to 2010 period, because the solution may not be optimal. In order to comply with the requirements of the Habitats Directive and other statutory drivers it is essential that companies progress schemes urgently.

Sewerage

20. The sewerage systems of the water and sewerage companies provide three services:

- collection and treatment of customers' foul water;
- collection of customers' surface and roof water; and,
- drainage of highways and adjacent surface water runoff.

21. These interact because many sewerage systems combine foul water and surface water drainage. In this periodic review, business plans contained plans for various aspects of the sewerage network, including addressing sewer flooding, improving unsatisfactory storm sewage discharges, capital maintenance, and plans for increased growth. But it is for companies to decide how they manage these plans.

22. Most of the emphasis of these plans in this periodic review is directed at short-term solutions (the next five years), and would not allow for the potential increase in storm run-off caused by climate change.

23. We welcome the recommendations of the report by the National Audit Office⁶, which called for the industry to develop integrated sewerage plans. Further, the recent Government consultation "Making Space for Water" sets out how the sewerage system could be better integrated with the management of urban drainage. We now need a strategic approach to sewerage that matches that for water resources.

4. HOW THE REVIEW WAS DONE

24. There were some areas where the 2004 Periodic Review worked well: the main stakeholders undertook joint market research; and we worked closely with Ofwat and water companies on the development of the framework for water resources plans (which in this review formed an integral part of business plans).

25. As noted by the Environmental Audit Committee⁷ much of the scrutiny of the periodic review falls on the environment programme. We are disappointed in the way Ofwat has presented the contribution of environmental improvements to the overall increase in bills. The environment programme is only 20% of the capital programme, but is presented by Ofwat as contributing £20 out of a total proposed £33 rise in customers' bills. Table 1 shows how the capital cost of the environment programme, and the way the contribution to bills has been presented, has changed during this periodic review.

Table 1

COMPARISON OF THE COST OF THE ENVIRONMENT PROGRAMME WITH BILLS

	<i>Cost of Environment Programme (£ billion)</i>	<i>Water industry/Ofwat analysis of how much bills will rise between 2005 to 2010 (£)</i>	
		<i>Environment</i>	<i>Total</i>
Draft Business Plans*	5.3	26	72
Final Business Plans	4.6	20	70
Draft Determinations	3.2	20	33

* Although the scope of the scope of the environment programme costed by companies have changed—Companies' preferred strategies did not include the full programme of schemes required by Principal Guidance and Final Business Plans reflect Principal Guidance—it illustrates the change in cost and impact on bills as PR04 has progressed.

26. We believe that the public and decision-makers have been given an unfair impression of the cost burden of environmental improvements on customers.

27. The draft determinations have demonstrated, as we stated to this committee in 2003⁸ that there was significant scope to challenge the companies' costs for delivering environmental improvements. In Philip Fletcher's open letter to the Secretary of State on 18 December 2003, he states "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". Table 1 above shows that the cost of the environment programme has fallen

⁶ "Out of sight—not out of mind". Ofwat and the public sewer network in England and Wales. National Audit Office report, January 2004, HC161.

⁷ House of Commons Environmental Audit Committee. Water: The Periodic Review 2004 and the Environmental Programme. HC416.

⁸ See summary of Environment Agency Memorandum of Evidence. EFRA Select Committee Inquiry into Water Pricing. 2003.

significantly between draft business plans and draft determinations yet in the draft determinations,⁹ Ofwat still states “there is no evidence that an apparent systematic bias towards overestimating the costs of improvements has been corrected by the industry.” It is essential that in future price reviews decision-takers have reliable costs as early as possible in the process.

28. We are also concerned about the transparency of the process. While we understand the need to maintain commercial confidentiality, much of the detail on how environmental schemes (and other aspects) have been treated by Ofwat and companies in draft determinations is confidential. There is a lack of consistency about how much information is made publicly available by companies in their business plans. While respecting the commercial confidentiality, we do believe that more information could be placed in the public domain in a more consistent manner.

29. Companies plan their supply demand balance for the next 25 years. Emphasis in the price limits is for the next five years. As a result, long-term funding for measures of demand management suffer compared with resource development. This is because it is hard to demonstrate under these conditions that demand management has an immediate monetary cost-benefit.

30. The price-setting system struggles to cope with options that may prove essential in the long-term, but which are without clear-cut cost-benefit advantages now. We believe there needs to be more scope for long-term policy in price determinations. At the moment, customers benefit from the investment of past generations in the capacity of the infrastructure but we may not be investing enough for future generations.

31. In November 2002, the Government published its priorities for policy on the water in England.¹⁰ In the light of the experience from this review we think that there is scope for a review by Government of its priorities for the water industry in preparation for the next periodic review.

5. BEYOND THE 2004 PERIODIC REVIEW

32. The water industry faces challenges. The price review process needs to change to meet these. We should encourage long term planning and ensure sufficient flexibility to allow for new circumstances between reviews.

Housing

33. We believe that pressure for new housing is a significant threat to the water environment, both through the demand for water, and from pressure on the capacity of the sewerage system and sewage treatment works. The water resources plans allow companies to take account of the longer-term pressures on demand for water. However, for sewerage the emphasis is on short-term solutions for the next five-years.

Water Framework Directive

34. The next periodic review will need to take account of the requirements and timetable of the Water Framework Directive. The Directive has four objectives:

- achieve good ecological status;
- prevent deterioration in status;
- promote efficient and sustainable use of water; and,
- prevent increases in the level of treatment required for drinking water.

These will drive some investment by the water industry and other sectors in future.

35. The Directive sets out the process and timetable by which decisions will be made. The Programme of Measures will be published by December 2009, and operational before 2013. This will include the action by the water industry that will be funded in price reviews. Objectives will be reviewed every six years until 2027. In order to ensure the right decisions are made for the water industry, it will be necessary to have information at the right stage in the planning cycle of the Directive. A means will need to be found whereby the costs of water industry actions can be presented and compared with other options as part of an open process of decision making.

Climate Change

36. Climate change¹¹ has implications for how we manage our water resources and the associated environment. The scenarios suggest that by the 2080s:

- winters will be warmer and wetter, with more intense periods of rainfall;

⁹ Page 130. Future Water and Sewerage Charges 2005–2010. Draft determinations. Ofwat, 5 August 2004.

¹⁰ Directing the flow. Priorities for future water policy. Defra 2002.

¹¹ Climate Change Scenarios for the United Kingdom. The UKCIP 2002 Scientific Report. Hulme et al 2002 Tyndal Centre for Climate Change.

- summers may be warmer and dryer, especially in the south east; and,
- extreme events such as heavy rain and coastal storm surges will be more frequent.

37. While the evidence is not sufficient to justify investment now, investigations by companies are needed to look at the implications of climate change on water supply and sewerage systems. We would like to see companies consider a full range of possible responses to climate change, including demand management, rather than just engineering solutions. We are undertaking a new research project with UKWIR to ensure climate change is considered adequately in the next periodic review.

Sewerage Systems

38. Flooding from sewers is generally a mix of raw sewage and storm water. It occurs where there is inadequate capacity (for example to handle summer storms), or where the system cannot operate properly due to surface water flooding.

39. We believe that companies should take a more strategic approach to the planning of urban flood risk management, so that a clear understanding is formed of the sources of risk and the most effective solutions. Integrated urban drainage plans would help achieve this. This aspect is considered in the current Government consultation “Making Space for Water”.

Water Resources

40. Under the Water Act 2003, the water resources plans of the water companies are statutory. The next plans will be submitted to Ministers. We envisage that the technical basis of these plans will be in line with the present process. The main change will be the need for public consultation on the draft plans.

41. If there are objections to the draft, Ministers may hold a public inquiry to allow them to be heard. We look forward to seeing the same level of openness by companies with other aspects of their business plans. We look to Ofwat for more transparency in what is included in the determinations.

SUMMARY OF FUTURE CHALLENGES

42. To meet the challenges of new housing, the Water Framework Directive, climate change and sewer flooding, changes are needed to future periodic reviews:

- to ensure expectations of Ministers and legal obligations are reflected in price determinations;
- to accommodate increased uncertainty there needs to be sufficient flexibility to allow for changes between reviews;
- timetables should be synchronised to reduce uncertainty and to allow for European obligations;
- to improve the companies’ approach to managing demand for water;
- to reflect long-term policy aims and encourage a move away from short-term measures; and
- planning for the next review needs to start now to make sure that the current process is improved.

28 September 2004

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

Q203 Chairman: Can I welcome you both. Baroness Young, you were before the Committee yesterday and we are very grateful that you have been able to find time to come back and see us again. In your very helpful summary of evidence you say, “We are disappointed that the draft determinations have excluded some of the schemes we proposed, which are required to meet the environmental obligations and polices required by the Government’s principal guidance on the 2004 Periodic Review. The Agency will issue permits requiring the improvements to water companies’ assets to be delivered by 2010 whether or not companies consider them to be funded.” It is a sort of disappointment on the one hand but a “get on and do it” on the other hand. Does that raise in your minds issues about the effectiveness of the way in which this review has been conducted? It would be very interesting, in the

context of that interesting paragraph which I read out from your evidence, to know what your impressions have been about the way that this particular exercise has been carried out. Is it better this time than it was last time, notwithstanding your comment?

Baroness Young of Old Scone: I think we should say from the outset that there are some things that have gone much better this time than they went last time. For example, the joint market research that WaterVoice also referred to I think was a major step forward, as indeed was the work that happened between Ofwat and the companies themselves on getting water resources plans into the process and making sure that water resources plans flowed through into the companies’ business plans. I think that was a major step forward, as was the work, though it was rather late, with Ofwat to challenge the

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costs of schemes that resulted in some of the reduction in the total cost of the programme. I think those things went better. There is the fact that we have arrived at the end of the process with a substantial size of environment programme. Though it is smaller than the previous two settlements, nevertheless a substantial number of schemes that we believe should have been funded are not funded, but there is still further work between now and the final determination on many of these schemes to see whether we can reach a point where they can be brought back into the programme. That does highlight some issues that we believe need to be corrected in any future process. Perhaps I could run through some of the things that we think need to be better in the process. Clearly the issue of cost reductions came quite late in the day and therefore it was quite difficult for the Minister to adequately frame his principal guidance, since he did not really know what the full and proper costs were of the guidance he was going to give. That has resulted in us, with the Minister's support, saying that we will alter the permit requirements for companies to reflect the totality of what the Minister had in the principal guidance, because we believe those are the basic environmental requirements that need to be delivered during the period of a review. We will have to go ahead with those changes if we are going to comply with European legislation and to meet the mandatory requirements for the environment. The cost issue was a factor. I think there are a number of other things that we would like to see differently. There was a huge nervousness about affordability, and you have had a very long discussion about it. I should say that affordability was about a range of issues, not just the environment programme, though it was very much laid at the door of the environment programme for a period at least during the review. We would like to make the point that moves towards universal metering, or near universal metering, would allow a much more sophisticated approach to charging customers through the tariffing system. Though metering is going up and there is some money for metering in the price settlement, nevertheless, it is only going to improve by 2% per annum, which is really a very slow rate. We are not going to be close to satisfactory levels of metering very fast at that rate. One of the last issues that we would like to make refers very much to the point you made about our clarity as a result of the ministerial guidance. For future reviews, apart from issues like transparency and taking a much longer term approach and a whole variety of things about timing, we believe that one of the key things is that there is a real clarity of roles. We must be careful about the roles that are supposed to operate. As the environmental regulator, we put forward the objectives for the environment; the Minister takes a view about those and decides what needs to be included in the programme, taking account of a whole range of issues, including the political issue of affordability. The economic regulator is there to make sure that those programmes are delivered at the most cost-effective level and that the companies can finance their operations. I think in the review

this time we have, from time to time, reached a point where the economic regulator has begun to take environmental decisions *de facto*. We are particularly concerned about that in terms of a further feature of the final determination, which I do not think has been touched on so far, and that is the protocol that the economic regulator will announce with the final determination for what is going to happen to all those schemes on which decisions need to be made during the next five years. That changes the rules of the game completely and I think significantly diminishes our role and diminishes the role of the Minister, and certainly changes the rules about schemes that are driven by the statutory drivers of environmental requirements coming from Europe and enshrined in UK law in that they are not simply going to be judged on how that can be delivered in the most cost-effective way but they actually say: are we really going to deliver them? Is there a cost benefit case for this environmental improvement happening at all? That is a very different kettle of fish from the way the rules of the current price determination are done. We are concerned about that protocol for the interim determinations of the future. There is a multitude of other changes we would like in the system. We will be doing some work with the economic regulator, but also on our own behalf, to look at the changes we would want to feature in the whole way that the next review is conducted.

Q204 Chairman: So a bit more objectivity and a little less horse trading?

Baroness Young of Old Scone: It is always going to be a horse-trading process because, as you have heard, it is a big political issue of great concern to people; it is a big chunk of money and it is a big chunk of environment, the biggest single environmental programme at all of any of the bits of policy that we have around on the environment at the moment. It is always going to be hotly contested but I think we do need to have clarity of roles and, at the end of the day, alas, the poor Minister has to be the one who stands up and is counted in terms of the environment programme.

Q205 Chairman: One thing that worries me is this. You have laid out a series of unavoidable environmental agendas. You did not name them but it was implicit in what you were saying. The point that I put to the companies earlier on is that they have a pretty shrewd idea of what, in the nicest sense, the customer can bear. It is surprising that they do not start from the point of view of how much does what the customer can bear generate in revenue and then break it back within the business to what can that revenue buy, to take into account those obligations which they have to fulfil. Therefore, by definition what is left can do some of the things that you can prioritise. What is the process is bottom-up? The company starts off against a background of some initial guidance and puts up a big shopping list knowing it is going to be hacked back. That does not strike me as entirely rational. I want to move on to transparency issues briefly because, in paragraph 11

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of your evidence, you make a point here in the context of commenting about London and the efficiencies of the Victorian sewerage scheme. You say: "However, the exact detail of how Ofwat have dealt with schemes in the environmental programme in draft determinations is confidential to Ofwat and companies but have been shared with the Agency under a confidentiality agreement." What information, more so than is at present, do you think ought to go into the public domain? What information would you have liked to have had that you have not had and what are the gains to the greater transparency? I am still struggling a little bit to understand what is so confidential, particularly about the ways of meeting the environmental programme. I can understand from the point of view of those companies where, on the industrial supply side, there may be people who are competing with them to supply water. I can understand that. Here we have: how do you deal with environmental issues? This is dealt with under "commercially confidential". Perhaps you could shine a bit of light into this?

Dr Skinner: Certainly, and I will do so in two contexts: the situation now and as it would pertain to future price rounds. These are not rules that we make. We have found it very difficult when talking to our interest groups around the regions to explain to them what the consequences of the draft determinations are because, although we know under privy information from Ofwat what schemes are funded, parked or minded not to be funded, that is not public information.

Q206 Chairman: Let us just stop there because you are putting up a fog for me. You talk about schemes that are parked. You know about the schemes. Help me to understand it because I do not.

Dr Skinner: In the draft determination, which was published in August, the Director General effectively classed all the environment programmes into three categories: those which he did not want to fund and was not minded to; those which he had problems with; and those which he accepted on ministerial advice and our advice could go forward.

Q207 Chairman: Are the ingredients of those three areas confidential?

Dr Skinner: The contents of those three categories are not in the public domain.

Q208 Chairman: Here we have a public servant who has made a judgment within categories of environmental programme as to what he is prepared to allow the water companies to spend money on or not. Do some of them fall into the category of statutory obligations?

Dr Skinner: They most certainly do.

Q209 Chairman: Why does Mr Fletcher decide he is going to be judge and jury when, either at European or national level or ministerial level, there has been a determination that something will or should

happen? You are telling this Committee that Mr Fletcher effectively is saying there are some things that he says will not happen.

Dr Skinner: In his draft determinations he has said they are something that might not happen. In his defence, although we do see this as a problem, there is a search for further information from the companies on some issues. Sometimes companies have not provided a good defence for their scheme or their cost.

Q210 Chairman: Coming back to the programme, if he has a list of things which are in the three categories, why is he unwilling to make those public? What is so secret about them?

Dr Skinner: That is a question you ought to ask him.

Q211 Chairman: What do you think it is? The next question I want to ask you is: what are they?

Dr Skinner: We do not think it is a good idea, and indeed quite often the companies whose information it is have made that available under their own aegis but it is not part of the defined process.

Baroness Young of Old Scone: One thing is going to have to change for the future because water resources plans are going to be statutory in future and will have to be consulted about, so that part of it is going to have to be in the public domain. I think also one of the things we would like to see in any future process is a much greater standardisation of what the companies have to put into the public domain. Some of the companies were very open and did put a lot of information into the public domain and others did not.

Q212 Chairman: Let me probe this a bit. I do not want to put you into the difficult decision of having to break confidences that have been shared with you. I think there are dangers in doing that. Give me your view as somebody who knows what is on this list: what would be the consequences, in your judgment, if all of that information was in the public domain?

Baroness Young of Old Scone: We have had this discussion with the economic regulator and my understanding of his concern—and I may be misquoting him—is that if all of the array of capital schemes in the environment programme were in the public domain, people who wanted to make investment decisions anticipating his settlement would be able to begin to guess at what his settlement was and, since that is share price sensitive, that would be unfair on the market. Only he can judge that. I cannot judge that; I am not sufficiently financially expert to be able to judge that. It is quite a bit chunk of these settlements but not the totality. It is probably the bit that is most unpredictable, unless you have insider information. This would be tantamount to insider information. He gives us pretty hard grief if we even look as if we are going to leak any of this.

Dr Skinner: Could I make a point, Chairman, about taking that forward into the next price review because the next price review will be intimately linked with the Water Framework Directive. The Water Framework Directive is, as you have heard

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from a number of your witnesses today, a cross-sectoral issue where one has to make in river basin plans decisions about whether it is a diffuse pollution scheme affecting farmers or a water company scheme or something affecting drainage in urban areas. Unless all those sectoral plans have an equivalent level of transparency, the Agency as ring-master of the Framework Directive, and the public, whom we are obliged to consult, cannot possibly have any clear idea about the issues. We think it is a position that has to change. It has been a struggle this time but it is going to be fatal for future price rounds.

Q213 Chairman: I can understand what I might call the “things that I would like to do because I would like to make an improvement” approach as opposed to “the things that result from water framework and other similar statutory obligations”. If you are going to explain this process to people, you have got to understand the universe of the interior in which it operates. The fact that a regulator is making decisions in secret about things which various elected and other statutory bodies have said ought to happen is concerning. I think the Committee may well wish to probe the regulator further on some of these matters. As I say, my task is not to put you into the embarrassing position of disclosing to us that about which you have been sworn to secrecy. I am going to conclude on that programme.

Baroness Young of Old Scone: There is one other point. If we are blowing the gaff on schemes, I think the most difficult one that is omitted is the Thames Tideway, the whole business of cleaning up sewer pollution into the Thames. We did not spring that on an unsuspecting world and break the confidence, it managed to do it itself the day before the draft determination by having the worst sewerage incident for some considerable time, but not totally out of line with the ones that happen on average about 50 times a year in the Thames.

Chairman: You have talked about market sensitivity. Market sensitivity is a two-way street. If in fact people do not disclose what is happening, that can be as bad as disclosing. Let us park this and deal with the regulator on that and move on to Mr Tipping.

Q214 Paddy Tipping: Can we return to the environmental programme? It has moved around certainly in the newspapers, and I think you used the phrase “it was laid at the door”, that price rises are the cost of the environmental programme. That is not the reality, is it?

Baroness Young of Old Scone: No. In fact, we have always made the point that the environment programme is a big of a bargain, to be honest. It has been pretty rigorously tested. Quite a large number of schemes that did not stand muster in terms of their value for money were dropped out of it. The remaining schemes have had some pretty hard hammering in terms of reduction in costs. So the programme really is pretty finely honed and we believe is not at the minimum but below the minimum that is required. That has meant that of all

the drivers for price increases, the total drivers for price increase are on average about £54 per bill over a five-year period; only £20 of that £54 is actually for the environment programme. We are not entirely clear as to why that is not the way the environment programme is represented in the draft determination where it is represented as a much higher proportion of the bill increases. That is because of the way in which things like the efficiency programme are dealt with in the way that the economic regulator presents the figures. We feel that the environment programme has been overrepresented as causing bill increases, both at the beginning part of the programme when the horse trading about what would actually be in and out and how much it would cost was taking place and latterly in the draft determination and presentation of the figures. I do not know whether Andrew Skinner wants to come in.

Q215 Paddy Tipping: Before Dr Skinner comes in, let us just stick with the figures for a minute. In your evidence to us you said the bill was going up to £33 not the £54 you have just mentioned.

Baroness Young of Old Scone: The figure of £54 is net before you take efficiency savings into account.

Q216 Paddy Tipping: You say £20 of that is portrayed by the regulator as for the environmental programme. The environmental programme is only 20% of the total capital costs.

Baroness Young of Old Scone: That is right.

Q217 Paddy Tipping: There is a disparity that leads to a false perception?

Baroness Young of Old Scone: This is part of the problem in the way in which the price increase can be portrayed. There are apples and pears in this. It is quite difficult to pin down exactly what the environment programme represents but it is 20% of the capital programme. Alongside all the other drivers, things like pension costs, the taxation issue, some of the financing issues for the companies, operating costs, capital maintenance of assets, plus other improvements like the drinking water quality and various improvements, the environment programme is only one part of that.

Dr Skinner: Could I perhaps develop the point? One of the issues which gives rise to that problem and we think will be a problem in the future is that effectively we are counting money two ways: we are counting money for the environment programme and we are counting money for other costs the companies incur. Although that may have been a useful distinction in 1989 when there was a big backlog of investment in sewerage works, as water companies have dealt with many of those issues, we get a much closer interaction between the infrastructure management for the water companies and the environment programme. The best I can understand the way the financial regulator presents the figures is that he is essentially saying that the environment programme sits at one side and all the efficiencies bear down on all the other costs, and therefore they reduce, but our environment

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programme somehow is not delivered with efficiency and therefore it sits there as a larger and larger proportion of a declining total sum. I think that is a false representation to the public and to stakeholders. I also think it is leading us to a situation where we are looking at funding of companies in a way which does not actually relate to the way in which companies' actions impact on the environment because increasingly it is about the way they manage their sewerage systems, it is the way in which they manage the broader infrastructure, and it is an example of where a 1989 way of doing things is not going to be a very good way in 2009 for the next price review.

Q218 Paddy Tipping: Can I just pick up one of the points. I think I understood what you were telling me but I want to be clear on this. I think you were saying, Barbara, that you are the environmental regulator and you have got to make a judgment about the European Directives that have been translated into UK legislation and regulations and you can prise that open; you have a clear view on that. In reality, because economic regulation has got to take affordability questions into account, things that you believe should be done because of statutory environmental requirements are either not happening or, to use the phrase that is around, being parked. In a sense, you are being superseded by the economic regulator?

Baroness Young of Old Scone: It is quite a complex process and there is quite legitimately the capacity for joint judgements, as it were, in that we look at the environmental drivers and come to the conclusion as to what needs to be delivered. We then talk to the companies and ask them to put forward schemes to deliver those programmes. The companies cost the schemes and those costs are reviewed by Ofwat, not by us, but we do take a view because we have a track record of working through those schemes with the companies. It has been a joint programme of trying to reduce the costs of those schemes. I think where we are anxious, and we are certainly anxious in terms of the protocol that is going to be used for the interim determinations for the future, is when the economic regulator, with the issues of affordability in his mind no doubt, takes a view that, despite the statutory nature of a driver, the price, the cost of a scheme, is just higher than he thinks is legitimate and it is not value for money. In the case of optional schemes where it is not statutory, I think cost benefit is quite a legitimate process. Our understanding of the way in which the system should operate in this price round is that if there is a statutory driver that means that environmental benefit needs to be delivered. The question is: how can we get that delivered in the cheapest, most cost-effective way and not: should we be delivering that at all? We have helped that process of getting the programme down to levels which are affordable by being pretty hard-nosed ourselves and saying: for schemes that are coming in at big costs, perhaps that is not the answer and perhaps we should take it away, look at it again and see if there is another way of doing this. If companies are coming forward and they have clearly

not quite cracked how they are going to deliver this, we might agree that they would look at investigation rather than at full delivery of a scheme so that we could get a better handle on what is required and what the scheme would actually be. Having done that pretty rigorously, we are now in a position where a number of schemes we felt are fully justified and are pretty good value for money are still being challenged. That is the process we are working through between now and the final determination.

Q219 Paddy Tipping: Can you tell us what those schemes are or is that confidential?

Baroness Young of Old Scone: We can tell you what sorts of schemes there are.

Q220 Paddy Tipping: You have told us about the Thames scheme.

Dr Skinner: Mr Roberts mentioned the Daveyhulme scheme and the Manchester Ship Canal. That is a scheme which is linked inexorably to the fulfilment of the obligation of the Fresh Water Fish Directive. This is an obligation which is, I might say, the Thames Tideway of the North-West. The scheme in our view is necessary to meet that obligation. It is not just our view. We are relying upon the principal guidance given by Mrs Beckett and Elliot Morley this time last year, none of which has been rescinded in the final guidance a month ago, and so it is not just our judgement about what are the statutory drivers; they are there in the principal guidance which we have received and which we will work to in our regulatory activities over the next five years.

Baroness Young of Old Scone: To give you another example, I am always deeply angst-ridden about the Fylde coast which used to fail the Bathing Water Directive with alarming regularity, and we really bust a gut to get it to pass. There is a remaining storm sewerage discharge from Preston which really could well lead us back into infraction again and we have not got that scheme in, so the Fylde coast is looking a bit iffy.

Q221 Chairman: You have sparked me off now! The Fylde coast does raise a very important and interesting issue. When one looks at the amount of money that has been spent, I am going to hazard a guess that over time we have probably spent three-quarters of a billion pounds on a coastal clean-up programme. The investment to one direct sewerage discharge into the sea off Fleetwood cost half a billion in its own right. If the end result was to achieve in this case the European environmental requirements, for the sake of one additional component, the value of all of that other investment is not being allowed to come to fruition. That does seem to be a classic, very small part of the dog's tail wagging the whole dog. I cannot, in all honesty, think that that is right. There is a further economic knock-on to that: whilst there is a blight over the Fylde coast through not having this programme completed—not that there are many brave souls who would wish to venture into the water, and I have ventured in and it is on record in the local paper that I have taken my clothes off and ventured in—I put

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that in the context that if you are looking at encouraging tourism by saying that the beaches are safe and all that goes with that, the little missing part of the programme is holding up a potential series of other gains. I am not clear whether in fact the regulator, in coming to conclusions as highlighted by that part of your evidence, has weighed the totality of the impact of not proceeding with this one part in the whole picture.

Baroness Young of Old Scone: I obviously cannot comment for the economic regulator. We should make one caveat on the Fylde coast and that is that it is not just this sewerage treatment works, it is not just one straw that will break the camel's back; there is still quite an issue of pollution from land management that needs to be dealt with as well. Yes, I am sure that the wider issues of the economic value in tourism, recreation and regeneration are not issues that are taken into the cost-benefit equation when we are looking at the clean-up benefits of the water improvement programme.

Q222 Chairman: I want to draw our questioning to a conclusion and to wrap a couple of themes up in one question. There is going to be, as I think witnesses have indicated, a review of this process once it is concluded. I am sure you will be involved in that. If that is the case, how do you think we should tackle the long-term issues of some of the big ticket expenditures like the water framework, other environmental issues, issues of long-term water security, the massive potential implications of climate change, which have big numbers and long timescales against the background of a current pricing review which is of five years duration? Where there are questions now, particularly in the case of climate change? Is it "fair" or not for the consumer as it impacts area by area to have to bear that cost when in actual fact it is the result of global events well beyond their and their water suppliers' influence? In fact, I think that in WaterVoice's evidence they conjectured that there may be a need for general taxation to be involved in addressing that kind of issue. In conclusion, your comments on that would be of assistance.

Baroness Young of Old Scone: I think Dr Skinner will want to come in on this. May I simply say that at least we have now begun to get a handle on what these longer term issues are and so we can put successive price reviews into that framework, which is a major step forward. One particular longer term issue which we think has been under valued is the need to get integrated sewerage strategies. At the moment, I think both the short-term way in which the price round deals with sewerage and the fact that we really do not have agreed longer term sewerage strategies is an issue that we also need to put into your mix. Before I hand over to Andrew, one last point is: as yet, we have never managed to get a price round to deal with a really big ticket or huge investment item. It has always flunked those so far because it is not easy to put a really big investment programme into any single price round. That is something that we are going to have to overcome. I know that Dr Skinner has been thinking about his

retirement job, which is going to be looking on our behalf at what we would want out of the price review for the future.

Q223 Chairman: That sounds like a new career, not retirement!

Dr Skinner: In a couple of words; I think the answer is: basin plans. The Framework Directive is the vehicle by which all your questions can be answered. It is comprehensive in respect of the issues from sectors. These are required to be assessed against targets over a long time. There is a mechanism for prioritising and staging what one does. Longer term goals like climate change impacts can be assessed. The much vaunted Framework Directive has got potentially all the planning and decision-making concepts built into it. The problem is that these things will not happen for nothing. If you look at it in terms of a basic plan which integrates water industry issues, agricultural issues, mining issues, urban management issues, only one of those has actually got a means of funding, which is called the periodic review price round. There are challenges in working out how the price round can operate over a longer timescale and pick up big things like Thames Tideway or the next reservoir which will span more than one five-year period. Secondly, it should make sure that the water industry, the only bit of the cycle that has a funding mechanism, is not penalised and asked to meet environmental obligations which should fall elsewhere. For me, that is where the question about specific customer costs as against general taxation comes in because if you are going to have the really integrated and publicly supported basic plan, then it is going to have to find ways of dealing with the other sectors.

Baroness Young of Old Scone: May I just make the point that Andrew has already made and that is that this stuff will not happen on thin air. The reality is that water customers and taxpayers are pretty well one and the same folk at the end of the day; they just pay in different ways. We must maintain the overview that says that if we are going to achieve the Water Framework Directive challenges, and I suspect that we are going to achieve them rather more slowly than we are supposed to, there is going to be some sort of money coming out of people's back pockets through some mechanism or other.

Q224 Chairman: I think there is one missing element and that is that quite often with these large-scale environmental programmes, such as in the case of the Fylde coast, you could define to the water customers, say of United Utilities, what the gains were. It was very simple to understand and it was visible, but in the case of water framework, it is not so easy to see. What I think is missing is any kind of public education programme—not consultations, there is plenty of those—to explain to people why Europe as a collective has taken the decision to have this improvement and what it will actually mean for them. Otherwise, you are going to be selling potential increases in cost to a group of people who are saying, "Why are we doing this?" I think there is a real challenge there.

3 November 2004 Baroness Young of Old Scone and Dr Andrew Skinner

Baroness Young of Old Scone: May I make one last point? First, we have the pilot project on the Ribble, which you know well, but it will need resources if we are going to have a proper engagement with the community around these very real improvements that can be quite charismatic for them; and, secondly, we must not leave you with the view that the Water Framework Directive is just about cost and nothing else because some of the things that are going to be delivered through the Water Framework

Directive are about doing things smarter, not doing things more expensively.

Chairman: I concur with that and I think it should be part of a much bigger public discussion, but there we are. That is slightly beyond the scope of this particular inquiry. Thank you very much for your patience in waiting to give evidence and again, Barbara, for coming twice before the Committee in one shape or another this week. Thank you very much indeed.

Written evidence

Memorandum submitted by Northumbrian Water Ltd

SUMMARY

1. The Committee's decision to conduct a second inquiry into water pricing is appropriate, since Ofwat's 2004 Periodic Review of water company price caps (PR04) has now reached a crucial stage. Ofwat published its Draft Determination (DD) for each company on 5 August. The companies had until 15 September to respond. Ofwat will issue its Final Determination (FD) for each company on 2 December, and then it is for companies to decide whether to accept the FD or to make an appeal to the Competition Commission. The deadline for making an appeal is 2 February 2005.

2. The committee has stated that the issues it wishes to focus on in this second inquiry are:

- Stakeholder reactions to the DD.
- Conduct of PR04.
- The extent to which the review takes into account long term planning for climate change and environmental improvements.

We have therefore structured this evidence around these major topics.

3. Inevitably, our views on the DD reflect our particular situation. However, we have tried to present a balanced and objective view, incorporating the views of other stakeholders where known. In doing so, we do not elaborate on the technical details. These are for Ofwat, and, if necessary, the Competition Commission, to consider.

4. Our reaction to the DD can be summarised as follows. We are surprised by Ofwat's reduced allowances for operating costs, both in terms of its assumptions for future efficiency gains and in its treatment of known prospective increases in base operating costs. We are less surprised by, but strongly disagree with, Ofwat's approach to the Cost of Capital and a number of other critical financing issues.

5. To surprise and disagreement can be added disappointment that Ofwat has removed from our capital expenditure proposals, or substantially reduced in scope, important projects that are at the top of customer priorities for improvements in service—projects that also have the full support of our regional WaterVoice representatives. These projects deal with discolouration of water supplies and relief from sewer flooding. We understand that other companies have also had their capital investment proposals in these areas reduced by Ofwat.

6. Ofwat's conduct of PR04 has, thus far, been much more transparent than either of the two previous reviews in 1994 and 1999. We wish to record our appreciation of the level of detail provided by Ofwat in its confidential DD Supplementary Report, and in the Aquarius financial model that Ofwat has supplied, which together have enabled us to reconstruct with some accuracy the changes made to our Final Business Plan (FBP).

7. Nevertheless, as indicated above, some aspects of the DD come as a complete surprise. We were led by Ofwat's previous statements on the subject¹ to expect a much lower average efficiency assumption than has been applied to operating costs (average 3% per year across the industry). The DD efficiency assumptions are not supported by the evidence and cannot be reconciled even with studies published by Ofwat itself. We have made it clear to Ofwat that we consider the DD efficiency assumption we are now faced with is totally unachievable if compliance and customer service standards are to be maintained. We are also concerned that Ofwat has failed to take account of recommendations by the Competition Commission², which would entail a less aggressive application of its efficiency models with greater recognition given to their limited accuracy.

8. In contrast to the last two price reviews, Ofwat now appears to accept that allowance for increased maintenance expenditure is needed in PR04. To this extent, Ofwat is acting in a much less short-termist way than hitherto. Failure to make proper allowance for the maintenance of water assets increases the risk of service deterioration for current customers and increases costs for future customers. Unfortunately, the change in Ofwat's stance appears less than whole-hearted. The uplift in our maintenance investment, proposed in our FBP, has been significantly reduced in the DD.

9. Climate change is probably responsible—at least in part—for the increases in the frequency and severity of sewer flooding problems. In the North East region there is a rising trend in the number of properties flooded each year, and each year brings additional properties onto the "at risk" register. Uplift in investment is needed to simultaneously cope with these new properties while dealing with those already identified. It is therefore regrettable that Ofwat has chosen to reduce the investment we assumed in the FBP so that not all known problems are addressed by 2010.

¹ Water and sewerage service unit costs and relative efficiency 2002–03 report (page 41): Ofwat, January 2004.

² Reports on Mid Kent Water plc and Sutton and East Surrey Water plc references under sections 12 and 14 of the Water Industry Act 1991: Competition Commission, August 2000.

10. Whilst we recognise that the cost of dealing with sewer flooding of some properties is relatively high, we do not consider Ofwat's ceiling cost of £120k per property to be appropriate. We believe all customers have a right to expect investment to alleviate sewer flooding. We also consider it unacceptable that the company is asked to take the risk of new problems arising faster than historic trends. This is dependent upon changing weather patterns, over which the company has no control.

11. In our previous evidence to the Committee's first inquiry into water pricing we concluded:

“Water prices are artificially low. Price cuts imposed at the 1999 price review were focused on the short term and it was always clear they were not sustainable.”

The issue of sustainable prices links to another conclusion from that previous evidence:

“The water industry is a long-term industry. Its assets are long-lived, it invests for future generations as well as the current generation, and competent stewardship by a water company requires it to focus on maintaining those assets properly.”

The evidence from the DD is that Ofwat has not yet elevated longer-term priorities sufficiently above the short-term pressures to hold prices as low as possible.

STAKEHOLDER REACTIONS TO THE DRAFT DETERMINATION

12. As indicated in the Summary, we were surprised by Ofwat's DD treatment of our projected operating costs for the next five years. These are built up from “base opex” (essentially the company's current operating costs) and “additions to base” (forecast increases in opex above inflation due either to externally imposed costs, over which the company has no control, or to the costs of running new assets constructed to meet imposed quality standards). Ofwat applies efficiency targets to both base opex and additions to base.

13. Ofwat has excluded from additions to base, in part or in whole, several well-researched cost increases that the company is certain to face. These relate to abstraction charges levied by the Environment Agency and necessary increases in pension fund contributions. In addition, we also face increases in bad debt, which is on a rising trend.

14. Some of these additional costs can be made the subject of an “Interim Determination”, after they have materialised and provided they both satisfy the threshold requirements and qualify as increases resulting from industry-specific legislation.³ We made a successful IDoK (Interim Determination of K) claim last year, a major part of which related to increased bad debt. However, the company has to bear the increased costs until the threshold is reached and this threshold is set very high.

15. Since these additional costs not recognised by Ofwat are not covered by prices charged to customers, or else in some cases the price-effect is delayed, the company can only cover the costs by outperforming Ofwat's efficiency targets. We therefore regard these disallowed costs as “hidden efficiency targets”.

16. Ofwat claims to have heeded industry complaints that its PR99 approach to setting efficiency targets left no incentive for outperformance. To meet these criticisms it has assumed around half of its 3% pa assumed scope for further efficiency within the price limit (the “stick” element), and the remaining half is assumed to be the “carrot”, available for outperformance.⁴ However, we do not believe Ofwat's assessment of the total scope for efficiency gains to be realistic, and we have challenged them to justify it. Even the studies commissioned by Ofwat do not appear to support such an aggressive assumption. In reality the “carrot” efficiency is not attainable and therefore does not provide a meaningful incentive. The scale of the hidden efficiencies referred to above only compounds this problem.

17. The opex issue would be less critical if there was headroom elsewhere in our finances to enable us to temporarily absorb the extra costs, but Ofwat has left no headroom in the DD. In common with most water companies, Ofwat has adjusted our price determination to produce absolute minimum values for the financial ratios it regards as critical to enable companies to finance their functions. Hence, it will only require a relatively minor adverse effect to place the whole industry in financial difficulty. In the light of this we are surprised by what we consider to be a short term positive reaction to the DD from the financial markets, as evidenced by share price movements.

18. WaterVoice, nationally, welcomed the DD as “better than expected” (meaning, of course, that the prospective increase in bills is not as great as WaterVoice had feared). However, Northumbria Region WaterVoice is less content. Its Chairman has written to Ofwat expressing concern that two projects, that were included in our FBP with their full support, have been cut. One of these, dealing with water discolouration, has been removed in its entirety. The Drinking Water Inspectorate has also expressed concern at the removal of this project, which it identified as a high priority water quality scheme. The other affected project, to address outstanding sewer flooding problems and deal with new ones as they arise, has

³ It will be noted that rises in pensions costs are not a consequence of industry-specific legislation, so would be excluded. Changes in taxation are also excluded, which is a major concern since these are totally outside of company control could have a material impact on finances. So far, Ofwat has accepted that increases in bad debt are due to the ban on disconnection of domestic properties for non-payment, introduced in the Water Industry Act 1999.

⁴ Companies are allowed to retain any outperformance for five years, after which it is all transferred to customers, who benefit every year thereafter.

been substantially reduced in scope. These projects are at the top of the customer priorities emerging from the most recent comprehensive customer research. This gives cause to reflect on what Ofwat may have sacrificed in order to produce the “better than expected” DD result.

THE CONDUCT OF PR04

19. We have already noted the transparency of the review thus far. As a consequence of this we find we have more detail with which to take issue than at previous price reviews. But, we do at least know how Ofwat has adjusted our FBP to arrive at the DD. In the two previous reviews we were given little or no detail, and our requests for further information were to no avail.

20. Ofwat consulted extensively on the price review process, and, by and large, has conducted the review in line with the conclusions it drew from the consultation. There are some exceptions, and this partly explains why the DD contains some surprises for us. We discussed earlier the unexpected scale of the efficiency targets, but we also did not expect that Ofwat would deviate from Ministerial guidance in adjusting our capital investment programme. We hope we are successful in persuading Ofwat to correct these aspects in the FD.

21. Although Ofwat is the key player in Periodic Reviews, there are other players who influence its conduct. Apart from the water companies themselves, the Environment Agency, Drinking Water Inspectorate, English Nature, Defra and, not least, Ministers, all play important roles. From next year, WaterVoice will assume a separate statutory role as the Consumer Council for Water.

22. This interplay between key players makes the Periodic Review a complex task for all concerned. Work must start about three years before the Final Determination is made, with tightly timetabled review activities taking place throughout the price review process, and a very extensive data collection exercise to inform the myriad decisions.

23. Some of the complexity of the review process arises from its “batch” nature. After each review is completed and the inevitable post mortems are conducted, it is time to start all over again, preparing for the next review. Some observers have remarked that the scale of Periodic Reviews is such that they should be conducted only every 10 years, rather than every five. But this would be impractical unless the interim adjustment mechanisms were significantly strengthened.

24. The concept of the Periodic Review is something that grew out of ideas about price cap regulation for utility privatisations in the 1980s. The basic principle is that the regulator should reset the price cap periodically and not intervene until the next scheduled review, thereby giving the regulated utility an incentive to cut costs and increase profits between reviews. The revealed efficiencies can then be captured by the regulator and transferred to customers at the next price review. This process has proved very effective, but it is not perfect. It was realised at an early stage that the incentive to make efficiencies reduces as the next price review approaches. Ofwat has addressed this by introducing rolling efficiency adjustments for both capex and opex, so that the incentive to make efficiencies is the same irrespective of when they are made.⁵

25. It has also become obvious that Periodic Reviews are very disruptive to company capital investment programmes. After each of the two previous reviews, water industry investment dropped sharply—principally because company programmes depend on the outcome of the price review, and Final Determinations come too late to allow the next year’s programme to be planned properly. Ofwat has tried to address this problem by introducing an “Early Start” programme, for which Ofwat can give early sanction to projects with feasibility and design stages spanning between two review periods. It remains to be seen how effective this is.

26. These shifts in the regulatory review process are all in the direction of a rolling, or semi-continuous, review process, as opposed to the current “batch” process. The idea of a rolling review is also attractive from a number of other perspectives. Prices charged to customers would become less volatile⁶, and stakeholders would be less inclined to treat Periodic Reviews as once-in-five-years opportunities to secure investment in favoured projects. This would help to reduce the adversarial nature of the regulatory process.

LONGER-TERM SUSTAINABILITY ISSUES

27. The Committee will be pleased to note that Ofwat has made increased allowance for capital maintenance across the industry, compared to that allowed at PR99. However, the overall allowance at national level is still considerably less than companies have indicated they need in their FBPs, and on a company-specific basis the extent of the uplift varies considerably.

28. The debate on the appropriate level of capital maintenance is not about company profits. Ofwat assumes no allowance in price caps for investment returns on capital maintenance, which is treated as a cost-recovery item. Companies are concerned, instead, to protect services to customers and avoid additional

⁵ In practice only a very small number of companies appear to have received any incentive allowance in the DD.

⁶ It was clear long beforehand that prices could be reduced significantly at PR99, but it has also been obvious for some time that prices would need to increase significantly again at PR04. A rolling review process would allow these adjustments to take place gradually, rather than in sudden steps.

operating costs arising from service deterioration. Ofwat has resisted calls by companies for it to increase allowances for capital maintenance at previous reviews mainly because it is such a significant cost element. Significant increases in maintenance expenditure result in material price increases in the short term.

29. Whilst Ofwat has partially recognised the need for long-term planning of capital maintenance for a sustainable future water industry, there is less evidence that the financial arrangements it has in mind are sustainable. The Weighted Average Cost of Capital assumed by Ofwat in the DD is little higher, at 5.1% post tax, than the 4.75% Ofwat assumed in 1999, which prompted a wave of financial restructuring in the industry. The WACC is a weighted average of the cost of debt and the cost of equity. The cost of debt is relatively easy to establish, but the cost of equity is subject to wide margins of error. We believe Ofwat has again seriously under-estimated the cost of equity and hence the WACC.

30. In our view, if Ofwat in the DD had allowed returns on regulatory capital values that equalled or exceeded the true WACC for the sector, it would not have found it necessary to increase price caps in some years to produce “bankable” financial ratios. We understand Ofwat has found this necessary in a number of companies’ DDs, not just a few. If Ofwat is seriously concerned to preserve the equity model for financing the future water industry in England and Wales, it needs to rethink its approach to the WACC.

31. Our final comment on the issue of sustainability is to remind the Committee that, as stated earlier, there are significant real cost increases, faced with some certainty by companies in the next five years, which have been excluded from consideration in the DD. By not making any allowance for these, Ofwat has both increased the financial risks faced by companies and made IDoK applications more likely. So, even once PR04 is complete, this does not mean prices are then fixed for the next five years.

CONCLUSIONS

32. In our previous evidence we warned that prices needed to increase sharply at this review, not because of exceptional investment requirements⁷, but mainly because prices have been held unsustainably low—especially in the last five years. Companies have been forced to gear up their balance sheets by borrowing heavily to make up the shortfall in cashflow, but their capacity to increase debt is approaching its limit and prices must increase.

33. Stakeholder reactions to the price increases indicated in the DD are mixed. Ofwat itself had warned customers to expect price rises, so some customer representatives have welcomed the fact that they are less than those indicated by companies in their FBPs. Others have noted the fact that Ofwat has achieved this partly by excluding projects at the top of customer priorities, and are less content.

34. Companies are reflecting on the enormity of the efficiency targets assumed in the DD, to which are added the “hidden efficiency targets”, or excluded costs they will be expected to absorb. In addition to these industry-wide issues, each company will have concerns over the detail of its own DD. They will have the opportunity to discuss these with Ofwat in October, and Ofwat will also seek further Ministerial guidance before issuing FDs in December.

35. Ofwat’s transparency in managing PR04 has been exemplary. This has made the important task of understanding the assumed changes to our FBP much easier for the company. Nevertheless, we believe the process is still overshadowed by short-termism, and we consider some fundamental changes to the regulatory regime are essential to make it more efficient in facilitating a sustainable water industry. We strongly recommend that Defra commences a review with these aims, in partnership with Ofwat, water companies and other stakeholders, as soon as PR04 is completed.

22 September 2004

Memorandum submitted by the Chartered Institution of Water and Environmental Management (CIWEM)

INQUIRY INTO WATER PRICING

1. 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.

2. CIWEM welcomes the opportunity to comment on this inquiry. The Institution is an interested, informed observer rather than a directly affected stakeholder. Our principal points may be summarised as:

⁷ The water industry is capital intensive and can be expected to require similar levels of investment to those in the last decade for the foreseeable future. The next major cost driver will be the Water Framework Directive.

- CIWEM cautiously welcomes the draft determination but qualifies this with a consideration that undue limitations to proposed price rises now are likely only to store up further significant rises for the future when they will be equally politically unattractive.
- CIWEM considers that the investment planning period should be longer (eg 20 or 30 years). The current period fosters short-termism.
- Long-run planning must pay greater attention to the impacts of variables such as climate change and environmental legislation such as the Water Framework Directive.
- The drive for value for money may result in under-investment, particularly in addressing risks which might seem remote at the moment (eg droughts).

REACTION OF STAKEHOLDERS TO THE DRAFT PRICE LIMITS

3. CIWEM understands that environmental stakeholders have signalled general satisfaction with the determination although there is some disappointment that some major schemes may not go ahead.

4. We believe it is likely that Water Company stakeholders will argue that their investment plans have been trimmed too far, to the potential detriment of asset maintenance and renewal, and the ability to meet level of service targets in the future. Water Companies asked for K increases (over inflation) of 29% over five years; customer surveys indicated that they wanted to see the increase (of 29%) cut by at least a third; whereas Ofwat's draft determination cuts the requested increase by around a half. Inevitably, Water Companies will object, and will point out the asset management, customer service and environmental protection consequences of reduced funding in their respective areas.

5. CIWEM has encouraged Ofwat to allow the proposed price increases and the full programme of environmental measures proposed by the water companies as we consider that these will be necessary to deliver the requirements of various European Directives. We therefore register our concern that some important schemes will be impossible with the proposed limits. In addition the determination does not give customers the appropriate price signal for what is becoming an increasingly scarce resource with both high customer and environmental value.

6. CIWEM considers that water is a most precious resource which remains too readily taken for granted. The way in which the management of water is becoming increasingly integrated through the implementation of framework policies is an indicator of growing recognition of its value. Despite this it is likely that many waters will fail to meet standards required by European legislation in coming years as a consequence of failure to invest sufficiently in the necessary improvements. There must be concern that deferring expenditure on, for example, the Water Framework Directive, is storing up future price rises which themselves may be seen as politically sensitive at the next periodic review.

7. The recent pollution incidents in the Thames in August are a demonstration of how the current storm sewerage system is in places insufficient to deal with extreme rainfall events that widely accepted climate change models predict will become increasingly commonplace. Furthermore, pressure on water resources is set to increase markedly, particularly in the South East of England where hundreds of thousands of new homes are planned as part of the Office of the Deputy Prime Minister's Sustainable Housing Initiative, and where the likely impacts of climate change will be hardest felt.

8. In this context we are also concerned about the lack of support by Ofwat for the funding of water efficiency investigations proposed by water companies. It is essential that robust information is obtained by companies on the costs and savings to customers of water efficiency and water conservation initiatives so they can be compared with resource augmentation proposals. The ODPM has set a target of between 25 to 30% reduction of water consumption in new builds compared with existing households in the south and east of England. The affected companies should be given incentive and funding to address this.

9. It is likely that the UK will experience a sustained period of increasing utility bills as the reality of the preciousness of natural resources becomes more accurately reflected. We do not consider that an inability of some customers to pay for such resources should be a reason for constraining necessary price increases across the board. We consider that genuine inability to pay is a social issue and assistance should be provided where legitimately required. CIWEM is pleased that the Government recognises global environmental issues however we consider that the rate of delivery of environmental improvement remains insufficient.

COMMENTS ON HOW THE PERIODIC REVIEW HAS BEEN CONDUCTED, PARTICULARLY LOOKING AT HOW IT HAS TAKEN—OR SHOULD TAKE—INTO ACCOUNT LONG-TERM PLANNING FOR CLIMATE CHANGE AND ENVIRONMENTAL IMPROVEMENTS

10. CIWEM considers that the price determination process has always suffered from a number of problems, in particular:

- short-termism (we believe that five years is too short as a planning horizon);
- lumpiness/cyclicality (the five-year period induces peaks, troughs and back-end loading into investment spending, with adverse impacts on efficiency and delivery of spend, and on the interests of the supply chain (consultants, contractors));

- range bidding whereby the Water Companies over-pitch and the regulator under-cuts.

CIWEM considers that the attempt to smooth out the lumpiness by introducing an early review and approval of year 1 expenditure appears to have had limited impact and benefit.

11. The Institution considers that the investment planning period needs to be 20 or 30 years (as per the period for demand forecasting and water resource planning, and as per the timescale required for engineering scheme planning and delivery). The present process carries the risk of five-year myopia—a long run perspective is taken as a starting point, but the process drags attention onto the first phase, to the detriment of efficient long run planning, as the knock on effects of the five-year determination ripple through the long run plan.

12. CIWEM suggests that long run planning requires explicit attention to the effects of present or potential variables such as:

- the Water Framework Directive and other nature conservation legislation;
- the potential impacts of climate change upon:
- water resources availability (security of supply), as the frequency and depths of droughts change, and as the volatility of the climate increases. This requires attention to storage and distribution capacity and flexibility;
- urban sewer flooding (in the sewer systems and treatment works for which the water companies are responsible). There is a prospect of systems designed for design storm magnitudes based on historically-judged frequencies being overloaded/swamped by higher magnitude events of the same design frequency and more frequent occurrence of events of the same magnitude; and
- the environment—in respect of the quantity and quality of water in the environment.

13. Long term planning for these effects has been taken into account in various ways, as per guidance issued by government and regulators (eg in headroom for water resources). However, CIWEM considers that there is a clear risk, as we filter planning for future risks through the lens of value for money to today's customers, of under-investing. For example, there may not have been a drought for some time now, and consequently it is easy to become complacent, however it is certain that droughts will occur sometime in the future.

14. A particular concern to CIWEM is that Water Companies were specifically requested by OFWAT and the Environment Agency to exclude the potential effects of the EU Habitats Directive and other nature conservation legislation in the water supply-demand analysis unless the impacts were clear and certain. Furthermore, Water Companies were prevented from including these substantial issues in the uncertainty analysis (through calculation of the "target headroom"). As a result the biggest water resources issue over the AMP4 and AMP5 periods could not be included in Water Resources Plans and Business Plans. This is contrary to the preparation of robust long-term water resource plans and in CIWEM's consideration, potentially puts the adequacy of water supplies and the environment at risk. It is essential that such calculations are incorporated fully into planning.

15. CIWEM would suggest that funds should be made available to companies to enable them to secure the least cost, most environmentally sensitive solution to delivering sufficient water to areas of the country that are under pressure, via water resources and water efficiency studies in co-operation with all stakeholders. A final suggestion is that water companies should be required to produce their water resources plans in tandem with a national water resources strategy by the Environment Agency.

23 September 2004

Memorandum submitted by the Royal Society for the Protection of Birds (RSPB)

SUMMARY

- The RSPB supports the environment programme of the Fourth Periodic Review of Water Prices (PRO4), which will deliver great benefits for the ecological health of our rivers, wetlands and coastal waters and bring real and significant benefits, social, as well as environmental.
- We believe that the programme is necessary and that projects have been scrutinised effectively and thoroughly to establish their cost and effectiveness. There is no further scope for cuts without running the risk of continuing environmental damage and failure to meet legal targets.
- Ofwat's draft price determinations have confirmed that there was scope for reducing costs of delivering environmental improvements. This supports earlier RSPB evidence to the Environmental Audit Committee, and we are relieved that Ofwat took this approach, rather than making deep cuts to sections of the environment programme, which at one time seemed likely.

- We are, however, disappointed that cost savings have been made by excluding some important environmental improvement schemes. Cutting out these schemes makes very little difference to customers' bills but could have a substantial negative impact on the quality of the environment in some areas. We are urging that these schemes be reinstated.
- We believe that Ofwat's price determinations paint a misleading picture of the environmental programme as a significant driver for price rises.
- We believe that there has been a much greater focus, by both Ofwat and WaterVoice, on scrutinising the need and justification for the environment programme in PR04 than on other parts of companies' business plans. This suggests that delivering environmental improvements is still not seen as part of the core business of water companies, and if this view prevails achieving truly sustainable water management will be very difficult.
- While we recognise the need for Ofwat to scrutinise the costs of delivering schemes, we are disappointed that, for some important projects, this scrutiny has cut costs so substantially that they are highly unlikely to achieve their objectives.

INTRODUCTION

1. A good quality water environment is vital to people's quality of life and economic well-being and investment through the process of the water price review is a key component of delivering environmental improvements. Previous water price reviews helped to end the worst of gross sewerage pollution to rivers and coastal waters, and provided many benefits for regeneration, recreation, tourism and nature conservation. However, water companies must do more to ensure they meet existing and new environmental laws and standards and make their industry truly sustainable.

2. Although many rivers have improved since 1990, further work is required to bring them to an acceptable standard. Over half of all rivers in England and Wales continue to suffer from high levels of phosphorus, and recent characterisation of water bodies by the Environment Agency suggests that over 90% are at risk of failing new standards of water quality based on ecological needs.

3. The Environment Agency (EA), with English Nature (EN) and the Countryside Council for Wales (CCW) proposed a programme of environmental improvements through the fourth periodic review, which has been supported by a rigorous assessment of the costs and benefits of delivering those improvements. The scope, costs and benefits of the programme were all carefully scrutinised, and the RSPB is convinced that what has been proposed is essential if water companies are to meet their legal targets, and make their contributions to Government commitments on environmental quality.

4. In their Principal Guidance in March 2004, Ministers set out their priorities for the environment programme. They agreed that the entire EA/EN/CCW programme is required to meet minimum legal obligations to protect the environment. This programme will include actions to:

- Stop pollution from sewerage overflows which discharge raw sewage into streams and rivers during storm events.
- Protect our most important rivers and wetlands from pollution and over-abstraction.

Ministers also gave advice on managing water resources. This outlined their determination to see water companies tackle and manage water demand before embarking on large-scale resource development.

5. The Environment Agency has estimated that this recommended environmental investment programme will bring benefits in the range of £3.1 to £5.6 billion to England and Wales over the next 25 years. These include the value to current and future generations of improvements to recreation, fishing, and nature conservation, but do not include other, unquantifiable benefits in terms of quality of life and economic regeneration.

6. Market research commissioned jointly by a group of stakeholders in 2003 (which used the inflated scheme costs provided by water companies in their draft business plans) showed that, in relation to the environment, 87% of bill payers nationally believe it is important to maintain current services; and over 70% believe it is important to improve services. The research suggested that more people are definitely or probably willing to pay for improvements than are not. No further research has been done since the considerably lower costs and impacts on bills emerged from water company final business plans and the draft price determinations.

DRAFT DETERMINATIONS

7. Ofwat published its draft price determinations on 5 August 2004. These radically reduced the costs of water company investment proposals while maintaining most of the content of the environment programme.

8. Just 20% (£3.2 billion) of the £15.7 billion capital programme allowed by Ofwat is for the environment. As we predicted in our evidence to the Environmental Audit Committee in February, the projected costs of achieving that programme have been substantially reduced.

9. We are pleased that most of the statutory and discretionary programme has been funded, including exciting and innovative catchment management projects by United Utilities and Northumbrian Water.

10. However, we are concerned about a number of schemes that Ofwat has dropped. We are particularly worried about the decision to remove vital schemes to protect the internationally important Hampshire Avon—a chalk river suffering from phosphorous pollution. We understand that Wessex Water has persuaded Ofwat that investment in reducing phosphorous discharges from their sewerage treatment works should not proceed until diffuse sources of phosphorous from agriculture have been tackled. We believe that this is unacceptable, and that efforts must be made in parallel from both sectors if the site is to be brought into the favourable condition required under the EC Habitats Directive. Other important schemes that we understand have been dropped include action to protect fisheries in the River Tame and the River Aire from the effects of pollution from storm sewage discharges. Nor has any provision been made for work to find a long-term solution to London’s storm overflow problem, the effects of which were so strikingly demonstrated by the pollution incident on the Thames on 4 August this year. However, we are frustrated that the exact details of which schemes Ofwat has recommended for funding is a confidential matter between Ofwat and the water companies. This has hindered our ability to respond adequately to the consultation, and is not the open and transparent approach we believe stakeholders, and the wider public, should be able to expect.

11. We also have concerns about the budget that Ofwat has allocated for the completion of some important projects. For example, Ofwat has recommended a reduction in the operating costs of the United Utilities catchment management project in northern England of over 90%, which would make it impossible to meet its objectives.

12. We are concerned that Ofwat appears not to have followed ministerial guidance in the area of water resource planning. The regulator has recommended substantial cuts in funding to promote water efficiency and manage demand, while effectively “rubber stamping” proposals for resource development. While a lot more effort on water efficiency is needed by the Government (in terms of establishing new building regulations which incorporate water efficiency into new homes, and in setting up a Water Savings Trust), there is still a significant and important role for water companies. Ofwat needs to ensure that those companies are given the resources to undertake that role satisfactorily.

THE PR04 PROCESS

13. Some elements of the PR04 process were an improvement on the conduct of PR99. There was a joint market research exercise with the main stakeholders in the review (including Wildlife and Countryside Link, representing a coalition of NGOs), and in the initial stages the regulators appeared to work closely together. However, early optimism about the conduct of the review faded as the final stages were reached. The process has become adversarial, with Ofwat determined to minimise bill increases with the result that it has become entrenched in a position of criticising the environment programme. As the process has become more adversarial, it has become more politicised and less transparent. This lack of openness and transparency is reinforced by the opaque nature of the draft determinations. The documents hold little detail on the fate of individual projects in the quality programme, not allowing stakeholders to make informed responses.

14. The regulators held an initial stakeholder consultation on PR04 in the autumn of 2003 in order to get a better understanding of priorities for investment. The results of that consultation were not widely promoted or publicised, perhaps because the responses, which were very supportive of further environmental investment, did not reinforce Ofwat’s view. We believe that the way in which Ofwat responded to that consultation was symptomatic of their approach to public opinion during this review.

15. Much of Ofwat’s scrutiny of the periodic review has fallen on the environment programme, even though it accounts for only 20% of the capital programme. Despite this, Ofwat has stated that environmental improvements are responsible for £20 of the proposed £33 rise in customers’ bills. The regulator has unsuccessfully attempted to clarify these figures in communications with us. We believe it is a matter of regret that such misleading figures are used in a public document.

BEYOND THE 2004 PERIODIC REVIEW

16. PR04 has not provided adequate preparation for the introduction of forthcoming environmental obligations under the Water Framework Directive. Determined efforts by Ofwat to restrict spending on the environment in this review will lead to a need for greater investment under PR09 and PR14. At present the price review process does not deliver the long-term planning based upon environmental requirements and obligations that is needed. Instead it promotes short-termism: demands to reduce investment for perceived short-term price advantage, rather than the sustained investment for the future required to deliver sustainable development in the water sector.

17. Reflection will be needed after the completion of PR04 to learn from the process and consider what changes may be necessary to align the periodic review process better with statutory river basin planning under the Water Framework Directive, and to promote innovation rather than stifle it. The RSPB and Water UK have commissioned Green Alliance to undertake a review over the next few months which will

look at ways of improving the process. We hope that this will also help to stimulate debate about the implementation of the regulatory changes to be established under the Water Act—notably Ofwat’s new sustainability duty.

23 September 2004

Memorandum submitted by the Institution of Civil Engineers Water Board

EXECUTIVE SUMMARY

The Institution of Civil Engineers (ICE) is a UK-based international organisation with over 70,000 members ranging from professional civil engineers to students. ICE welcomes the more transparent approach taken by Ofwat in the periodic review of 2004. This was in marked contrast to the review of 1999 which caused the Institution great concern, particularly over the question of the investment allowed in capital maintenance.

Key issues for consideration

1. Ofwat have clearly attempted to balance the pressures of rising prices, higher environmental standards and the need to address the backlog of maintenance in the water infrastructure. The Institution has concern that the draft determination has reduced the capital programmes to the detriment of asset renewal and maintenance and has set efficiency targets for both capital and operational activities that could threaten the integrity of operation of the water companies. This in turn threatens the high environmental and customer service standards achieved in recent years.

2. For the past three years the Institution has rated the water and wastewater sector higher than any other sector in its influential State of the Nation Report on the infrastructure of the country. In the report for 2004 (attached as Appendix 1 [not printed as available at http://www.ice.org.uk/downloads//SoN_2004.pdf]), the Institution drew attention, *inter alia*, to the following issues:

- The excellent standard of drinking water in England and Wales.
- Concerns that if water price rises resulting from the proposed programmes presented by companies in their business plans were unacceptable, then maintenance expenditure could be squeezed with serious consequences for our sewers, treatment works and water mains.
- The Sustainable Communities plans for southern England, with some extra 200,000 homes to be built, will put significant pressure on resources. Water resource planning is very long term and we are pleased that several companies have included reservoir schemes in their programmes. However, these can take 20 years or more to come on-stream.
- There has been an increase in the available funding for water companies to invest in work to reduce properties at risk of foul flooding and the number of properties at risk has fallen by 3,300 in the past three years; this leaves 11,600, or less than 0.1% of properties, at risk. However, there remains a major concern about the investment in the sewer system. The recent National Audit Office report, “Out of sight, not out of mind”, highlighted the problems we identified in our 2003 State of the Nation report and we agree with their conclusions. At the current rate of rehabilitation many of our sewers will have to last 1,000 years. Only 389 km of sewers in England and Wales out of a total of over 300,000 km were rehabilitated in 2002–03. This is not enough. (It should be noted that the recent incident of foul water discharge into the Thames is evidence of previous under-investment in sewer systems.)
- The public must be encouraged to value this resource more highly, conserve it better and be prepared to pay more for it.
- Five-year regulatory review periods are too short a term to deal with water and wastewater issues. A 10-year capital-planning window is needed to ensure a smooth workload flow and a 25-year strategic planning horizon.
- Acceptance of the likely requirement for new reservoirs on the precautionary principle. Planning and promotion should begin early and not be left until the last moment.
- Greater support being given to water resource developments, particularly in the light of new European Directives and climate change predictions.
- Government demonstrating an instinctive understanding of the interdependence of infrastructure issues and the particular importance of water, wastewater and flooding, along with the implications of climate change.

3. The Institution presented substantial evidence to the Efra Committee on “Climate change, water security and flooding” (Ev 1-15 of the report) and commented upon the need for long-term planning given the uncertainties surrounding climate change. Our comments about climate change and long term planning equally well apply in the context of the periodic review. The Institution is keen to see a more long term

approach to price reviews. Whilst there has been movement on this in relation to water resource planning and capital maintenance, little evidence of long-term planning exists when it comes to matters of quality or sewerage. The Defra document, "Directing the flow" published in November 2002 suggested that more long-term planning would be forthcoming. The Institution believes that funding to enable longer-term views of sewerage and quality-related matters is important, particularly with the Water Framework Directive in the wings for the next periodic review period.

CONCLUSION

4. Overall, whilst the Institution is not dissatisfied with the Ofwat process, it remains concerned that the water companies should be sufficiently funded to be able to carry out the work they believe is necessary on the infrastructure. Customers will not appreciate short-term savings if problems with water supply and wastewater treatment including sewerage occur in the medium term. There is provision in this periodic review for the Minister to review the environmental programme at the end of September. The Institution is concerned that this might present an opportunity for environmental schemes previously omitted, which might have been supported by a powerful lobby, to be reinstated at the possible expense of capital maintenance which has been the poor relation in previous periodic reviews. This would cause serious concern to the Institution. ICE hopes that the comments above assist the Committee and the Institution would be pleased to amplify upon any of the points made, should that be necessary.

23 September 2004

Memorandum submitted by the Association of British Insurers (ABI)

The insurance industry has agreed to continue to provide flood cover for as many homeowners as possible, provided the Government takes action to reduce the risk of flooding to homes and business. This includes effective action to address sewer-flooding problems for all those properties at very high risk (10% annual probability).

The number of sewer flooding incidents has remained approximately static at 5,000 to 7,000 properties each year since 1994. According to Ofwat research, more than 60% of customers affected by sewer flooding in the last three years have been flooded more than once, and 15% of those flooded due to sewer incapacity over this period have flooded more than six times.

In its draft determination on the pricing of water and sewerage services for 2005–10, Ofwat offers support for 80% of the sewerage improvement schemes put forward by water companies to alleviate sewer flooding for properties at very high flood risk. This will still leave at least 4,000 properties exposed to unacceptably high risk of sewer flooding, and at least 15,000 more at significant risk (5% annual probability). Allowing water companies to spend £830 million over and above the draft determination in order to tackle sewer flooding would add an extra £7.30 to the average customer sewerage bill each year.

The insurance industry would like Ofwat, in its final determination on water and sewerage prices for the coming five years, to:

- Work with water companies to ensure that effective mitigation measures are in place to protect those remaining 4,000 properties exposed to very high risk of sewer flooding where a capital scheme is not an economical solution.
- Ensure that some action is taken to assist those 15,000 properties still facing a significant risk of sewer flooding.
- Allow water companies to take full account of climate change and future housing projections in planning capital schemes to address sewer flooding.

By taking action to tackle sewer flooding today, flood insurance should remain readily available to the vast majority of householders in the UK, providing customers with the comfort that if they do suffer sewer flooding, the financial consequences at least will be minimised.

1. The Association of British Insurers (ABI) is the trade association for insurance companies operating in the UK. It represents over 400 members who, between them, transact around 95% of UK insurance business. It is estimated that the insurance industry accounts for 20% of investment in the stock market.

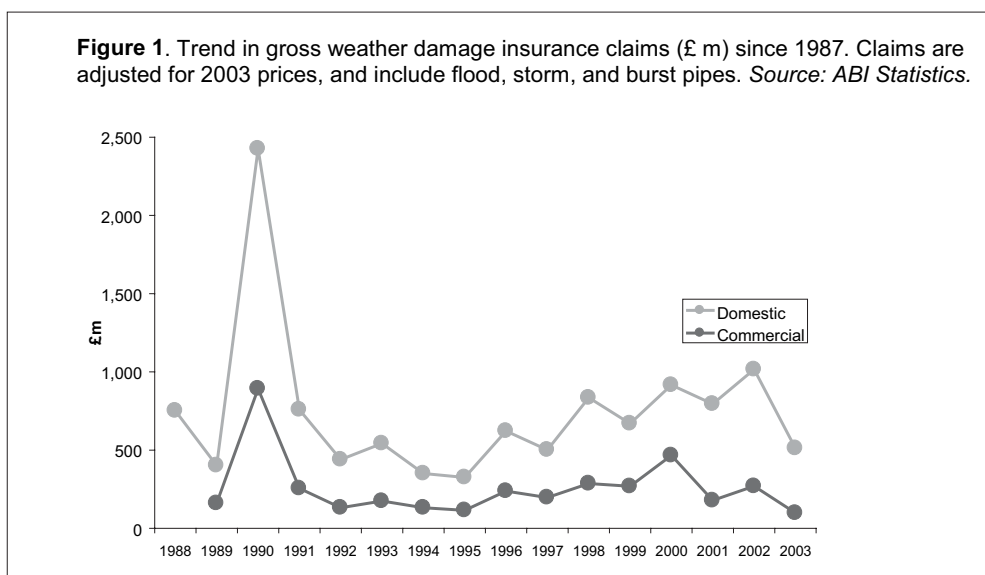
SEWER FLOODING AND INSURANCE

2. Sewer flooding is a serious and costly concern for the insurance industry and its customers. Insurers wish to provide flood cover to as many homeowners as possible, but can only continue to do so if flood risk is managed in a sustainable manner. Where events become too frequent or too costly to repair, insurance can only be offered at rates that may be considered uneconomic.

3. The UK insurance market is almost unique in offering voluntary, comprehensive flood cover as a standard feature of household policies. The insurance industry is able to provide this cover on the basis that the Government and other agencies would take adequate steps to manage flood risk effectively. On all weather damage claims (flood and storm primarily), insurers have paid out £6 billion in the last six years, over twice the amount in the previous period (Figure 1).

4. Since 1994, there have been between 5,000 and 7,000 sewer flooding incidents each year,⁸ with around half occurring because capacity of the system is exceeded. While the number of properties classified “at risk” has declined, the number of internal flooding incidents has remained fairly static. The Government recent Foresight study⁹ calculated that flooding from sewers costs the national economy £270 million each year on average.

5. Clearly, both the economic and financial consequences of sewer flooding mean that water companies should be allowed to take all necessary action to eliminate as many incidents of sewer flooding as possible.



CONTINUED PROVISION OF FLOOD COVER

6. In the severe flooding in Autumn 2000, over 11,000 homes were affected,¹⁰ and insurers paid out more than £1 billion in meeting weather-related claims. Around 14% of these properties were flooded with sewerage (1,500 homes).¹¹

7. After Autumn 2000, the Association of British Insurers (ABI) worked closely with the Government to agree a Statement of Principles,¹² setting out terms through which the industry would continue to provide cover for the vast majority of households in the country. In the Statement of Principles, the insurance industry agreed to provide a competitive market for all properties protected to a standard of 1.3% annual probability of flooding, and to stay on cover for all those properties that will be protected to this standard by 2007.

8. This agreement by the insurance industry is contingent on action by the Government to reduce the risk of flooding to homes and small businesses in the UK, including the “implementation of realistic solutions to sewer flooding including increased investment in improvement programmes”. The insurance industry expects to see water companies take effective action to address sewer-flooding problems for all those properties at very high risk (10% annual probability).

⁸ Out of sight—not out of mind: Ofwat and the public sewer network in England and Wales, National Audit Office, January 2004, <http://www.nao.org.uk/publications/nao-reports/03-04/0304161.pdf>

⁹ Future Flooding, Office of Science and Technology Foresight Programme, April 2004, <http://www.foresight.gov.uk/fcd.html>

¹⁰ Autumn 2000 floods in England and Wales—assessment of national economic and financial losses, Middlesex University Flood Hazard Research Centre, 2002.

¹¹ Lessons learned—Autumn 2000 floods, Environment Agency, March 2001, <http://www.environment-agency.gov.uk/commondata/105385/126637>

¹² ABI Statement of Principles on the provision of flood cover, Association of British Insurers, September 2002, <http://www.abi.org.uk/Display/File/Child/228/Statement.pdf>

9. For properties that remain at high risk of sewer flooding, multiple incidents over the course of a few years are likely—for example, Peter Marcic’s case to the House of Lords.¹³ Ofwat’s own research¹⁴ shows that more than 60% of customers affected by sewer flooding in the last three years have been flooded more than once, and 15% of those flooded due to sewer incapacity over this period have flooded more than six times.

10. In such high-risk properties, the annual risk-based premium would approach the full reinstatement costs, and insurance may no longer be viable. Ofwat’s own research shows 84% of those making an insurance claim were still able to obtain insurance on renewal, but nearly half (46%) could not get competitive quotes. The insurance market requires good risk management to operate most effectively.

11. Availability of insurance should not preclude efforts to reduce the incidence of sewer flooding. Ofwat research shows that the majority of people who had experienced sewer flooding not only found it very upsetting but also were afraid to leave their house for a week or so due to the risk of a repeat event. Over 90% of those questioned wanted future risk alleviated, rather than compensation after an incident.

12. When the ABI met with Government Ministers last year to review the Statement of Principles, Elliot Morley was sympathetic to the need to reduce the incidence of sewer flooding. But of course the final decision rests with the regulator, Ofwat.

EFFECTIVE SOLUTIONS TO TACKLE SEWER FLOODING

13. Water companies have now submitted their final business plans to Ofwat. The plans propose costs of an additional £1.5 billion to maintain and upgrade sewerage infrastructure over the 2005–10 period. This increased expenditure is essential to minimise service failure, safeguard public health, and ensure that financial protection against sewer flooding can continue to be provided.

14. The outcome of Ofwat’s draft determinations¹⁵ published in August 2004 are summarised in Table 1.

15. The ABI is pleased that Ofwat has recognised the particular problems of sewer flooding and agreed funding sufficient to address 8,200 cases with the highest risk of flooding (10% annual probability)—that is 80% of proposals set out in water company final business plans. But after these properties are dealt with, at least 4,000 properties will remain at very high risk of sewer flooding, and 15,000 more properties at significant risk (5% annual probability). Allowing water companies to spend £830 million over and above the draft determination in order to tackle sewer flooding would add an extra £7.30 to the average customer sewerage bill each year.

16. For these properties, Ofwat has determined that a capital solution would cost more than £120,000 per property protected by the scheme. According to water companies themselves, applying a simple cost cap would disadvantage those properties at most severe risk, because capital solutions for those properties that have already flooded more than once would often exceed the £120,000 cap. Therefore, it is important that Ofwat encourages water companies to find cost-effective solutions to mitigate sewer flooding for these remaining properties, potentially most at risk.

17. In the Ofwat draft determination, some water companies have been allowed to adopt mitigation measures that reduce the consequences of sewer flooding, eg back-flow valves, door-boards. In setting price limits, Ofwat should ensure that all water companies who will not be able to remove properties from a 10% annual risk of sewer flooding through a capital scheme have sufficient resource to use flood-resilient measures to mitigate the impacts of sewer flooding.

18. In addition, the ABI would like further clarity in the final determination addressing:

- why projections in the number of emerging sewer flooding problems differ between the two water companies with the greatest number of properties at risk (Thames and Severn Trent) and Ofwat figures;
- how water companies can begin to identify solutions for the additional 15,000 properties facing significant risk from sewer flooding (5% annual probability); and
- to what degree water companies are able to take account of climate change and future housing projections in developing solutions (capital or otherwise) to address sewer flooding. This final point is considered further in the next section.

¹³ Judgments—Marcic (Respondent) v. Thames Water Utilities Limited (Appellants), House of Lords, December 2003, <http://www.parliament.the-stationery-office.co.uk/pa/ld200304/ldjudgmt/jd031204/marcic-1.htm>

¹⁴ Customer research 2004: survey of customers affected by sewer flooding, Ofwat, August 2004, [http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/rd1504—sewerflooding.pdf/\\$FILE/rd1504—sewerflooding.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/rd1504—sewerflooding.pdf/$FILE/rd1504—sewerflooding.pdf)

¹⁵ Future water and sewerage charges 2005—2010: draft determinations, Ofwat, August 2004, <http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/pr04DD—Full>

ADDITIONAL RISKS—CLIMATE CHANGE AND NEW DEVELOPMENTS

Table 1. Ofwat draft determination for water company plans to address sewer flooding. *Source: Future water and sewerage charges 2005 – 2010: draft determinations, Ofwat, August 2004.*

Number of properties (10 % annual probability flooding)	Company Proposals	Draft Determination
Existing internal flooding solved	6540 ^a	4360
Emerging internal flooding solved	4000 ^a	3840
Total internal flooding solved	10540	8200
Remaining at risk in 2009/10	5120^b	4030^b
External flooding solved	7640	4480
Repeated blockages solved	unknown	3700
Reduced consequences if flood occurs	unknown	4000
Total investment in sewer improvements	£1,470m	£640m^c
Annual increase in average customer bill	£13.01	£5.70

^a Estimated breakdown between existing and emerging problems

^b Discrepancy due to different estimates of number of emerging problems between Ofwat and Severn Trent/Thames

^c Includes a 10 % reduction due to efficiency gains, £350m from service enhancements and £290m from capital maintenance

19. Sewers are typically only designed to deal with relatively common rainfall events (3–4% annual probability), compared with river or coastal defences that protect against less common events (0.5–1%).

20. Without taking action early, sewer flooding problems are likely to get worse, as climate change and pressures for new homes increase the amount of water running off the land and into the drainage system. The long lifetime of sewerage systems means that we need to start preparing today for the impacts of climate change and new development plans.

21. Water companies should be able to include an allowance for climate change in the costs of any new capital scheme. New sewers should ideally be designed with sufficient capacity to cope with the increased heavy rainfall we will experience as a result of climate change.

22. Climate change scenarios show that it is not just the quantity of rainfall but also its intensity that will increase in the future, perhaps by up to 20%.¹⁶ This will increase the risk of urban flash-flooding, as present-day extremes of rainfall that exceed the capacity of sewers will occur more frequently. Research projects such as UKWIR's work on climate change and the EPSRC-funded Audacious project¹⁷ will provide helpful guidance on design criteria for new systems.

23. According to the Government's recent Foresight study¹⁸, the number of properties at high risk of localised flooding could increase four-fold by the end of the century. Average annual damages from sewer and drainage flooding could increase from £270 million to £2 billion–£15 billion, unless we start to take action today. Damages due to climate change could be minimised with investments of £110 million–£400 million per year, but only under the lowest carbon emissions scenarios. Damages still increased by 10 to 15-fold under the higher emissions scenarios.

24. Building a climate change factor into infrastructure projects is most cost-effective at the start of a project or during a major renovation. New sewers should be designed with sufficient capacity to cope with the increased heavy rainfall we will experience as a result of climate change. Research projects such as UKWIR's work on climate change and the EPSRC-funded Audacious project¹⁹ will provide helpful guidance on design criteria for new systems.

¹⁶ Climate change scenarios for the United Kingdom, UK Climate Impacts Programme, April 2002, <http://www.ukcip.org.uk/scenarios>

¹⁷ <http://www.eng.brad.ac.uk/audacious>

¹⁸ Future Flooding, Office of Science and Technology Foresight Programme, April 2004, <http://www.foresight.gov.uk/fcd.html>

¹⁹ <http://www.eng.brad.ac.uk/audacious>

25. New developments will place even greater strain on the sewerage system, particularly in combination with the impacts of climate change. Housing increases hardened surfaces, and extends the area of impermeable ground. High-density developments, as proposed in the Government's Communities Plan²⁰, could potentially suffer serious water run-off issues, unless drainage issues are fully considered and the supporting infrastructure upgraded.

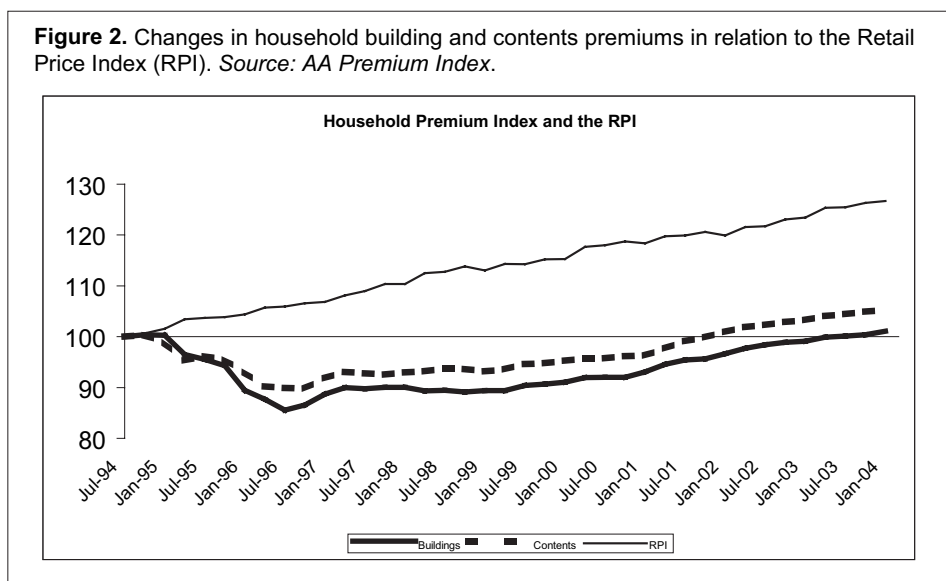
SOCIAL EXCLUSION AND COMPENSATION FOR FLOODING DAMAGE

26. Ofwat's customer research on sewer flooding²¹ suggests that disproportionately more customers aged 65 and over (36% compared to expected 28%) have experienced an internal sewer-flooding incident, perhaps due to the age of the property.

27. Although household insurance has risen in recent years in line with the Retail Price Index (Figure 2), ABI's own research has shown that 50% of households in the lowest income decile do not have contents insurance, often because other household costs leave no margin for "voluntary" charges such as insurance premiums. Poorer households facing higher sewer flood risk, and therefore higher risk-based premiums, could face particular difficulties in securing financial protection and face breaching their mortgage conditions.

28. In considering future investment needs, the ABI would support any approach that took into account social and financial exclusion concerns. The ABI actively promotes measures to extend the availability and affordability of financial protection products to the most vulnerable groups in society, such as "Insurance with rent" schemes, offering affordable homes contents cover to tenants of social housing.

29. The ABI supports Ofwat's work in reviewing the compensation arrangements for customers affected by sewer flooding.²² Insurance is the most effective mechanism for ensuring that customers are fully remunerated after a sewer-flooding incidence (provided the risk is managed). This process should be treated separately from the issue of compensation for the distress caused by sewer flooding, or financial assistance for vulnerable households where other factors, such as poor health, confinement, and fuel poverty, exacerbate the problems caused by such events.



CONCLUSION

30. The number of sewer flooding incidents has remained static at 5,000 to 7,000 properties each year since 1994. More than 60% of customers affected by sewer flooding in the last three years have been flooded more than once, and 15% of those flooded due to sewer incapacity over this period have flooded more than six times. The situation could become even worse in the future, as the impacts of climate change and increased housing development add further strain to the capacity of our ageing sewer systems.

31. As part of the ABI's Statement of Principles, the Government has agreed to examine solutions to reduce sewer flooding, including increased investment in the sewerage infrastructure.

²⁰ Sustainable communities: building for the future, Office of the Deputy Prime Minister, February 2003, http://www.odpm.gov.uk/stellent/groups/odpm_communities/documents/page/odpm_comm_023261.hcsp

²¹ Customer research 2004: survey of customers affected by sewer flooding, Ofwat, August 2004, [http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/rd1504_sewerflooding.pdf/\\$FILE/rd1504_sewerflooding.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/rd1504_sewerflooding.pdf/$FILE/rd1504_sewerflooding.pdf)

²² Out of sight-not out of mind: Ofwat and the public sewer network in England and Wales, Committee of Public Accounts, July 2004, <http://www.publications.parliament.uk/pa/cm200304/cmselect/cmpubacc/463/463.pdf>

32. The ABI is pleased that Ofwat has recognised the particular problems of sewer flooding and agreed funding sufficient to address 8,200 cases with the highest risk of flooding (10% annual probability)—that is 80% of proposals set out in water company final business plans. However, the ABI remains concerned that, after these properties are dealt with, at least 4,000 properties will remain at very high risk of sewer flooding (10% annual probability). Many of these properties are likely to flood several times more in coming years.

33. The ABI would urge Ofwat to do all it can through the periodic review of price limits to enable water companies to find cost-effective remedies to sewer flooding for properties with existing or emerging problems. By taking action to tackle sewer flooding today, flood insurance should remain readily available to the vast majority of householders in the UK, providing customers with the comfort that if they do suffer sewer flooding, the financial consequences at least will be minimised.

24 September 2004

Memorandum submitted by English Nature

KEY ISSUES AND SUMMARY

1. The draft price limits will deliver schemes and investigations worth almost £500 million to enable the statutory nature conservation programme as well as a small number of non-statutory nature conservation schemes, to be delivered.

2. The draft price limits excluded or amended around 86 nature conservation schemes or investigations. With the Environment Agency, we are discussing these changes with Ofwat, and will be seeking reinstatement of many of them. We are concerned that sufficient funding should be available to enable two pilot schemes at catchment level to be fully implemented.

3. We are working with Defra and other stakeholders to ensure that parallel action is taken to tackle diffuse water pollution from agriculture, targeted at priority catchments for SSSI protection, identified by English Nature.

4. The planned programme will provide an important contribution to future, more sustainable solutions to addressing some water quality issues, as well as contributing to some Water Framework Directive requirements.

5. However, there is scope to adapt the present price-setting process to enable:

- (a) Further use of more sustainable approaches to tackling water quality issues through catchment management, rather than through end-of-pipe solutions, with wider benefits to the environment and for people.
- (b) Where end of pipe solutions are needed, to encourage treatment methodologies that are themselves more sustainable.
- (c) Fuller consideration of the potential long-term requirements of nature conservation sites for water resources under changing climate scenarios, as modeling such relationships becomes more refined.
- (d) Greater flexibility in the way water resources scheme costs and requirements are provided for, based on sustainability reduction estimates, where the precise volume to be reduced is not known.
- (e) Early agreement among regulators on both shorter and longer term policy requirements.
- (f) Full consistency in policy approaches between Government guidance and the protocol for changes between planning rounds.

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: Sites of Special Scientific Interest (SSSIs), the most important of which are managed as National Nature Reserves.

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.

1. *Reaction to draft price limits*

1.1 The draft price limits have allowed for funding of around £454 million for schemes and investigations to tackle water quality and £38 million to tackle water resources problems affecting nature conservation sites. These are necessary in order to meet statutory requirements for Natura 2000 sites under the Habitats and Birds Directives, and SSSI protection under Countryside and Rights of Way (CRoW) Act 2000, as well as contributing to Government's commitment to achieving the UK Biodiversity Action Plan (UK BAP) objectives for wetland habitats. Ofwat has proposed funding which would deliver around 275 of the water quality and 82 of the water resources schemes and investigations proposed by English Nature and the Environment Agency under statutory policy drivers for nature conservation.

1.2 A number (86) of schemes and investigations under statutory nature conservation drivers were excluded or were otherwise amended in draft determinations. Reasons for this include challenges to the original cost estimates from companies; delays in the timetable for implementation of schemes, during which other measures for site protection (such as diffuse pollution control) should be introduced; and requirements for greater clarity in the outcomes required. English Nature is discussing these changes to statutory schemes with Ofwat and the other Regulators to clarify where uncertainties remain, and we will be seeking agreement for the reinstatement of many of them.

1.3 We consider it particularly important that schemes to achieve long-term and sustainable improvements to raw water quality through land management measures, should remain within the programme and receive sufficient funding to enable effective implementation. These schemes provide important pilot programmes for the wider adoption of longer-term sustainable solutions in future water planning rounds, as well as enabling companies to carry out their Section 28G duties under the CRoW Act 2000.

1.4 Among concerns raised during draft determinations has been the need to ensure that action is not required disproportionately from water customers to tackle problems that derive in part from other sources, such as diffuse pollution from agriculture. In our joint advice to Ministers (November 2003), the Environment Agency and English Nature 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. Both point and diffuse sources contribute in different ways to the problem of nutrient pollution of water, and both sources must be tackled together.

1.5 Diffuse water pollution from agriculture is a major source of nutrient enrichment and hence a cause of unfavourable condition in many freshwater SSSIs and Natura 2000 sites. In order to tackle this problem within the timescales required for achieving objectives for these sites, a transitional approach is needed which helps farmers to achieve the required changes in the short-term. To be effective, this needs to be adequately funded and implemented quickly. English Nature has identified those sites most at risk (Prioritising Designated Wildlife Sites at Risk from Diffuse Agricultural Pollution, English Nature Research Reports, No. 551, November 2003). This list of 105 catchments at greatest risk has been used in developing joint work with Defra and the Environment Agency to agree priority catchments for targeted action. This will include working with local partners and the farming community to make the most of opportunities for implementing best management practices created by the new Environmental Stewardship scheme.

2. *How has this periodic review taken into account longer term planning for pressures such as climate change?*

2.1 In addition to addressing long-term requirements for the protection of statutory nature conservation sites, a number of schemes within the proposed programme will contribute towards longer-term planning. These include the schemes proposed by United Utilities and Northumbrian Water for sustainable land management approaches to address long-term deterioration in raw water quality and schemes to implement solutions to emerging problems such as endocrine disruption.

2.2 Natura 2000 sites (Special Areas of Conservation under the Habitats Directive, and Special Protection Areas for Birds) are defined as Protected Areas under the Water Framework Directive. The Water Framework Directive requires action to achieve the conservation objectives of these Protected Areas to be in place by 2012, and for objectives to be met by 2015. In tackling risks and impacts to Natura 2000 sites, the water quality and water resources schemes and investigations under nature conservation drivers will also enable progress to be made towards achieving the objectives for these sites as Protected Areas under the Water Framework Directive.

2.3 However, we consider there is great scope to improve the process so that longer-term needs can be better identified and managed during the periodic reviews, as follows.

2.4 *Sustainable approaches to managing water quality via land management.* The schemes (United Utilities and Northumbrian Water) referred to in paragraph 1.3, will offer important benefits for upland SSSI management and long-term benefits for water quality. However they will also provide valuable lessons for

the adoption of similar approaches more widely in future. We believe that there is scope for similar schemes, for example in the chalk catchments of SE and SW England. Such schemes have not traditionally been promoted under the periodic review process because of the strict requirements on outcomes and criteria for their acceptance, which tends to favour “end-of-pipe” solutions, rather than schemes that address problems at source. Moreover, because the outcomes sought from such approaches often only emerge over the longer-term (especially changes to raw water quality) and so are less predictable, their benefits are less easily quantified using cost-benefit methodologies developed for more conventional schemes. Regulators should work together in future periodic reviews to build on the experience gained from these land management schemes to enable water companies to work in partnership with farmers, landowners and others to produce more sustainable solutions to environmental and raw water problems, help to reduce flood risk and thereby deliver multiple benefits for people.

2.5 Alternative treatment methodologies. There is a need for an approach which encourages the adoption of more innovative and sustainable treatment methodologies. Greater emphasis should be placed on the use of technologies which generally offer environmentally sustainable solutions, such as biological treatment or calcium treatment for phosphate removal. Such alternatives are often more costly to install or operate, but offer greater opportunities for phosphorus recovery and beneficial re-use and carry fewer risks of compromising water quality. Increasing requirements for phosphorus removal under the Water Framework Directive will make the need for alternative technologies increasingly acute.

2.6 Consideration of climate change. There are limitations in the degree to which predicted effects of climate change can be taken into account in a defined programme for investment covering a five-year period, but future planning rounds must incorporate more flexibility to enable such longer term consequences to be more fully considered. Investigations aimed at dealing with the changing rainfall pattern are likely to result in the recommendation of substantial changes to the infrastructure of water companies. The implementation of this will need long term planning, so that the infrastructure is in place before the problems become too large. This is particularly important in order to protect the water dependent environment, since supply problems usually result in water scarcity and thus an increased abstraction pressure on the environment which is already suffering from the effects of climate change. Most companies included an assessment of the implications of climate change for their water resources plans, however in future further work will be needed to understand the implications for requirements to protect biodiversity. Assessments of risks and impacts to nature conservation sites used in determining schemes under PR04 were based on existing estimates of water supply balance and existing estimates of requirements for functioning of ecosystems. Refinements to this approach, for example to take into account more episodic rainfall events and their consequences for river flow or groundwater recharge, will be needed in future.

2.7 English Nature and the Environmental Change Institute (University of Oxford) are leading a major research project (The MONARCH project: Modelling Natural Resource Responses to Climate Change) into the potential impacts of climate change on nature conservation in Britain and Ireland, funded by a consortium of 15 governmental organisations and NGOs. The model predictions include an assessment of the susceptibility of a range of habitats to changing water availability under climate change scenarios (described in English Nature’s evidence to the EFRA Inquiry into Climate Change and Water Security, April 2004). The first phase of the MONARCH project had as its primary focus terrestrial systems. A new project dealing with climate change impacts on freshwater ecosystems has started this year, led by the Environment Agency.

2.8 Future water resources planning strategies will need to take account of such further model predictions. Future industry pricing reviews should give further attention to measures which will mitigate the effects of climate change on water resource demand, and should enable more flexible arrangements to manage and exploit different sources of water within different regions. Water companies will need to plan to switch resources in response to seasonal availability from surface and groundwater sources, and to plan for water storage areas to enable exploitation of heavier, more episodic winter rainfall, and aquifer recharge.

2.9 Use of sustainability reduction estimates in water resource planning. Companies were required to prepare sustainability reduction estimates for water resources schemes in their business plans, where precise abstraction reductions needed to meet environmental requirements could not be estimated at this stage. Although such estimates were valuable in helping to identify the scale of investment likely to be required to develop water resources schemes within the AMP4 period, water companies were unable to use these estimates in deriving projected future costs of schemes. Whilst costs have been allocated to investigations or in some cases to carrying out options appraisal in PR04, the full cost of such schemes, which will need to be carried out during 2005–10, have to be recovered through interim determinations or logged up to the next price review. Further consideration should be given to methods of utilising costs based on sustainability reduction estimates in future price setting, to reduce uncertainty surrounding logging up and interim determination arrangements.

2.10 Early identification and agreement over policy requirements. There will always be policy issues requiring refinement or resolution during the periodic review planning process. However, where policy issues can be fully resolved in advance of detailed planning for a periodic review this should be concluded, with full acceptance by the regulators involved. An approach is needed which encourages early joint work between regulators and other stakeholders, to resolve policy conflicts where they are relevant to shorter term planning, as well as identifying longer-term policy planning needs beyond the immediate review period.

2.11 *Changes between programmes.* The mismatch between timetables for the Environment Agency's Review of Consents affecting Natura 2000 sites and AMP4 decision-making was recognised early in PR04. Investigations under AMP4 and RoC are likely to lead to changes to schemes which must be implemented within the period of AMP4 to comply with statutory requirements and avoid infraction risks. The Change Protocol, which enables the water companies to implement such changes, is therefore likely to be an important feature in enabling such compliance over the period 2005–10. The process must ensure that clear direction is given to companies about the requirements for meeting government policy, but at the same time maintain scrutiny over efficiency in operations. A cost-benefit challenge at this stage, as proposed in current draft of Change Protocol, is inconsistent with existing policy. Instead the focus should be maintained on ensuring timely and cost effective solutions.

27 September 2004

Memorandum submitted by Pippa Woods

I am a farmer with my own water supply, which is one of the reasons I manage to remain solvent. I write on behalf of those less fortunate.

The price South West Water charges for water is quite iniquitous. I understand it is a French company, so it no doubt enjoys making its British consumers suffer!

It is partly the fault of our government which is forcing SWW to bear the whole cost of "cleaning up the beaches" for the benefit of tourists from all over Britain, indeed the world. The cost of these sewage works should surely fall on the whole nation, not just the local inhabitants? I believe the SWW area has about the lowest average wage in England. If not the lowest, it is low.

(It may well be said that we benefit from the tourist industry. But in fact it is a lousy "industry", paying low wages, usually part time at that, and causing many physical and financial problems to the local inhabitants.)

To illustrate: A pensioner I know has a grandson who visits her a lot as his own home is most unsatisfactory. She does not worry about the cost of feeding him—what she worries about is the cost of his baths! And not the cost of the electricity which heats the bathwater, but of the actual water used. She is well aware that the more water used, the more she will also have to pay as a sewerage charge.

So this is a plea to do anything you can to induce South West Water to charge less. If possible, persuade central government that it should contribute to the cost of sewerage which, though seemingly local, in fact serves the whole nation.

Another point is that SWW is so inefficient that it is often fined for careless pollution. Fining seems pointless unless the money can be taken from the wages of the actual people at fault. Otherwise it simply increases the water bills further, adding to the poverty of SWW's customers.

September 2004

Memorandum submitted by the National Consumer Council

The National Consumer Council (NCC) is an independent consumer expert, championing the consumer interest to bring about change for the benefit of all consumers. We do this by working with people and organisations that can make change happen—governments, regulators, business and people and organisations who speak on behalf of consumers.

We are independent of government and all other interests. We conduct rigorous research and policy analysis and draw on the experiences of consumers and other consumer organisations. We have linked organisations in England Scotland and Wales, and a close relationship with colleagues in Northern Ireland. And we work with consumer organisations in Europe and worldwide to influence European and global governments and institutions.

We are a non-departmental body, limited by guarantee, and funded mostly by the Department of Trade and Industry.

INTRODUCTION

In November 2003, in a response to the setting of water and sewerage price limits, the NCC expressed concern for the position of low income consumers.²³ We reaffirmed our position that we had set out in January 2003 when we stated:

“We can see the logic of a period of stability, but given the reasonably robust financial health of the industry, we see no reason for prices to rise above inflation at the current levels of service. NCC is keen to see sustainable water resources developed which positively benefit the environment. But we would have to be persuaded of the merits of price increases for new capital expenditure.”

In the previous round of consultation we expressed serious concern about the inadequate justification given for the proposed steep price increases, and about consumers’ lack of capacity to afford such increases. So we are pleased that in these draft final determinations, the regulator, OFWAT, has set the average price rise at 13.7%, considerably less than the water companies’ proposed average increase of 29%. We also welcome that this final round of the review incorporates many of NCC’s previous recommendations on higher gearing, lower shareholder returns, a rate of return comparable with the public sector, cost effective use of research and development and greater attention to leakage control, in addition to more obvious environmental and drinking water quality improvements.

We fear, however, that the benefits of a generally moderate price determination could be lost for many low income consumers due to the growing price differential between metered and unmetered customers.

The issue of affordability for poor consumers is unlikely to disappear. It is almost impossible to reduce charges to the level at which no-one has difficulty, for the issue of affordability is not just a function of price it is also a function of income. Neither is this issue confined to payment for water services.

It is the need for balance between the level of prices required for the industry to function and the ability of poor consumers to pay which is proving to be so intractable. This is especially problematic in regions where costs are relatively high and incomes relatively low, such as the South West.

The solution to these problems cannot come from inside the water regulation structure alone. But the current vulnerable groups regulations are clearly not working and will not do so on the present basis. Given this failure, there needs to be a strategic approach to tackling affordability, and we are pleased that Defra is taking a lead on reviewing measures to help low income households.

AFFORDABILITY

There is a danger that OFWAT may send the wrong signal to companies if debt level is seen as a suitable candidate for interim determination, through being a notified item.²⁴ This would in effect mean that the generality of bill payers in a company area could be saddled with the cost of local debt.²⁵ This is bad in principle and in practice diminishes the pressure on companies to adopt the good practices that do seem to be working in some places. We repeat our disquiet at this proposal.

We reaffirm what we said in *Lifelines*, NCC’s policy document on essential services:

“OFWAT should consult on and formalise the guidelines on debt recovery so that they form a part of the companies’ licence conditions . . . This should be accompanied by a common approach for monitoring and routine publishing of companies’ practices on dealing with consumers in payment difficulties.”

NCC repeats its view that the vulnerable groups regulations are not working nor are they ever likely to do so as they combine so many of the disincentive effects that are common to means tested benefits. They are invasive of privacy, in terms both of income levels and personal medical conditions. It is entirely unsurprising that consumers have been reluctant to apply. There is evidence that the take-up level has risen²⁶ but only to 2.4% of those eligible, not of all of them consumers. This is a totally inadequate level and the experiment has clearly failed.

The longer term solution to the problem of affordability for low income consumers has to be firstly to restore the level of charge covered by the social security element closer to the full level. As we indicated in our response to the Defra consultation on the vulnerable groups regulations, the notional element of income support intended to cover water bills has not kept pace with actual water bills. During the decade following the social security changes of 1988, it fell from 80% of the average bill to 55%.²⁷

A second step would be for Defra to carry out a cost benefit analysis of all options for help with water bills. This could include consideration of up-to-date water charging systems, getting rid of optional metering, social tariffs, changes in the benefit system, payment methods and best practice for debt recovery.

²³ NCC. Maxine Holdsworth, NCC response to: setting water and sewerage price limits—a joint statement 12 August 2003. PD 91/E/03. p 3.

²⁴ NCC Setting price limits for 2005–10: framework and approach; response to OFWAT’s consultation. PD/05/03 2003 p 11.

²⁵ OFWAT *op cit* p 204.

²⁶ Public Utilities Access Forum briefing to members 2004, extrapolated from communication with OFWAT, August 2004.

²⁷ NCC, Water bill reductions for vulnerable groups; PD/47/03 p 5.

We are of course aware that much of this is outside the current remit of OFWAT, and so there is not much that can be done within the current set of determinations, other than to ensure that the problems are not worsened by higher price increases than necessary for poor consumers. The solution to this problem has to go wider. Nevertheless, OFWAT has a vital role to play in the wider development of options under Defra's current review of assistance to low-income households. Ofwat must cooperate fully with Defra, and further, take a creative and proactive approach to developing solutions to the problem of the unaffordability of water for many consumers. This is particularly pertinent, given its new duty towards disadvantaged consumers under the Water Act 2003.

THE COST OF DELIVERING THE OUTPUTS

We are extremely concerned about the widening differential between charges to measured and non-measured consumers. We actively disagree with the statement by OFWAT that when customers “with high rateable values and low consumption levels switch, it is fair to expect the remaining unmeasured customers—who have previously paid less than their cost of supply—to pay more”.²⁸

This largely reproduces a similar statement in the letter sent by OFWAT to the regulatory directors of the companies on January 20 2004.²⁹ This statement is more explicit than what is said in the periodic review:

“The present differential methodology ensures that this [ie the bill increase] happens because an increase in the average water delivered to remaining unmeasured customers will push the differential up, requiring companies to increase unmeasured charges relative to measured charges. In this way the differential helps to unwind the cross-subsidy that exists between existing unmeasured customers.”

In other words, even if there is no change in their consumption patterns, metered customers and non-metered customers bills will diverge. Optional metering ensures that this divergence will be in the direction of measured bills going down and unmeasured bills rising. This policy is predicated on the assumption that metering is cost reflective, an assumption which we have challenged many times.³⁰

In fact, in short run terms, the differences in costs of supply due to volume of water consumed are minor, being related to items such as electricity required for pumping. The bulk of the industry's short run costs are fixed. Indeed, most are on the sewerage side and consist largely of infrastructure maintenance. In long run terms it is true that volume has a greater impact, for example in creating the need to find new water sources. But in those circumstances it is far better to resort to compulsory comprehensive metering, which would not lead to arbitrary variations.

The differences between measured and non-measured bills are becoming very large indeed. Extrapolation from Table 10 of the Periodic Review document (Change in typical measured and unmeasured household bills) indicates that for South West water customers the differential will move from £169 to £244. This amounts to a colossal 41% variation for an unmeasured bill of £597 and cannot be justified by the differences between fixed and variable costs.

This approach flies in the face of the justification for metering that has been expressed by OFWAT in the past and which we recognise is accepted by many consumers too. That is the notion of greater individual choice and control by the consumer over his or her own bill.

But this notion of choice and control is only being applied to those who apply for a meter, while those who do not will face an increase. In effect, the consumer is being asked “would you prefer a high bill or a low bill?”. This is done in the knowledge that those who opt for a low bill will have their reduced payments made up by someone else.

This approach is certain to give the metering programme a bad reputation and to cause hardship to those consumers with high water needs. It will also undermine the relatively benign overall price determination. For it means that within that average there will be major distortions. This could then rebound and eventually affect companies' debt problems.

As we have said before, there may be times and places when and where single figure percentage reductions in consumption are needed that metering may bring. In those cases it should be compulsory. But it should be subjected to a analysis of an “economic level of metering” just as the leakage reduction programmes are subject to a “economic level of leakage”.

The OFWAT consultation in 2002 said: “There is an economic level of demand management activity in the same way that there is an economic level of leakage. We expect companies to approach their supply/demand investment appraisals in this manner.”³¹ But the 2004 review does not seem to take us any further in that direction, hindered as it is by an unwise legislation. We reiterate our opposition to optional metering.

²⁸ OFWAT *op cit* p 113.

²⁹ OFWAT Measured/Unmeasured Tariff Differential: Conclusions RD 02/04.

³⁰ NCC, Towards a sustainable water charging policy. November 2002.

³¹ OFWAT Setting price limits for 2005–10: framework and approach, PR 2004, 2002.

THE OUTPUTS REQUIRED

We believe that OFWAT is right to require “further and better particulars” where costs of particular projects or activities are not clear enough. But the problems do not relate simply to financial estimates for capital expenditure or maintenance. We have argued in the past for long term research and development to be integrated into the price setting cycle to allow for such uncertainties.³²

A positive development seems to be the development of “plumbosolvency” measures. According to Defra these have “virtually eliminated the need for strategic lead pipe replacement programme to meet . . . the standard” so that the cost allowed for in the determination is modest.³³ This will bring financial benefits for both companies and consumers. Similarly, progress is being made in dealing with nitrates which may involve less need for expensive nitrate removal treatment by use of blending.

In summary, NCC makes the following points:

Affordability

- We believe bad debt should not be a ‘notified item’ for purposes of interim determinations.
- We repeat our view that debt recovery guidelines should form a part of licence conditions, with a common approach to monitoring
- The vulnerable groups regulation are not working, and should be replaced. In the meantime, the element accounting for water charges in the benefit system should be restored to historic levels.
- Ofwat must take a proactive role in developing solutions to affordability problems. At present this is as an important player in the Defra review of measures to help low income households. In the future it will be an important part of fulfilling the regulator’s duty towards disadvantaged consumers.

Cost of delivery of outputs

- We express our serious concern about the high levels of differential between measured and unmeasured bills. This may undermine the benefits of a moderate overall price determination by causing problems for many families on low incomes
- We are sceptical about the methodology used by OFWAT in determining the price differentials
- We agree that unpredicted metering costs should be a notified item
- We reiterate our opposition to optional metering.

Outputs

- The cycle needs to allow for the need for long-term research and development
- We welcome continued emphasis on leakage control in the framework of economic level of leakage.

ADDITIONAL REFERENCES

- OFWAT Future water and sewerage charges 2005—10. Periodic review 2004. OFWAT 2004 p 204.
- NCC, Georgia Klein, Lifelines, PD/75/03; p 32.
- NCC *ibid*.
- Private correspondence.
- OFWAT *op cit* p 179.
- *Financial Times*, Insurers bolster defences against flood claims. 14/15 August 2004.
- *Economist*, Fog about floods, 28 August 2004.

30 September 2004

³² NCC *op cit* PD/05/03 pp 12–14.

³³ Defra, Principal guidance from the Secretary of State to the Director General of Water Services. 2004. pp 30-31; OFWAT *op cit* p 168.

Memorandum submitted by the Office for National Statistics

WEIGHTING OF WATER AND SEWERAGE CHARGES IN THE RETAIL PRICES INDEX

Water and sewerage charges are included in the Retail Prices Index (RPI), with a separate sub-index published monthly under the heading "Water and other charges" within the housing group.

In both cases, tariffs are collected throughout the country each April, from a range of major suppliers, and combined via information on company revenues to form a (weighted) overall price index. A distinction is drawn between unmeasured and metered charges, and for the latter average bills are calculated using estimates of average consumption to combine usage charges with standing charges.

Like (nearly all) other sections of the RPI, the weight for "Water and other charges" within the overall index is based on household spending estimates derived from ONS's main household spending survey (the Expenditure and Food Survey). RPI weights are updated annually. In 2004, the "Water and other charges" section has a published weight of 11 parts per 1,000, ie just over 1%.

Since the ROSSI index is currently defined to exclude certain housing components that are included in the RPI (specifically, mortgage interest payments, depreciation, rent and council tax), the weight for "Water and other charges" within ROSSI will be somewhat greater than in the RPI (the same is true of all other items included in ROSSI).

Using published information, its weight within ROSSI can be calculated as follows:

Weight for "Water and other charges" in ROSSI =

Weight for "Water and other charges in RPI / (total RPI weight less combined weight of those housing costs excluded from ROSSI) =

$$11 / (1,000 - 39 - 47 - 43 - 38) =$$

$$11 / 833 =$$

$$13 \text{ parts per } 1,000 \text{ or } 1.3\%.$$

November 2004

Benefit uprating: Note by Department for Work and Pensions

The Secretary of State for Work and Pensions is required to review the levels of all benefits and their components annually with a further requirement to increase contributory and non-contributory benefits at least in line with prices having regard to the economic situation. Therefore, it has been the practice for many years to increase these benefits, which include State Pension and Incapacity Benefit, in line with the Retail Prices Index which protects the purchasing power of benefits. Water and sewerage charges are included in the Retail Prices Index.

Income-related benefits, such as Income Support and income-based Jobseeker's Allowance, are uprated in line with an index based on the Retail Price Index less housing costs known as the "Rossi" index. This is the published index which most clearly reflects the cost of living increases for Income Support recipients since housing costs, such as rent or mortgage interest, are separately provided for under Housing Benefit, Income Support or income-based Jobseeker's Allowance.

Using an index linked to the increase in the general level of prices helps benefits keep their real value while increasing specific benefits by different amounts at particular times allows us to target resources on those who need help most. For example, our commitment to increase Pension Credit guarantee credit by earnings addresses the inequality between the richest and poorest pensioners.

November 2004

Memorandum submitted by Unison

PAYING FOR WATER (ENGLAND AND WALES)

1. This report from UNISON is concerned with how everyone in the UK pays for their water and sanitation services. It reviews the present arrangements and considers various alternatives. The report concludes by calling on Government to launch a public consultation exercise to explore the options for replacing the present arrangements with a new system for paying for water that is fairer and that takes account of the needs of low income households.

UNISON'S VIEW

2. At the 2004 Annual UNISON Water and Environment Conference the following resolution was carried.

“UNISON recognises that a new basis for paying for water services should be found to replace the existing outdated rateable value based system. UNISON believes that any new system has to ensure that sufficient income is generated to maintain a properly trained and adequately resourced workforce.

UNISON further recognises that consumers will expect a new system to be fair and reasonable with proper provisions to deal with socially excluded and financially disadvantaged people.

UNISON notes that unlike other essential public services, little or no public money is provided by Government for investment in water and sewerage infrastructure.

UNISON therefore calls on the Government to publish a consultative paper on the options for Paying for Water that takes full account of, among other things, the views of UNISON on behalf of the employees in the UK Water Industry.”

In addition, UNISON's policy is against the *compulsory* installation of domestic water meters.

THE EXISTING ARRANGEMENTS

3. Domestic water consumers pay for their water and sanitation services in one of two ways. Traditionally water charges were based on the rateable value of the property they occupied. This basis of payment has its historic roots in the municipal provision of water services and was retained by the water authorities in 1973 and again by the privatised water companies from 1989. 76% of domestic customers still pay for their water services using this system.

4. The level of charge actually paid by a consumer varies from one company to another dependent upon the price determination by OFWAT. Consequently consumers living in accommodation with the same rateable value in different parts of the country will pay a different charge. In 2004–05 a customer in Severn Trent would pay on average about £250 per annum while in the Southwest they would pay on average £442 per annum. Moreover these charges take no account of the consumer's rate of consumption.

5. Customers can elect to pay by water meter but just 24% of domestic customers do so. Consumers living in properties with a high rateable value may be better off paying by water meter. Certainly small households in properties with a high rateable value with just one or two residents are generally better off with a water meter. In 2004/05 in Severn Trent the average metered bill was £200 as opposed to an average of £250 for an unmeasured service. In the Southwest the difference was much larger with metered customers paying on average £273 compared to £442 for an unmeasured service. In effect unmeasured consumers are subsidising metered consumers and because better off consumers are more likely to exercise their choice to have a water meter it is the least well off that subsidise the better off.

6. Because of the municipal public service heritage of water services and charges there is no contractual relationship between a customer and the water service supplier—the water company. There is a public service obligation on water companies to provide water and sanitation services to all domestic households. These households are represented in a variety of forms including owner occupied dwellings, rented houses, blocks of owner occupied flats, blocks of rental flats and multi occupied houses and blocks of flats. It is not always clear to the water companies who exactly is using the water services and who is liable to pay. According to Water UK some 13% of water debt is owed by 6% of customers in multiple occupation dwellings.

7. Water debt is a growing problem. However, UNISON is a strong supporter of the Government's decision in 1999 to outlaw water cut-offs. UNISON believes that water is an essential public service and to deny access to water and sanitation services on economic grounds would severely compromise not just the health and well being of the consumers concerned but of society at large. By 2003 the annual non-recoverable debt was £164 million—equivalent to 700,000 households not paying their bills. According to OFWAT based on 2001–02 figures the average debt per customer was £156. Watervoice reckons that the current outstanding revenue is £893 million of which £527 million is over 12 months old. Some water companies make donations to charitable trusts set up to help consumers pay off their water debt. However according to OFWAT these donations have declined by 20% since 1999 and in 2001–02 the industry contributed just £3.5 million to charitable trusts. The Government, through the Ministry for Work and Pensions operates the Water Direct scheme whereby water charges are taken directly from benefit payments, but the consensus in the water industry is that this scheme is ineffective and needs to be replaced by some alternative scheme. This view is also shared by Watervoice.

8. The whole of water companies' expenditure on both operational maintenance and capital investment is financed almost totally from charges to consumers, supplemented only by each company's management of its equity and debt portfolios. The Government although recognising the strategic importance of the water industry's contribution towards environmental improvements makes no direct contribution towards the huge costs involved and seems content to leave matters with OFWAT to wrestle with the conflicting interests of consumers and environmentalists.

 THE ISSUES TO BE ADDRESSED

9. It is not difficult to recognise that the present regime for paying for water and sanitation services is arcane, outdated, unfair and ultimately unsustainable. The main issues of concern can be summarised as follows:

— *Unmeasured or Metered*

There exists considerable anxiety if not outright opposition to the idea of wholesale domestic metering. As far as it is possible to tell this view is based on fears that water metering would lead to higher costs for those most in need. These are often characterised as households that use more than the average amount of water, such as young families with children, single parent families on low income and multi-occupied dwellings. It is argued that for such groups an unmeasured system of charging is best. However this argument is not directed against meters *per se*, but the basis for charging. It is not difficult, technically, to design a tariff structure for use with meters that recognises the needs of low income households. It is interesting to note that the South African Government has agreed what they call a “life line tariff” that provides all citizens with a minimum supply of water at no cost. Consumption in excess of that is charged for.

This is but one example of how a tariff structure can be designed on a “step” basis to govern the consumption of water. There is also a strong water resource argument in favour of meters. They can act as a deterrent against wasteful use and they can assist with leakage control and the measurement of consumption. One difficulty that would need to be overcome is the identity, or lack of it, of who the water consumers are and what their individual circumstances are. Moreover the installation costs for domestic meters would need to continue to be borne by the water companies. Although there are persuasive reasons to justify an element of public subsidy from general taxation in recognition of the general social benefits of universal water metering.

— *Paying for Investment*

Having regard to the essential nature of water and sanitation it is curious that so little government support is given towards meeting the costs of investment in water infrastructure. Cleaning up rivers and estuaries, eliminating sewer flooding, replacing ageing sewers and water pipes—all this and more is paid for by water consumers through their water bills. Other, arguably, less essential services like energy, public transport and leisure receive massive amounts of public subsidy from government. Why not water? Because water consumers are not coterminous with taxpayers there is an argument that the cost of socially and legislatively required investment might be more equitably funded from the taxpayer than the water consumer. If this was achieved then the price of water to the consumers in the Southwest could be substantially reduced as much of the investment there is directed at coastal improvements for the benefit of holiday makers.

— *Water Debt*

The extent of water debt is clear and unless action is taken the problem will get worse. In theory there is a distinction between the “can’t pay” and the “won’t pay” but because consumer information held by companies is incomplete, such social categorisation is difficult to apply and the criteria would need to be universally agreed across the water industry. Leaving assistance in the hands of voluntary efforts by the water companies is not acceptable as it is patchy and insufficiently resourced. Government seems best placed to develop a scheme to operate alongside a new water charging system that can direct its assistance to those most in need like the elderly and low income households, possibly by means of a revitalised vulnerable groups system of support.

CONCLUSION

10. The purpose of this report is not to identify a preferred option for change but merely to convince Government and other stakeholders that some urgent thinking is needed to develop a new system for charging for water services that can command the support of most if not all stakeholders. That is why UNISON believes the Government should publish a consultation exercise now as a prelude to the introduction of a new water charging regime fit for the 21st century.

2 November 2004
