



Final Business Plans Full Statement
Tuesday 7 April 2009

Setting water and sewerage charges – industry takes next step in business planning for 2010-2015

Main statement

Water companies in England and Wales have today published final business plans for maintaining and improving water and sewerage services in the five years beginning 2010. The proposals have been submitted to Ofwat, the water regulator, in the latest stage of the 2009 water price review process.

Final business plans show how the industry proposes to continue investment in the reliability of the service while doing all it can to hold down the impact on bills.

Ofwat will now scrutinise the plans prior to publishing draft price limits for public consultation in July. Having taken account of responses to its consultation, Ofwat will publish final price determinations in November. Companies will use the new price limits to set charges that take effect a year from now in April 2010.

The price review is still at a relatively early stage. Plans submitted today contain a lot of information affecting customer bills which must be treated as provisional. Companies have made the best assumptions and forecasts they could on the information available about some factors which are very uncertain in the present turmoil. These include the rate of inflation, the impact of recession on demand for water, and the effect of financial market turbulence on the cost of capital.

Overview

Altogether the 21 companies are proposing to invest around £24 billion in capital projects between 2010 and 2015. Within this figure, levels of expenditure vary considerably between companies, reflecting differences in the customers they serve, the condition of the assets they operate, and the environment and climate they have to manage.

The effect on bills over the five years ranges from no real increase (bills will rise or fall only with inflation) to an increase of around £49 by 2015. The average bill in 2015 is forecast to be around £349 before inflation, an increase of about £28 (less than 9%) over the five years, or about £5.50 per year. (NOTE – all figures in 2007-08 prices.)

Advice

In preparing the business plans, companies have taken account of advice and comments on their draft business plans (published August 2008) received from interest groups including:

- Customers: the biggest research programme the industry has ever undertaken
- Ofwat: early guidance from its baseline capital incentive scheme
- Consumer Council for Water: learning from its extensive consumer research
- Drinking Water Inspectorate: on requirements of drinking water quality regulation
- Environment Agency: cooperation in planning the National Environment Programme
- Natural England: advice on catchment management and rural areas of special need.

Changes from draft plans

The result of bringing this advice to bear on their plans, together with the companies' assumptions about the variable factors means that there have been many changes in the detail of the plans.

Almost all companies have reduced their investment programmes - on average by 12% reflecting:

- customer priorities,
- discussion with regulators on priorities for meeting quality standards
- further internal challenge on costs and efficiency, and
- an assessment of how reduced economic growth expectations have affected their projections of demand and therefore need for new resources and capacity in the immediate future.

These growth assumptions have particularly (but not exclusively) affected companies in the south-east. Across the industry, companies' plans recognise the need to sustain expenditure on maintenance in order to ensure they can meet customers' top priority of a reliable and quality service. Total investment across the industry, although reduced, is still significantly higher than in the current five year period.

Upward cost pressures

Whilst companies have tried to contain the cost of their investment programmes, they have also had to factor in upward pressures on some costs that are outside their control. For instance, new information since draft business plans on proposed increases to business rates suggests a significant rise in these costs going forward. The recession has

increased bad debts and the cost of collection and at the same time reduced revenue projections. In addition, companies have seen further deterioration in investor sentiment feeding through into the cost of finance. For many, this has led to an upward adjustment of their cost of capital estimate.

Across the industry the interplay of these factors varies, with differing impacts on their proposed price limits. For some, proposed price limits are now higher than in the DBPs whilst for others, they are lower. On average across the industry, the result is expected price limits and bill increases of a similar order to those proposed in the draft business plans.

Companies have in effect managed to contain cost pressures by, in varying measures, reassessing investment needs and challenging their cost estimates.

In the current unpredictable circumstances it is almost certain that there will be other changes as the price-setting process goes forward.

Business plan themes

The main themes in the industry's final business plans are:

- 1) Concentrating on customers' priorities
- 2) Affordability
- 3) Price impacts beyond companies' control
- 4) Investment in resilience
- 5) Diversity
- 6) Financing investment

Concentrating on customers' priorities

Companies have put their customers' priorities at the heart of business planning. In the biggest research programme the industry has ever undertaken customers said that their top priority was a reliable, high quality water supply and wastewater service. They are willing to pay for essential improvements to ensure that this is delivered, but want prices to be fair and no higher than necessary.

Companies have reflected customers' wishes by seeking a balance between keeping prices as low as possible and continuing to improve reliability.

They could be proposing to make deep cuts in expenditure on maintaining and renewing assets vital to delivery of a reliable service. But this would put at risk the hard-won improvements of recent years and less, not more, reliability in future. Instead, they looked for efficiencies in every part of the business so that the essential work could continue and water charges still provide good value for money.

Ofwat said recently that efficiencies made by water companies have resulted in this year's average household bill being £100 less than it would have been without these savings.

Affordability

Companies have done everything they could to keep their prices for 2010-15 as low as possible. The price paid by the average household in 2015 will be about £349 before inflation, a rise of about £28 over 2009 (an average increase of about 8 pence per day). (2007-08 prices.)

The industry knows that any price rise is unwelcome, especially in a recession, and is working hard to ensure that customers, especially more vulnerable customers, find water bills affordable.

For example, companies provide help lines, flexible payment plans, help from charitable trusts and hardship funds, free water meters, help in applying for direct payment from benefits, advice on the 'WaterSure' tariff, promotion of debt advice agencies and support of local Citizens Advice offices.

Companies are working hard to help vulnerable customers. However ultimately it must be society's responsibility to ensure that everyone can pay for essential services - especially when society's wishes, expressed through legal obligations on companies, are in large part responsible for water bills rising. Government should consider how it could provide additional support through the tax and benefit system.

Price impacts beyond companies' control

In producing their plans, companies have had to take into account a number of factors that have increased costs. Although energy costs have come down recently, they are still higher than the levels built into current price limits, and increased bad debts, business rates and Environment Agency charges have also raised operating costs. In addition, the economic recession is also having an impact, with reduced water use requiring higher charges to recover costs.

Companies will continue to seek further ways to improve their efficiency over the next five years, but these external cost pressures mean that there is a need for an increase to overall operating expenditure before efficiencies for the next period are taken into account.

Investment in resilience

In their plans all companies propose to continue with significant investment in the resilience of their infrastructure. The importance of this has been heightened by the

serious drought in Southern England in 2005-06 and the floods of summer 2007. Much has been achieved by major investment in recent years to make up for the neglect of many decades in the last century. However the rate of renewal is still low with the replacement period for many assets running into hundreds of years. It would indeed be a false economy to put the achievements at risk by cutting back now to the level that got us into serious trouble in the past.

Diversity

Water companies are very different from each other for the good reason that they have evolved as businesses serving very different catchments and communities. In the water sector one size definitely does not fit all.

Each water company has produced a business plan for 2010-15 that will meet the priorities of its customers by taking into account the local geography, climate, population and economy, as well as the condition of the company's water mains, sewers and treatment works.

All these factors mean that the path to more reliable services is different for each company. For example, all companies plan to help customers reduce demand by using water more efficiently, but some must also plan to develop new sources of water for the future perhaps by enlarging an existing reservoir or investigating the need for a new reservoir in future. Different actions are also needed to improve the environment. For example, continued work to improve bathing water quality is important for some companies.

Financing investment

With the scale of capital investment that the industry needs to undertake, access to finance at the best possible rates is essential in order to spread costs associated with investing for the long term across generations and to underpin the affordability of the plans.

The credit crunch, and the ensuing financial turmoil and wider economic crisis, have made this a particular challenge for the next five years. The prospect of deflation has added to this challenge, as indeed it has to anyone who has to borrow – since the debt financing costs become a much higher proportion of the value of the investment. A recent survey of investors by Water UK indicated that for PR09 investors have become more cautious and sensitive to news flow.

In preparing their plans companies have used assumptions on the cost of capital that will enable them to attract investment under a range of plausible scenarios. Nonetheless, whilst markets remain so volatile, this remains a particularly difficult issue to pin down, and will be a focus of continuing assessment over the coming months.

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