

Financial performance is important for cost effective investment

1 Water companies and water bills are tightly regulated

Public water services in England and Wales are provided by private sector companies subject to tough economic, environmental and quality regulation. The Drinking Water Inspectorate, the Environment Agency and Ofwat, with guidance from the government, set the priorities and the standards the industry is legally obliged to meet.

To finance their work the companies are allowed to charge customers according to price limits set by Ofwat every five years. Ofwat carries out a detailed review of the funds the companies will need if they are efficient to deliver the service (operating expenditure) and invest in improvements (capital expenditure).

Decisions about investment (and therefore how much capital will be needed) are taken only after thorough consultation with the other regulators, the government, customer representatives and others like business and environmental interest groups.

When the requirements are settled the companies prepare management plans with budgets that are tested for Ofwat by independent consultants (called reporters).

2 For every £2 the industry makes in profit it invests £3 in the service

The companies must then implement their management plans and this is where financial performance and profits come in.

Regulation means that companies are expected to make enough profit to fund required improvements in a strict timeframe through paying interest and dividends to existing investors and attracting new investment if it is needed.

Ofwat allows a certain amount of finance for investment in the bills paid by today's customers but assumes that companies will be able to obtain any extra finance they need from the capital markets. Every year since 1990 there has been a significant gap – often as much as £1 billion – which has been filled by market investors. In fact for every £2

companies make in profits they invest £3 in equipment, plant, construction and maintenance.

They obtain most of their new investment by borrowing from financial institutions like pension funds. The institutions are happy to lend as long as they receive a fair rate of interest. In recent years companies' debt to the institutions has risen substantially and in March last year stood at over £30.8 billion or well over £1000 for every water customer.

Efficient companies that meet their obligations within the price limits and make satisfactory profits win investors' confidence and can obtain funds at competitive rates of interest. This is very much in customers' interests because it means lower cost investments which help to keep water bills down.

Companies have an incentive to be efficient because if they can meet their obligations for less than the cost agreed with Ofwat they are allowed to keep the additional earnings until the next price review. Then this reward for 'out-performance' is returned to customers in the price limits set for the following five years.

3 Water company profits make possible major investments in our quality of life

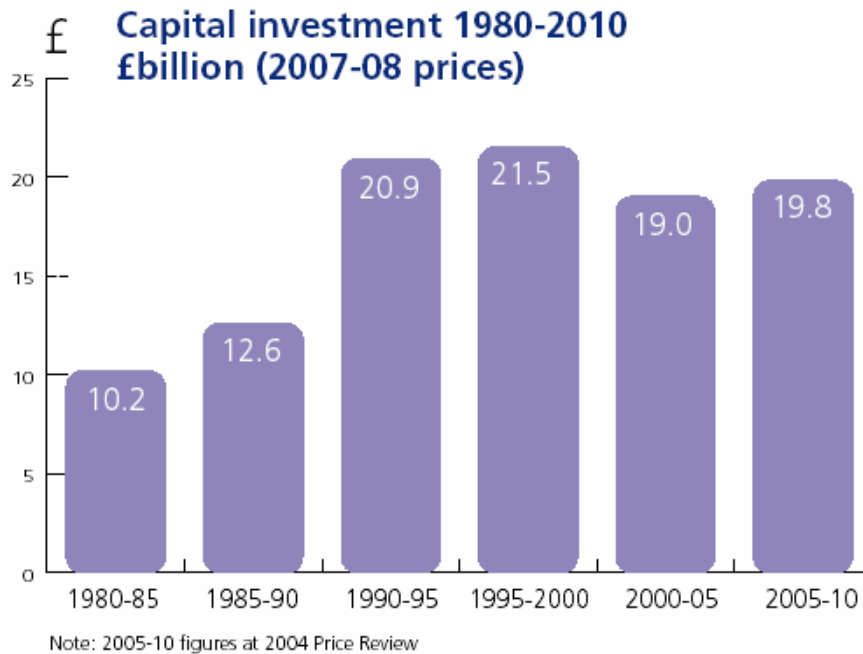
Not everyone realises (or remembers) how much value has been added to our quality of life by water industry investment. When we talk about water company profits we are also talking about successful investment in our quality of life including:

- the health of our rivers and streams
- cleaner beaches
- recovering wildlife
- near perfect drinking water quality,
- water resources to meet increased demand
- reduced flooding from sewers.

Between 1990 and 2010 the water industry will have invested nearly £80 billion in England and Wales – nearly double the rate of investment made when the industry was in public ownership. (Chart page 3).

The main advantage of this kind of regulated investment is that the benefits come more quickly and the costs are lower than they would be if the industry used a pay-as-you-go system. The costs can be spread over a longer term like a mortgage.

In 2008-09 the average combined water and sewerage bill in England and Wales was £330 or 90p a day. The average bill for 2009-10 is £342 a year. A litre of tap water costs around one tenth of one penny (0.01p).



4 Profit figures are meaningless on their own

Everyone depends on their water company for an essential service. Many people are also shareholders in water companies or have an interest in funds that invest in UK water. So naturally there is great interest when company results are announced. This interest often highlights profits but ignores other aspects.

It is simplistic to quote or compare profit figures without mentioning the assets (or capital) a company uses and the rate of return to investors.

In common with other utilities the assets owned and managed by water companies are very large. In 2007-08 the tangible assets employed are given a replacement value by Ofwat of £250 billion. But the regulator uses a more market-related base – regulatory capital value or RCV – to measure return on capital. In 2007-08 this figure stood at £45 billion and the average return on capital across the industry was 6.5%.

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