



WATER UK



Meeting Future Challenges

a blueprint for policy action

June 2010

Meeting Future Challenges – a blueprint for policy action

Contents

Foreword	3
Summary	4
1. Introduction	5
2. Context	6-8
2.1 What is wanted?	
2.2 The industry's ability to meet society's expectations	
2.3 The role of regulation	
2.4 The role of competition	
3. The way forward	9-14
3.1 Putting customers first	
3.2 Renewing incentives for efficient and sustainable delivery	
3.3 Developing flexible regulation that encourages sustainable and innovative behaviour	
3.4 Ensuring sustainable access to the capital markets	
4. Working together to implement the way forward	15

Water UK represents all statutory water and wastewater service supply organizations in England, Wales, Scotland and Northern Ireland. It works at national and European level for a strong water industry on behalf of its members and in the interests of all stakeholders.

Foreword

The UK water industry makes a significant contribution to public health, society, the economy and the environment. As citizens, we benefit from a drinking water supply and wastewater services that are among the best in the world.

Since privatisation in 1990, the industry has invested about £85 billion in UK infrastructure, with no contribution from the public purse – that is over £4 billion every year to maintain and improve the infrastructure on which the service depends. We will invest a further £22 billion over the next five years. The industry has an annual turnover of around £10 billion and employs over 35,000 people.

Customers are at the heart of the water industry. The most recent tracking survey shows that 95% are satisfied with the reliability of their water supply and 84% with their sewerage service. They trust their water company far more than their energy company¹. The industry was instrumental in pressing for, and obtaining, independent representation of water customers in the 2003 Water Act. Companies help customers – especially vulnerable customers – to afford their water bills in many ways: they provide helplines, flexible payment plans, free water meters, charitable trusts, and advice on the 'WaterSure' tariff and applications for direct payment from benefits. The average household bill is £100 lower than it would have been without efficiency gains made by the companies.

The water industry is inextricably linked to the environment. Our service to customers depends on a healthy environment and the industry places environmental performance and sustainability at the centre of everything it does. The UK water sector is the largest environmental investor in Europe and has achieved major improvements. Rivers are cleaner than at any time since the industrial revolution and are increasingly home to eels, otters and salmon.

Climate change will affect all aspects of the water industry – the quality and availability of resources, the supply and drainage infrastructure, the treatment needed to meet ever rising quality standards. We expect to manage more frequent droughts and flooding in future. To meet these challenges, the industry is actively involved in both mitigation and adaptation. We are seeking to be more carbon-efficient and to reduce our carbon footprint.

Water is the planet's most precious (and probably most undervalued) resource. We all need to make an effort to conserve it. The industry takes a lead in promoting water efficiency. UK water companies have been refitting customers' homes with efficient devices, subsidising water-saving equipment, and providing water audits. In November 2005, the industry set up and funded the independent NGO, Waterwise, to make the case for large-scale water conservation.

In the UK, we take clean water and decent sanitation for granted. But not everybody can. 884 million people in the world – one in eight – have no access to safe water, and 2.5 billion – nearly 40% – do not have adequate sanitation. At any one time in the developing world, half the hospital beds are filled with people suffering from diarrhoea caused by contaminated water. The misery and the economic impact caused are severe. Mindful of this, in 1981 the industry set up the international water and sanitation charity, WaterAid.

The water industry is successful. Now is the time to build on success for our customers, the economy and the environment. This paper sets out the industry's ideas about how this can be achieved in partnership with customers, government, regulators and many other interested groups.

Chris Loughlin, Chairman, Water UK
Pamela Taylor, Chief Executive, Water UK

¹ Consumer Council for Water Annual Tracking Survey 2009, FDS International, 2010

Summary

Introduction and Context

There is broad consensus about the challenges facing the water sector: pollution of water courses; managing surface water, flooding and coastal erosion; managing water resources to provide an affordable public supply; reducing greenhouse gas emissions; and adapting the service to climate change.

These challenges are relatively well defined and understood, as is the context in which they must be addressed. Company 25-year Strategic Direction Statements were well received¹. Customers are clear and consistent about what they want and what they are willing to pay. The companies have the experience and expertise to meet these expectations, but businesses are more likely to identify effective solutions in response to incentives than direction. It will be vital that they retain the support of customers and investors.

The paper looks at the complementary roles of regulation and competition and proposes an ambitious but realistic way forward. The existing regulatory system is a robust platform from which to work, but must evolve to allow delivery of the broader sustainability agenda that we now face – particularly in relation to carbon.

The way forward

Putting customers first

- A measured pace to improvements which ensures, overall, that prices are acceptable
- Customers and companies should take greater responsibility for customer service, negotiating through a strong and representative consumer body within parameters agreed by Ofwat
- Establishing a charging strategy which encourages customers to use water wisely and ensures that water and sewerage services are affordable

Renewing incentives for efficient and sustainable delivery

- Removing the bias between capital and operating solutions
- Improving incentives for operating savings
- Incentivising exemplary environmental and sustainability performance
- Facilitating capital market competition

Developing flexible regulation that encourages sustainable and innovative behaviour

- Decisions which have clear linkages to government policies and strategies
- Risk based regulation which focuses upon issues that are material to customers and other stakeholders
- Greater flexibility over compliance and the use of price signals to encourage sustainable outcomes

Ensuring sustainable access to the capital markets

- Re-emphasising with policy makers the ongoing need to raise large amounts of equity and debt capital, and Ofwat's joint primary duty to allow companies to finance their functions
- Ringfencing or allocating the Regulatory Capital Value (RCV) in a way which ensures the competition agenda does not strand existing investment

Working together to implement the way forward

There is much the industry can, and must, do, to take this way forward, but it cannot achieve society's goals on its own. Fortunately, the industry has a strong record of working successfully in partnership and looks forward to cooperating with many different groups to bring about the necessary reforms. In setting public policy, the government will find the water industry a willing, constructive and able partner.

¹ Published December 2007

1. Introduction

The water sector has delivered much over the last twenty years, building on what went before. It is well placed to meet the challenges of the future. But the time is now right to see if it can do more – for its customers, the environment, the economy and society.

The time is right because the formation of a new government provides an opportunity to look with fresh eyes at individual policies, the strategic framework within which they sit, and more collaborative ways of working.

The time is right because the sector has just concluded a round of price reviews, which, for a regulated sector like water, are significant milestones and set the context for a number of years. Before long, preparations for the next price reviews will start but there is a short window of opportunity to look forward at how best to meet the challenges of the future. This time – perhaps two years or less – must be used to identify, evaluate and implement the changes required.

The time is also right because there is a clear appetite to consider reform, both in the water sector and more generally. As well as price reviews, there have been two independent reviews in the water sector¹. Companies, regulators and commentators are proposing changes. More broadly, reform is being considered in other regulated sectors – energy, telecommunications, transport – and the turmoil in financial markets continues to have an impact on policy debates.

This paper reflects on the challenges the water sector faces over the next twenty years, and considers changes to the regulatory and competition regime that would help companies to meet them. It recommends targeted, practical reforms that can be adopted by the government and regulators in time for the next price review in 2014 and ways of working successfully together.

The paper has three core themes:

- First, there is a broad consensus on the challenges the industry faces. They have been clearly articulated by many commentators, in companies' 25-year Strategic Direction Statements, and through well-established customer views.
- Second, existing regulatory frameworks can provide a strong platform for the future, but need to evolve so that the sector can become more sustainable – particularly in relation to carbon. Reform should be evolutionary.
- Third, the industry's progress has made it well-placed to meet the challenges it faces. To continue to build on its success, two things need to happen:
 - Companies must be incentivised and regulated differently and
 - Companies and regulators must take customers and investors with them.

¹ Cave Review into Competition and innovation in water markets; Walker Review of Charging for household water and sewerage services

2. Context

2.1 What is wanted?

There is broad consensus on the challenges the industry faces and the long term goals it must aim for. By 2030, at the latest, there should be:

- Improved quality for the water environment and ecology that supports it, and continued high drinking water quality
- Sustainable management of risks from flooding and coastal erosion, with greater understanding and more effective management of surface water
- Sustainable use of water resources and fair affordable and cost reflective charges
- Reduced greenhouse gas emissions and
- Continuous adaptation to climate change and other resources across the water industry and water customers.

These objectives provide a sound basis for companies to plan, but it is recognised that they may evolve. Indeed companies would already welcome greater clarity on the government's view of their role in, for example, use of assets to co-digest food waste and generate renewable energy, as part of the national effort to increase energy from waste through anaerobic digestion.

The customer agenda is similar, albeit with a slightly different order and emphasis. In summary, customers are willing to support the wider environmental and sustainability agenda provided the basics of the service are transparently and reliably delivered at a price that is affordable. More specifically customers want:

- high quality, reliable services, delivered without restriction or interruption
- problems fixed quickly, efficiently and first time
- high quality, responsible and proactive customer services
- services delivered in a sustainable way, specifically by

- reducing the industry's carbon footprint
- improving environmental standards
- maintaining assets for future generations.

Evidence over time suggests that the typical water customer is willing for bills to rise in line with their incomes (1-2% per annum above the rate of inflation) although research at the last price review suggests that willingness to pay is now falling¹. Perhaps more importantly it is recognised that willingness to pay does vary between households and businesses, and between income groups. Whilst water remains cheap for most, 1 in 10 households now spend more than 3% of their budgets on water and sewerage services. This suggests the need to place as much emphasis on charging policy as on overall price controls.

2.2 The industry's ability to meet society's expectations

Companies have already proven themselves able to deliver the outcomes that customers and wider society wants. Since privatisation there have been substantial improvements in environmental standards, drinking water quality and customer service. Recent business plans have begun to embrace wider sustainability objectives. New tariff structures aimed at encouraging sustainable use and dealing with affordability have been introduced. All this has been achieved against a background of improved operating efficiency and a proven ability to raise large amounts of capital even in the most challenging of economic conditions.

Over the twenty years since privatisation, the industry has invested about £85 billion in improving drinking water quality, the water environment and customer service. This investment has delivered step changes in performance:

- consumers have access to excellent drinking water, with 99.96% compliance with tough EU

1 Understanding customers' views, Ofwat, February 2009

standards under a sampling regime that is second to none

- leakage levels are down by 35% from their peak in the mid-1990s
- the proportion of properties that are at highest risk of sewer flooding has reduced by more than 75% in the last 10 years
- environmental standards have improved significantly:
- 98.6% of bathing waters in England and Wales meeting the required standards, compared to 78% in 1990
- In 2008, 72% of English rivers were rated either good or excellent compared with 55% in 1990; 88% in Wales compared with 79% in 1990.

Bills have gone up by about 44% in real terms, but customers on average still pay less than £1 per day for water and sewerage services.

2.3 The role of regulation

The industry's success has been greatly assisted by stable and transparent regulation. The fundamentals of water regulation have largely been preserved since privatisation in 1990 and are one of the underlying reasons why the industry has been able to attract the necessary investment and improve overall performance.

Ofwat's RPI-X+K framework has proved to be a powerful cost reduction mechanism, whilst the creation of Regulatory Capital Value (RCV) and the associated duty to finance functions has enabled improvements to service through large capital programmes. The system worked well because:

- at privatisation there was enough headroom in balance sheets to accommodate a capital investment programme expected to last for 10-15 years
- customer service could readily be improved
- compliance standards could be narrowly defined

- there was scope to reduce operating costs, and
- understanding of the demands of sustainability was in its infancy.

Today, the situation has changed, in particular:

- capital investment to meet new obligations will continue for at least 15 more years, and probably beyond
- willingness to pay for improvements has fallen but expectations of service have grown
- there is a growing affordability problem amongst some customer groups, and
- there are diminishing returns in operating efficiency.

Perhaps most crucially, the demands of sustainability, particularly in relation to carbon, now require companies to think outside of traditional, end-of-pipe, capital based solutions – and possibly beyond their existing statutory duties. Sustainability also requires regulators to account better for external and social costs when setting compliance targets.

While the basic regulatory framework is robust and should continue, it must also evolve to create incentives for the kind of solutions that will increasingly be needed.

As changes to the framework are considered, it will be crucial to manage the risk of losing the support of customers or the capital markets on which the industry depends in order to fund investment in essential maintenance and service improvement.

2.4 The role of competition

Market forces have a significant role to play in promoting innovation and delivering services sustainably. Competition among contractors and equipment and service suppliers exists throughout the supply chain. Comparative competition

between water companies has driven efficiency and service improvements. Market pressures have encouraged companies to be innovative in financing. All this benefits both customers and investors, but companies would welcome more forms of competition where it is in the interests of customers.

It is recognised that competition for final customers may improve the focus on service and provide greater choice. In Scotland, where there is competition for business customers, there is evidence that prices have fallen and service has improved. But as the share of final bills that is accounted for by “supply activities” is modest, widespread customer interest may be limited. Moreover, as noted by the Cave Review¹, the transaction costs associated with a wholly liberalised market may be disproportionate to benefits.

There is also a question about whether customers – at least household and small and medium business customers – actually want a liberalized market. Their experience from the energy sector has led them to distrust competition as a means to deliver the value for money, quality of service and simplicity that they seek from utilities. This is backed up by evidence which indicates that customers are more likely to trust their water and sewerage company, and agree that it cares more about the service they receive, than their energy company².

Other parts of the delivery process are, and will remain, natural monopolies. It makes little sense to duplicate pipe networks, but competition for green field developments is possible and should

be welcomed provided that access prices are appropriately set, and service standards properly regulated and coordinated.

Upstream competition is also possible and may well offer the best prospects for further efficiencies and innovation. For example, there is more resource capacity available than is needed at times of peak demand but it is not fully utilised because companies and others do not trade water extensively. Currently there are difficulties and barriers to entry which limit trading, including:

- Planning permissions for new assets, such as water treatment works, are hard to obtain
- Asset networks are not integrated
- Access pricing arrangements have not been appropriately developed or agreed. In particular, consideration has yet to be given to how capital value should be allocated across the supply chain
- Increasing the value of assets to make them contestable may increase the risk of stranding and lead to a higher cost of capital.

Most importantly, there are limited incentives to encourage full consideration of the economics of trading, so it is hard to assess whether or not extensive trading is viable

Competition is not an end in itself but should be seen as one of the tools available to policy makers. Whether or not greater use of competition is made should depend upon whether it is the best tool available to spur delivery of the customer and government agenda for the sector.

1 Independent Review of Competition and Innovation in Water Markets, Professor Martin Cave, 2009

2 Consumer Council for Water Annual Tracking Survey 2009, FDS International, 2010

3. The way forward

In order to deliver what customers and wider stakeholders want companies, regulators and government should focus on four activities:

- 3.1 Putting customers first
- 3.2 Renewing incentives for efficient and sustainable delivery
- 3.3 Developing flexible regulation that encourages sustainable and innovative behaviour
- 3.4 Ensuring sustainable access to the capital markets

These priorities are aimed at incentivising the industry to meet successfully the challenges it faces, taking both customers and investors with it.

3.1 Putting customers first

A measured pace to improvements which ensures overall prices are acceptable

At each price review mandatory improvements in water or environmental quality, combined with a political imperative to keep the headline prices down, have crowded out many of the improvements that matter most to customers. Environmental regulators and NGOs have had more success as political lobbyists than consumers or their representatives. In an attempt to counter-balance this, Ofwat has tried to take the role of consumer champion but, understandably, has struggled with a true understanding of the needs of customers in each region, relying heavily on surveys and cost benefit analysis.

Whilst companies have delivered the improvements resulting from price reviews, the bias towards what customers might regard as opaque environmental outputs has led customers to question what they are getting for their money. It is hardly surprising that this has resulted in a reduced willingness to pay.

In an environment driven by media and politics the headline number at a price review is an important determinant of the overall acceptability of the package. Companies and regulators need to ensure a measured pace to improvements, with a focus on the issues that matter to customers, so that prices remain acceptable.

Negotiate with a strong and representative consumer body

In most markets competition means a company's priority is to understand and deliver what customers want, whilst issues such as mandatory environmental standards are regarded more as constraints within which to operate, rather than key business drivers. In water, it is arguably the lack of meaningful choice that tips the balance of power away from the consumer towards regulators.

Customers and companies both need to take greater responsibility for outcomes. It has been suggested that this could be achieved by some form of constructive engagement, or even negotiated settlement, with a consumer body. At its simplest this could be an extension of the current process. The Cave Review has suggested that things could go further with negotiated settlements between water companies and the Consumer Council for Water (CCWater) in time for the next price control in 2014-15.

It may also be possible to empower customers by allowing the final package of services and price to be negotiated directly with a consumer representative within broader parameters agreed with the economic regulator. The process may give additional legitimacy to the consumer voice and, in doing so, improve willingness to pay for the broader sustainability agenda.

For any of this to be successful the consumer body must be strong, representative, knowledgeable and probably local. It is questionable whether CCWater

as currently constituted meets all of those criteria. Suggested alternatives include consumer panels drawn from local authorities, consumers themselves or a combination of both. In any event, for the change to be successful the consumer body must be given both the power and the ability to represent customers effectively.

Establishing a charging strategy which encourages customers to use water wisely and ensures that our services are affordable for all

As individuals, customers are concerned with the specific price they pay and the service they receive. It is this which ultimately drives how they use water, and determines whether they can and will pay their bill.

The majority of domestic customers continue to pay in relation to the old rateable value system with little, if any, incentive to use water wisely. This is despite the fact that in many parts of the country demand management will be increasingly important if we are to balance demand and supply and reduce the industry's carbon footprint.

Metering does have a marked impact on demand and leakage from customers' pipes and, with the right tariff, has the ability to reduce usage at times of high demand. Customers largely accept that metering is the fairest way to charge. However it is recognised that a move to compulsory metering of customers in their existing homes could risk increases in bills for some customers, which may lead to increasing bad debt. When customers move into properties where they know a meter is installed the change is readily accepted.

A further challenge is the unwinding of existing cross subsidies as people choose to move to meters. The consequence of optional metering is that the bills to remaining unmeasured customers (who increasingly are those on lower incomes with little choice other than to use large amounts of water) increase much faster than average. This is

already raising concerns in the industry, amongst consumer groups and the media.

The industry's role in social policy remains unresolved. Customers believe that subsidies should be a matter for government, not private sector companies. Most people would probably agree, but the reality is that government has refused to offer any meaningful support for water customers (unlike for energy customers) and, consequently, companies have to deal with affordability problems daily. Failure to deal with the issue will at best result in additional bad debt but could also risk a significant backlash.

Where the challenge is to encourage sustainable use of water whilst ensuring our services are affordable for all, four steps should be considered:

- Meter properties on change of ownership
- Evaluate alternatives to flat rate tariffs, particularly using smart metering technology
- Explore with government the acceptability of social tariffs and if necessary implement, and
- Rework the unmeasured / measured differential¹ to slow the pace at which existing cross subsidies are unwound.

It is understood that this charging approach is not the cheapest, nor is it necessarily appropriate for all companies. There are clearly regional differences which should be recognised. However, where there is potential water shortage, or where metering is widespread, this policy should reduce both leakage from customers' pipes and lower demand in a way that mitigates price increases for vulnerable customers.

3.2 Renewing incentives for efficient and sustainable delivery

The industry is prepared for future challenges but in

¹ For example by basing it upon the average use rather than the residual unmeasured use

order to deliver the best outcomes, it needs barriers to be removed and to have appropriate incentives. There are four changes that would help:

Removing the bias between capital and operating solutions

Immediately after privatisation in 1990, companies were encouraged to reduce operating costs by outperforming the assumptions made at price controls. This was one of the foundations of incentive-based regulation. Through time the scope to do this has been significantly reduced, highlighting the fact that, at least in the long term, the regulatory regime only allows companies to make profits by building assets.

It is not surprising therefore that companies show reluctance to embrace activities which should fit relatively comfortably with existing functions. Examples of these activities are adoption of private sewers and some sustainable urban drainage systems (SDSs), and undertaking more extensive catchment management. Another increasingly important example is water trading.

Water trading is a complex subject that needs to be fully evaluated and understood. One reason why this has not happened to the extent that it might have done is doubt about whether it is worth exploring. If trading is to deliver more sustainable outcomes, the Environment Agency (EA) will have to assign values to abstraction rights which properly reflect environmental costs. This is a big task in comparison with simply time-limiting or removing rights they deem to be unacceptable and thereby forcing companies to construct alternative assets. Companies have accepted this position, perhaps because they have very limited incentives to trade. If a company sells water to a neighbour then any profits are captured after 5 years and its own customers have reduced security of supply. If a company buys water from a neighbour they forgo the return on the new assets they would otherwise

have built, and are deemed to have lower operating efficiency.

The resulting bias towards local, capital-based solutions is well recognised and readily remedied. The regulatory regime should allow companies to earn the same present value return on operating and capital based solutions¹. As a starting point this should apply to proposals to meet new quality or environmental obligations, or clearly identified improvements to customer service, in the 2015-2020 price control.

Improving incentives for operating outperformance

Most companies would agree that further savings in operating costs are possible. However with around 80% of the gross benefit of the savings continuing to flow to customers, diminishing returns and heavy penalties for operational failures, the case to find savings is increasingly limited. In order to give fresh impetus to a system that has done much to keep customer bills down, the period before which efficiencies are clawed back should be progressively extended. This is particularly important where there are also carbon benefits such as those arising from further investment in renewable energy.

Incentivising exemplary environmental and sustainability performance

Ofwat's Overall Performance Assessment (OPA) successfully improved customer service, quality standards and environmental standards. However, as companies increasingly bunched towards maximum scores the system began to lose its value as a tool for innovation. Moreover, the incentives within the OPA were not well balanced between customers and other stakeholders. The creation of Ofwat's Service Incentive Mechanism should be welcomed as it is likely to increase the prominence of the issues that matter most to customers.

However, this change has left environmental

¹ The WICS is considering going further and creating a positive bias towards operating based solutions, but this may be motivated by pressure on public sector finances in Scotland.

standards, and a number of important sustainability objectives, subject only to sticks and not to carrots. It is good for a company's reputation to outperform minimum standards, but this does not leave investors with any tangible returns on the investments made, for example, to ensure zero pollution or an exemplary reduction in greenhouse gas emissions. These are areas that matter to both customers and wider stakeholder groups, who welcome outperformance provided that it does not increase bills too rapidly. As such, exemplary performance should be incentivised and rewarded.

Facilitating capital market competition

People looking at the sector from outside struggle to see why the industry is organised as it is, particularly as customers think of water and sewerage services as integrated services. Whilst there have been mergers between companies since privatisation, the pressure from Ofwat to maintain comparators and the perception of a "merger tax" has resulted in limited activity.

The Cave Review considers that innovation has been stifled by the perceived inability of one company to take over another. It further considers that Ofwat is over-reliant on comparators, particularly when there is evidence that the power of comparative competition is not what it was ten or so years ago. If reforms identified in the Cave Review were implemented then, Cave argues, the need for so many comparators would be reduced. To that end the Review recommends:

- raising the threshold for an automatic reference to the Competition Commission to a turnover of £70m, and applying it to the smaller of the 2 entities that propose to merge
- removing the threshold completely for retail only mergers
- introducing a first stage test where Ofwat has to advise the Office of Fair Trading (OFT) on the potential detriment from a merger before the OFT

recommends whether there should be a reference to the Competition Commission

- Ofwat should quantify the value it places on the loss of comparators, and that it should publish the findings. This should include a methodology which could be used by companies and investors who are considering a merger.

These are positive proposals which could stimulate further innovation and efficiency.

3.3 Developing flexible regulation that encourages sustainable and innovative behaviour

Companies respond to the signals and demands of government and regulators. For companies to deliver the new agenda, regulation needs to evolve from a position where it is detailed and focussed on complete compliance, to a position where it is risk-based and focussed on issues which are material to customers or other stakeholders.

Specific changes in regulatory behaviour that may result in more sustainable outcomes, greater innovation and lower regulatory costs, include:

- an acceptance of potential for compliance failure where innovative sustainable solutions are being implemented but are not guaranteed to succeed
- penalties for failure which balance rewards for success
- demonstrating that decisions taken clearly fit within government policies and strategies
- setting compliance standards having demonstrated that the benefits to be achieved outweigh the costs – including the carbon and social costs – of delivery
- making greater use of price signals – for example by developing a more flexible abstraction and discharge charging regime, with variable prices which reflect the environmental costs actually

- imposed at specific times or locations
- greater clarity on which regulatory body is responsible for policy decisions such as those relating to balancing demand and supply
- the application of materiality tests to regulatory reporting, and
- lighter touch regulation for companies with strong track records, and transparent and robust reporting systems.

3.4 Ensuring sustainable access to the capital markets

The cost and availability of capital is arguably the biggest single issue the industry faces. The sector is, and will remain, cashflow negative and will require on-going refinancing. The cost of capital is the single biggest influence on customer bills.

The industry has clearly been successful in raising capital, and there is little indication that this position will change in the near future as:

- in accepting price controls existing equity holders accepted, at least implicitly, that they would provide a third of the finance required for new investment
- the conventional bond market is open, and prices are reasonable and
- other key lenders such as the European Investment Bank indicate that they will continue to support the sector.

This should not be taken as complacency on the part of the industry.

The cost of finance is higher, and its availability lower, than in the past. Equity returns may be acceptable now, but only because companies remain able to pass on to shareholders the low debt costs that were incurred in the first part of the last price control period. There are concerns about

capital market conditions, in particular whether the scale of government borrowing will crowd out water companies' attempts to raise finance and whether the index-linked market will open up.

Regulators cannot assume that capital will be available when it is required. Investors have choices and many opportunities to place their money. Just within the UK infrastructure market, it has been estimated that over £400 billion will need to be invested by 2020, with over £300 billion of this in the UK utility sector¹. The water industry will need to compete hard if it is to obtain the capital it requires. Crucial to the outcome will be the balance between reward and risk, particularly regulatory risk.

Some investors are concerned about Ofwat's attitude towards the City. Invesco (the largest single institutional investor in the sector) was critical of Ofwat and its process earlier this year² and clearly signalled that its support for the sector cannot be taken for granted. This is worrying as attracting and retaining equity within the sector is crucial to risk taking and therefore to innovation. It is vital that policy makers and companies make a compelling case when proposing change, particularly in relation to competition, if they are to take investors with them.

Existing investors did not buy into a competitive water model, and some are concerned that Ofwat's reform and competition agenda will result in stranded assets. This concern may be overplayed, but nonetheless it must be dealt with.

One approach, suggested in Scotland by the WICS, would be to ring-fence the existing RCV. This would facilitate competition for new assets, but would do little for the overall efficiency of water services, as customers may end up paying for two sets of assets.

1 Delivering a 21st century infrastructure for Britain, Dieter Helm, James Wardlaw and Ben Caldecott, Policy Exchange, 2009

2 Water UK City Conference, 25 February 2010

Rather than promoting entry for entry's sake, it would be better to encourage the use of existing assets. The cost of these assets has already been incurred, and it would be in the interests of the overall efficiency and sustainability of the UK economy to make full use of them. This could be encouraged by increasing the proportion of the industry's total capital value allocated to the water and sewerage networks.

This may under-estimate the value of water resources and treatment, particularly from an environmental perspective¹, and would create a barrier to third party upstream entry, but it would avoid expensive duplication of existing assets, and would not preclude competition for new assets. The industry would welcome further debate on this particular subject.

1 Although this can be dealt with by the EA pricing abstraction in a way which reflects true environmental costs

4. Working together to implement the way forward

There is a broad consensus about the challenges facing the water sector, which are relatively well defined and understood. Companies' 25-year Strategic Direction Statements were well received. Customers are clear and consistent about what they want and what they are willing to pay. Companies have the experience and expertise to meet these expectations, but it would be more effective to incentivise, than to compel, them. It will be vital that they retain the support of customers and investors.

The existing regulatory system is a robust platform from which to work, but must evolve to allow delivery of the broader sustainability agenda that we now face – particularly in relation to carbon.

This paper sets out a direction based on four priorities we should all focus on:

- Putting customers first
- Renewing incentives for efficient and sustainable delivery
- Developing flexible regulation that encourages sustainable and innovative behaviour
- Ensuring sustainable access to the capital markets.

There is much the industry can, and must, do, to take this way forward, but it cannot achieve society's goals on its own. Fortunately, it has a strong record of working successfully in partnership and looks forward to cooperating with many different groups to bring about the necessary reforms. In setting public policy, the Government will find the water industry a willing, constructive and able partner.

Working together, we can deliver more, for customers, the environment, the economy and the whole of society.



Water UK • 1 Queen Anne's Gate • London SW1H 9BT • www.water.org.uk