



**Future water and sewerage charges 2010-2015:  
Draft determinations Ofwat 23 July 2009**

**Water UK Response  
22 September 2009**

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## **1 Introduction**

This response is made by Water UK in representing the views of the 22 statutory water supply and sewerage companies in England and Wales. Our members' opinions may differ in some respects but this paper provides a summary of the main concerns shared by companies at an industry level, with additional detail provided in annexes.

The response is divided into 3 parts.

Sections 2 and 3 contain general observations on: challenges facing the industry; and concern that, despite encouraging signs that the review would follow a sustainable, incentive-based approach, implementation has fallen short of expectation.

Sections 4 to 9 cover specific concerns about: a perceived disconnection in the Draft Determinations (DDs) from companies' Strategic Direction Statements; flaws in Ofwat's implementation of the capital expenditure incentive scheme and approach to the recognition of operating expenditure; failure to reflect the exceptional changes in macroeconomic and financial market conditions when setting financial parameters; and the resulting impact of the DDs on investor confidence.

A final section contains annexes setting out in more detail concerns around the Capital Incentive Scheme assessments and adjustments and Ofwat's reduced number of Notified Items.

The response draws on, and should be read in conjunction with, two new independent research reports commissioned by Water UK, referred to in the text.

- 'Ofwat's PR09 Draft Determinations: A Review of the Financial Assumptions', by NERA, August 2009 (available on Water UK's website, along with NERA's earlier January 2009 report)
- 'Investor Survey: Ofwat's PR09 Draft Determinations' by Indepen, September 2009 (available on Water UK's website along with earlier Indepen surveys)

## **2 Challenges facing the water sector**

The water sector is a fundamental part of the national infrastructure, essential to the health and economy of the country. The challenges facing the sector are becoming ever more evident. Just as there are increasing concerns about energy supply security and capacity issues in transport, overlaid by a common need to mitigate the impacts of and adapt to climate change, so these issues are to the fore in the water sector.

Through extensive research undertaken by all companies, and close consultation with customers and other stakeholder groups through the business planning process, it is clear that customers value above all a reliable service and high quality water supplies. There is an increasing awareness of the significant challenges ahead and a willingness to support companies' plans – and to pay for necessary investment to address these.

Recent droughts and floods have highlighted the need for a resilient water and sewerage infrastructure, the pressure points in an ageing network of pipes and sewers, and increasing capacity constraints in highly populated regions and those expecting further growth. There are also increasing concerns about the further costs of improving water and wastewater treatment, both to customers and in terms of reducing the industry's carbon footprint and impact on the climate – making clear the need to develop more integrated, locally sensitive, catchment wide solutions. The future means that the water industry may have to look very different by 2050, in terms of its infrastructure and its processes. This will require forward thinking, innovation and investment. The regulatory framework should seek to encourage this.

### **3 Early indications of a sustainable, incentive-based approach ... but implementation has not met expectations**

These challenges were clearly set out in the Government's long term vision for the sector, Future Water, and have been further articulated in both the recent independent Cave and Walker reviews of the sector and in the Council for Science and Technology's report on innovation in the sector. Ofwat was given a new Sustainable Development duty by the Water Act 2003. Companies were quick to rise to the challenge of producing the new 25 year Strategic Direction Statements that Ofwat introduced for PR09 with the intention that these strategies should drive the review and ensure a long term sustainable approach.

The industry were pleased with the direction that Ofwat took in terms of emphasising that companies should 'own' their business plans, conduct detailed customer research, and undertake extensive cost benefit analysis.

To underpin this, the industry recognised the potential benefits of the new capital incentive scheme (CIS) – the aims of which were to encourage companies to produce accurate business plans, and to incentivise them to further efficiency in delivery. They were, however, concerned that it would be developed and applied effectively.

It has therefore been of considerable concern that the implementation of the price review has not matched expectations. Throughout the development of the methodology, and in particular the development of the CIS, and the subsequent scrutiny of business plans, the industry has noted a lack of due process, transparency and consistency employed by the regulator. The price review has also continued to be beset by regulatory complexity and ever growing data intensity . Companies have been concerned that this might have been hindering Ofwat from taking a strategic and holistic view of companies' plans. The effect is a perceived erosion - rather than strengthening - of the fabric of incentive based regulation. Water UK has recorded concerns in numerous consultation responses and letters to Ofwat.

The Draft Determinations have now served to confirm the industry's concerns. Whilst the headlines achieved by the regulator are no doubt seductive to a range of stakeholders (many of whom were not however, in receipt of key details of the determinations) the real impact of the determinations is more worrying.

In short, the industry's view is that Ofwat's adjustments to business plans have often appeared arbitrary, unhelped by a lack of transparency. It appears from the Investor Survey that many in the city feel the DDs have 'backfitted' assumptions in order to achieve an industry wide target of flat or reducing prices.

Ofwat alone has the knowledge about the consistency of its rationale and treatment of individual companies. However, greater transparency of the regulatory approach would permit more confidence in the rigour and consistency and adherence to understood and reasonable principles in the regulator's approach – and a more sustainable and acceptable outcome at the Final Determination.

#### **4 Disconnection from Strategic Direction Statements**

The industry is particularly concerned about a lack of evidence to show how Ofwat has taken account of the companies' Strategic Direction Statements (SDS). Nowhere in any company's Draft Determination does Ofwat indicate how it has assessed whether it is aligned with the SDS, or how the SDS has influenced its view of the Draft Determination.

This has led to a number of paradoxes in companies' business plans, examples of which vary from company to company, including for some

- the elimination of expenditure on trials and development;
- cuts in leakage reduction that defy public and customer expectations;
- penalising proposals for innovative 'spend- to-save' schemes where a company has identified specific operating efficiencies, by adding "standard" efficiency targets **on top** of the company identified efficiencies – making the effective efficiency target significantly larger and going against the desire for greater openness and transparency
- reductions in metering proposals even where companies face significant challenges from growth.

Many companies have cited instances when Ofwat has simply, and opportunistically, ignored evidence from customer surveys, with no apparent justification from alternative evidence.

## 5 Capital expenditure and the Capital Incentive Scheme - flawed implementation and distorted incentives

Related to this, is concern with the application of the Capital Incentive Scheme (CIS). In principle, the CIS has merit in strengthening incentive-based regulation, as Ofwat described in the original PR09/02 consultation – the CIS would “*incentivise companies to reveal their true expectations of costs*” and would overcome existing incentives for companies to “*pad their business plan submissions*”.

However, the way in which Ofwat has implemented the CIS in the Draft Determinations has not met these objectives. Far from being a “*new tool*” or “*fresh incentive .....to deliver further improvements to services and enable companies to plan and deliver against the challenges of the future*”<sup>1</sup>, giving “*companies greater certainty about the likely shape of the capital programme*”, this mechanism has in practice simply replaced companies’ plans with the Ofwat (often apparently subjective and unexplained) view of expenditure, and penalised companies for putting forward an alternative view. This approach implies that across an industry of some 22 companies Ofwat believes that *none* has responded to Ofwat’s encouragement to deliver accurate plans. This is simply implausible.

More damaging is that the regulator assumes that in essence, *no* company, even a leading company, if it achieves the Ofwat ‘baseline’ expenditure (the expenditure the regulator considers necessary as opposed to the company view) will earn the stated WACC. This is an unacceptable departure from Ofwat precedent, and from the more basic expectation underpinning RPI-X regulation, that the WACC should be achievable if a company meets the efficiency expectations of the regulator. It will be important to understand the degree to which investors have considered this potential impact from the Draft Determinations. By comparison, it is not the approach that Ofgem is adopting in its implementation of the IQI, the equivalent regulatory tool for the electricity DNOs.

We estimate that Ofwat’s approach means that whilst the WACC may be set at 4.5%, an averagely efficient company meeting Ofwat’s assumptions would earn a return that was effectively less - only approximately 4.4%.<sup>2</sup> This represents a material difference at the margin, on an already very low WACC, for investors.

Far from encouraging ‘truth telling’, encouraging companies to undertake detailed customer research, promote investments of a more innovative (and inherently more uncertain) nature, or exercise ‘choice’ over their proposed investment, this process penalises honest behaviour and damages incentives and has served to disillusion companies – both at management and Board level. It also potentially encourages short-termism to avoid penalties, rather than a longer term view that ensures better value for the customer.

If uncorrected at the Final Determinations, Ofwat’s commitment beyond PR09 to an incentive-based, longer term regulatory framework risks coming into question.

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<sup>1</sup> Future water and sewerage charges 2010-2015, Foreword

<sup>2</sup> NERA, Ofwat’s PR09 Draft Determinations: A Review of the Financial Assumptions September 2009.

Two particular concerns are the way in which Ofwat has made “one-sided” or “two-sided” adjustments to companies’ capital expenditure plans, and the changes to the AMA process. In Annex A (page 12) we provide further details and outline a proposed approach to one- and two-sided adjustments that would help Ofwat make consistent and transparent decisions on capital expenditure inclusions and exclusions for the Final Determinations.

## **6 Operating expenditure: multiple concerns**

Ofwat’s treatment of operating expenditure is in some cases even more of a concern than is its approach to capex. For many opex categories, Ofwat has set base opex to a level that is not a central, but instead a low, estimate of likely costs in the next 5 years. This is the case for pensions costs, wastewater rates and EA abstraction charges in particular.

### **6.1 Pension costs**

On pension costs, a number of issues need to be resolved.

Ofwat should be more transparent in its treatment of pension deficit costs and ensure that it is consistent in the principles it applies across companies, for instance with regard to valuation date and recovery profile.

Clarity and evidence is sought by companies on the rationale for Ofwat adopting an approach that allows for only half of the deficit recovery to be funded through customers’ bills. At PR04 the approach of allowing half the deficit recovery to be funded through customers’ bills was on the basis of the market recovering over that period. It was not on the basis that customers should fund only half of any deficit recovery payments.

Given the changes in the way companies account for their pension costs, we welcome the approach of recognising cash contributions, but this should be extended to ensure that efficiently incurred cash contributions made in a price control period are recognised in full.

### **6.2 Wastewater discharge charges**

On wastewater rates, Ofwat assumes any increase will be covered by RPI indexation, whereas it is already known that these are likely to increase by an order of magnitude that for some companies is around 40% or higher.

### **6.3 Abstraction charges**

On EA abstraction charges, again, it is already known that the EA plans to increase charges by up to 10%, well above RPI.

In such cases where operating cost increases are both already known, and unavoidable, it is not clear why the regulator should ignore these in setting base opex. The implication is that any rewards to innovation and outperformance elsewhere will simply be absorbed by by these increases – serving to undermine incentives for efficiency.

It is also misleading to suggest that any further increases in these items could be picked up by the scope for price adjustments through the IDoK or logging up process, as they would either be ineligible for these processes, would not pass the materiality and / or triviality tests, or the adjustment would not take place until the next price review.

For investors this approach effectively means allowed returns may be further depressed below the stated WACC – and, in particular the returns to equity.

A further concern companies share regarding operating costs is the prospect for increased bad debt costs as the full impact of the recession and rising unemployment is felt. This is discussed below in the section on notified items.

## **7 Financial parameters: failure to reflect economic and financial conditions**

### **7.1 WACC**

Worryingly in the context of current economic conditions, Ofwat's approach to the determination of a weighted average cost of capital (WACC) and financeability lacks a rigorous or transparent explanation. Ofwat clearly has a difficult task in setting, for all companies, a single point estimate of the cost of capital for a five year period in the face of considerable market turmoil. However, Ofwat has failed to recognise the exceptional recent disruption in the financial and economic environment and the ongoing aftershocks in the system.

Our response is accompanied by two reports commissioned from independent consultants, NERA (available on Water UK's website). The first is their report from January 2009, setting out their view of the plausible range for the WACC for the next quinquennium, and the second is their report from September 2009 providing an assessment of Ofwat's approach in the Draft Determinations. These two reports provide a detailed analysis of the appropriate range for WACC for PR09, and of Ofwat's approach to WACC in the Draft Determination. In the section below, we highlight key points.

Given the macro-economic context for the Draft Determinations, the key point to note is that it is inconsistent that the regulator should have chosen to set its WACC at an extreme low level by reference to robust estimates of a plausible range for the long run WACC for the industry (4.6 to 5.1% as estimated by NERA in their January report). Allowed returns, as a result of the CIS and downward bias in base opex assumptions, are in fact substantially below the bottom end of this range<sup>3</sup>, as has been noted with some concern recently by city analysts and credit ratings agencies<sup>4</sup>. In our view, this represents a highly risky regulatory stance. We would like to see – indeed believe it incumbent on the regulator to set out - the evidence that Ofwat has stress tested its estimates against a number of plausible outturn scenarios.

The regulator's figure ignores the uncertainties surrounding the likely cost of debt in the next 5 years, being quick to assume that recent stability in debt markets and reductions in rates will persist for the next 5 years and that low rates achieved for short tenor debt will be repeated for longer tenor debt and larger placings. It also significantly underestimates the cost of equity, at a time when investment in equities is clearly seen (as demonstrated in analyst reports) as having become considerably riskier, even for water stocks, as shown in the NERA's September report. In this context an assumption of market returns at the long term average of 7% over the next 5 years is unconvincing.

## 7.2 Financeability

Given the continuing need to finance a large investment programme, and the impact of current market uncertainty on access to sources of finance, financeability remains a key consideration at PR09. However, Ofwat's approach fails in both the tests it proposes for financeability and the measures it proposes for addressing it. A key concern is that the approach is not consistent with financial market realities.

First, an assumption of BBB+ for financeability tests appears a very low threshold, given the balance of risk and return implicit in the DDs and against the backdrop of tighter financial market.

Second, this assumption is not consistent with Ofwat's A- assumption underpinning Ofwat's WACC assumption. In terms of remedies, Ofwat's suggestion that companies should have recourse to raising new equity finance to meet any financeability gap, does not square with the lack of financial incentive for equity investors presented by the DDs – and as noted by investors in the Investor Survey.

Clarity over the stress testing which Ofwat has carried out in determining the financeability of the DDs under central and plausible downside scenarios would be helpful.

Financeability is further explored in NERA's January and September 2009 reports.

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<sup>3</sup> See NERA's September 2009 report

<sup>4</sup> See for instance, Moody's report 'UK Water Sector: Moody's comments on the Draft Determination' September 2009 and Merrill Lynch water sector reports September 15 2009.

## 8 Uncertainty, risk and return

In sum, as has been very clearly set out by Ofgem in its DPCR5 draft determinations, the cost of capital needs to be seen in the round: providing a balanced assessment of risk and return. In this regard, Ofwat's cost of capital and financeability assumptions need to be set very clearly alongside its approach to opex, capex and risk mitigation measures. There is a real question as to whether this has been the case, given that returns allowed by the DDs for efficient companies are less than the already very low proposed cost of capital, limited opportunities to earn additional rewards, a reduction in risk mitigation measures, and a perception of much greater risks being posed by the macro-economy, and potentially through a less transparent regulatory process. Whether Ofwat has achieved a balanced package in its draft determinations will be a matter each individual company will judge for its own circumstances.

### 8.1 Notified items

In the Draft Determinations, Ofwat has significantly reduced the risk mitigation provided by Notified Items, by proposing that only expenditure to deal with the impact of climate change and costs associated with the impact of the Traffic Management Act are treated as notified items.

While we welcome the inclusion of these items, which do provide some degree of risk mitigation, this represents a very sharp reduction from the current price review period, against a backdrop of significant uncertainty.

There are two additional items that the industry believes strongly should be treated as notified items for PR09, to mitigate significant risks that are largely outside of management control. These are bad debt, and the consequences of potential changes to the tax regime. The arguments for treating these items as notified items are summarised below - further details are set out in **Annex B**.

#### Bad debt

Ofwat has argued that the levels of companies' debt charges as a percentage of turnover and debt related costs per customer have been relatively stable, and that only including 2008-09 costs in the Draft Determination should mean that companies are able to manage bad debt as a normal business risk.

This approach is inappropriate for two reasons. Firstly, it is based on a selective use of the historic data – over recent years the trend in the two parameters Ofwat have identified has clearly been rising, and the total amount of outstanding revenue continues to rise.

Secondly, this historic increase in debt levels took place, until recently, in benign economic circumstances. The current economic climate is very different from that of recent years, and this is an area where the future is likely to be very different from the past. The full impact of the recession on bad debt levels has not yet been felt, as unemployment is forecast to rise significantly over the next few years, and we therefore urge Ofwat to continue to treat bad debt as a notified item.

## Taxation

Ofwat has a primary duty to ensure that efficient companies can finance their functions. The firm proposals from the Conservative Party to reduce tax relief on capital investment would have a material and disproportionate impact on the water industry, significantly increasing the industry's tax costs.

As the proposals that have been publicly set out by the Conservatives would be subject to change in the event of the election of a Conservative government, a notified item is the appropriate regulatory mechanism to handle this uncertainty and ensure that companies will be able to continue to finance their functions.

## **9 Investor confidence – findings of an independent investor survey**

Investor confidence is hard to win, and easily lost, as the experience following PR99 illustrates. Furthermore, the DDs for PR09 have themselves elicited a significant reduction in share prices for the listed water companies, of 10% or more at a time of a broader stock market rally, so that the underperformance of water stocks is even more pronounced. These reactions should serve as a warning that investor confidence for PR09 is in the balance.

A sustainable water sector requires access to a variety of investors and financing. The need to sustain the interest of equity investors in the sector has long been recognised. Ofwat's own approach even assumes that equity investors will be a frontline source of funding to address any emergent financeability problems. Furthermore the need to encourage innovation in the sector demands an equity presence, as innovation requires an appetite for and ability to bear risk. It is not in customers' long term interests if equity investors are discouraged from the industry.

It is crucial to recognise that investors only consider future returns, (the past is past), and have an extensive choice in terms of investment possibilities. Regulatory and political risk have consistently featured as prime drivers of investors' assessment of the attractiveness of the water sector. Having calmed city nerves in the period up to 2004, stemming a departure of equity from the sector, it would be a step backwards to again elicit a sustained negative view of the sector from investors.

To investigate investors' views on the Draft Determinations, we have sponsored another in the series of Investor Surveys, carried out by Indepen. We would like to thank Ofwat for again working with the industry on this survey as a member of the Project Steering Group.

The final report from this Investor Survey will be available later this month and will be a key piece of information for Ofwat to take into account when considering the Final Determinations. In the meantime, there are several key points we would like to highlight from the interim results provided by Indepen:

- the Draft Determinations were widely seen as being tougher than expected, especially by equity investors
- there is a widely held view that there was a predetermined outcome for the Draft Determinations
- investors regard the Draft Determinations as transferring risk from customers to investors
- the Draft Determinations have made the sector less attractive to investors, in particular for equity investors, who have a wide range of alternative investment opportunities outside of UK infrastructure

In sum, the industry faces significant challenges and a significant requirement for capital investment. This is not the time for a regulator to take undue risks with the financing of investment, as we believe its approach on WACC and financeability does. We would question whether Ofwat's proposed approach is consistent with its duty to "secure that ... companies are able to finance their functions, in particular by securing a reasonable rate of return on their capital".

#### **10 From draft to final determinations – next steps in price review process**

The Draft Determinations are a phase in the process and there is now an opportunity for Ofwat to review its approach against its initial objectives, and to ensure appropriate and sustainable Final Determinations. The companies have individually written to Ofwat setting out their specific issues, and are looking forward to the opportunity to gain Ofwat's deeper engagement at their forthcoming meetings.

Clearly, it will be in all stakeholders interests to reach a balanced outcome that avoids costly and drawn out Competition Commission inquiries that divert resources away from the real task for companies of managing the delivery of investment and services, and for Ofwat of working to move the regulatory framework forward to an enhanced incentive-based platform.

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## **Annex A: CIS issues: AMA assessments and framework for CIS adjustments**

Two particular concerns that companies have with Ofwat's Draft Determination is the way in which Ofwat has made AMA assessments and "one-sided" or "two-sided" CIS adjustments to companies' capital expenditure plans.

### **1. AMA assessments**

The Draft Determination contained changes in the Asset Management Assessment (AMA) process that were poorly signalled in the draft CIS baseline assessment. Companies responded to the draft assessment in their Final Business Plans believing that they were meeting the challenges of the Ofwat framework. These changes have contributed to the perverse result for some companies, that the draft determination increased the amount challenged despite companies having reduced their capex plans between DBP and FBP.

The two key process changes at the DDs were:

- Ofwat introduced a minimum 25% challenge (think need to spell out).
- Ofwat changed the definition for exceptional items (where an AMA challenge is not applied) from that which they had set out in the draft CIS baseline, and on which basis companies had prepared Final Business Plans.

These process issues have undermined the effectiveness of the CIS as an incentive mechanism.

Our concerns go further. Many companies are puzzled why, since they have provided more information and further constrained their investment plans since the draft CIS baseline, elements of the AMA score have worsened. The "balance" score in particular appear to have been particularly vulnerable to unexpected downgrading.

The Draft Determination AMA scores lack enough clarity to allow us to be definitive as to how this has occurred. From the Draft Determination documents and PR09/32 there appear to be two judgement based adjustments that Ofwat have used in parallel:

- Where historic or future expenditure is high compared to the industry average, using metrics such as population to compare the different company plans, Ofwat have reduced AMA scores on the grounds that past or future spend may not be effective.
- Where companies had proposed price increases from capital maintenance or if the national PR09 customer research suggested dissatisfaction with proposed prices, the AMA scores were reduced.

The first of these adjustments risks double counting cost base efficiency results in the CIS. It does not appear to account for valid reasons for relatively high past or future expenditure, such as timing of quality investment programmes. If companies have delivered stable serviceability in the past, their forecasting models are technically robust and their costs are efficient then Ofwat should not apply this additional challenge.

Other CIS and AMA adjustments are made for any shortfall on these criteria in any case. Although Ofwat should have used this type of analysis to judge how much of historic expenditure should be subject to AMA challenge, we see no case for it to influence the AMA scores.

The second of these adjustments risks double counting cost efficiency and other CIS deductions. The PR09 customer research was not designed to be fit for this use. Given that the Draft Determination shows real price reductions across most of the industry, what justification can be made for adjusting AMA scores for such an approach?

#### Continuing capital efficiency

Ofwat has made an assumption of a continuing capital efficiency scope above that reflected in RPI. However, the rationale is not transparent, since neither Ofwat's consultants nor any other recent report refer to first economics report submitted previously to Ofwat has identified evidence to support this conclusion. The draft determination does not set out the basis for the assumption. We would also question why companies should be penalised through the CIS mechanism for using a different industry future efficiency assumption from Ofwat. CIS is intended to provide an incentive that optimises this efficiency potential. Ofwat's approach to CIS reduces this incentive.

## **2. One-sided and two-sided adjustments**

One of the key concerns companies have with the Draft Determinations is the way in which Ofwat has implemented the CIS, and in particular the way in which it has made many "one-sided" adjustments to companies' plans where Ofwat disagrees with the company's view of capital expenditure.

This has changed the CIS from being a focussed incentive for companies to submit robust business plans, to a mechanism for penalising companies for **any** difference with Ofwat's view, which is clearly inappropriate.

We outline below a proposed approach to one- and two-sided adjustments that would help Ofwat make consistent and transparent and justifiable decisions on capital expenditure inclusions and exclusions for the Final Determinations.

This is that "two-sided" adjustments, where both the company view and the CIS baseline is adjusted, with no effect on the CIS ratio, would be applied in the circumstances set out below.

"One-sided" adjustments, where only the CIS baseline is adjusted, and hence the company is penalised, would only be made when the criteria below are not met.

### **Criteria for two-sided adjustments**

1. Regulatory guidance or requirements (including Ofwat's methodology) have been clarified since the FBP
2. New evidence has become available since the submission of FBP
3. Ofwat remove a proposed discretionary output or increase in service level (e.g. due to a level of cost benefit regarded as being unacceptable)
4. Ofwat have treated proposed capital expenditure as operating expenditure
5. An error has been made in the FBP by the company
6. Capex that was included in the company's FBP has been treated as a notified item
7. Capex that was included in the company's FBP would be eligible for logging up or for an IDoK as an RCC (e.g. the driver is not yet sufficiently clear to be included in price limits)

Information from our members shows that, while some adjustments to FBP proposals have been appropriately treated as "two-sided" adjustments, there are many adjustments that Ofwat has made inappropriately as "one-sided" adjustments. Areas of particular concern are discussed below.

### **Removing a proposed discretionary output or increase in service level**

There are numerous examples where Ofwat has taken a different view of the need for a discretionary output or increase in service level, in effect substituting its view of customers' priorities and what constitutes an "acceptable" level of cost benefit for that of the company.

Sewer flooding programmes, measures to improve the resilience of water supplies, to improve the appearance of drinking water and metering programmes have been excluded or reduced on this basis.

There may in some cases be legitimate grounds for taking a different view on customers' priorities. However, where this is done the appropriate way to treat this difference of opinion is through a two-sided adjustment to avoid Ofwat penalising the company for simply having taken a different view on the level of service or outputs to provide to customers.

While in some cases, Ofwat has made the appropriate "two-sided" adjustment, in many cases an inappropriate "one-sided" adjustment has been made in the Draft Determination, which companies expect to be amended for the Final Determination.

### **Regulatory guidance or requirements clarified since the draft baseline**

In a number of areas, regulatory guidance or requirements have been clarified late in the PR09 process, after companies produced their FBPs. While we appreciate that these issues of timing cause process difficulties for all parties, companies are concerned that while some changes to requirements have been correctly treated as two-sided adjustments (such as changes to the requirements under the Security and Emergency Measures Direction and some Water Framework Directive requirements), others, such as changes to lead programme requirements have not.

### **New evidence available since the FBP and corrections to errors made in the FBP**

Similarly, there are a number of cases where new information has become available since the FBP, or where companies have identified errors in their FBP submissions. In some cases these have been treated as one-sided adjustments, rather than the appropriate treatment of two-sided adjustments.

Individual companies will be raising these issues directly with Ofwat, and will look for the appropriate two-sided adjustments to be made in the Final Determination.

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## **Annex B: Notified Items**

There are two additional items that the industry believes strongly should be treated as notified items for PR09, to mitigate significant risks that are largely outside of management control. These are bad debt, and the consequences of changes to the corporate tax regime.

### **Bad debt**

Ofwat has argued that the levels of companies' debt charges as a percentage of turnover and debt related costs per customer have been relatively stable, and that only including 2008-09 costs in the Draft Determination should mean that companies are able to manage bad debt as a normal business risk.

This approach is inappropriate for two reasons. Firstly, it is based on a selective use of the historic data. As Ofwat's published information shows, over recent years there is a clear rising trend of both debt charges as a percentage of turnover and debt related costs per customer, indicating a growing problem despite companies continuing to improve their revenue collection efficiency. The total amount of revenue outstanding continues to rise sharply, reaching £1.24 billion in 2008-09 (revenue outstanding for more than 3 months).

Secondly, this historic increase in debt levels took place, until recently, in benign economic circumstances. The current economic climate is very different from that of recent years, and this is an area where the future is likely to be very different from the past.

Companies are already seeing negative trends in their debt collection metrics due to the economic conditions, and this is mirrored by a sharp increase in contacts that third party debt advisors have been receiving. The latest figures from Citizens Advice show that contacts relating to water debt in the first quarter of 2009-10 were 21% higher than for the equivalent period in 2008-09.

In addition, there is a consensus that unemployment will increase significantly over the next period, which is likely to lead to increased bad debt levels. The average of the most recent independent forecasts published by HMT shows claimant unemployment rising from the current level of 1.6 million to over 2 million, and remaining at elevated levels throughout the period of the forecasts.

As water companies are not able to disconnect customers for non-payment, or use devices such as pre-payment or trickle-flow meters to incentivise payment, the tools at companies' disposal are limited, so it is not reasonable to regard the potential increase in bad debt levels as purely a normal business risk. We therefore urge Ofwat to continue to treat bad debt as a notified item.

## Changes to corporate taxation

Ofwat has a primary duty to ensure that efficient companies can finance their functions. The firm proposals from the Conservative Party to reduce tax relief on capital investment would have a material and disproportionate impact on the water industry, significantly increasing the industry's tax costs. However, given the country's fiscal situation, there is a strong likelihood that whatever the outcome of the next election, the overall tax take will rise, so the industry's concerns do not relate solely to the intentions of a potential Conservative government.

As the proposals that have been publicly set out by the Conservatives would be subject to change in the event of the election of a Conservative government, and the current government's intentions have not been set out at this stage, a notified item is the appropriate regulatory mechanism to handle this uncertainty and ensure that companies will be able to continue to finance their functions.

Ofwat's position as set out in the Draft Determination is as follows:

- It is not clear whether any changes would be made or how they might be implemented within AMP5
- Such changes affect all sectors
- The risk of change is part of normal business risk

On the first point, we note that the purpose of notified items is to mitigate material uncertainties where there is insufficient information to be able to take account of them when price limits are set.

On the basis of the information previously provided to Ofwat by Water UK, and the additional explanation we understand was provided by Stephen Machin (representing the Conservative party's Treasury team) when he met with Ofwat on 8 July, there is now sufficient evidence available to be confident that there is a high likelihood of these material changes taking place. Not having complete information at this stage is a rationale **for** treating this issue as a notified item.

The next general election will be held no later than June 2010, and based on recent opinion polls, a Conservative government remains the most likely outcome. There is therefore a realistic prospect that the proposals that have been set out could be implemented as soon as April 2011, and so be impacting on water companies for the majority of the AMP5 period.

In March 2008, the Conservatives published plans to reduce capital allowances (reducing general plant and machinery allowances from 20% to 12.5%, and reducing long life asset allowances from 10% to 6%). As part of the same package, the main corporation tax rate would be reduced from 28% to 25%. This intention was confirmed as something that would be done "as a first move" in the Autumn 2008 with the publication of "Reconstruction Plan for a Strong Economy". Since then, it has become clearer that the reduction to capital allowances may be introduced in advance of the reduced corporation rate, given the need for revenue raising measures.

Using the information publicly available about the Conservative proposals, member companies have been able to make a preliminary assessment of the likely impact of both the reduced capital allowances and the reduced rate of corporation tax, assuming that both were introduced in April 2011.

This preliminary assessment shows that the **net** effect of these two changes could be equivalent to a 1-3% increase in prices, as the increase in tax costs due to lower capital allowances would significantly outweigh reduced corporation tax – even if the corporation tax reduction was introduced at the same time as the reduced capital allowances.

Turning to the second and third points made by Ofwat, that the change affects all sectors and is part of normal business risk, the impact of these changes is disproportionately higher for the water sector than for other sectors on account of the capital intensive nature of the industry, particularly in this context, the highly material amounts which are spent on tax plant and machinery assets to meet legal and regulatory requirements.

The tax policy set out by the Conservatives in March 2008 is intended to be overall revenue neutral, which implies that there will be no compensatory effect on income from a rise in RPI. Accordingly, the possibility that the changes will be introduced is not a ‘normal business risk’ – the potential impact on the sector is much greater than in the corporate sector as a whole.

Unless these changes are treated as a notified item, companies’ ability to finance their functions could be put at risk. We would be happy to work with Ofwat of drafting an appropriate notified item. We would suggest that, as in Ofgem’s case, it might apply to any *legislative* change, to cover both the clear intentions of the Conservative Party and potential changes that might be introduced by the current government if they were re-elected, and that it should be symmetrical, applying to both materially increased and materially decreased tax liabilities.