



Future regulation for the water industry: A consultation

Foreword



I am delighted to be able to introduce this paper which is the culmination of a year of work for Water UK. I believe it will contribute to the debate about the shape of regulation in the future.

2005 is an important 'positioning' year for the industry. The outcome to PR04 was challenging. There are choices to be made by all of us about future investment, implementing the Water Framework Directive and providing essential infrastructure for economic growth.

These choices need to be addressed in the context of demands for better regulation, institutional change and the need to ensure the continued financiability of the industry.

This work builds on an earlier report on stakeholder research for Water UK, which sought to identify the range of opinion amongst the industry's stakeholders. We can now take this forward into an agenda for change.

I hope you find our consultation interesting. We will be embarking on an ambitious programme of discussion with our key stakeholders over the next few months. This will lead to a written statement from Water UK early next year about the changes we would like to see in the regulatory system. I hope you will engage with us in a stimulating and productive debate.

A handwritten signature in black ink that reads "Pamela Taylor". The signature is written in a cursive, flowing style.

Pamela Taylor
Chief Executive, Water UK

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Executive summary

This consultation paper presents Water UK's current views on future regulatory change in the water and sewerage sector in England and Wales. The paper focuses on the price setting regime and the associated policy framework. Our aim is to develop an agenda that is in line with Water UK's purpose statement to:

'work with Government, regulators and stakeholders' organisations to develop and implement a sustainable water policy for the benefit of the operators, their customers and the UK'.

Water UK intends that this consultation will contribute to a constructive and collaborative process of review and development of the regulatory system. The paper focuses on the price setting regime, its links with environmental and public health regulation, and the associated policy framework. It ties in with the Government's desire to promote more appropriate regulation and reducing red tape.

Our agenda for change is about ensuring that the regulatory framework is robust to future challenges facing the industry. It starts from recognition that there is much about the present framework that has worked. The theme is evolution not revolution. However some ideas may have a more radical impact.

The agenda for change is grounded in the concept of sustainability: financial/economic, environmental and social. This means decisions and actions that are: proportionate, innovative, inclusive and long-term. We believe that it is possible to achieve improvements in terms of:

- better service to customers
- environmental protection
- efficiency and innovation
- reduced regulatory costs, and
- sustaining efficient investment in the industry.

The objectives and actions we believe necessary are summarised in the table below.

Water UK invites stakeholders to comment on the ideas and issues raised, and to give their views on priorities and changes that might be workable. In the coming months we aim to make contact with many stakeholders in preparation for a public conference. The aim is to facilitate an inclusive debate between stakeholders, to identify collaborative and individual actions to develop ideas for change, and jointly to assist regulators in taking forward changes in the public interest.

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by October 15th 2005.

Summary of Water UK objectives and actions for future regulation

OBJECTIVE	ACTION
A long-term strategic framework	<ul style="list-style-type: none"> • Government publishes an updated and quantified water strategy, "Directing the Flow 2" • The industry, Government and regulators collaborate to achieve comprehensive long-term investment planning • Government ensures effective resourcing of Defra to meet wider water policy challenges
More consistent and co-ordinated regulation	<ul style="list-style-type: none"> • Government articulates earlier and more clearly Ministers' priorities in the business planning process for price reviews • Regulators to draw up Memoranda of Understanding and all stakeholders to ensure they are implemented effectively Regulators outline and co-ordinate their interpretation of 'sustainable development duties' and develop transparent methods of appraising decisions and processes against a 'sustainable development' benchmark • Ofwat-WSRA and Defra/EA ensure effective co-ordination of the periodic review process and accommodate environmental planning processes (for example the Water Framework Directive) to ensure alignment of economic provisions with environmental objectives • The industry, Government and regulators agree and implement effective processes of stakeholder engagement on River Basin Management Plans, to understand customers' willingness to pay and ensure an effective use of the Polluter Pays principle • The industry, Government and regulators agree and implement a common approach to cost-benefit analysis, with outputs clearly factored into the price review process
Regulation to deliver an appropriate risk-return balance	<ul style="list-style-type: none"> • Ofwat-WSRA places the approach to financiability on a firmer footing • Ofwat-WSRA overhauls the approach to efficiency • Ofwat-WSRA redefines incentives to encourage: innovation and efficiency; first class customer service; least-cost long-term investment; and central estimates of costs • The industry, Government and regulators develop a common approach to risk
Simpler, smarter regulation	<ul style="list-style-type: none"> • Government, regulators and the industry to work together to identify scope for simplifying and modernising regulation, including reviewing options for co-regulation, self-regulation and economic instruments • Regulators adopt a transparent and systematic code of practice for ongoing information management and the development of regulatory methodology
Enhanced accountability all round	<ul style="list-style-type: none"> • All stakeholders make better use of the Parliamentary committee system • Ofwat-WSRA new structure provides enhanced transparency and consultation to resolve contentious methodologies • Government and regulators apply Regulatory Impact Assessments in a robust and systematic way, and work with the industry to influence the European Commission to do the same • Government measures, and carries out timely reviews of, regulatory performance, identifying costs and benefits • Ofwat, Environment Agency and WaterVoice-Consumer Council for Water to define common data requirements, so that the industry could share data in an effective way, enhancing accountability to customers • The industry and all stakeholders improve their understanding of customer priorities and the industry develops best practice in maintaining a sound relationship with customers.

Questions for stakeholders

Objective 1: a robust and clear long-term strategic framework

- Do you agree that a longer-term approach to planning will yield benefits? If so what are they?
- What do you see as the barriers to longer term planning and investment?
- How can regulation deliver long-term planning in the most cost-effective and sustainable way?
- Do you support the three actions set out on page 11?
- Do you think there are any other key actions which are necessary?

Objective 2: more consistent and coordinated regulation

- Do you agree that there is a need for greater consistency and co-ordination between regulators? If so, in what respects?
- Do you consider that the six steps summarised on page 15 will assist in delivering more consistent and coordinated regulation?
- Are there any other changes which you think would be beneficial?
- Do you think the current work programmes in Annex 3 will deliver an agreed framework for cost-benefit analysis? If not, what more needs to be done?

Objective 3: regulation to deliver the right risk-return balance

- What balance of risk do you think it is appropriate for companies, shareholders and customers respectively to bear?
- Would a longer framework increase or decrease the risk for these stakeholders?
- What scope do you think there is for incentives (i.e. carrots rather than sticks) to achieve environmental, social and economic benefits?
- Do you agree that we should focus on the four issues identified on page 17 in order to ensure that regulation delivers the right risk-return balance?
- Are there any other issues or actions which need to be considered?
- Do you agree with the criteria set out for setting efficiency targets, and that the alternative approaches set out are the right ones to consider?
- Are there any other alternatives we should be considering?

Objective 4: Simpler, smarter regulation

- Do you agree that there is a need to simplify and sharpen up regulation? If so, in what areas? What benefits can be derived?
- Do you agree that, in order to achieve significant progress towards simpler and smarter regulation, it is necessary to review whether alternative methodologies are appropriate, rather than just to review the use made of data within existing methodologies?
- What new ways of regulating should be considered to simplify regulation and, at the same time, ensure better outcomes? Which areas of regulation could have a lighter touch?
- Do you think the actions identified on page 20 are necessary to achieve the objective of simpler and smarter regulation?

Objective 5: greater accountability of government, regulators and the industry

- Do you think there is sufficient accountability in the regulatory framework already?
- Do you agree that there is a need to increase accountability? If so, in what respects? What would be the benefits?
- Do you agree that the actions set out on page 22 are appropriate to achieve this?
- Are there any other actions which should be taken?

Introduction

This consultation paper presents Water UK's current views on future regulatory change in the water and sewerage sector in England and Wales. The paper focuses on the price setting regime and the associated policy framework¹. Our aim is to develop an agenda that is in line with Water UK's purpose statement to:

'work with Government, regulators and stakeholders' organisations to develop and implement a sustainable water policy for the benefit of the operators, their customers and the UK'.

Since privatisation in 1989, the water sector has matured in its understanding of regulation and its stakeholder relationships. Water UK intends that this consultation will contribute to a constructive and collaborative process of review and development of the regulatory system. We want to build on the positive changes towards greater transparency and consultation that have emerged in recent years, and to play our part in the drive to 'better regulation' that lies at the heart of UK, and European, industrial and environmental policies. This paper sets out proposals for change to foster better understanding and consensus on the right way forward for regulation, shared with all stakeholders.

The paper does not explore policy and regulation towards mergers and acquisitions in the sector, or the development of competition, which are significant issues in their own right. Mergers currently remain limited by legal provisions which effectively require the automatic referral of all mergers between two water companies to the Competition Commission².

The Water Act 2003 made provisions for developing competition in the water and sewerage sector in England and Wales. Ofwat has now been given a new duty to promote competition. This is an important new challenge for the industry, although it is widely accepted that, in the short to medium term its impact is likely to be modest and regulation will remain at the heart of the sector.

In developing our agenda for regulatory change, we carried out some initial work to understand our stakeholders' concerns and expectations for regulation. A presentation of the key findings was made at Water UK's City Conference in January 2005³. In putting together this consultation, we have taken account of the final determinations which were announced on 2nd December 2004². We have also carried out our own review with our stakeholders of Water UK's performance during PR04, undertaken by independent researchers ELUCIDATION.

Fifteen years ago, the industry faced a backlog of investment in capital maintenance. Pipes were leaky; the industry was not sufficiently resilient to drought. Many rivers and bathing waters were badly polluted, and the European Community was embarking on an ambitious programme of tightening environmental standards for the water environment, and for drinking water quality. A huge capital investment programme was in prospect if reliability of service was to be maintained and environmental and drinking water quality improved. Investors needed to be attracted to the sector, and companies needed to be encouraged to become leaner and more efficient.

The industry, working jointly with Government and the regulators, has exceeded expectations. Some £50bn worth investment in the sewerage and drinking water infrastructure has been made, benefiting society and the environment. The quality of water in our rivers, bathing waters and habitats has all been improved. The industry is almost at 100% compliance on tests covering all the health-based and aesthetic parameters for drinking water. Customers have experienced significant increases in levels of service, with particular efforts in recent years to reduce the incidence of sewer flooding, and to improve pressure at the tap. Leakage from our pipes has reduced by some 25% over the last 10 years. Annex 1 provides more detailed facts and figures.

This has all been achieved whilst at the same time sharply improving our productivity. Operating cost efficiency has improved by approximately 2% pa, 30% over the last 15 years. As a result, despite the massive investment that has taken place, today the average household bill is some £278 p.a. The industry, its regulators and customers can be rightly proud of the value for money that the system as a whole has delivered.

All parties have contributed. The industry has worked hard to improve its services and efficiency. Government and regulators have taken heed of calls for 'better regulation', adapting regulatory processes and introducing new legislation respectively, and all parties have endeavoured to build constructive and collaborative working relationships.

The final report of this work, and its key findings, will be placed on Water UK's website (<http://www.water.org.uk>) towards the end of July 2005.

¹ The Competition Commission must assess whether the merger might cause a detriment to Ofwat's ability to carry out comparative competition between companies. It is possible that this could change if the new Water Services Regulation Authority (to replace Ofwat) were to change its stance towards the need for comparators.

² See Janet Wright's slide presentation at Water UK City Conference available to download on Water UK's website

³ Ofwat, 'Future Water and Sewerage charges 2005-2010, Final Determinations', December 2005

2005 is clearly an important positioning year for the water sector, and most of the other main stakeholders are also considering what lessons can be learned from the recently completed Periodic Review of prices (PR04), and what they would like to see for the next review in 2009 (PR09).

Ofwat has commissioned an independent review, led by John Baker, to explore stakeholders' views of the PR04 process. The Environment Agency has also carried out an internal review. The Green Alliance and the Royal Society for the Protection of Birds (RSPB) are also conducting a review of the regulatory framework for the water sector in England and Wales. Defra has not been directly involved in these review processes. It is also possible that the Parliamentary Select Committee system will carry out a further inquiry into water pricing in due course. These reviews will be important in clarifying the issues that stakeholders have with the regulatory process and how it has operated in the past and we will take them into account as our consultation process rolls out.

Our agenda for change is about ensuring that the regulatory framework is robust to future challenges facing the industry. It starts from recognition that there is much about the present framework that has worked. The performance of the industry, in becoming more efficient, and at the same time delivering significant improvements in drinking water quality, reliability of supply and environmental quality, stands as testament to this.

It has not all been plain sailing. But the industry and the regulatory system has been robust enough to withstand tests of public and investor confidence in recent years. The high-profit era in the early years after privatisation, combined with high levels of leakage, and water shortages in the drought of 1995 served to alienate customers. The ensuing tough price determinations in

1999 triggered a shift to much higher levels of financial gearing. Industry gearing has risen from around 40% to around 60% now, with five companies now even more highly geared. Some have seen this as a flight of equity from the sector, raising concerns about the continued ability of the industry to finance its ongoing investment programmes. At the same time, looking across to other sectors, such as railways and growing concerns about the security of energy supplies, meant worries about regulation were contagious.

The efforts of all parties to improve the regulatory process for the recent water price review have, however, resulted in a broadly positive outcome at PR04. In particular, considerable efforts have been made by Ofwat in the last five years to improve the transparency of the regulatory regime, such that a recent Water UK survey of investors⁴ revealed that the perception of regulatory risk in the industry had significantly declined since the last price review.

For these reasons, the current mood among stakeholders, before preparation work begins for PR09, can be described as one that seeks 'evolution not revolution' in regulation, as seismic change will only increase uncertainty and hence regulatory risk. Our agenda broadly reflects this theme. It recognises that, despite recent improvements, there remain underlying concerns, which we share with our stakeholders and which will become yet stronger in future.

Our agenda is founded in a commitment to the broad principles of independent regulators, private-sector financing and incentive-based regulation. We recognise that in meeting future challenges, there are many options for change, some more radical than others. We look forward to an open and robust debate that can lead to constructive change in time for the next price review.

⁴Water UK Investor's Survey 2005 (<http://www.water.org.uk/home/news/press-releases/invest-survey/2005-investor-survey-final.pdf>)

Future challenges

Water UK believes the system will increasingly come under strain. It will need to refocus on the challenge of sustainable development and take a more long-term and holistic approach. Consequently, a greater recognition of the complex interactions between policies, sectors and stakeholders will be needed.

The impact of EU legislation is changing –moving away from ‘command and control’ measures to a new vision of the European Community with an expanded membership of 25 states, espousing the Lisbon Agenda¹, with social and economic harmony and integrated environmental and economic policies at its heart. Framework directives are taking the place of issue-specific legislation – a move that, whilst conducive to more ‘joined-up’ policy approaches, presents greater challenges in terms of implementation. The Water Framework Directive is the single most significant piece of environmental legislation that will impact on the water sector in coming years (see Annex 2).

We therefore need to consider whether the current regulatory framework will be an effective delivery mechanism going forward.

Future challenges will include:

- anticipating and interpreting the requirements of complex framework legislation such as the Water Framework Directive;
- factoring in the need to plan comprehensively for climate change;
- ensuring that a holistic approach is taken to the environment, identifying the impacts of activities and solutions across all environmental media;
- adapting to patterns of economic and population growth, in particular the challenge of managing water stress in the south east of England where a significant housebuilding programme is in prospect;
- maintaining and improving an ageing infrastructure, especially in the major conurbations;
- maintaining and improving levels of service to customers, and understanding that what customers want may go beyond strict regulatory requirements, for instance on the taste of drinking water;
- addressing the risks of sewer flooding, particularly in the context of wider area flooding risks, and the impacts of climate change and demographic change;
- ensuring the availability of long-term, affordable financing in order to deliver the large investment

required to maintain services, provide for growth, and deliver environmental and public health improvements;

- managing the introduction of competition, to meet the Government’s objectives in the Water Act 2003;
- addressing rising concerns regarding debt and affordability,
- striving for further cost efficiencies whilst maintaining compliance and serviced risk at appropriate levels
- striving for continued innovation in processes and sustainable solutions to deliver the industry’s services and wider public health and environmental obligations

These challenges will need to be met against a background of wider policy and institutional change. In particular, the Government has taken to heart a policy of reducing regulatory burdens, a theme that is reflected in the European policy agenda.

The better regulation agenda

In recent years there has been considerable Government activity in this area, reflecting European and worldwide concerns about the inhibiting effect regulation can have on economic growth. These include:

- the Better Regulation Task Force (BRTF) has produced a number of reports making the case for simplified regulation to reduce the burden on business and to improve the effectiveness of regulation;
- Defra and the Environment Agency have made their own efforts to improve regulation, increasingly committing to move to a risk-based approach;
- In March 2005, the Hampton Review reported on the scope for improving regulation in inspections and monitoring, adopting a risk-based approach and reducing the number of Government bodies undertaking inspection and enforcement.

As a consequence, the number of enforcement bodies regulating the environment, particularly those in the Defra ‘family’, will almost certainly reduce. Chief among these will be the Drinking Water Inspectorate, about whose future the Government are expected to consult shortly. In addition, the Natural Environment and Rural Communities Bill published in February 2005, will set up a new body, Natural England, to replace English Nature, the Countryside Agency and the environment and land management functions of the Rural Development Service, from January 2007.

The Water Act 2003 will mean the replacement of Ofwat

¹The EU Lisbon Strategy for Growth and Jobs, 2000 (http://europa.eu.int/comm/lisbon_strategy/index_en.pdf)

by a new Water Services Regulatory Authority, and Water Voice with the Consumer Council for Water from April 2006. The new Water Services Regulatory Authority will have a Board structure to replace the single regulator, following the example of other economic regulators.

There has also been a move towards more regulatory accountability. The House of Lords Constitution Committee concluded in a report published on 6 May 2005, that there was a need for greater accountability of the State for the body of regulation. The Government has largely rejected its recommendations, but it is probably fair to say that it has had an effect on the move towards deregulation generally. The Government has for example taken steps to ensure a more comprehensive and consistent use of Regulatory Impact Assessments (Regulatory Impact Assessments) across Government and regulators. We welcome the moves that have already been made towards the adoption of better regulation principles and greater transparency by regulators, which help to increase their accountability.

In addition, companies have become more accountable. This accountability has been reinforced by the creation of the Consumer Council for Water, strengthening the role of independent consumer representation, and the Water Services Regulatory Authority's power, under section 48 of the Water Act 2003, to impose financial penalties on any company contravening its conditions of appointment or failing to meet prescribed standards of performance.

The implications for regulation

In the light of these challenges, we will need a regulatory system that recognises the long-term nature of our business and its investments so that we can manage efficiently the large uncertainties and risks in our path. This will require flexibility – flexibility to meet local circumstances, to seek out innovative solutions and to anticipate and be prepared for a range of circumstances.

At the same time, and especially given the institutional changes ahead, there is a challenge for regulators to deliver regulatory certainty, crucial to our financial stability. Recent progress towards implementing the better regulation principles must be enshrined and built upon. And, given the potentially large pressures on prices and bills, the system must give proper weight to customer issues, enabling us to meet the expectations of our customers for a value for money service. From decisions at European level on new

environmental legislation, to their implementation domestically, what customers are prepared to pay for must be a central consideration.

In all of this there is a need to recognise that the water industry is just one of many potential delivery agents for Government policies towards the economy, the environment and social inclusion. Water companies look forward to playing their part, seeking efficiencies, engaging in partnerships and exploring alternative approaches to traditional end-of-pipe solutions, understanding their customer needs and improving services to customers and the environment and promoting mechanisms for helping customers to manage bill payments. But Government must also engage other stakeholders and explore other tools for policy delivery: in particular, it must not rely on water customers to foot the bill for pollution caused by others, and it must give proper consideration to measures it can take through more direct social policies to resolving issues of debt and affordability.

Affordability and bad debt

The industry calculated that in 2002/03 about 3% of household water charges were not recoverable. That works out at £164m for the year and is equivalent to the charges from 700,000 households. The cost of managing and financing this debt works out at just under £10 for every paying customer.

Currently debt in the water industry is about twice that in the gas and electricity sectors, with a bad debt to sales ratio of almost 2%. Debt has been increasing in the water industry since the 1999 Water Industry Act removed the right to disconnect household customers for non-payment. Companies' ability to manage bad debt is further hampered by the fact that they have no contract with domestic customers - hence a lack of information on customers.

Read more about the debt issue facing the water industry at Annex 5.

The next section outlines our objectives for future regulation and our suggestions for actions to take them forward.

Objectives for future regulation

We believe that it is possible to achieve improvements in terms of:

- better service to customers
- environmental protection
- efficiency and innovation
- reduced regulatory costs, and
- sustaining efficient investment in the industry

To achieve this given the challenges outlined in section 2, we believe it is important to refocus on the objective of sustainable development. This is now a common thread through the statutory duties of all regulators. The Government's current thinking on progress towards sustainable development in the UK was set out in the UK Sustainable Development strategy¹.

Sustainable development is about balance:

- balance between financial/economic, environmental and social needs,
- balance between stakeholders, and, crucially,
- balance across the short, medium and longer term.

Sustainable development means decisions and actions that are:

- proportionate: good value, genuine integration.
- efficient: resource productive; do more with less, innovate
- inclusive: people-centred; partnerships.
- long-term: deliver lasting benefit.

Our agenda for change is grounded in the concept of sustainable development. We have five main high-level objectives for change to the regulatory framework:

- a robust and clear long term strategic framework for policy and regulation;
- more consistent and co-ordinated regulation
- regulation that delivers the right balance of risk and return
- simpler, smarter regulation
- greater accountability throughout the framework

These objectives and the actions we believe are necessary to deliver them are discussed in the next sections.

3.1 A long term strategic framework

Regulation needs a long-term strategic focus to:

- understand future pressures so as to avoid short term

price fixes at the expense of longer term sustainability;

- avoid roller coaster prices;
- identify uncertainties so that surprises can be avoided and flexibility can be built into investment plans;
- identify and incentivise the most efficient long-term solutions;
- increase political/regulatory commitment with benefits for cost of capital and to ensure investors remain willing to invest in the industry;
- facilitate the funding of large long-term projects and research and development into innovative solutions.

We believe a more long-term view is necessary throughout the system from policy, through regulation to delivery by companies. We propose the following actions.

Objective 1: A long term strategic framework

- Government publishes an updated and quantified water strategy 'Directing the Flow 2'
- The industry, Government and regulators collaborate to achieve comprehensive long-term investment planning
- Government ensures effective resourcing at Defra to meet wider water policy challenges

3.1.1 An updated and quantified water strategy: Directing the Flow 2

The Government needs to take a more long-term view in deciding policies on the investment it wishes the water industry to undertake, and on how it should deal with difficult issues such as diffuse pollution and affordability. It needs to understand the potential impacts of its decisions on customer bills, the environment and the future financial sustainability of the industry.

The Government's 'vision' for water policy, 'Directing the flow- Priorities for future water policy', was published by Defra in November 2002. It set out the Government's view of the challenges ahead, but there were few clear indications of the direction they expected policy to take in a number of key areas such as the Water Framework Directive. At that time, of course, the Directive had not been transposed in the UK. Even allowing for this, there was a notable lack of focus on how priorities would be decided and how conflicting interests and objectives might be resolved.

Environment Secretary Margaret Beckett said in the foreword that 'Directing the Flow' would be a 'living'

¹'Securing the Future', which was launched by Environment Secretary of State, Margaret Beckett, on 7 March 2005 (<http://www.sustainable-development.gov.uk/publications/uk-strategy/uk-strategy-2005.htm>).

Yorkshire Water: Freshwater Fish Directive

During the current five year investment programme (AMP4, 2005-2010) Yorkshire Water was required to achieve compliance with the Freshwater Fish Directive. This involved upgrading some of its largest and most complex sewage treatment works and consequently involved large solution costs. The cheapest solution to achieve the required levels of ammonia discharged to rivers was £32m.

When planning the investment the company recognised that during the current or the next five year investment programme (AMP4 or AMP5) the Humber Estuary could become designated as a Sensitive Area under the Urban Waste Water Treatment Directive and that the Water Framework Directive would be implemented. Both of these would be likely to drive the Company to reduce the levels of nutrient discharged to rivers. Nutrient removal would require a different type of treatment process to the ammonia removal required under the Freshwater Fish Directive. This nutrient removal treatment would cost £73m.

Meeting the Freshwater Fish Directive ammonia levels at least cost in AMP4 and then, additionally, meeting the expected nutrient removal at least cost in AMP5 would cost £32m + £73m; a total cost of £105m. This would mean the initial £32m would be abortive.

However, as the nutrient removal processes would also enable the company to meet the required level of ammonia removal, taking the longer term view, the AMP4 and anticipated AMP5 objectives could all be met at £73m.

Consequently the company proposed this second option. Ofwat accepted the arguments for meeting the AMP4 Freshwater Fish Directive with the AMP5 requirements in mind and funded Yorkshire's proposal. This gave a long term cost saving of £32m.

document, to be regularly reviewed over time. We believe it is now time for it to be updated and developed further, with the Government assisted in this by industry and the regulators.

A clear understanding of the Government's view of long term pressures and the areas it sees as a priority for future action would help to generate greater confidence in the long-term stability of the system. This in itself would go a long way towards encouraging better regulatory consistency and co-ordination. Against a clearer picture of Government's priorities, companies' own business planning processes could also be improved for PR09 and beyond.

3.1.2 Long-term investment planning

In addition to this strategy document we believe it is

Northumbrian Water: Freshwater Fish Directive

The National Environment Programme (NEP) for AMP3 (1999/2000-2004/5) included a scheme at Aycliffe sewage treatment works to reduce ammonia to 5mg/l under the Freshwater Fish driver. This was to be completed by March 2005.

During the planning process for PR04 the Environment Agency indicated that ammonia would now have to be further reduced at Aycliffe to 3mg/l in AMP4, (2005/6-2009/10) again under the Freshwater Fish Directive.

The treatment process requirements to achieve 3mg/l efficiently are different from those to achieve 5mg/l. If the 5mg/l and 3mg/l processes had been delivered consecutively this would have resulted in abortive work and increased costs.

Although work had commenced on improvements to achieve the 5mg/l standard when the increased requirement became known, no abortive work had been undertaken. With the support of the Environment Agency and Ofwat it was agreed to deliver a single AMP3/4 scheme with a delivery date of March 2006. This meant that:

- The 5mg/l standard will not be met by the original date but the tighter 3mg/l standard, with the full environmental benefits, will be delivered a year early
- Capex for the single 3mg/l scheme will be £3m less than that for the phased approach
- New opex for the single 3mg/l process solution will be £0.4m per annum less than that for the phased solution

important for the long-term focus of investment planning to be enhanced in the industry. A more strategic long-term vision is needed within an industry that many have regarded as conservative and risk-averse. More innovative approaches will increasingly be needed, and a new way of thinking needs to emerge, embracing dynamic change and putting the industry ahead of the game rather than simply reacting to it.

Long-term planning is central to the day-to-day business of water companies, whose assets generally have very long lives. Good long-term planning assesses uncertainties and risks in the future, enables the industry to build in flexibility through phasing of investment, and delivers investment at least-cost when assessed over its whole lifetime. Good long-term planning is about future-proofing the industry and delivering long-term value for money.

In recent years steps have been taken by the industry, together with Ofwat and the Environment Agency, to improve the robustness of this planning, by introducing more forward looking risk-based approaches, for instance towards the maintenance of our network and treatment

assets and towards security of supply for water resources.

However, more needs to be done in this respect as there remain notable gaps: in sewerage and water resource supply-demand¹ investment planning and in investment planning for improvements to service (such as to reduce sewer flooding). The capital maintenance framework is also in its early phases, and requires considerably more work to improve its reliability, which the industry is undertaking through its research body, UK Water Industry Research Ltd (UKWIR).

Robust frameworks for long-term planning by companies are a crucial input to instil regulatory confidence in companies' business plans, and in return, to give companies confidence that regulators can commit to funding well thought through plans over the long-term. On capital maintenance for instance, whilst companies welcomed Ofwat's recognition that investment needed to be increased at PR04, it is our belief that the industry is still not replacing assets at the required rate for long-term sustainability. The industry believes that as long-term planning improves, this will illuminate the appropriate replacement cycle over time, which can then be factored robustly into business plans, and be funded by Ofwat.

It is vital that, as companies make the effort to improve their long-term planning, that Ofwat at the same time adapts its approach to funding. (This is discussed further in section 3.3 below). In particular, the regulator's reluctance to fund investment that does not have clear outputs may sometimes inhibit the ability of the industry to future-proof and to achieve 'least cost' long-term solutions. Nonetheless the industry recognises that Ofwat too is beginning to take a longer-term view. The boxes below provide an illustration of the more flexible approach that the industry would like to see more readily countenanced by Ofwat in future reviews.

The industry recognises that it is predominantly its own responsibility to develop better methods of long term investment planning. However, there are often many overlaps with other problems: for instance, sewer flooding may be influenced by area flooding and climate change may also have a knock on effect. An integrated approach is ultimately essential, and Government and other regulators must be involved.

There are some long-term trends and projections that it is Government's responsibility to develop. In particular, it is for Government to ensure that environmental

expenditure projections are developed, and to make robust projections of housebuilding growth, so that a more fully integrated approach to investment planning can eventually take place. To date, environmental investment has tended to be determined at 5 yearly intervals, when a price review is taking place. The industry believes longer term planning is crucial to providing more stability and predictability regarding what it must deliver and to reducing the potential for goal posts to be shifted unpredictably. Taking this longer term approach will, as shown by the Northumbrian Freshwater Fish example, above, enable longer term standards to be at lower cost to customers in the long run than if standards were instead ratcheted down every 5 years. Uncertainty and risk will remain, but clarity about these risks will enable more robust and flexible investment decisions to be proposed by companies, and funded by Ofwat.

Challenges of the Water Framework Directive

We believe that the Water Framework Directive now provides a good basis for making longer-term projections of environmental investment demands². There is clearly a long way to go in reaching robust projections, as processes for delivering the first River Basin Management Plans are still being developed. The challenges for this process are discussed further in section 3.2.5.

Whilst Government needs to lead this work, advised by the Environment Agency, the industry recognises, and welcomes, that it – along with other stakeholders – has a significant role to play, making sure that its customers' interests are fully represented in any decisions on future investment for the sector. The industry will help by providing views on the scope of work that it might be required to undertake and the costs of meeting prospective new standards. It will also work with customer bodies to identify customer priorities, and to evaluate the potential benefits of new standards. The industry is currently working with the farming community to minimise pesticide use (through a Voluntary Initiative), and with Defra to develop agri-environment schemes that will help to tackle agricultural diffuse pollution, and concepts. We are also fully engaged on work to understand the costs and benefits of alternative measures to implement the Water Framework Directive such as the pilot Catchment Sensitive Farming projects being developed by Defra. See section 3.2.6 below.

¹ i.e. identifying the need for increased sewerage capacity to respond to growth in sewage and effluent flows from population pressures, patterns of industrial growth and climate change. This was recognised in a report by the National Audit Office in January 2004, 'Out of Sight – not out of mind, Ofwat and the public sewer network in England and Wales'

² The Water Framework Directive provides for goals of 'good ecological status' to be set for water bodies, and for these to be achieved by December 2027, by means of a series of river basin plans to be implemented in 6 year cycles from December 2009; these plans will set out programmes of measures which should indicate how responsibility for achieving the targets will be shared between sectors.

3.1.3 Focussed resources to meet policy challenges

In making policy, Defra must take advice from many diverse regulators and stakeholders. It should have a central role to play in 'holding the ring' on the environment. It must ensure that policies are developed and articulated at an early enough stage for the industry to respond. An important issue concerns the transparency with which Defra engages with other departments and bodies within government – which is considerably less than the degree of transparency that has now developed in Ofwat's processes. An example is the lack of clarity regarding the role played by other departments such as HM Treasury and other parts of Government in the last stages of the price review process. In our view, this has added unnecessarily to the perception of regulatory risk to the outside world. This point is taken up later in this paper in section 3.5.

Another issue that many stakeholders have raised has been whether Defra is sufficiently resourced and skilled to undertake these complex tasks effectively.

The industry recognises the overarching Government objective to reduce administrative burdens, and in particular the efficiencies that it is seeking from its departments including Defra. Defra itself has stated its intention to refocus on its core policy functions and to reduce staff numbers. At the same time, it is clear that Defra's role is expanding to deal with some large issues, such as climate change, the Water Framework Directive (where Ministers will need to take decisions about who pays for any improvement measures needed, and when those improvements must be delivered), and water resources in the south-east of England. Against this background the industry believes it is important that Defra should have, and should be seen to have, the requisite flexibility and skills to meet these challenges.

3.2 More consistent and co-ordinated regulation

The water industry is regulated by Ofwat, the Environment Agency and the Drinking Water Inspectorate. The work carried out by the Health and Safety Executive and English Nature (now part of the Natural England consortium) also impacts on the industry. English Nature is of particular significance in some regions of the country.

Clear differences of view and approach have emerged between different regulators, especially between the Environment Agency and Ofwat, during PR04. Some of these are inevitable and reflect the different focus of each regulator's duties on a particular aspect of sustainable development (e.g. Ofwat on the economic and the Environment Agency on the environmental). The lack of a clear long-term strategic direction from Government adds to the potential for conflict.

We accept that the focus on core functions by each regulator has advantages in terms of their effectiveness, and that the debate in the public domain between the

regulators has advantages of transparency. For these reasons we are not recommending any institutional change involving merging of economic and environmental regulators. However, we do believe that a more collaborative rather than confrontational approach will be more effective in delivering true sustainability.

Where differences of view have led to under-funded schemes or unfunded environmental obligations, water companies are caught in the middle. This impacts adversely on companies' ability to secure investment on the markets, and is also arguably not in customers' interests either. The environment also suffers, as schemes are put to one side or not fully costed and implemented. Often these are left to be funded in subsequent price reviews which can mean shorter deadlines and higher costs.

Water UK believes that to improve consistency and coordination, much progress can be made by aligning key policy principles and methodologies adopted by each regulator under the common goal of sustainable development.

From the Environment Agency and English Nature (Natural England) we would like to see more robust cost-benefit justification of proposed environmental programmes, the use of more economic incentives, and the application of the polluter pays principle in determining for instance the relative contributions to reducing diffuse pollution from the water and the agricultural sectors respectively. It is essential that customers are asked only to fund what is properly their responsibility, and that improvements are seen to be value for money and to align with their priorities.

From Ofwat we would like to see a focus that is longer term than the next 5-year period. We would also like to see the regulator developing more flexibility in its assessment of investment requirements, to meet local needs, encourage innovative approaches, build in robustness to alternative scenarios, and support least-cost long-term solutions. Again, it will be essential to ensure that the potential customer benefits are clear, and that there is customer support for such approaches.

Many of the methodological issues raised above are taken up further in Water UK's 3rd and 4th objectives.

Here we focus on:

- actions that may direct such change, such as memoranda of understanding, codes of practice and government guidance;
- actions that focus on aligning processes of economic and environmental regulation (e.g. the periodic review cycle and the cycles for implementing environmental policies);
- actions that focus on establishing agreed fundamental principles such as the polluter pays and the centrality of customer priorities; and

- actions that focus on establishing agreed cost-benefit methodologies: which bridge the domains of economic and environmental regulation.

We outline below our preferred options for encouraging greater co-ordination and consistency between regulators.

Objective 2: More consistent and co-ordinated regulation

1. Government articulates earlier and more clearly Ministerial priorities in the business planning process for price reviews
2. Regulators to draw up Memoranda of Understanding and all stakeholders to ensure they are effectively implemented
3. Regulators outline and co-ordinate their interpretation of 'sustainable development duties' and develop transparent self-check methods for appraising their decisions and processes against a 'sustainable development' benchmark
4. Ofwat-WSRA and Defra/EA ensure effective co-ordination of the Periodic Review process and other planning processes (for example for the Water Framework Directive) to ensure alignment of economic provisions with environmental objectives
5. The industry, Government and regulators agree and implement effective processes of stakeholder engagement on River Basin Management Plans, to understand customers' willingness to pay and ensure proportionate implementation of the polluter pays principle
6. The industry, Government and regulators agree and implement a common approach to cost-benefit and cost-effectiveness analysis, with outputs clearly factored into the price review process

3.2.1 Ministerial priorities for price reviews

We are proposing actions above to improve long-term strategic planning for water by Defra, effective stakeholder engagement and alignment in processes for environmental and economic regulation. Ultimately, Defra should be in a better position earlier in a price review to explain its priorities for water. Policies should not be decided under pressure of meeting a price review deadline.

To improve the process of the price review, and the quality of companies own business planning, we would like to see Defra adopting this as a specific objective, spelling out the decisions it plans to make and when in order to feed into the price review at an appropriately early time.

Defra will need to consider the interaction between the process for issuing Ministerial guidance under the Periodic Review timetable, with the new power (in the Water Act 2003) to issue statutory guidance for regulators, as described in section 3.2.2. As part of this process, it

would be helpful if Defra Ministers gave some early indication of the sorts of issues that this guidance would cover, the broad timetable for issuing it, and what sort of parameters and considerations will inform the content of this guidance. Clearly, Defra will not want to fetter the discretion of their Ministers who need to be able to reflect current political and fiscal concerns but we believe this factor needs to be balanced against the water sector's need for more certainty during the price-setting process. Lack of clarity about Ministerial guidance, content as well as timing, adds to the uncertainty and risk for companies, regulators and investors. It is also, we believe, an unwelcome distraction from the real issues.

3.2.2 Memoranda of Understanding between regulators

The Water Act 2003 requires Government and regulators to consult one another, and to develop bilateral Memoranda of Understanding. Defra are planning to publish a framework Memorandum of Understanding for all parties to use (Defra, regulators and the Consumer Council for Water). The Memorandum of Understanding will be effective from 1 October 2005; the others are likely to be commenced on 1 April 2006. These changes are welcome, but will not be effective unless they secure significant changes in approach and behaviour by both sides.

In particular, the roles and responsibilities of the regulators need to be clarified and requirements for data collection, priorities for investment and environmental outcomes should be more co-ordinated if the industry is to be able to participate fully in the regulatory process. The final Report of the Hampton Review, published in March 2005, made some important recommendations about streamlining regulation and enforcement which will be a welcome move in the right direction. In its response to the Review, Water UK pressed for a formal consultation on the future of the Drinking Water Inspectorate, in which we look forward to participating in due course.

3.2.3 Self-check methods - sustainable development

Current legislation enables Government to provide guidance and directions to regulators. For instance, under the Water Act 2003 the Government has powers to issue social and environmental guidance to Ofwat (see 3.2.1 below). It also has powers of direction towards the Environment Agency. To date these powers have not been tested. The Government also has powers to introduce regulations and to set standards, which Ofwat would then be required to fund. The establishment of the Water Services Regulatory Authority provides an opportunity for Government to provide guidance to the new authority.

Government could make regulations or give guidance (or directions in the case of the Environment Agency) to regulators, with the intention of clarifying roles and

responsibilities, and particularly the consistent interpretation of sustainability duties. For instance such measures could be used to clarify how the polluter pays principle should be applied with regard to diffuse pollution, and to pave the way for appropriate co-operative agreements in agriculture. In the case of Ofwat, it could also be used to specify that they should encourage sustainable solutions, and could specify that Ofwat should take actions with regard to social objectives e.g. regarding affordability and customer debt.

However, the role of guidance would have to be balanced against the need to ensure the independence and effectiveness of regulators, and to minimise the perception of political risk by investors. Furthermore, any development of further regulations would need close scrutiny in the context of the wider Government policy of lighter-touch 'better' regulation. Likewise, any more radical institutional measures involving the possible merging of regulators would also need to be carefully considered, and a regulatory impact assessment undertaken.

On balance, the industry considers that in the first instance, regulators could themselves take the initiative and draw up their own interpretations of their duties towards sustainable development. Furthermore, we think that regulators could systematically submit their decision-making process and decisions to a 'sustainable development' check – and to submit this to public scrutiny. That will mean each regulator developing a code of practice for the interpretation and assessment of its performance with regard to sustainable development. The industry would be very willing to assist the regulators in developing such a code, and to provide case studies by which to test it out.

The regulators could go further and consider, perhaps by reference in the first instance to the sustainability indicators already developed and published by Water UK, how to monitor their own performance. We understand that Ofwat is to review a number of its PR04 decisions in the light of its sustainable development duty, which took effect from 1 April 2005. The industry welcomes this as potentially a first step along the way to the more systematic design and delivery of regulatory methodologies in line with this duty.

3.2.4 Effective co-ordination of the Periodic Review and environmental planning mechanisms

For the future, Water UK would like to see more integrated approaches, jointly with Defra and the Environment Agency, to take forward River Basin Management Planning under the Water Framework Directive, and how to plan for it within the Periodic Review investment planning cycle.

There has been much discussion as to whether the price review cycle, which is currently a 5 year process, should be brought into line with the Water Framework Directive

River Basin management plan cycle of 6 years. However, it is important to recognise, that notwithstanding the significance of the Water Framework Directive, there are other equally significant investment drivers at a price review, such as for capital maintenance and sewage infrastructure capacity. Similarly, there will be other stakeholders called upon to contribute to reaching Water Framework Directive targets. In particular given that it is diffuse pollution which today remains the outstanding source of pollution to be tackled, proper application of the polluter pays principle should mean that the water industry is not the primary means of reaching Water Framework Directive targets in future. Thus the price review should not be driven by the Water Framework Directive alone.

There are however, significant concerns that if the two cycles are not synchronised, at the time of a price review, the RBMP work will not be ready to deliver sufficient certainty about investment needs for funding purposes. There would be a potential for schemes to require funding between price reviews, leading to a re-opening of price controls, with a potentially damaging impact on incentives and perceived risk (depending on the frequency and scale of such adjustments, and the effectiveness of interim mechanisms). Secondly, the industry has concerns that if Defra and the Environment Agency fail to deliver appropriate controls on diffuse pollution by the time of a price review, water companies will be seen as an easy source of funding. This would go against the grain of the polluter pays principle and inflict high costs on undeserving water customers, already facing increasing problems of debt and affordability.

It makes sense to attempt to avoid the need for re-opening price controls between price periods as far as possible. Hence some alignment of Periodic Review and Water Framework Directive processes may be reasonable. But perhaps more important is that mechanisms are in place so that any remaining uncertainty and changes in obligations between price review periods can be dealt with satisfactorily. The industry believes the present mechanisms fall short of providing sufficient risk mitigation.

As far as the second issue is concerned, it is important that the processes allow for investment to be phased, to manage uncertainty, and to allow least cost solutions to be tried before resorting to imposing costly obligations on water companies. This has implications for Defra and the Environment Agency in determining the programmes of measures to deliver the Water Framework Directive, the timetables for delivery, and the legal underpinnings for monitoring and enforcing delivery (where current arrangements remain ambiguous, for instance as relevant to diffuse pollution from agricultural and urban sources). In addition, it will be necessary to consider the integration of other planning mechanisms, such as catchment abstraction management (CAMs), within the River Basin Management Planning process if these mechanisms are to continue to be of value.

Ultimately however, the question of the length of the price cap period affects the overall incentive properties of the price cap regime, and Ofwat's ability to ensure the efficient financing of companies. The length of the price review and timetable issues is therefore discussed further under our third objective.

3.2.5 River Basin Management Plans

The Water Framework Directive requires investment to be undertaken in accordance with the polluter pays principle. As noted above, the industry believes it is crucial that there is robust implementation of the polluter pays principle in determining the responsibilities for delivering the Water Framework Directive targets of good ecological quality. Likewise, we believe that it is vitally important that customer preferences and willingness to pay for improvements are taken into account when decisions on investment are taken.

The key to ensuring this is that the customers' voice is properly represented in stakeholder forums where these decisions are made. Companies aim to ensure that the interests of their customers are well understood. But Defra and the Environment Agency must ensure that proper weight is given to these views. Processes for determining stakeholder involvement are still being drawn up, and Water UK will continue to work for effective representation for companies and customers.

3.2.6 Cost effectiveness and cost benefit analysis

Water UK believes that it is important to ensure the continued positive support by, and involvement of, all stakeholders in the considerable collaborative research efforts that are now underway to reach more robust methodologies for cost-benefit & cost-effectiveness analysis (see Annex 3). These projects should produce a framework of analysis that is agreed amongst stakeholders, to underpin the decisions to be made regarding the extent of investment to be made by water companies and other stakeholders, and the specific programmes to be put forward for funding at the next price review. However, the issues are extremely complex, and there are many potential pitfalls along the way. Whilst most stakeholders are involved in the process, none is specifically bound to accept the outcome of the analysis.

Key aspects that remain to be resolved include:

- Ensuring consistency between analysis and choices at the level of national programmes and local schemes and solutions
- Ensuring that water customer and other stakeholder priorities are robustly evaluated and taken into account in analysis; we believe there is more room for involvement of customer representative organisations, and for companies to ensure that their own work with customers is aligned with any national studies that are undertaken.

- Ensuring robust and comparable cost analysis across all sectors. Companies are already co-operating in the provision and checking of data being used in the studies. Concerns surround ensuring that data from other sectors is robust and subject to equal scrutiny as is water industry data.
- Enabling fair and consistent treatment of options with different levels of risk. It is important that the framework enables the comparison of more certain, costlier options with less certain, less expensive options.
- Ensuring that the best overall practicable environmental solutions are developed, not just those which merely move pollution from one medium to another, by taking account of the costs and benefits across all media.

3.3 Delivering an appropriate balance of risk and return

The water industry continues to invest in maintaining existing assets, some required to maintain essential services, some to improve customer service and some to secure environmental improvements. New assets will be required to secure adequate water resources, to meet the challenge of climate change, and in some cases, to implement the Water Framework Directive cost-effectively.

Investors do not have to invest in water - if there are more attractive returns elsewhere, or if the risk is too great, they will choose not to. The water industry in England and Wales is competing for investment on worldwide capital markets. However, secure stable regulation can help to ensure reliable returns at an appropriate level of risk and there are investors - pension funds for example - who find investing in the industry an attractive long-term prospect. One of the most pressing issues post PR09 will be how best to reward investment, while adequately protecting customers' interests.

If this is to be achieved, given the challenges ahead, we believe the present price-capping methodology will need adapting in the following ways.

Objective 3: Regulation to deliver an appropriate risk-return balance

1. Ofwat-WSRA places the approach to financiability on a firmer footing
2. Ofwat-WSRA overhauls the approach to efficiency
3. Ofwat-WSRA redefines incentives to encourage: innovation and efficiency; the delivery of good service to customers and the environment; least cost long term investment; and, central estimates of costs
4. The industry, Government and regulators develop a common approach to risk

3.3.1 Putting financiability on a firmer footing

At the 2004 price review, Ofwat gave an uplift to allowed

returns to meet concerns about 'financiability', effectively, the ability of the sector to continue to attract investment funds⁴. These uplifts essentially amounted to an increase in the allowed cost of capital in order to sustain credit ratings and financial ratios, important benchmarks referred to by investors in choosing whether and how much to invest in a company or sector. These financiability adjustments applied to many companies in PR04 and were an important factor in the acceptability of the determinations.

But the sustainability of these arrangements, and whether there are better ways of sustaining the flow of both debt and equity funds to the sector, is already a matter of debate in the industry. It is already under review by Ofgem and Ofwat as part of the follow-up to the Department of Trade and Industry/HM Treasury study on higher gearing⁵.

Recognising the importance of financiability will continue to be a crucial element of the price review, ensuring that the industry can continue to attract funds for long-term investment, particularly given the likelihood of continued high levels of investment. Water UK looks forward to participating in Ofwat's review and ensuring that the approach to financiability is placed on a more transparent and firmer footing for the next price review.

3.3.2 Overhauling the approach to efficiency

Another key area of concern with Ofwat's approach is the way it sets efficiency targets for companies. To date Ofwat has relied on its econometric models to determine efficiency targets, although the industry has long raised concerns regarding the statistical robustness of several of the models, and their underlying economic sense. It is crucial in Water UK's view, that a new approach is developed for the next review.

For instance, it is widely accepted that the early 'low-hanging fruit' following privatisation has now been picked, and that future scope for efficiency will be much less. It will be even more important next review, that methodologies are developed and used that will deliver realistic targets for companies. It is important that there is agreement and transparency about those methodologies, to reduce uncertainty and enhance investor confidence.

The statistical models on which the catch-up efficiency targets have been based are fundamentally unreliable. The combination of a complex industry, relatively few comparators, and uncertainties about data comparability between companies, lead inevitably to inadequate models, often with low statistical reliability and/or counter-intuitive

explanatory factors. Therefore apparent differences between companies' efficiency are likely to reflect inadequacies in the analysis rather than real efficiency differences. The margins of imprecision that are inherent in Ofwat's models do not support the level of reliance that is placed on them in setting efficiency targets.

Alternative methods available for evaluating comparative efficiency may not produce results that are any more reliable than those currently produced by Ofwat. It is necessary to accept that the scope for performing reliable comparative benchmarking in the water industry is limited. The approach to capital maintenance is in particular need of review (as highlighted by the Competition Commission⁶), as both the capital maintenance econometric models and the cost base that Ofwat employs have serious shortcomings.

A further drawback of the use of comparative efficiency analysis is that it requires considerable volumes of data. A reduced role for comparative efficiency could make a substantial contribution towards reducing regulation.

In addition to the "catch-up" efficiency targets, the overall scope for efficiency which includes the continuing improvement factor, or frontier shift, assumed by Ofwat at the 2004 price review was not supported by the available evidence. Some of the cost reductions since privatisation reflect falling input prices, particularly electricity. This cannot be expected to continue – prices for energy and for chemicals have been increasing significantly.

Work carried out by independent consultants, National Economic Research Associates (NERA), for Water UK established a 'Checklist of Best Practice' for setting efficiency targets, which included:

- efficiency forecasts for operating and capital expenditures should be set consistently within price limits
- productivity gains in water should reflect differences from those expected in the economy as a whole⁷, to avoid double counting
- past trends in productivity and input prices should be assessed separately in forecasting future efficiencies
- recognition of the limitations of comparisons across sectors or internationally,

We believe that this work forms a good starting point for reviewing the setting of efficiency targets.

In view of its inherent limitations, we believe that the current framework for setting efficiency targets is unlikely

⁵ Department of Trade and Industry and HM Treasury, 'The drivers and consequences of increased gearing', October 2004. Gearing refers to the degree to which companies rely on debt as opposed to equity in their balance sheets.

⁶ Competition Commission, 'Sutton and East Surrey Water plc', August 2000

⁷ as these whole economy gains are already assumed within the RPI component of the price cap

to deliver the best outcome for customers and the right risk/reward relationship. Companies consider that it is essential that there should be a fundamental review of the basis for setting efficiency targets. This needs to include:

- reviewing the scope for placing more weight on market evidence from competitively tendered or partnership contracts;
- consideration of how the application of the Common Framework for Capital Maintenance could be developed to assist in efficiency assessments;
- whether companies could be responsible for setting their own targets, for example by applying the type of approach used by Ofgem for setting capital expenditure at the recent electricity distribution price review, with a trade-off being available between efficiency targets and cost of capital and/or rewards for out-performance;
- whether setting a uniform target for all companies, with incentives to out-perform and reveal efficient costs, would be a more satisfactory basis than efficiency targets based on flawed comparisons.
- Lessons can be learned from recent innovations in capital procurement practice, which have seen a move away from the aggressive tendering of the last decade towards a partnership approach; with long-term relationships, clear specification of outputs, and incentivised benefit sharing. The current approach to setting efficiency targets has had an adverse effect on the industry's relationships with the supply chain – stifling innovation and driving suppliers out of the market.

3.3.3 Redefining incentives

Incentives are at the heart of the system of price cap regulation. In the absence of competition, they are essential to drive innovation, efficiency and first class customer service, and to ensure long-term least cost investment. We believe that there is a need now for Ofwat to review how incentives work, and how they can be preserved and improved. It will be important, given the pressures on bills, and the new problems to be tackled, that the industry continues to innovate and to increase its productivity, and to deliver least-cost long-term solutions.

Overall, we believe this means that Ofwat needs to develop a more flexible approach to regulation. We recognise that this may mean more risk in some areas, and less in others. There is an important debate to be had regarding the appropriate level of risk that customers, companies and their shareholders, and the environment should bear, including the extent to which the system should allow for local variation to reflect local views and conditions.

In reviewing incentives, there are a number of aspects of the regime that we would wish Ofwat and other stakeholders to consider.

- the price cap system gives stronger incentives for opex

than capex efficiency. This might imply that there are then greater incentives for companies to seek capital solutions to problems rather than those with a high operating cost component, which may be more sustainable;

- Ofwat's definition of activities and outputs reduces the scope for companies to optimise their operations. We would like to see more monitoring of performance by outcomes rather than by inputs and outputs;
- Ofwat needs to reconsider the need for outputs to be defined with certainty and generally deliverable in the 5-year period ahead. This may tend to discourage investments whose returns are longer term, or where, for instance with innovative approaches, outputs may be less certain. Companies will only adopt more sustainable, but possibly riskier solutions if the regulatory system incentivises them to do so;
- The industry welcomed the inclusion of pilot land management schemes in PR04. We would like to see such schemes encouraged, where they have customer support. Ofwat already has mechanisms to encourage enhanced service, which could be developed perhaps by reference to selected sustainability indicators;
- We would also like to see constraints on additional investment between price reviews being reviewed. Currently incentives are asymmetric: if a company under invests, the benefit is returned to customers, whilst if a company overspends, it is not added to the asset base. This means that additional spending between price control periods to meet genuine customer needs is discouraged. Instead the industry would like to see positive incentives to encourage investment where there are clear benefits;
- Finally, the 5-year period of the price review is due to be reviewed by Ofwat later in 2005. There has been much discussion as to whether the 5-year period should be extended, to enhance investor certainty and incentives. However, Water UK's view is that any significant lengthening of the period would place more reliance on an assessment of risk at a price review, and on Ofwat's mechanisms for dealing with uncertainty between reviews - the 'interim determination of K' mechanism (IDoK) and logging up procedures. This would re-introduce regulatory risk, and it is not clear that incentives to invest would be strengthened, as has been suggested. Water UK considers that the existing mechanisms for dealing with uncertainty remain unsatisfactory, and it would be even more important to improve these if there were any lengthening of the price period. These are important issues and we welcome the opportunity to participate in Ofwat's forthcoming review.

Conclusions

Water UK would like to see the debate on the 5-year period opened up to consider whether all investment

needs to be reviewed on a 5-year cycle. Implementation of the longer term investment planning framework proposed in Section 3.1.2 would enable appropriate provision for those parts of the programme which lend themselves to being addressed in a more rolling manner, in the context of clear projections of requirements and likely costs. Where very large scale investments may be anticipated, it may be appropriate to consider different funding mechanisms, such as Public-Private Partnerships or more innovative risk-sharing approaches. Such measures may contribute to enhancing the perception of regulatory commitment to funding investment and hence sustain investor confidence.

We believe that, as well as encouraging efficient long-term investment, redefining incentives could help towards maintaining investor interest and the financial flexibility of the sector, and we would therefore wish to engage in a wide-ranging and comprehensive review of the issues raised above with regulators and other stakeholders.

3.3.4 Developing a common approach to risk

The level of risk which it is appropriate for companies (and consequently, customers and/or the environment) to bear needs to be reviewed. This cannot be considered in isolation, but needs to take into account:

- the trade-off between risk and return required by financial markets
- the extent to which companies bearing risk increases the requirement for some financial headroom for any unexpected cost shocks which are not eligible for interim determination
- the relationship between the level of risk borne by companies and incentives for efficiency and innovation, for instance in determining how tightly outputs and activities should be specified
- any change in the length of the price review period, discussed in Section 3.24
- The extent to which it is appropriate for companies to risk failure in service delivery, taking into account probability and consequence, as assessed, for example, as part of the Common Framework analysis for capital maintenance

In addition, it is important that a price determination is robust both to central and downside economic scenarios materialising. For this purpose, it would be possible for the regulator to develop its financial model to accommodate risk modelling – as was recommended to Ofwat by the industry during PR04.

3.4 Simpler, smarter regulation

The industry welcomes the Government's current policy of cutting the burden of regulation, which is in part being driven by the EC Lisbon Agenda, with its emphasis on growth and prosperity fuelled by a knowledge-based economy. In his last Budget the Chancellor adopted in full the recommendations of the Hampton report and the

Better Regulation Task Force report 'Less is more: reducing burdens, improving outcomes', published alongside the Budget. The Chancellor also announced the creation of a new Better Regulation Executive to take forward implementation of the "Less is More" agenda, and a reorganisation of the Better Regulation Task Force to become the Better Regulation Commission. Further details are available at <http://www.cabinetoffice.gov.uk/regulation/>

In the water sector, Defra, the Environment Agency and the Drinking Water Inspectorate have all embraced the policy of reducing regulation, the former committing to cutting red tape by 25%, the Agency developing its own 'modernising regulation' agenda. Ofwat has announced a review of its annual information requirements (the 'June Return') from water and sewerage companies, and we understand will be considering the implications of the Hampton and Better Regulation Task Force reports for itself, despite formally being outside the remit of those studies. A report by HM Treasury noted that the cost of regulation had increased since privatisation⁸.

Water UK has for some time been concerned at the growing plethora of regulation, the administrative burdens it imposes, and the impact it can have on efficiency and on incentives. Water UK is currently working closely with Defra, the Environment Agency and Ofwat on a project to contribute to the Department's 'cutting red tape' project. This project is aiming to highlight a priority list of regulatory activities where it is felt that regulation could be simplified, without hindering the ability of regulators to meet their objectives. Indeed, we believe that in some cases a lighter-touch approach to regulation can help to free business to deliver regulatory outcomes more efficiently. As part of the project we are identifying case studies where it is hoped that specific actions will be agreed by the regulators and the industry towards a reduction in regulatory burdens.

Water UK has the following recommendations for actions to support the objective of simpler, smarter regulation.

Objective 4: Simpler, smarter regulation

1. Government, regulators and the industry to work together to identify scope for simplifying and modernising regulation, including reviewing options for co-regulation, self-regulation and economic instruments;
2. Regulators to adopt transparent and systematic codes of practice for ongoing information management and for the development of regulatory methodologies and techniques

3.4.1 Simplifying and modernising regulation

Water UK's concern is that 'simplification' is not limited to processes, such as e.g. the amount of form filling. We want regulators to think about how administrative

burdens can be reduced, what data may be required, what it is to be used for, and if simpler methodologies, requiring less information could do the same job better. More effective, lighter touch regulation, so that companies have greater freedom to find optimal solutions to delivering the outcomes regulators want to see. We recognise that simplification can bring more risk and incentive, so it is important to simplify the right things, where it is appropriate to have stronger incentives.

The Better Regulation Task Force and the Hampton reports have strongly endorsed a risk-based approach to regulation: meaning that regulation should be proportionate to the severity of the estimated risks. The Better Regulation Task Force has urged regulators to consider whether the stringency and rigidity of command and control regulation is always the most effective means of regulation, or whether sometimes, companies can be trusted to regulate themselves (self-regulation), or under some code of practice which might be drawn up with the regulator (co-regulation). Regulation by way of tradeable permits or incentive charges (e.g. pollution charges) may offer another lighter-touch mechanism for regulation which can potentially deliver outcomes at lower cost. The Hampton report particularly focused on the benefits of risk based regulation, in the context of inspection regimes. It is of note that the Drinking Water Inspectorate has for some time practised a risk-based self-regulatory approach to cryptosporidium monitoring, and is now taking a similar approach to its inspections policies.

We would like to see the Environment Agency give more consideration to the scope for co-regulation, self-regulation and economic instruments in place of command and control regulation, (mirroring a recommendation for regulators more generally, made by the Better Regulation Task Force). A case study on which Water UK and the Environment Agency are working, on discharge consent sampling, is one example where self-regulation could save considerable resources. We are also encouraged by the Environment Agency's willingness to consider novel ways of regulating for delivering the Water Framework Directive targets of good ecological status in water bodies. The Agency has recently proposed catchment-based targets, which would open up the scope for trading of discharge permits within a designated catchment. The use of economic instruments to deliver environmental objectives more efficiently is worth exploring. However, this would raise questions for Ofwat, which have yet to be discussed, for their funding mechanisms within price caps.

Amongst our priorities for simpler regulation, going beyond the issue of information requirements, is for Ofwat to simplify its approach to assessing comparative efficiency of companies and the development of a more outcome-based approach to regulation. (as discussed in sections 3.3.2 and 3.3.3 above).

A Water UK/Department of Trade and Industry joint-

sponsored workshop on innovation, held on 23 May 2005, highlighted that a lighter-touch approach to outputs could enable companies more flexibility and provide a greater incentive to innovate. In addition, companies would like to explore with Ofwat the scope for lighter-touch approach to business plan appraisal at a price review, where a company is considered to have produced a plan considered to be of high quality. To this end, companies propose to work towards developing an industry view of best practice principles to guide future submissions to regulators. This should also help to make the periodic review process more efficient.

3.4.2 Information management

To monitor the future development of regulation, Water UK would like to see regulators adopt a transparent and systematic approach to information management and to the development of regulatory methodologies and techniques.

This might for instance involve five basic strands:

- review existing stock of regulation as whether fit for purpose
- cut redundant, duplicative or excessively complex requirements
- adopt a one-in-one-out approach to the adoption of new regulation
- review the alternatives to traditional regulation
- introduce sunset clauses on regulations, to ensure they are regularly reviewed

Regulators should develop their own codes of practice and criteria for implementing each of these strands.

During the price review of 2004, the water industry submitted to Ofwat a 'Check list of Best Practice', devised by independent consultants, and based on a review of the literature, and UK and international experience, for the regulator to use in determining how to set X at Periodic Review for use in water company price caps. The industry believes that such a check-list system can enhance the transparency, consistency and robustness of regulators' decisions in determining methodologies.

We would like to explore with Ofwat the potential for using this checklist, and the development of others for other areas of methodology, in the process of producing the methodology for the next price review

3.5 Greater accountability of Government, regulators and the industry

In order to ensure that the regulatory framework operates effectively to deliver the broad public interest objectives for the water sector, it is important that there are effective checks and balances on the various players and processes through the system.

An important means of ensuring the accountability of

regulators and Government is through ensuring they operate with openness, transparency and effective consultation. In Water UK's view, although significant improvements were made during PR04, there are still weaknesses in the regulatory process. Ofwat has significantly improved the transparency of its processes, and has engaged in greater consultation, but key decisions, particularly on the content of the environmental programme as part of the price review, are still taken by Government behind closed doors. The role of other Government departments such as HM Treasury and Department of Trade and Industry in this process remains unclear to outside parties. This lack of transparency remains an important weakness in the regulatory process.

The lack of an accessible appeal route for utility companies is also a cause for concern. Appeal rates to the Competition Commission are low because the process is disproportionately costly and time-consuming. Although there are other factors involved, no water or electricity distribution company appealed to the Competition Commission against recent price determinations. We do not believe this means companies were universally satisfied with the outcome of these reviews. Indeed the water industry had significant reservations about some of the methodologies applied by Ofwat. Despite recommendations from the Better Regulation Task Force and the House of Lords Constitution Committee, and lobbying by Water UK and others, the Government has to date rejected proposals for change.

Companies recognise that it is insufficient to expect Defra and regulators to improve their transparency, and accountability, and to develop more flexible and lighter touch forms of regulation, without offering any assurances to regulators or to customers in return. The aim ultimately is for regulators, customers and the companies to develop a greater sense of shared purpose and mutual trust. However, to help this on the way, the companies are willing to make some commitments to signal their genuine intentions. Above, we have said that companies wish to explore with the regulators incentives to encourage more central estimates, to underline their interest in reducing the incentive for companies to be over-cautious in estimating costs. We have also explained that we are willing to explore how Ofwat might take the robustness of our business plans into account when making price determinations. In addition, here we consider ways that we can become more transparent with our own information and in our business planning processes.

Our proposals for improving accountability include:

Objective 5: Greater Accountability of Government, Regulators and the industry

- All stakeholders make better use of parliamentary committee system, such as the EFRA and EAC committees
- Ofwat- WSRA Board to provide enhanced transparency and consultation to resolve contentious methodologies
- Government and regulators apply Regulatory Impact Assessments in a robust and systematic way, and work with the industry to influence the European Commission to do the same
- Government/regulators measure and carries out timely reviews of regulatory performance identifying the costs and benefits of regulations
- The industry improves its understanding of WaterVoice- Consumer Council for Water data requirements of new Consumer Council for Water and how these might be delivered, enhancing accountability to customers
- Companies – and all stakeholders - to improve their understanding of customer priorities and to develop best practice in dealing with customer issues

3.5.1 The Parliamentary committee system

Water UK considers that the Parliamentary committee system has generally had a beneficial impact on regulation of the water sector. In particular it is an important mechanism to secure transparency of Government and regulators processes and decisions. However, both committees, the Environment Audit Committee and the Environment, Food and Rural Affairs Committee (EFRA) have a strong environmental focus. Sometimes the system has not worked effectively, and has added considerably to regulatory burdens at what have on occasion been particularly busy times for regulators and companies. For this reason we would not recommend the creation of any additional Parliamentary structures.

The industry would like to see the committee system being developed further to secure greater accountability of Defra for setting long-term strategy for the water sector, and to call regulators to account where divergent views have been seen to create regulatory conflict and uncertainty. We consider that the most useful approach may be to ensure that the topics and terms of reference are well directed to key issues. For instance, we would like to suggest that the EFRA Committee undertakes a specific review of the consistency with which regulators and Government interpret their duties towards sustainable development. Consideration could be given to widening the terms of reference of the EFRA Committee to include more explicitly issues of economic regulation and to undertake more regular reviews of such matters, particularly after each price review.

3.5.2 The Water Services Regulatory Authority board– increasing transparency

The industry has long been concerned that existing appeal mechanisms provide little recourse for companies to bring Ofwat to account for its particular methodologies. Appeals to the Competition Commission must be made on the whole package of price determinations, and the barriers to appeal are high. The adoption of better regulation principles by Ofwat and their practical manifestation in improved transparency and consultation has been welcomed. However, the industry's experience is that despite this, on occasions Ofwat has not taken proper account of all the evidence in reaching conclusions on methodologies. The industry believes this is particularly the case with regards to the regulator's approach to efficiency, where the views of eminent independent experts were dismissed without proper explanation. Furthermore, during price reviews, the industry often found that the splitting of issues into team responsibilities sometimes meant there was a lack of an overall view of the interactions between different elements, which could affect the approach taken.

We believe that the new Water Services Regulatory Authority board provides an opportunity for developing a more robust internal 'appeal route' on methodologies. For instance, should companies individually or collectively have an issue with a proposed methodology or judgement by the Water Services Regulatory Authority executive, then, subject to its materiality, this could be raised with the Water Services Regulatory Authority board for a decision having heard the views of both the Water Services Regulatory Authority executive and the affected companies, and potentially other stakeholders if affected significantly. We recognise that this approach would need to be manageable and proportionate to be effective.

3.5.3 Regulatory Impact Assessments

The Regulatory Impact Assessment process has been an excellent introduction to the regulatory arena. However, its use remains patchy, both in coverage and quality. We would like to see this mechanism used much more systematically across the most significant areas of regulation.

3.5.4 Costs and benefits of regulation

The HM Treasury report on the cost of regulation was a useful exercise. By adopting the systematic approach suggested above, regulators should be in a position to report regularly on the costs and benefits of regulation that they impose. This will provide a useful tool for monitoring their performance, particularly if extended across several regulators, for instance other economic regulators, and within the Environment Agency, between different areas of regulation.

3.5.5 Improved data sharing with the Consumer Council for Water

At PR04 it was clear that WaterVoice had expectations for data and information sharing about companies' business plans that were not always met. Going forward, the industry is keen to explore with the new Consumer Council for Water, its information needs and how the industry can better serve them.

3.5.6 Customer priorities

The industry is already committed to establishing memoranda of understanding with the new Consumer Council for Water to create a clearly understood arena for discussion between us. We have committed to working with the Consumer Council for Water on issues of key concern with customers, such as tariffs and metering, debt, sewer flooding, and water efficiency. Companies are also committed to developing best practice in dealing with customer issues.

4. Annexes

Annex 1: Recent Trends in Water Sector Performance in England and Wales

Over the last fifteen years the water industry has been a success story. Together, the regulatory regime and companies have delivered. We have seen:

- Better customer service
- Significant improvements in drinking water quality
- A major programme of environmental improvements, with a much higher standard of river and bathing water quality
- A capital programme well above pre-privatisation levels to deliver these improvements
- Efficiency gains on a scale far greater than envisaged at privatisation

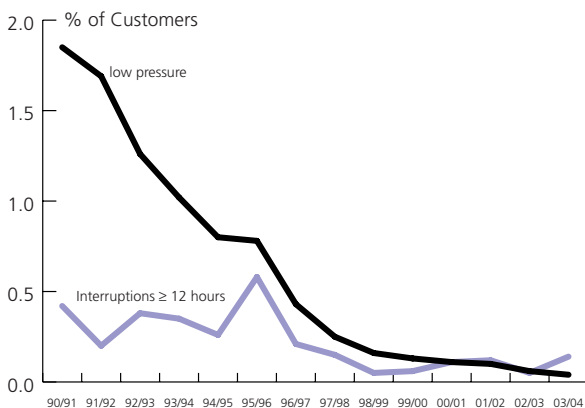
This annex illustrates the achievements.

Customer Service

All areas of service have shown an improvement – this has included:

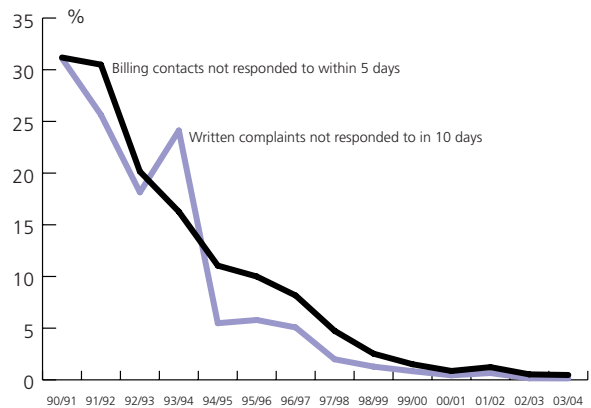
- A very large reduction (over 90%) in the number of customers affected by low water pressure
- Close to 100% performance in terms of speed of response to complaints and queries
- Sewer flooding incidents down by 70%
- Supply interruptions reduced by two-thirds

Water Supply

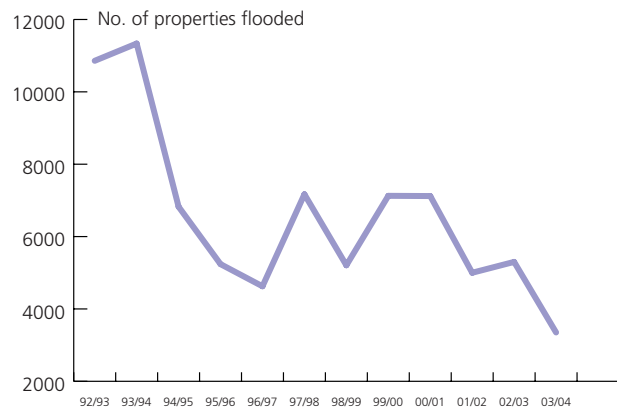


These improvements are illustrated in the graphs below:

Responding to Customers



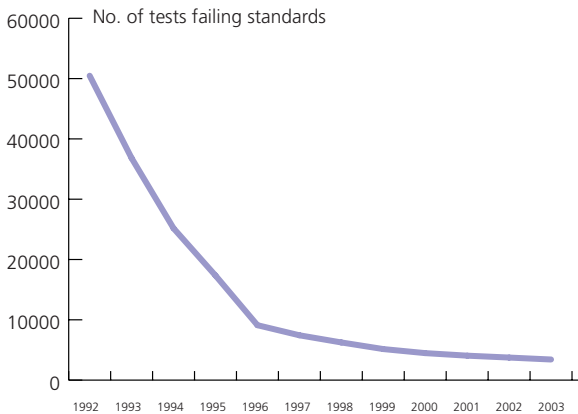
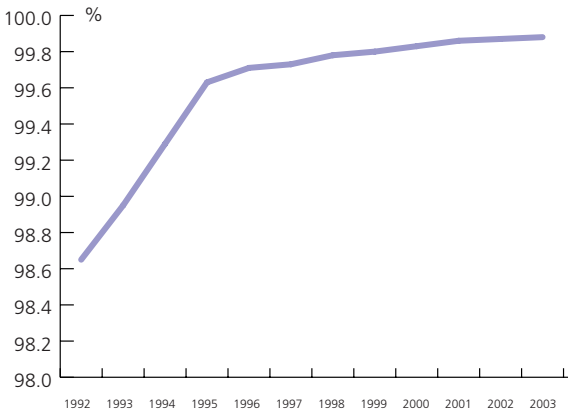
Sewer Flooding



Drinking Water Quality

- The number of tests failing quality standards has fallen by 93% since 1992
- Almost 100% of samples tested meet the health-based and aesthetic standards for drinking water.

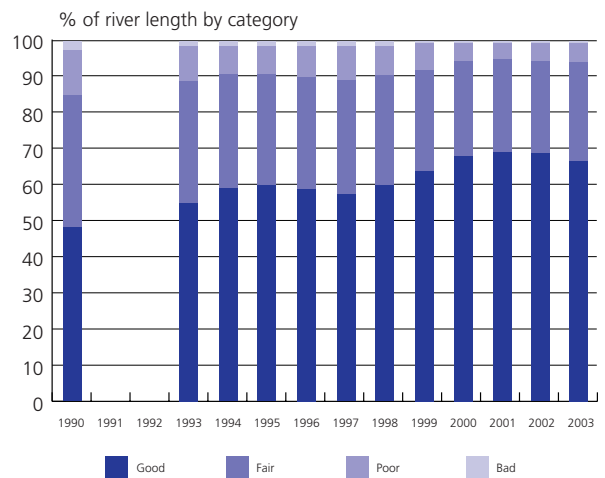
Water Quality Compliance



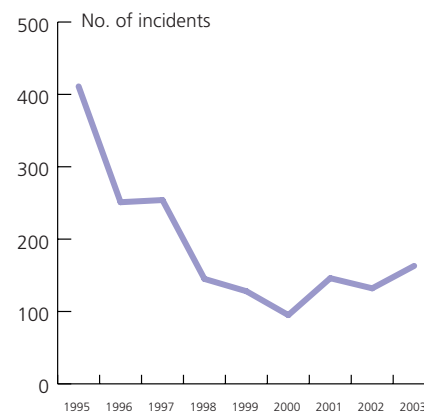
Environmental Improvements

River water quality has improved considerably, against a background of increasing diffuse pollution – the proportion of rivers in the good or fair category has increased from 85% in 1990 to 93% in 2003. The number of major or significant pollution incidents has more than halved since 1995.

River Quality

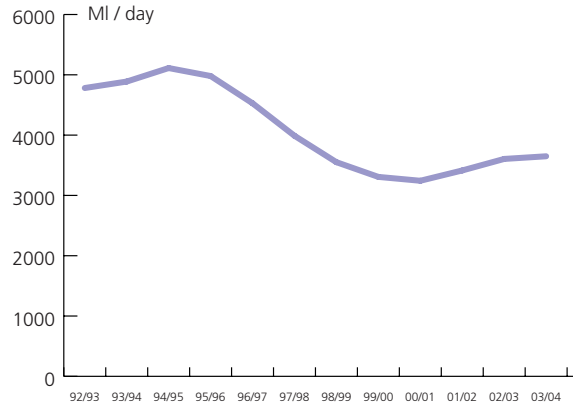


Category 1 & 2 Pollution Incidents



Leakage

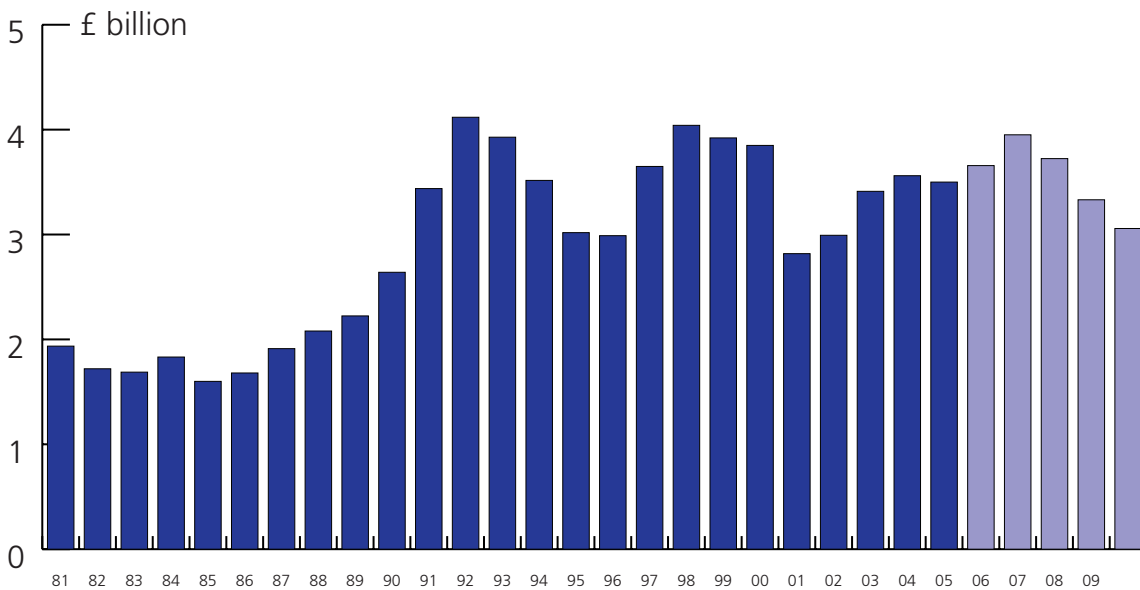
Leakage from water mains has been reduced by about 25% from the levels of 10 years ago, as the result of introduction of new methods of leak detection and increased resources put into leakage control. This has had a significant impact on the need for development of new water resources to meet demand.



Capital Programme

The industry has successfully delivered a large capital programme, consistently above pre-privatisation levels. This is projected to continue to 2010 and beyond.

Actual and projected capital expenditure levels 1981 to 2010 (information supplied by Ofwat)

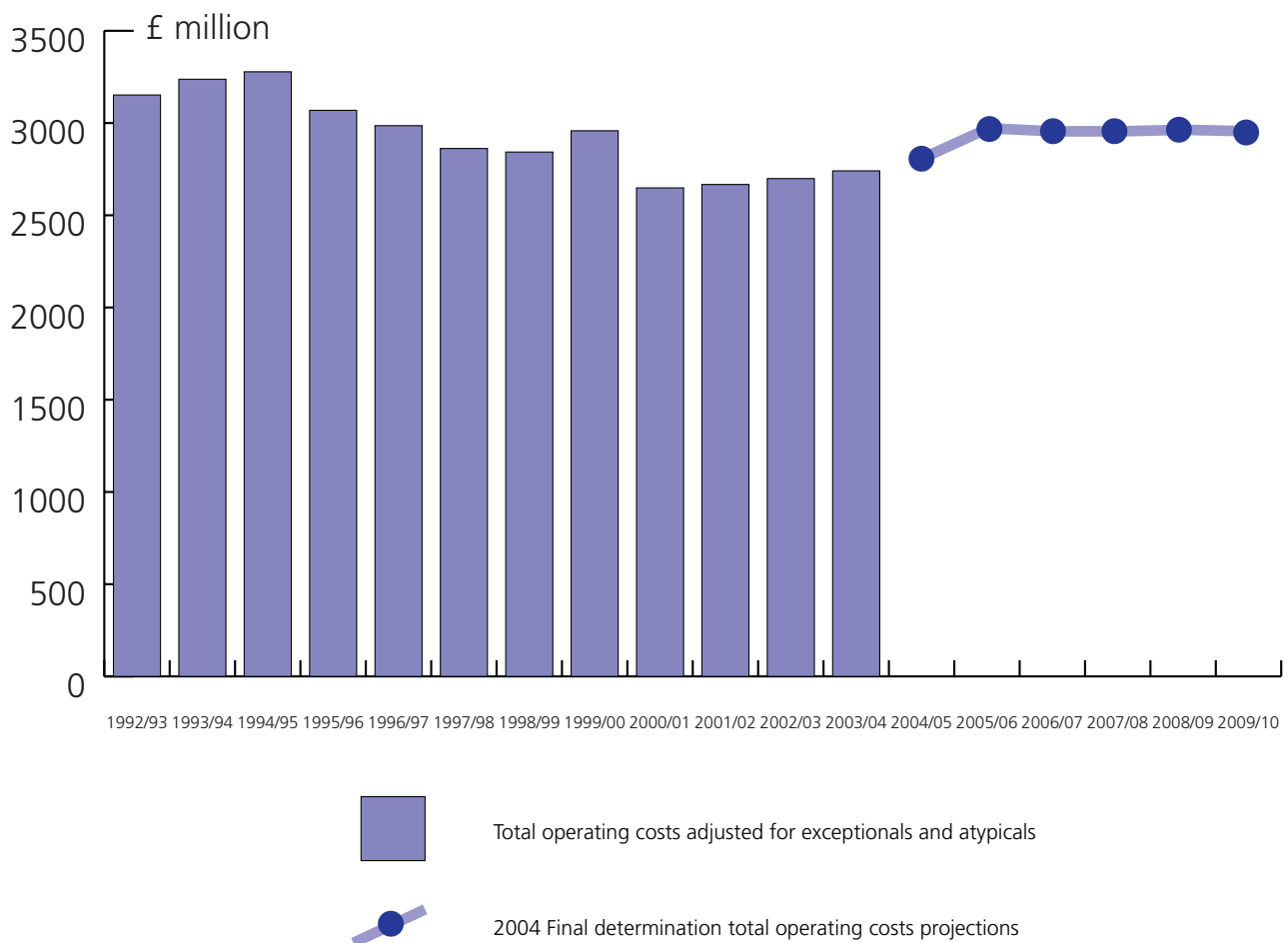


Efficiency

The additional costs of operating the much-expanded asset base have been substantial. However, the efficiencies which have been delivered mean that operating costs remain below levels immediately post-privatisation.

Passing on past efficiency savings and out performance, and making allowance for future efficiency savings, has minimised the increase in bills to deliver improvements. The overall impact of efficiency savings allowed for in the last two price reviews is to reduce bills by around 30%, relative to where they would have been without efficiencies.

Actual and projected operating costs 1993 to 2010

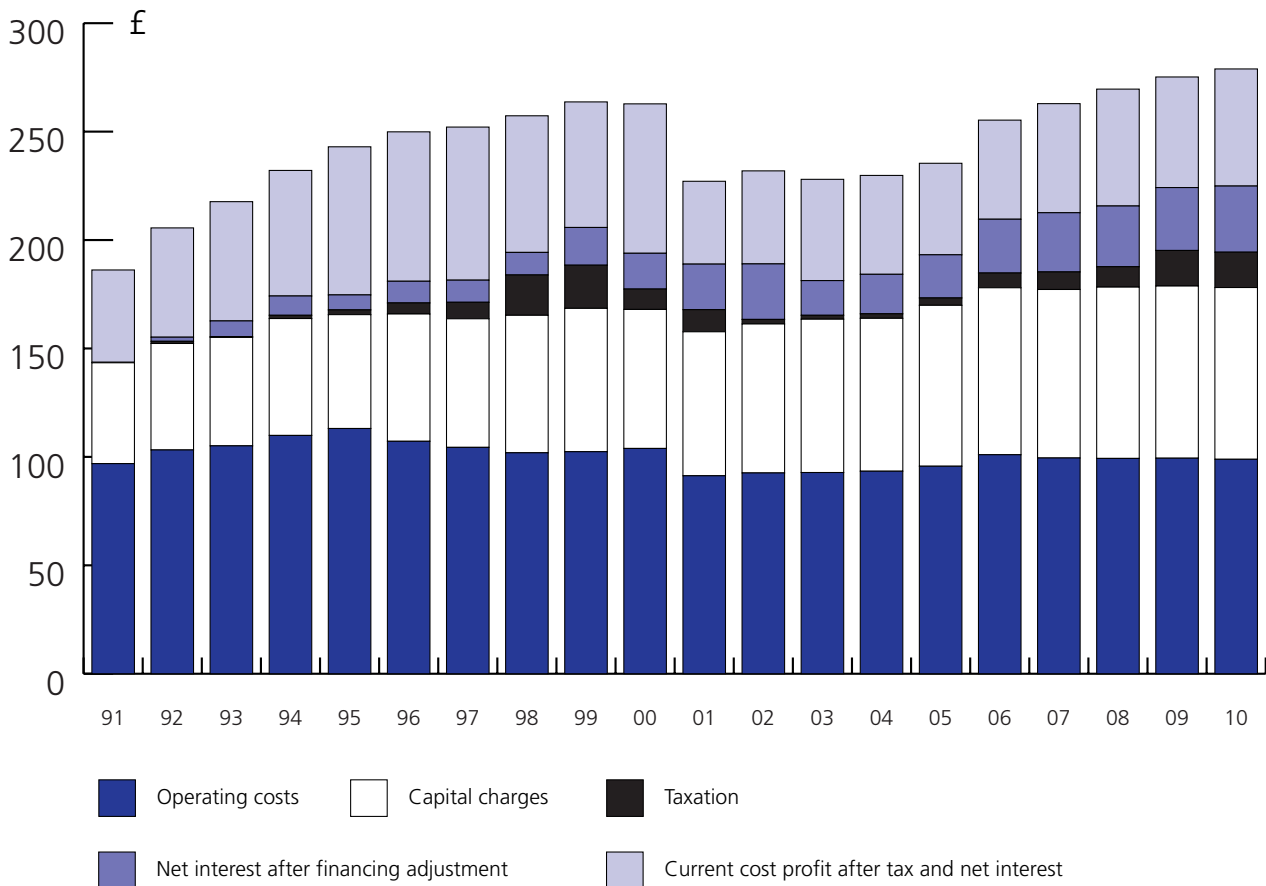


Source: Ofwat - "Future water and sewerage charges 2005-2010 - final determinations"

Bills

The costs of financing the large capital programme have inevitably resulted in an increase in bills. However, efficiencies in delivering the programme and in operations have minimised the increase. As shown below, the operating cost efficiencies mean that the part of the bill to customers attributable to operations has reduced; bills have risen as a result of rising capital charges, increased taxation, and interest on borrowing to finance the capital expenditure.

Components of the average household bill 1991 to 2010

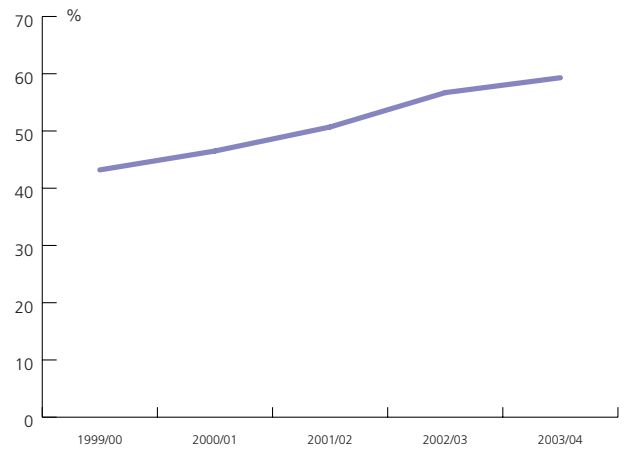


Source: Ofwat - "Future water and sewerage charges 2005-2010 - final determinations"

Debt and Gearing Levels

As shown in the graph below, industry gearing levels have increased substantially in recent years, from 43% in 1999-00 to 59% in 2003-04. Five companies now have gearing levels over 75%.

Industry Gearing (Net Debt/RCV), 1999-00 to 2003-04



Source: NERA presentation of Ofwat (2004), "Financial Performance and Expenditure of the Water Companies in England and Wales", p. 29.

Annex 2: The Water Framework Directive (2000/60/EC)

The Water Framework Directive establishes a strategic framework for managing the water environment and represents an important departure from previous European Commission legislation on water quality. It rationalises and updates existing water legislation by setting common, outcome-based EU-wide objectives for water. It establishes a common approach to protecting and setting environmental objectives for all groundwater and surface waters within the Community.

The Directive specifies how the objectives must be set, which for surface waters must include a chemical quality objective and, for the first time, an ecological quality objective. Quantitative and chemical quality objectives must be set for groundwater. Provision is included for the achievement of higher standards in Special Protection Areas. Derogations against the primary environmental objective can be made, in certain limited circumstances.

At the heart of the Directive is the requirement to produce strategic management plans for each river basin, setting out how the objectives that have been set for the water bodies within the river basin are to be achieved. The plans must be based on a detailed analysis of the pressures on the water bodies within the river basin and an assessment of their impact. This allows a comprehensive programme of measures to be drawn up that is tailored to the specific circumstances in the river basin and, in particular, to target improvements and monitoring effort on those water bodies that are most at risk of failing to meet their objectives. An important feature of the Water Framework Directive is that it specifically endorses cost recovery in charging, the application of the polluter pays principle and the use of economic instruments as a regulatory tool.

The principal milestones of the Water Framework Directive are:

- 2004** Characterise river basin districts in terms of pressures, impacts and economics of water use
 - 2006** Implement the monitoring of water status
 - 2007** Consult on significant water management issues for each river basin district
 - 2008** Consult on drafts of river basin management plans
 - 2009** Identify a programme of measures for achieving the environmental objectives of the Water Framework Directive cost-effectively
 - 2009** Produce and publish River Basin Management Plans for each River Basin District, and establish programme of measures to achieve objectives
 - 2010** Implement water pricing policies that enhance the sustainability of water resources
 - 2012** Make operational the measures of the programme to achieve the environmental objectives
 - 2015** Achieve the environmental objectives
- Beyond 2015** Timescales for delivery may extend beyond 2015, subject to derogations and exemptions. Six-yearly review and update of plans

Annex 3: Water Sector: Overview of Cost-benefit Research Activities

Project	Objectives	Stakeholders involved	Timescale
Water Framework Directive Collaborative Research Programme on Economics Sub-projects: 1. Scope decision-making context and processes 2. Cost-effectiveness methods and analysis 3. Scoping of disproportionately costly cases and how to assess their benefits 4. Focus group specification of benefits and concerns 5. Guidance for assessing benefits 6. New benefits studies	To develop methods to assess costs and benefits of options to aid decisions on River Basin Management for Water Framework Directive – To assess cost-effectiveness of measures – To aid determination of whether or not they are disproportionately expensive	all key stakeholders: 11+ collaborators (Defra (lead), WAG, SE, DTI, EA, SEPA, EN, UKWIR, Ofwat, Ports, RSPB + CLA)	Completion in 2008 Sub-projects completed from 2005 onwards
UKWIR Project on "The Role and Application of Cost-Benefit Analysis"	To provide a framework for all CBA applications – environmental, sewer flooding, maintenance, leakage, drinking water improvements	UKWIR, Defra, Ofwat, DWI	1st stage completion in 2005 2nd stage – application to sewer flooding – completion in 2006
Cost benefit analysis for drinking water quality standards and enhancements	Developing a framework for assessing costs and benefits of non-mandatory improvements to improve water acceptability to consumers	DWI, UKWIR	Scoping study completed in 2005

Annex 4: Affordability and Bad Debt

Background

The industry calculated that in 2002/03 about 3% of household charges were not recoverable. That works out at £164m for the year and is equivalent to the charges from 700,000 households. The cost of managing and financing this debt works out at just under £10 for every paying customer

Comparison with energy sector

Currently debt in the water industry is about twice that in the gas and electricity sectors, with a bad debt to sales ratio of almost 2%. This debt has been increasing since the 1999 Water Industry Act removed the right to disconnect household customers for non-payment. The industry disconnected very few household customers, it was the threat of disconnection that encouraged the many customers, who could afford their water charges, to pay.

With the ban on disconnection and removal of the ultimate incentive to pay, the government made the water industry a special case. But there are other factors which make the industry unique compared not just with utilities but with all other service sectors. These include:

- No contract with domestic customers, hence
- A lack of information on customers
- No ability to impose special conditions for bad credit risks
- A statutory duty to supply – irrespective of whether the customer pays or not

Data protection issues

The Data Protection Act has also added to the difficulties companies face in trying to trace those customers who choose not to pay. Previously water companies could exchange information on "absconding" customers with other utilities and local authorities. "Leavers" now account for almost one quarter of all household water debt.

The only resort left to water companies to recover outstanding debt from hardened and determined debtors is the Court Service. Water companies are the largest users of the Court Service with some 160,000 claims brought in 2003/04. However without a customer name no case can be brought. However, the obligation to supply is to premises and water companies have no power to find out the name of tenants from landlords or the name of a responsible person in multiple occupation accommodations.

Industry actions

The industry has commissioned a number of research projects into customer debt. The first project by CreditScorer compared water with

other sectors and concluded that "given regulatory constraints and the effects of scale the industry is adopting good practices. The water industry is comparable with gas and electricity across several key performance indicators".

Subsequent research by Equifax focused on the socioeconomic and demographic effects behind customer debt. It compared water industry debtors with those in the general population and found that:

1. Majority of debtors are high-risk individuals, but
2. Better credit risk scores and higher incomes show there are defiant and calculating debtors who are able to afford their bills
3. Affluent singles and couples in "Exclusive Urban Neighbourhoods" are over represented in the debtor file
4. Leaver debt accounts for 23% of total debt
5. High proportion (41%) of debtors have moved residence in last 4 years

Equifax concluded that:

1. Water industry needs to share data with other stakeholders and the credit industry to identify "at risk" individuals – to allow earlier identification and better management of the problem - preventing the build-up debt
2. Water industry needs to better align collection strategies with ability to pay.

Other service and retail sectors have the ability to exchange information on new and existing customers and assess their credit risk. They can then tailor debt management approaches according to customers' individual circumstances. But to do this water companies need similar information on their customers. The prerequisite is an industry contract with customers.

Helping with affordability

As well as providing practical help through a range of measures to those customers who need it, the industry works through Water UK with stakeholders including WaterVoice, Ofwat, Help the Aged and NCC to raise the profile of the water affordability and debt issue with Government.

Way forward

There is little scope for reducing household water debt without changes to legislation or help from government. Other household costs have or are rising. The question is which ones take priority in customers' view? And at a time of increased consumer indebtedness which organisations have the information on customers to follow up and tailor debt management approaches to the circumstances and needs of individual customers?

Water UK maintains that without some easing of the restrictions placed on water companies on the use of data, the industry is in danger of being sidelined in the

increasingly competitive market for debtors' money.

We are therefore calling on government to provide a more level playing field by

1. Ensuring companies receive proper information on customers receiving water services by requiring all customers to enter into a contract with their water company
2. Introducing a requirement for solicitors, conveyancers and landlords to notify water companies details of new property occupiers/owners (similar to the requirement on retail electrical outlets and TV licensing)
3. Improving the Water Direct scheme for customers in receipt of certain benefit payments so that customers on the verge of debt or who have just cleared their

debt can remain on the direct payment scheme. This would help the "poor money managers".

4. Reviewing data protection requirements and sharing of information to help
 - Identify customer needs and target appropriate help and debt management strategies.
 - trace absconding customers and the hardened non-payers who can afford to pay, thus reducing the debt burden on all paying customers

The industry also supports the view widely held by consumer groups that resolving the issue requires a national policy on poverty and affordability. That is something only government can address through a review of the tax credits and benefits system.

Sources of Information from the Water Industry (website links)

Water UK	www.water.org.uk
Eureau	www.eureau.org
UK Water Industry Research Ltd (UKWIR)	www.ukwir.org.uk
Anglian Water Services Ltd	www.anglianwater.co.uk
Bournemouth & West Hampshire Water plc	www.bwhwater.co.uk
Bristol Water plc	www.bristolwater.co.uk
Cambridge Water plc	www.cambridge-water.co.uk
Dee Valley Water plc	www.deevalleygroup.com
Dŵr Cymru	www.dwrcymru.co.uk
Essex & Suffolk Water plc (part of Northumbrian Water Ltd)	www.eswater.co.uk
Folkestone & Dover Water Services Ltd	www.fdws.co.uk
Mid Kent Water plc	www.midkentwater.co.uk
Northern Ireland Water Service	www.waterni.gov.uk
Northumbrian Water Ltd	www.nwl.co.uk
Portsmouth Water plc	www.portsmouthwater.co.uk
Scottish Water	www.scottishwater.co.uk
Severn Trent plc	www.stwater.com
South East Water plc	www.southeastwater.co.uk
South Staffordshire Water plc	www.south-staffs-water.co.uk
South West Water Ltd	www.swwater.co.uk
Southern Water	www.southernwater.co.uk
Sutton & East Surrey Water plc	www.waterplc.com
Tendring Hundred Water Services Ltd	www.thws.co.uk
Thames Water Utilities Ltd	www.thameswateruk.co.uk
Three Valleys Water plc	www.3valleys.co.uk
United Utilities Water plc	www.unitedutilities.com
Wessex Water Services Ltd	www.wessexwater.co.uk
Yorkshire Water Services Ltd	www.yorkshirewater.com

Government and Regulators' Websites

Department for Environment Food and Rural Affairs (Defra)	www.defra.gov.uk
Drinking Water Inspectorate (DWI)	www.dwi.gov.uk
English Nature	www.english-nature.org.uk
Environment Agency	www.environment-agency.gov.uk
European Commission	europa.eu.int/comm/index_en.htm
Health & Safety Executive (HSE)	www.hse.gov.uk
Joint Nature Conservation Committee (JNCC)	www.jncc.gov.uk
Northern Ireland Department for Regional Development	www.drdni.gov.uk
Office of Water Services (OFWAT)	www.ofwat.gov.uk
Scottish Environment Protection Agency (SEPA)	www.sepa.org.uk
Scottish Executive	www.scotland.gov.uk
Water Industry Commissioner for Scotland	www.watercommissioner.co.uk



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