setting price limits for 2005-10: framework and approach

response to Ofwat's consultation

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Please contact us for details.

National Consumer Council
20 Grosvenor Gardens
London SW1W 0DH
Telephone 020 7730 3469
Facsimile 020 7730 0191

www.ncc.org.uk

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Summary

Every five years the water industry economic regulator, Ofwat, sets price limits for customers' water bills. This consultation begins the two-year review process by defining Ofwat's approach to price setting. NCC campaigned vigorously at the last price review to bring down water bills to give customers a fairer deal. We welcomed the decrease in 2000, since when bills have been stable. We are pleased that the EU Water Framework Directive and the proposed water resource management plans move towards a long-term view of the environmental measures needed to ensure sustainable water resources. At present it is unclear what levels of investment will be needed to achieve this, and it is likely that capital investment will vary from company to company and region to region. However, at the current levels of service, we think it is possible and desirable for customers' bills not to increase above the rate of inflation over the 2005-10 period.

NCC welcomes the consultation, and Ofwat's efforts to gather stakeholder opinion in this complex and highly technical area. We would like to see consumers' interests at the heart of Ofwat's approach to the price review. At present we think the consultation gives insufficient weight to two key consumer concerns: affordability of bills, and the profitability of the companies.

Affordability

At present an increasing number of consumers are in water bill arrears. The poorest 30 per cent of households have to spend three per cent of their income on water, as compared to an average of one per cent of income. Among the poorest, those on Jobseekers Allowance or Minimum Income Guarantee, the 'spend' rises to 6per cent. Furthermore the current scheme to help vulnerable customers with their bill is a failure, with less than one per cent take up amongst eligible customers. This all doubtless contributes to the serious problem of debt among many consumers. New legislation will introduce a duty on Ofwat to have particular regard to disadvantaged groups of consumers. It is therefore essential that affordability for consumers is a major consideration in the price review. It should also be the subject of the next phase of customer research.

Profitability and financial transparency

Consumer concern about profit levels and distrust of companies' motivations emerges in the opinion research accompanying the review. The periodic review presents a golden opportunity to set out the facts clearly on profits, which are scarcely mentioned in the paper. OFWAT has a primary duty to ensure that companies can

secure a reasonable return on their capital. What is reasonable is a legitimate matter for debate. The consultation paper does not give a rate of return on capital, which is a key index of profitability - the ‘bang’ for the investors ‘buck’. Whilst operating profits and dividends are down from the 1990s, dividends are still showing growth and water companies have outperformed the FT All Share Index by 58per cent in the last two years. A full discussion of these issues will be essential in a transparent price review. Consumers’ views of a “fair return” should also be sought in the next phase of customer research.

Also neglected is the flow of loans and dividends between regulated businesses and the parent companies. We believe that this raises questions about the need for clear reporting, not only of the core businesses’ accounts but also of the ‘fit’ between them and the parent company accounts. Common reporting standards need to be implemented so that companies can be compared and the water aspects of large companies are properly transparent.

Time length for the review

The consultation asks whether the price review period should be extended beyond five years. At present we still see the five-year cycle as the basic building block of the price review process, in order that consumers are not disadvantaged by companies keeping profits over longer periods if they have overestimated their expenditure. However, in planning for sustainable investment, there are some cheaper longer-term solutions available than would be envisaged under a five-year cycle. This may be because solutions are intrinsically slow, such as reafforestation, or because they require lengthy research and development work, such as research on lead solubility or ground water contamination. We would like to see a five-year cycle taking place within a longer planning cycle with some carefully determined capacity for price variations for longer-term projects.

Safeguarding consumers from uncertain increases

At present mid-term price rises (interim determinations) are allowed to compensate water companies for the effects of no longer having the power to disconnect customers who fail to pay their bill. In practice this means that some companies have put their prices up because of the level of arrears and cost of debt collection. We think it is too early to conclude that removal of the power of disconnection has caused arrears to build up, and we are concerned that allowing mid term price rises as a kind of compensation for this sends the wrong signal to companies doing badly on arrears recovery. Some companies do well in this respect and it is important to be fair to them. We believe that this should not be a factor in allowing price increases.

Metering

The consultation does usefully explore the difficulties around the costs of optional metering. At present water customers can choose whether or not to have a meter. In practice they do so if their bill will decrease, meaning that other customers have to bear the considerable costs of meter installation and administration. The discussion confirms our view that the current legislation promoting optional metering is a mess. Our position remains that if metering is justified in cost/benefit terms (and this is a significant hurdle) then it should be compulsory in those areas. In the meantime, the costs of optional metering should be spread across consumers and should not lead to gains for some at the expense of others.

Complexity

Price setting involves highly technical considerations and this consultation is complex. The complexity of the issues is not made easier to deal with by the use of industry jargon in the consultation. This is a public consultation document that could have been much clearer with a little more of an eye for the external reader. We look forward to continuing the debate in a more accessible way.

1. Introduction

Context

Every five years the water industry economic regulator, Ofwat, sets price limits for customers' water bills. This consultation begins the two-year review process by defining Ofwat's approach to price setting. Since the last periodic review, things have changed in the water and sewerage sector. Prices have come down and standards have continued to rise. In the context of the new review (1), the balance of advantage between shareholder and consumer has shifted in favour of the latter. The shift has been accompanied by radical discussion on new patterns of ownership. This has had greatest effect in the case of Glas Cymru, a publicly owned company limited by guarantee, but there has also been a more general shift towards increased debt finance rather than equity financing of the industry. This puts into sharp relief the history of the industry since privatisation, which has been extremely volatile. Sharp price increases (1989 -94) were followed by decelerating increases (1995 -99) followed by a sharp decrease (2000), and a subsequent period of stability. By March 2005, the average household bill will still be lower in real terms than in 1999(2). Meanwhile, prices in other EU member states have risen towards the cost recovery levels already attained in the UK. This means that in England & Wales, water and sewerage prices are not notably higher than in comparable countries (3). Adverse public opinion towards the industry has been mitigated, doubtless affected by the price reductions and the high profile reports of environmental improvements, as well as fewer water shortages. Changed company fortunes have led to far fewer hostile analyses in the financial press, which has perhaps shifted its attention to the rail industry.

The *Research into Customers' Views* carried out by MORI during 2002 on behalf of DEFRA, OFWAT, Water UK, the Environment Agency and others gives some indication of the levels of satisfaction with water and sewerage services. Consumer satisfaction with water services was recorded as 87per cent for water and 81per cent for sewerage with dissatisfaction being recorded as 7per cent and 6per cent respectively. Satisfaction with value for money was 67 and 65per cent and dissatisfaction 13 and 11per cent respectively (4).

But the relative decline in bad news for consumers does not mean that there are no problems. Floods in recent years have led to a new set of physical problems including foul water flooding, consumer arrears in payments remain high, the government's vulnerable users scheme looks like being a failure (5), and confusion and inequity still surround the charging system (6). Commitments expected to follow from implementation of the EU Water Framework Directive have yet to be worked out and cost estimates vary immensely, for example from two to nine billion pounds (7). Perhaps most notably of all, the public retain a significant level of suspicion of the industry from the controversies of the '90s. In the MORI poll, almost three times more agreed than disagreed with the assertion that *"water companies are more interested in making money than providing a good service to customers"* (48per cent against 17per cent) (8). Four in ten respondents were unsure as to whether privatisation was a good thing or not and the remainder were divided in their views. This illustrates the importance of questions of profit to the consumer's perception of the industry and yet this question is hardly touched on by the consultation document.

Structure

Where possible, we follow the structure of questions set out in the consultation paper. We do not answer all the questions and some of them we group together. We also add our own comments at the end. It would have been helpful to the lay reader if the questions in the text had been accompanied by an indication as to which sections of the document were most relevant.

2. Omissions and complications in the approach

Q 1 Does this paper provide the information the companies, and other stakeholders, need to understand our approach to the 2004 review? If there are gaps what are they?
Q 2 Are there omissions or unnecessary complications in our approach?

Complexity

We can only speak for consumers, but we are critical of the way in which the paper manages to be complex and technical and yet also leaves out dimensions of considerable importance to consumers, in particular, profitability and affordability. We hope another phase of consumer research will investigate matters of affordability and consumers views on a 'fair return'. We have to accept that a degree of technical complexity is the inevitable result of adopting a more open style of reporting. The Consultation Document is not intended as a 'cheap and cheerful' guide to the industry. Nevertheless, it would have been useful for the paper to have a redraft by a non-industry editor in order to make it comprehensible to an interested 'lay' person coming from outside the circle of expertise. Even with our experience of the industry, it is not immediately apparent what is meant by such concepts as 'logging up and down', 'symmetrical shipwreck clauses', and what is the difference between 'capital charges' and 'return on capital' (which together account for 60per cent of consumers bills). Such problems of definition may result in our having misunderstood some of the questions. At the very least, a glossary would have been useful.

Q.7 is a particularly vivid example of unhelpful complexity and unexplained terms. It depends on understanding the difference between 'depreciation charged on base asset' and maintenance expenditure. A lay person could not be expected to know that infrastructure assets are only underground and that above ground assets such as treatment works are non-infrastructure. But this is not stated until para 4.32. Then para 4.41 sets out the principles of depreciation which, we assume, are therefore applied to non-infrastructure (ie above ground) assets, with standard lives applied to different types of asset. This again may be perfectly sensible, but what is not made clear at all is why the two sets of assets are treated in such different ways. Such questions introduce additional unnecessary complexity into what is already a highly complex process.

Affordability

Price setting is about customers' water bills. What customers can afford should therefore be an important factor in Ofwat's approach to the review, but it is barely discussed. Using data derived from the Office of National Statistics, Fitch and Price conclude that while the average UK household spends one per cent of its income on water, this figure rises to three per cent among the lowest three deciles. This could amount to over four million households, one in six. (9). Among the poorest households, those on Jobseekers Allowance or Minimum Income Guarantee, the ‘spend’ rises to 6per cent. This doubtless contributes to the serious and apparently growing problem of debt among many consumers. According to OFWAT, the level of household revenue outstanding for up to 48 months has risen 10per cent since 1998-99 and stands at £717 million. As a proportion of total household revenue, outstanding payments have increased from 13per cent in 1998-99 to 16per cent in 2001-02. The number of households in arrears stands at 4.5 million or 19per cent of households served, a very similar figure to that given by Fitch & Price as reaching the 3per cent figure (10).

Many in the industry attribute these trends to the abolition of disconnections; it is probably too early to say with certainty. But the issue of affordability and price must be a part of the picture. Single pensioners on income support for example spend six to eight per cent on their water bill. The Severn Trent charitable fund reports that households that come to them for help report typical accumulated debts of around £3,000. Water payment arrears are then, part of a wider spectrum of indebtedness (11). When such households default, they are in effect cross-subsidised by other consumers. It should also be pointed out however, that the poorest do not gain from such schemes as direct debit discounts which could be seen in fact as a cross subsidy in the opposite direction.

Furthermore the current scheme to help vulnerable customers with their bill is a failure, with less than one per cent take up amongst eligible customers. New legislation will introduce a duty on Ofwat to have particular regard to the interests of consumers who are chronically sick or disabled, of pensionable age, with low incomes or living in rural areas. It is essential that affordability for consumers is a major consideration in the price review, and should also be the subject of the next phase of customer research.

Financial context

There is no discussion in the paper of the operating profits of the companies, and very little of the rate of return on capital. In the past we have had great difficulty in obtaining information about operating profits and been told by OFWAT staff that it is not available (12). We have therefore had to make our own estimates and have been told in doing so that we are not being fair to the industry or to OFWAT. This avoidance of discussion seems to us to be unnecessary and is probably to the detriment of the public image of the companies if it is the case that levels of profits have diminished as is widely reported.

We are of course aware that OFWAT regulates prices and not profits, and we do not propose that that should be changed. But that does not preclude discussion of profit levels, which were major reasons for public criticism of the industry during the '90s and remain a concern, as can be seen in the MORI customer research. If such perceptions are thought to be misplaced, then the best way to correct them is to discuss such company results in the review process. Turning to the OFWAT *Report on Company Performance in 2001-2002* (13) we calculate that current cost operating profits in the year ending March 2002 were running at 30.5per cent of turnover, in contrast to 36.1per cent in the year ending March 2000, when the new price settlement took effect. While the trend is down, this is hardly a catastrophic rate when the wider economy is threatened with recession. Dividends too are down compared to years ending March 1998 and 1999, when they actually exceeded pre-tax profits, but the year ending March 2002 still saw £876 million paid out in reported dividends, some 68.2per cent of pre-tax profits (extrapolations from Total Industry Table, ref. 13). The underlying trend is that dividends are still showing growth of 1-2per cent per annum in real terms. Although the Consultation Document says at Para. 8.24 that: "share prices have been at levels below that implied by the Regulated Capital Value for sustained periods since the 1999 Review", the UK water companies have actually outperformed the FT All Share Index by 58per cent over the last two years. The dividend yield at 7.25per cent is higher than water industry equivalents elsewhere in Europe (5.96per cent) (14). The perception that the industry is in the doldrums is based on the history of double digit increases in dividends during the '90s. We would suggest that an industry as monopolistic and as safe as the water and sewerage industry ought to be attracting modest returns and we therefore see the present rates as more appropriate than was the case in the past. Whatever the accuracy of our judgement, a significant segment of the public clearly shares this view, as the MORI evidence shows.

The consultation paper invites speculation about these factors in para 2.20 where it presents a table of costs to customers which indicates that 33per cent of the average bill consists of return on capital, a level which is actually greater than capital charges. That indicates the relative importance of return on capital in **volume** terms. This is such a capital intensive industry that there will always be a high volume of capital costs. But the overall volume of money spent on capital return is only part of the story. Unfortunately, the paper does not actually give a **rate** of return, which is a key index of profitability, the 'bang' for the investors 'buck'. We understand Return on Capital Employed (ROCE) to be the operating/trading profit divided by available capital employed expressed as an annual percentage. To obtain ROCE, we have to turn to the OXERA study of *The capital structure of water companies* (15), which informs us that: 'there has been a progressive reduction in the return that water companies have **been allowed** to earn. (Our emphasis) Average rates of return have fallen from 12per cent in the immediate post privatisation period to less than 6per cent now.' This happens to be a little less than the required rate of return for the public sector (discount rate) secured by HM Treasury which has operated at 6-8per cent for the last 12 years (16). These are very important items of information in setting the context for the review, especially the observation that the companies have 'been allowed' a certain rate of return. For effectively that is what OFWAT does through its price reviews, albeit indirectly, and the public would expect that to happen, given the monopoly status of the industry. So why not discuss profitability in the review document? After all, OFWAT has a primary duty to ensure that companies can finance functions: 'in particular by securing a reasonable return on their capital'. What is reasonable is a legitimate matter for debate. What consumers consider to be a fair return should be the subject of the next phase of the customer research.

3. Framework for setting price limits

Contingencies for uncertainties

Q 3 As a general principle we will set price limits to allow companies to deliver agreed outputs and we will not include contingencies for uncertainties. Do you agree?

At present price limits are set at a level that does not allow a fund for factors, which it is impossible for companies to cost now. We agree that Ofwat should not include contingencies for uncertainties. There will always be uncertainties such as trends in the weather or other cost factors, which will have an effect on the industry. But while the droughts of the 'early '90s come to mind, so do such 'windfalls' as the declining cost of construction during that same period, due to recession. Such varying factors will tend to balance out over time and it is the job of the companies to make provision for them. Arguably, having a safe demand for their product, they are better insulated against contingencies than are most industries. Some particular contingencies can be 'logged up and down' as is envisaged for changes in legislation and quality standards (see Q 20). This is justifiable. But if undefined contingencies were to be funded through the price mechanism then there would be little financial incentive for companies to take pre-emptive action, and every incentive to define as contingencies events that other businesses would consider to be part of their everyday risks. Consumers would have to pay for this 'slack', so we agree with the approach suggested.

Safeguarding consumers from uncertain increases

However the price setting regime does allow for certain interim determinations around factors that Ofwat has specified as impossible to quantify at the beginning of the five year period. There is therefore something of a mismatch between this question and the fact that Interim Determinations of the K factors (IDoKs) are designed precisely to allow for contingencies. These are either relevant changes in circumstances, which can include such matters as changed legal requirements, or 'notified items' which have not been initially allowed for. At present, notified items includes the effects of the prohibition of disconnections on arrears. In practice this means that some companies have put their prices up because of the level of arrears and cost of debt collection. We think it is too early to conclude that removal of the power of disconnection has caused arrears to build up, and we are concerned that allowing mid-term price rises as a kind of compensation for this sends the wrong signal to companies doing badly on arrears recovery. These companies are then bailed out by the generality of consumers. Some companies do well in this respect and it is important to be fair to them. We think these purported effects should not be allowed as a cost factor.

(Notified Items also include unexpectedly high take up of free metering, which we deal with later).

Length of review period

Q 4 What issues should we have in mind as we consider whether the 2009 review should cover a longer period than five years?

The NCC is concerned that sustainable water resources are developed which both enhance the environment and minimise any negative impacts. We see this as in the long-term interest of all consumers. We are pleased that the EU Water Framework Directive and the proposed water resource management plans move towards a long-term view of the environmental measures needed to ensure sustainable water resources. At present it is unclear what levels of investment will be needed to achieve this, and it is likely that capital investment will vary from company to company and region to region. When considering whether to lengthen the review period, the issues are both legal and environmental. They can move in opposite directions, creating a tension around whether or not to lengthen the review period.

Firstly, the effect of the decision by OFWAT to extend the licence termination notice period from ten to 25 years gives the companies continued licences for an extra fifteen years, that is from 2014 to 2029. Given such an extension, it would be reasonable to expect the companies to operate under a tighter regulatory regime, as it removes an element of uncertainty from their operations. This should trickle down to such matters as their credit ratings, and should reduce the cost of capital. This amounts to a kind of windfall and consumers should be able to benefit from it, either through price mitigation or improvement in service levels such as measures to reduce foul water flooding for example. Resources could also be used for such demand management mechanisms as appliance modification, which we believe to be much more cost-effective than metering (NCC 2002). We would therefore envisage this greater security for the companies being reflected in longer-term price restriction scenarios or commitments to subsidising domestic demand reduction or other service improvements. Such programmes require long term planning such as the Water Resource Management Plans, which plan forward to the 2020s and will be put on a statutory basis under the terms of the Water Bill (17).

The Water Resource Management Plans will form part of the implementation of the EU Water Framework Directive. The timetable envisages measures running up to 2015, while the estimates as to cost and who should pay them are still to be worked out. Yet some of the work involved in management of river basins needs to be started urgently, if only because 2004 is the deadline for a *"complete analysis of characteristics of the surface and ground waters"*(18). Such analysis is not a simple process. For example, the restoration of groundwater quality can take 20 years, first for 'contaminant plumes' to be researched and then for the contaminants to be flushed.

A further example with even more direct implications for consumers is that of lead in pipes. Companies are having to replace fewer lead pipes than anticipated at the last review because, there has been a delay while the Drinking Water Inspectorate tests orthophosphate dosing, a chemical treatment that reduces the solubility of lead in water. Success could lead to a reduction in the lead pipe replacement programme, a significant diminution of disruption to the industry and to consumers. Clearly it is vital that such tests are allowed to run their course (19).

The research has to be thorough if inappropriate and needlessly expensive solutions are to be avoided (such as using 'end of pipe' solutions to diffuse pollution). Such processes are both uncertain and long term, and so the pricing mechanism needs to be able to accommodate that uncertainty.

Perhaps such long-term programmes require some kind of ring-fencing, and to that extent we support funding to meet particular contingencies (to revert to Q.3). It would be perverse if we were to see a repetition of the 'outperformance' of previous price rounds which led to consumers providing money to the companies up front (through price increases) only for the expenditure not to take place for several years (20). This is what the DG of OFWAT has called the 'roller coaster' expenditure pattern that we have seen hitherto, and which he and the companies attribute to the five year cycle (21). In effect, the companies overestimated their future expenditure, prices were set accordingly and when the expenditure proved to be less, then they received windfalls until the next price review. The issue was resolved in 1999 by the use of a one-off price reduction, ('P nought'), which NCC supported. But we would prefer if such a mechanism were not to be necessary in the first place as it introduces an element of volatility into prices, and indeed, the industry, leading to lay offs of expert staff for example. The danger with a longer review time frame is that the scope for unjustified gains from 'outperformance' could be increased. Suitable opportunities for interim determinations (logging up or down) would therefore have to be maintained. So we are not opposed to a longer time horizon for price reviews providing they come with safeguards.

To summarise, the 'proper' compromise position would seem to us to be to continue with five-year price reviews within a longer-term framework. The five-year cycle would continue to allow the kind of shorter-term amendments that IDoKs now involve, **but some of them would be specifically directed at longer-term projects where uncertainty has made it difficult to make a firm determination at the time of the general price settlement.** This would therefore reduce the 'big bang' effect of the quinquennial price determination, which may be no bad thing. It does not mean a diminution of the price control powers of OFWAT, but rather their evolution into a more continuous adjustment mechanism. There needs to be continued discussion of this difficult issue.

4. Incentives and efficiency

Q5 Will this approach provide a sufficient incentive for companies to seek to outperform our assumptions?

The 2000-2005 price review approach to efficiency based on a single efficiency assumption across the companies. Then individual 'catch up' assumptions were made with a five-year period for rolling incentive mechanisms. The 2005-10 review proposes to use the same mechanism. It is not certain if it will provide incentives to *outperform*, and, as explained above, some kinds of financial 'outperformance' are not necessarily in the consumers' interest anyway. What matters is that the industry does not *underperform* in terms of standards of service. We agree with the efficiency mechanisms referred to including the price adjustment mechanism of +0.5 and –1per cent of revenue, a quality assurance mechanism with 'teeth'.

5. Maintaining the balance between supply and demand, and forecasting revenues

Metering

Q 8 Do you agree that we should only allow growth costs that are not self-financing if companies make a robust case?

Q 14 We propose that following the 2004 review licences will be amended so that price limits can be adjusted up or down to allow for significant over or under estimate of numbers of meters. Do you agree?

Question 8 is unclear as it does not identify what growth is under discussion. Part of the relevant section seems to be about metering but Q.8 does not state as much explicitly. If Q.8 means that OFWAT should not allow growth costs for metering unless it is cost effective then we agree. We have argued that the process of metering should not be subsidised by the generality of consumers unless it brings clear general benefits. In *Towards a sustainable water charging policy* (22) we show how optional metering is less efficient than compulsory metering in cost terms. We have generally taken the view that if metering is required for reasons of conservation, then better to make it compulsory and as comprehensive as possible in those locations where shortages would otherwise result. Under those circumstances, we would normally expect justification in the form of cost-effectiveness (i.e. to the effect that metering is a cheaper conservation strategy than others) and therefore self-financing.

So we agree with OFWAT when it says in para. 5.14 : 'There is an economic level of demand management activity in the same way that there is an economic level of leakage. We expect companies to approach their supply/demand investment appraisals in this manner.' Unfortunately, in this respect, the legislation seems to allow for cross-subsidy of optional metering through the general level of prices. Under those circumstances, better that all prices be amended than that the overall price level remain unchanged and non-metered customers cross-subsidise those who have opted for meters and got a lower bill. So in that respect, under present legislation, we would agree with the proposition put in Q 14.

However, we must point out that the two propositions seem to be at risk of contradiction. If over- or under-estimates require amending prices, then surely Q.14 should be subject to the discipline suggested by Q.8 and the companies should be required to produce a 'robust case' before the amendment is allowed?

A practical example of the problems caused by optional metering comes from South West region. The average unmeasured household bill (water and sewerage) comes to £384 and the measured (metered) bill to £234 a difference of £150 (23). Not surprisingly, faced with this difference, many customers have migrated to meters. Clearly those who transfer will be low users such as pensioners of whom there is a very high proportion in the region. But, as Linda Gilroy MP for Plymouth Sutton, has pointed out: 'what about others such as the larger households whose use (of water) does not allow them to benefit from the meter? Their bills are going up not down, owing to water meters' (24). Much of the high industry cost in the South West is due to the huge length of coast, but that problem is not addressed by metering. In those circumstances, optional metering would not seem to be cost effective, and yet for the moment we are stuck with it in the legislation.

We believe that price limits should be adjusted to mitigate the unjustifiable differentials, but in the long term we regard optional metering as inefficient and divisive. We repeat, if metering is needed in a given area for reasons of conservation, then it should be made compulsory.

Other possible growth elements are dealt with in the discussion of flooding (below) and ground waters (above).

6. Service enhancements

Quality improvements

Q 9 Are these well-established criteria for improvements that will be included in price limits still appropriate?

The question refers to a list of criteria for quality improvements. They should be required by the regulator or by law, deliver a measurable output in a defined time, be definable in terms of assets or operation, and have identified costs. We agree, with a slight qualification. We would not want to argue that companies cannot introduce quality improvements spontaneously, within existing cost constraints. Quality enhancement is one of the more positive aspects of the service since 1989. For example, as reported to the House of Commons Public Accounts Committee, properties subject to unplanned interruptions in water supply fell from four per thousand properties in 1991 to one per thousand in 2000/1. Breaches of water quality standards in 2001 were less than one tenth of what they were in 1992 (25). The list set out in para. 1.37 reads as rather forbidding; we would not want to strangle innovation. But equally, if significant cost increases are to result, then a checklist such as this is needed.

Sewer Flooding

Q 10 Do you agree that as a starting point for discussion companies should plan for tackling problems where the risk of flooding is once or more than once in ten years?

It is very difficult to come up with an 'acceptable' level of risk/frequency for something as horrible as foul water flooding. The public are quite rightly horrified by it and the victims are traumatised. Watervoice are pressing hard for this problem to be dealt with as a priority. One criterion based on simple notion of natural justice would be to concentrate on those properties that have already fallen victim to such flooding, as their risk is proven. Companies can then proceed on the basis of diminishing risk from that 'hard core'.

But a strategic approach is necessary. This issue is linked to the whole question of river basin management. For foul water flooding is linked to the flood control generally. Riverside defences, while appropriate to particular properties at risk, are only attacking the symptom not the cause that is rapid run off and diminished 'safety valves' such as flood plains and water meadows. Draconian flood defences can simply result in exporting the problem further downstream. Solutions to this problem involve a multiplicity of highly localised solutions along the length of rivers, such as restored flood plains, or at a micro level, 'flood ponds' which can have considerable amenity value, or the use of soft absorbent surfaces in urban areas, upstream afforestation, or less intensive grazing. Some of these problems are outside of the companies' control. In those cases that they can influence more directly, as in the case of ground water restoration, some of this work needs to start forthwith, other aspects will take longer. So the answer to this question extends to questions 11 and 12.

Planning capital investment for 2005-6

Q.11 Should we try to define all or part of the capital schemes for the service enhancements programme for 2005-6 before the price setting in November 2004?
Q.12 Do we need to define the whole programme or, where this is not possible, is it helpful to define part of this programme?

In circumstances such as flooding and ground water restoration where a long term and at times experimental approach is needed, then some elements need to be defined urgently, but there needs to be scope for amendment later. Too rigid an approach based on defined projects could lead to rushing into expensive schemes which could be counter productive. So the answer to Q.11 is yes in part, and in the case of Q.12 one can define a programme but that programme needs to incorporate elements of flexibility in the light of experience. We recognise that this is very difficult in practice both for OFWAT and for the industry.

7. Financial issues

Cost of Capital

Q 15 Is an industry wide cost of capital a valid assumption given the differing capital structures within the industry?

Q 17 Do the conventional methods used to assess the cost of capital capture all the appropriate risks faced by the water companies?

An answer to Q.17 is not clear. We agree with the consultation document when it says in para: 8.17 that 'the cost of capital is the minimum return investors will accept for investing in a particular company, taking account of risk, both absolute and relative to other particular investments'. We also agree that: 'the water industry remains fundamentally low risk both in absolute terms and relative to other industries.'(Para. 8.21). Taken together these two statements add up to a very stringent approach to capital finance, especially given the high proportion of costs to consumers taken up by return on capital (33per cent). Yet, the paper, for all its discussion on capital has very little discussion on the rates of return on capital employed (ROCE) or equivalent measures, as discussed in the introduction. So we do not know if conventional methods capture all the risks. Some thought may be needed as to whether the shift to debt finance may increase the financial risks to consumers, as some have feared. Consumers Association, for example, expressed concern in the case of Glas Cymru about: 'the disappearance of the 'equity buffer.' If, in the new structure, debt holders were unable to finance Glas's functions, the burden will shift to consumers. Shareholders can lose share value temporarily and withstand it. If bond markets default, customers prices will be raised.' (26). Rigorous scrutiny of reserves was necessary therefore and in that particular case, OFWAT and our colleagues at the Welsh Consumer Council were reassured.

In answer to Q.15, an industry wide assumption is needed or there will be no incentive to obtain the lowest cost of capital and consumers will have to bear the cost of poor judgement as to industry financing. In the past, we generally favoured raising the gearing ratio and increasing use of debt finance. But there is a hazard in the use of debt and we alluded to that in our previous price review submissions when we pointed to the use of loans from the parent company back to the regulated business. (27).

Transparency

Loans from the parent company back to the regulated business have in the past been of similar magnitude to the dividends paid out. It is not clear if such practices are continuing. If they are, OFWAT need to obtain reassurance that they represent good value in terms of the cost of capital. This is particularly the case when it is considered that moving from equity finance to debt finance. This issue straddles the regulated/unregulated boundary within single companies and it is necessary to look for common reporting standards to improve transparency. As we said in 1999: 'It is crucial for consumers to be satisfied that the terms on which regulated businesses make loans to, or receive loans from parent companies are fair and equitable, and that they do not have the effect of artificially putting upwards pressure on water and sewerage charges. We believe that OFWAT needs to do more to satisfy consumers that the terms of these transfers, in the form of loans, are justifiable and fair'. (28).

The same issue of transfers arises in the case of dividend transfers between the regulated businesses and the parent companies. Such transfers have been substantial in the past often exceeding OFWAT's estimates by billions of pounds. Again in 1999 we said: 'we need to know what effects this transfer of funds out of the core business has had on the companies' ability to fund their investment programme....what are the implications for the costs of running the core businesses – and for their cost of capital-which arise from corporate decisions to use the steady and substantial source of profits from these businesses for the benefit of the parent companies?'(29).
Our views stand.

8. Future uncertainties

Q 20 We shall make the process to be followed in logging up or down more transparent, but do not propose to change it. We shall reconsider the circumstances in which an interim determination can be triggered but do not intend to change the process. Do you agree?

'Logging up and down' refers to significant changes that occur between price reviews that are not sufficient to trigger an interim determination of price limits (IDoK). Instead the logged factors are 'stored' ready for the next review. This is perfectly sensible. Perhaps more contentious is the triggering of IDoK.

Of the possible trigger factors listed, clearly legislation should fall into the category of allowing for interim determination, but we would not take for granted that the same should apply to case law. If companies are liable because they are judged to be at fault, it does not follow that consumers should have to bail them out forthwith.

We have already mentioned IDoKs in our response to Q.3 and our doubts about the assumed link between prohibition of disconnection and non-payment of bills.

9. Information to support price setting

Q.21 The scenario approach is intended to enable companies to expose all the issues for debate in the autumn of 2003, before Ministers and others are in a position to issue full guidance. Do you agree that this is a workable approach?

As far as we can understand from the text, this means that comprehensive alternative options with different projects and different costs should be prepared by companies as soon as possible, even ahead of Ministerial guidance. We agree. It would help in the process of public discussion and shared decision making.

10. Conclusions

The consumer interest in the water and sewerage sector in the context of the new price review, is that the consolidation and stability of the last few years be 'bedded down', and we venture to suggest that this is also in the interests of the companies too. The past decade has seen great volatility as the excesses of the early '90s have been curbed. The DG OFWAT has hinted that it will be a conservative price settlement. He has suggested that it would be 'unwise for customers to expect real terms reductions in bills to result from the new price limits'. But equally, he has said that he will ensure that: 'customers of the monopoly companies face no higher burden than is necessary' (30).

We can see the logic of a period of stability, but given the reasonably robust financial health of the industry, we see no reason for prices to rise above inflation at the current levels of service. NCC is keen to see sustainable water resources developed which positively benefit the environment. But we would have to be persuaded of the merits of price increases for new capital expenditure.

We support moves towards longer time horizons because it could well be that there are cheaper longer-term solutions available than would be envisaged under a five-year cycle. This may be because they are intrinsically slow, such as reafforestation, or because they require lengthy research and development work such as research on lead solubility or ground water contamination. Nevertheless, we still see the five-year cycle as the basic building block of the price review process, but with flexibility for long-term uncertainties to be allowed for in and between the reviews.

The consultation document makes a good effort to tackle these difficult issues. But we are rather more critical of the insufficiency of discussion (despite the length of the paper) of the issues of profitability and affordability. The latter is of acute interest to large numbers (millions) of poor consumers. Water bills are a problem for some, often in the context of other multiple debts, and the failure of the government's vulnerable users scheme. That is why we want to remain vigilant on prices. We think it is too early to conclude that removal of the power of disconnection has caused arrears to build up, and we are concerned that allowing Interim Determinations (i.e. mid term price rises) as a kind of compensation for this sends the wrong signal to companies doing badly on arrears recovery. Some companies do well in this respect and it is important to be fair to them.

Concern about profit levels emerges in the MORI opinion research accompanying the review. Consumer feelings on this issue were sharply at variance with the generally positive view of company performance. People appreciate the quality of service but are suspicious of the industry in financial terms. These suspicions are not without foundation given the past history and given the contrast between the rather downbeat public statements on company finances and the reality which continues to be quite healthy, judging from stock market and dividend performance, not to mention operational profits.

The periodic review presents a golden opportunity to set out the facts clearly on profits, which are scarcely mentioned in the paper. Also neglected is the flow of loans and dividends between regulated businesses and the parent companies. We believe that this raises questions about the need for clear reporting, not only of the core businesses' accounts but also of the 'fit' between them and the parent company accounts.

The paper does usefully explore the difficulties around the costs of optional metering. The discussion confirms our view that the current legislation promoting optional metering is a mess. Our position remains that if metering is justified in cost/benefit terms (and this is a significant hurdle) then it should be compulsory in those areas. In the meantime, the costs of optional metering should be spread across consumers and should not lead to gains for some at the expense of others.

The complexity of the issues is not made easier to deal with by the use of industry jargon in the consultation. Clearly the more that is published, the more technical details will come out and some will be difficult – the issues are intrinsically complex. But this is a public consultation document. It could have been so much clearer with a little more of an eye for the external reader. We are conscious that our own response is not plain sailing either; the terms of discussion forces its participants into an exclusive language. We look forward to continuing the debate in a more accessible way.

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