

Water Industry Finance and Investment Priorities and Prices

Summary

Water and sewerage services are vital to our well-being; so vital that society must be fully involved in setting priorities for those who provide them. In England and Wales these essential public services are supplied by private sector companies.

Company priorities are decided through a process of price regulation based on consultation with the public, customers, and other groups with wide interests.

The process is known as the 'Periodic Price Review'. It is led by the water regulator Ofwat and the companies themselves. Its most visible outputs are limits on the prices companies can charge for the 5 years following a review.

But the focus on prices is only half the story. The review is also a shared effort to research major investment programmes that will allow companies to give consumers a better service and make environmental improvements required by the government.

Public service and private companies

The aim is the best of both worlds – the ethos of public service combined with private sector expertise and access to capital.

Water supply and sewerage are essential public services. This is not questioned by anyone involved in providing, regulating or setting the policy framework. In England and Wales the services are provided by private companies who own and manage the plant and infrastructure. In Scotland and Northern Ireland the businesses are publicly owned but much of the service is supplied by private companies.

This structure is intended to give the best of both worlds: the ethos of public service combined with the expertise and access to capital markets provided by private sector management.

The companies are subject to statutory obligations. Their performance is monitored

by a primary regulatory authority – Ofwat in England and Wales – in cooperation with drinking water and environmental quality regulators.

This briefing concentrates on England and Wales.

Priorities

Water company priorities are set by the people they exist to serve. They reflect local needs and wishes and national standards.

The process used to set priorities and price limits is led by Ofwat and the water companies, overseen by ministers. It has been continuously developed since it was introduced in 1989 when the water and sewerage companies were privatised.

Its main characteristics are thoroughness and consultation. Priorities are published in company business plans looking 5 years

ahead in detail, 25-plus years in broader terms. The 5-year plans contain chapter and verse on operations, capital projects, income and expenditure forecasts, and prices net of inflation.

At every stage the emphasis is on research and debate between companies, regulators, government and the public.

Ofwat begins the price review by consulting on how it will assess the company plans and set price limits. The regulator must take account of government guidance on behalf of society as a whole – this will lead to legal obligations for companies to include specific projects in their plans.

The Consumer Council for Water, the official customer watchdog for England and Wales, is an influential voice in the price review. Its contribution is based on extensive research of consumer attitudes and opinion.

Companies work with all their regulators to ensure that business plans take account of legal requirements, especially quality standards. They research customer wishes and needs. They consult the public on key aspects such as planning for continuity of supply. They publish draft plans and seek the views of local and regional organisations, consumer, environmental and business interest groups.

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Prices

No one wants to pay more than necessary for something they can't do without. Analysis of cost and value for money are inseparable from deciding priorities.

The 5-yearly review culminates in Ofwat setting price limits for each company. The regulator summarises its role as “protecting consumers, promoting value and safeguarding the future”.

Such a wide brief means working with fellow regulators, the Environment Agency, Natural England and the Countryside Council for Wales (for water resources and wastewater management) and the Drinking Water Inspectorate (for tap water quality).

The basis of the review is the 5-year company business plan.

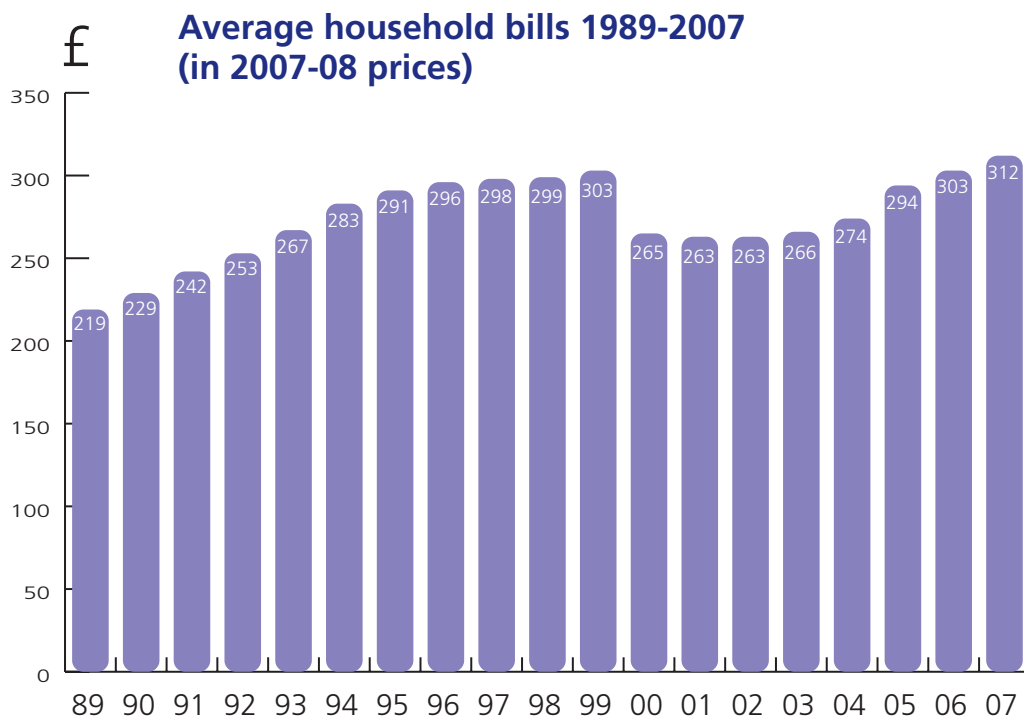
No one wants to pay more than necessary for something they can't do without. Obviously this includes reliable water services. So analysis of cost and value for money are inseparable from deciding priorities.

Companies use the business plan to set out their priorities and show in detail how they will meet them through day-to-day operations and capital investment. They show the standards and levels of service they expect to deliver and propose investment projects with explanations of costs and benefits. Finally they estimate, for each year in the plan, customer prices, company revenues and operating profits.

Setting price limits for 2010 - 2015

October 2007 - January 2008	Ofwat consults on its approach to the 2009 price review
August 2008	Companies publish draft business investment plans and price proposals
September 2008 - January 2009	Joint research by companies, regulators and stakeholders into consumers' views on draft plans
April 2009	Companies publish final business plans and price proposals
July 2009	Ofwat publishes draft price limits for consultation
November 2009	Ofwat publishes final price limits
April 2010	2010-11 prices take effect

Source: Ofwat



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The companies submit draft plans to Ofwat and at the same time publish them for another phase of consultation, this time based on specific proposals. (See page 2 Timetable for the 2009 price review.)

Ofwat reviews the plans in the light of its duties and the companies' legal responsibilities. Its main focus is the revenue they will need to cover the costs of delivering the service and financing investment.

Investment falls into 4 categories:

- keeping the plant and infrastructure fit for purpose;
- improving drinking water and environmental (wastewater service) quality;
- ensuring a satisfactory balance between supply and demand; and
- improving specific customer services.

Ofwat makes assumptions about how far the company can be stretched to improve cost-efficiency in both its operations and its management of investment projects.

It compares the efficiency of the companies against each other and against other sectors and sets targets to incentivise the least efficient to catch up with the most efficient.

Next Ofwat sets draft price limits for each of the 5 years. At this point there is one last public consultation – effectively a value for money test – before the business plans and price limits become legal obligations for the company. It will obtain the revenue it needs to finance its obligations, as long as it is efficient.

Incentive to efficiency

If the company can meet its obligations by spending less than the regulator has assumed, it is said to "out-perform". It may keep the additional revenue until the next price review when this amount is counted into price limits for the following period and so leads to lower bills.

Together with the consultation on priorities this provides a 'win-win' situation. The company has an incentive to be more efficient than the regulator has assumed and the customer gains if the company is successful.

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Other briefings in this series look at: water priorities and prices, the water sector's relations with the capital markets, and the benefits of investment in water services.