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18 July 2001

Dear Jane

RESPONSE TO RESEARCH PAPER SUBMITTED BY PSIRU RE: UK WATER PRIVATISATION

I have recently had the opportunity to read the document submitted to the inquiry by Public Services International Research Unit. Having considered the content of the submission I was disappointed to see that it has not provided you with a balanced view of water privatisation in the UK. The information contained in the paper has been reported in a selective manner and presents material out of context. This means that it does not provide you with an up to date picture of the industry in England and Wales.

Without suggesting that every aspect of privatisation in England and Wales has been a complete success, it is equally wrong to suggest, as this paper does, that privatisation has been a complete failure. Indeed the scale of environmental and customer service improvements, alongside major efficiency savings has been unprecedented.

I am happy for you to show the content of this letter to whomever you think appropriate provided you acknowledge the source.

The regulatory regime

The regulatory regime in England and Wales is incentive based. Ofwat sets the annual price increase, or 'K' factor, for each company to allow it to finance the provision of services to customers. Our price limits restrict the amount of revenue water companies can raise. We do not as suggested control profits or dividends. To maximise profits, and so satisfy their shareholders, companies must reduce costs and provide services to customers more economically. This gives companies incentives to make efficiencies. Companies are allowed scope to improve efficiency and hence profitability and to share these rewards with shareholders and customers. If they succeed, savings are passed to customers at the next price review through lower price limits.

Levels of service

We monitor the standard of service received by customers on an annual basis and publish the findings in the *Levels of service for the water industry in England & Wales* report. The report shows that the industry has, since privatisation, achieved a substantial year on year improvement in the level of service provided to customers across a range of activities. Where a company's performance is below the level that we consider acceptable we can, and have, required companies to improve the service and, where necessary, set targets for improvements.

Water Quality and Environmental standards

Monitoring drinking water quality and environmental performance is not within our remit. Responsibility lies with the Drinking Water Inspectorate (DWI) and the Environment Agency (EA) respectively. Water companies must provide services to all customers and must also comply with quality obligations. If companies fail to meet their obligations, they face prosecution or enforcement action by the EA and the DWI. Ofwat works closely with the two quality regulators and Ministers to clarify current and future quality obligations (including those set out in European Union Directives) and the scope for other environmental improvements. We decide what price limits are necessary to enable companies to deliver the environmental programme required. Both quality regulators publish reports analysing the performance of companies across a range of measures. We summarise these in our level of service report. Again since privatisation there has been a clear, sustained, trend of improving quality compliance across most parameters.

Assigning revenue to the investment programme

The assertion that companies have been able to include plans for work it will not undertake, in order to boost profits, is incorrect. Companies submit proposals for work, and we allow for these in price limits, based on the best information available at the time of setting price limits. It is not always possible to predict the exact scale of improvements required by legislation at the time of a price review, in some cases the need for extra, or less, may only become clear once price limits have been set.

Such changes are not under the control of the companies and, consequently, there may be changes to requirements during a round of price limits. Changes in policy by the government/quality regulators may require additional funding. In this case provisions are in place to ensure that companies can recover the costs of any additional schemes. Conversely changes in government policy/quality regulator policy or best practice may mean that planned investment is no longer required. Cases may also occur where funding for improvements have been allowed but circumstances have prevented the work from being completed on time (for example delays in the planning application process have seriously affected the start and completion dates of some projects).

…/…

Where price limits have included funding for an improvement that has not been completed/required we will adjust company revenues at the next setting of price limits. This ensures that companies only receive funding for those schemes that it is actually required to complete or, in the case of projects seriously delayed, only receive funding once.

Customer bills and efficiency savings

Since 1990 customers have experienced increases, particularly large between 1990 and 1995, in their combined water and sewerage bills. Between 1990 and 1999 capital investment, to deliver higher standards, was close to £33 billion (in May 1999 prices). This was to fund the extensive investment required to meet higher standards of water quality and sewage treatment set both nationally and at a European level. A trend of increasing bills during the 1990s is not unique to England and Wales. Whilst it is difficult to make like for like comparisons between countries it can be said that continuous increases in customer bills, in order to achieve quality obligations, is a recurring theme across Europe regardless of the structure of the water industry in a country. These obligations have masked the impact that large efficiency savings within the industry have had on customer bills.

The principal way in which companies can increase returns to shareholders is to reduce costs. If a company beats efficiency assumptions it keeps the additional savings for five years, after which savings are passed onto customers forever in the form of lower operating expenditure. If a company were, for example, to make savings of £10m in a year it will save, in present value terms, £42m over the following five years. This £10m saving is then passed to customers. Over the next, say, 25 years customers would benefit from a present value saving of £89m (assuming a discount rate of 6.5%). The value of the saving is split roughly 70:30 in the customers' favour so while companies benefit from retaining savings in the short term, in the long term it is customers who benefit most.

Since privatisation companies have outperformed expectations for both capital and operating expenditure. The PSIRU paper failed to note that eight companies voluntarily shared such savings with customers early (in the form of rebates). Moreover it is also important to acknowledge that, under the regulatory regime, customers have benefited from savings made by companies each time price limits have been reset. We have set price limits twice since privatisation. Savings made before the first review in 1994 allowed us to reduce the scale of increases in bills between 1995 and 2000 envisaged at privatisation. Savings made between 1995 and the second review in 1999 were passed on to customers as a one off (average) reduction in bills of 12% in 2000-01 to be followed by a slight increase, in real terms, until 2005. This reduction was possible despite the demands of the biggest environmental programme to date that will take investment since privatisation beyond £50billion by 2005.

…/…

Comparison of bills in England and Wales only to 1997-98 is therefore misleading because the full benefit of efficiency savings made between 1994-2000 is being passed to customers in bills between 2000-2005.

Comparing the average bill for England and Wales to Scotland between 1994-95 and 1997-98 is not reasonable. Differences in bills at this time were as much a reflection of earlier investment in England and Wales. As with England and Wales before it Scotland required large increases in investment in order to meet future quality improvements and to catch up on past under investment. Revenue currently received by the Scottish Authorities from charge payers is not considered sufficient to fund the on going business costs. A strategic review of charges in Scotland set out expected increases in customer bills of 22% between 2000-03 for East and West Scotland Authorities and 42% for North Scotland in real terms for the same period[1]. In contrast the average price in England and Wales, as set out in *Future water and sewerage charges 2000-05: Final determinations,* forecast a 12.3% decrease in 2000-01 followed by an increase in customer bills of 2.3% between 2001-05. Comparing the latest bills in England and Wales to Scotland for 2001-02 reveals the impact of these increases and paints a different picture to the one suggested in the PSIRU paper:

	2001-02
East Scotland	257
North Scotland	278
West Scotland	240
E&W	224

Despite the high level of investment and the increasing level of treatment required for both drinking water and wastewater since privatisation the industry total operating expenditure in 2005 is predicted to be similar to total operating expenditure pre privatisation. Clearly incentives for the efficient operation of assets is high. I was therefore concerned by section 4.1 of the PSUI paper (entitled “no incentive to improve efficiency”) that included a quote that, rather than discussing efficiency generally, actually related to the rather more specific issue of efficient use of water by <u>customers</u>.

Yours sincerely

Dr W.H. Emery
Director of Costs & Performance
and Chief Engineer

[1] As set out in Ministerial response to strategic review by the Water Industry Commissioner for Scotland, 24 January 2000