

A CIWEM Conference

Issues Arising from the Periodic Review Process

30 November, 2005

SOAS, London

Keynote speeches by
Keith Mason Director of Regulatory Finance, OFWAT

Martin Griffiths, Head of Water Quality, Environment
Agency

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Welcome to the conference

If you have any questions regarding the event (e.g. payment etc) please put these to the staff at the registration desk.

Fire alarms If there is a fire, on hearing the alarm, please leave by the marked exists and meet outside the entrance to the Brunei Gallery.

Timing There have been slight changes to timing and running order to allow greater time for questions at the end of each session. The meeting will run on time - a bell will be rung 5 minutes before the end of each refreshment break – please take up your places promptly so that we can do justice to the speakers and allow time for the question and answer sessions

Valuables If you have any valuables e.g. laptops, please keep these with you at all times.

Mobiles Please turn these off during the presentations

Refreshments The buffet and sweet courses are served separately in each of the two breaks – once you have collected your food – there is always enough for seconds! - please move away from the tables as this saves queuing time.

Conference outputs

Delegate feedback We will ask you for your views – to be completed on the coloured forms at the end of the delegate notes - at the end of the 2nd and 3rd sessions. This will provide feedback both during and after the event.

The speaker presentations will be posted on the CIWEM and CMS websites about a week after the event. You will be notified by email when this happens.

The analysis of your responses to the two questions posed during the conference will also be posted on the website – we hope that this feedback will enable a wide range of views to be captured and for you to assess the key messages from the event.

At the end of the Event

Refreshments are provided at the end of the conference

Please complete the evaluation form – it helps us improve future events and it will provide valuable feedback in relation to the objectives of the event. Please hand in your badge before you go.

Background

Since 1990 the investment undertaken by the water companies in England and Wales has been funded through a series of 5-year programmes, with income regulated by the Office for Water Services (Ofwat). A Periodic Review is carried out to enable Ofwat decide on price limits for each company and, in practice, maximum capital expenditure allowable for the succeeding 5-year period. This has been intended to provide sufficient funds to enable the companies to procure, maintain and operate appropriate assets in order to meet legal commitments.

The investment has brought about major improvements in surface and drinking water quality and has ensured that the water companies delivered these efficiently. The amount of money allowed for each company arouses keen debate, but this is a matter for the individual companies to negotiate. However other aspects of the process are of more general interest within the water industry and it is now timely to consider whether improvements could be made. For example, whilst a five-year review may have been adequate in the past, legislation such as the water framework Directive will require planning over a longer period and in a broad context. The outcomes required may be achievable by a variety of means, only one of which is end-of-pipe solutions requiring water company investment. Consequently, the Periodic Review planning mechanism involving the Government, Ofwat, Environment Agency, Drinking Water Inspectorate and water companies may not be sufficient in future.

Other issues include:

- the difficulty of planning effective investment during the early part of the cycle
- possible incorporation of the Periodic Review into a broader context to include whole catchment plans and work on diffuse pollution
- consideration of a longer timescale in view of likely climate change
- possible improvements to increase the effectiveness of Ofwat incentive schemes
- whether sustainable solutions should be overtly encouraged
- how to encourage innovation.

To address some of these issues, alternatives might include plans with a longer time horizon, or a rolling review.

Aims and Objectives of the conference

The conference aims to bring together those responsible in Government, Ofwat, Environment Agency, Drinking Water Inspectorate and water companies for making plans for investment to manage surface and drinking water quality and water resources, and their impact on the environment. It should also be of interest to representatives from NGOs, academics, consultants, designers, contractors and manufacturers who contribute to these plans. It will review the existing arrangements and establish whether, in the light of legislative and environmental changes, greater benefits could be brought about by modifications to the current system.

The objectives of the conference are to:

- review the benefits of the current Periodic Review system
- highlight any shortcomings
- suggest changes
- consider how these changes might be implemented

Programme

- 09.00 Registration and refreshments
- 09.45 **Chairman's introduction and welcome to the Conference on behalf of CIWEM**
Robin Green, Wardell Armstrong LLP & CIWEM President
- 09.50-11.25 Session 1 Ruth Allen**, Ewan Group plc
- 09.50-10.10 **Economic regulation of a changing water industry**
Keith Mason, Director of Regulatory Finance Ofwat
- 10.10-10.30 **Future water quality improvements – an Agency view**
Martin Griffiths, Head of Water Quality, Environment Agency
- 10.30-10.50 **Developments in the common framework** **Derek Parsons**, Ofwat
- 10.50-11.25 **Session 1 Discussion**
- 11.25-12.10 Buffet and refreshments
- 12.10-13.45 Session 2 Lorna Richardson** MWH
- 12.10-12.30 **Funding what consumers need** **Milo Purcell**, Drinking Water Inspectorate
- 12.30-12.50 **Supply demand planning in water services** **Helen Twelves**, Ofwat
- 12.50-13.10 **Twin-track approach – opportunities for streamlining water resources regulation**
Mike Pocock, Three Valleys Water
- 13.10-13.45 **Session 2 Discussion**
- 13.45-14.30 Sweets and refreshments
- 14.30-16.00 Session 3 Ruth Allen**, Ewan Group plc
- 14.30-14.50 **Issues affecting service providers – proposals for improvement** **Ken Farrer**, MWH
- 14.50-15.10 **Paying for sustainability** **Graeme Sims**, United Utilities
- 15.10-15.30 **The case for a rolling programme** **Nigel Annett**, Welsh Water
- 15.30-15.55 **Session 3 Discussion**
- 15.55 Conclusions and Summary
- 16.00 Close Refreshments**

Economic regulation of a changing water industry

Keith Mason

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Currently there is an opportunity to take stock of the last periodic review and develop with stakeholders views on the next one in 2009. This presentation will cover 3 main areas

1. Lessons from the review of the 2004 review
2. Issues relating to regulation in the long term, for example:
 - How long the review should be
 - Long term planning and the WFD
3. The changes affecting water regulation including:
 - Internal structural changes at Ofwat
 - Competition
 - Sustainability
 - Incentives

Future water quality improvements – an Agency view

Martin Griffiths

Head of Water Quality, Environment Agency, Rio House, Waterside Drive, Aztec West, Almondsbury, Bristol, BS12 4UD

The presentation will give an overview of the Water Framework Directive (WFD) and set this in the context of the developing regulatory approach in relation to the water industry and other stakeholders. The Agency sees the WFD as an example of a modern approach to regulation that is consistent with its work with the water industry, and that is outcome based, risk focussed and takes a toolbox approach to improvement measures.

The presentation will cover a number of key issue areas including:

- The timetable of WFD and how this fits the PR09 timetable
- Stakeholder engagement and the importance of the River Basin District scale
- The links to our current catchment scale initiatives , for example CAMS
- The combination of national top-down and bottom-up approaches to Rive Basin Planning
- The role and importance of the WFD characterisation risk maps
- The emerging framework for ecological and biological standards as the basis for environmental standards

As the work on the WFD comes on stream it will provide the 'framework' for the way we manage a great deal of our water planning work. It is forcing a much more integrated approach to the way the Agency views water, its protection and improvement. We will be developing our views in partnership with the water industry and other interested parties.

Regulating for efficient investment and asset management

Derek Parsons BSc (Hons) MICE MCIWEM

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The talk focuses on the development of the 'common framework for capital maintenance planning' (CMPCF) used in the water industry 2004 periodic review, goes on to highlight learning points for both industry and Ofwat and identifies some of the key challenges for PR09. Prices are currently set on a five-year regulatory cycle. At PR99 there was no agreed framework for assessing capital maintenance expenditure requirements. The Environment Audit Committee (arguably unfairly) accused Ofwat of 'intellectual neglect'. Ofwat's post PR99 response to company business plan submissions was to challenge companies [letter in April 2000 to managing directors of water companies MD161] to develop a forward-looking economic appraisal of capital maintenance. The industry responded, through United Kingdom Water Industry Research [UKWIR] with the development of a common framework for capital maintenance planning. Ofwat, DWI, EA, WICS, Defra & the water companies supported the initiative. The resulting CMPCF has a service and customer focus. It requires a forward-looking risk-based approach that is compared with a historic review, from which conclusions are drawn as to whether future capital maintenance spending needs to be different. The overall outcome for the English and Welsh companies was a 22% uplift compared with PR99.

What are the lessons from PR04? Companies have made a good start. Arguably the common framework has changed the asset management landscape in the water industry, but what can be improved? Following PR04 a joint review of the CMPCF was commissioned by UKWIR and has just reported. The main findings will be shared in this presentation. There are challenges for companies and Ofwat. Ultimately the Regulator wants comfort that companies have sound business planning processes, and that these underlie their regulatory submissions. Regulators are always concerned with issues of efficiency and incentives. Thus these two areas will be key themes as we develop our thinking in the run up to PR09. On efficiency we will need to review and update our regulatory tools. On incentives we will refine our processes for assessing company plans - the bar will be set higher. There will be a greater challenge to each company's historic spend and more emphasis on the quality of forward-looking case. And during AMP4 we will continue emphasis on the delivery of outputs and look at penalties for failure.

Key references & websites:

1. MD161: MAINTAINING SERVICEABILITY TO CUSTOMERS

<http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/maintainingserviceability>

2. UKWIR Report Ref 02/RG/05/3: CAPITAL MAINTENANCE PLANNING: A COMMON FRAMEWORK

<http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/ukwirreport>

http://www.ukwir.org/templates/UKWIRSite/ukwir_frame.asp

3. PR04 Final business plan reporting requirements: Part B - Key Components; B3 Maintaining service and serviceability to customers.

[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/busplan04_040204_b3.doc/\\$FILE/busplan04_040204_b3.doc](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/busplan04_040204_b3.doc/$FILE/busplan04_040204_b3.doc)

4. Future water and sewerage charges 2005-10: Final determinations

[http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/pr04FD_all.pdf/\\$FILE/pr04FD_all.pdf](http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/AttachmentsByTitle/pr04FD_all.pdf/$FILE/pr04FD_all.pdf)

Funding what consumers need

Milo Purcell

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The outcomes of the 2004 Periodic Review of Prices were generally positive for drinking water consumers.

The positive outcomes included:

- all drinking water quality improvement schemes supported by DWI were funded;
- commitments on long-term programmes of work were met;
- priorities were aligned with what consumers said they wanted;
- there was recognition of the need to act on consumer acceptability issues to deal with gaps in strategic programmes of work;
- there was progress in moving from a reactive, failure-tolerant culture supporting proscriptive regulatory requirements to a proactive, preventative management of the risk of failure determined by water companies themselves; and
- the management of risk was facilitated by appropriate legal instruments, and clarity on key issues such as omission of funding for future lead standards.

Some aspects of the process worked less well:

- affordability of the outcomes for disadvantaged consumers and those consumers on fixed incomes increased in significance;
- the early start programme failed to meet the needs of suppliers;
- in some areas, conflicts between regulatory objectives were more pronounced; and
- application of the capital maintenance planning common framework was more troublesome for some companies than expected.

Looking forward, will the PR process deliver what consumers need? Some challenges include:

- the climate of regulatory change in Government;
- finding the appropriate means of maintaining momentum on drinking water quality matters, given the range of other issues pressing for attention;

More specifically,

- can we achieve a common recognition of the priorities of consumers; the need to tackle continuing drinking water quality problems; and provide clarification of the justification and funding mechanisms to facilitate action?;
- how can we better manage delivery of improvement programmes?;
- is a one size fits all approach to PR sustainable?; and
- can we reduce the burden of PR on all stakeholders?

Drinking water consumers may judge future PR processes by whether they:

- underpin protection of public health;
- facilitate deliver of clean safe drinking water at consumers' taps; and
- maintain consumer confidence in public water supplies.

Supply demand planning in water services

Helen Twelves

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The water shortages this summer in the south east has raised the profile of water resources issues, and there is currently a lot of interest at national and regional level in water resources and water efficiency.

At PR04 Ofwat assumed that water and sewerage companies will need to invest £2.3 billion (net of capital contributions from developers) to ensure that the supply of water meets essential demands and that companies' sewerage systems can deal with the increased volume of sewage. This represents a significant increase from PR99.

On water resource issues we work closely with Defra, the Welsh Assembly Government and the Environment Agency. Both the water industry and its regulators need to take account of uncertainties, such as climate change, when looking to the long term. The framework of regulatory and asset planning systems will allow the companies to identify and address the impact of these as they become evident.

This presentation will look at the issues of current interest from the economic regulator's perspective and consider the possible issues for PR09.

References

Website: www.ofwat.gov.uk

Key Ofwat publications

2004-05 Report on Security of supply, leakage and the efficient use of water (Ofwat, October 2005)

Future water and sewerage charges 2005-10: Final determinations periodic review 2004 (Ofwat, December 2004)

Twin-track approach – opportunities for streamlining water resources regulation

Mike Pocock

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The aim of this presentation is to highlight a number of issues that present an opportunity for improvements for PR09. This perspective is clearly from a water industry viewpoint but many of these if resolved would lead to major benefits in delivering improvements for both customers, regulators and the industry; the issues include:

- Overlap of Ofwat and EA leading to duplication of work
- Inconsistencies in policy stance between Ofwat and EA, for example, water efficiency measures
- Technical problems with climate change impacts on groundwater
- No provision for WFD impacts and costs
- No inclusion of target environmental abstraction licence reductions as specified in 2001 regional EA plans
- The increasing demand of housing growth and population
- National Environment Programme implementation - mismatch of timing with Habitat Directive
- Relationship of Headroom with Level of Service targets

The presentation will use these issues to highlight a range of solutions which could be explored in order to lead to greater effectiveness for PR09.

Issues affecting service providers – proposals for improvement

Ken Farrer

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The paper addresses the impact of 5-year programmes on those who supply services to the industry. Whilst most of the comments relate to the type of consultancy and design services provided by MWH, many are equally relevant to suppliers of equipment and construction contractors. In a resource limited market where knowledge is being lost with the departure of staff to other types of work, it is essential that the water industry operates in a way that instils confidence and security in its suppliers – without it they will work elsewhere. The operation of framework agreements spread over 5 or even 10 years will have some benefits. However, they are obtained at a cost, and whether this translates into value is a matter of debate. Each AMP imposes demands on the industry to improve its efficiency, and quite rightly so. However, increased efficiency by cost reduction can be achieved only if all parties take a share of the responsibility. Squeezing a supplier's margins is not the answer. The paper concludes by making some suggestions on how real benefit and improved efficiency might be achieved for all as we move forward.

Paying for sustainability

Graeme Sims

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A collision of events is forcing examination of how the water sector can be made to contribute to sustainable development. Ofwat has acquired a new sustainable development duty, the regulator has also undertaken to look at the length of price review periods, and the Water Framework Directive forces a more integrated view of water planning. Underlying all this is perhaps a sense that for all the successes of the post-privatisation period, there seems no end in sight to substantial environmental improvement programmes with their attendant costs and a feeling that the water industry's investments have taken inadequate account of their wider environmental impacts.

This presentation looks at how the regulatory regime might respond to these twin challenges of an improved planning framework, and recognition of the broader sustainability agenda.

References

Environment, Food and Rural Affairs Committee, Water Pricing, First Report of Session 2003-04, 18 December 2003, HC 121.

Bottled water: understanding a social phenomenon, Catherine Ferrier, WWF 2001.

Regulating for a sustainable water sector, Ruth Davis, Caroline Read and Phil Burston, Green Alliance, October 2005.

Philip Fletcher and Kevin Ridout, Minutes of Evidence, House of Lords Science And Technology Committee (Sub-Committee I), Water Management, 2 November 2005.

Future regulation for the water industry: a consultation, Water UK, July 2005.

The Case for a Rolling Programme

Nigel Annett

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The fixed term price control regime has served the water industry well. The dynamic incentive properties it creates, together with a stable set of rules, delivers fair results for investors and good value for customers. However, as the system has matured - it has just entered its fourth quinquennium - the case for replacing fixed periods with a smoother "rolling" price control mechanism has gathered strength. The "one-shot" nature of the determination of the quality-related investment programme has created too much unproductive effort and tension at one stage in the five-year cycle: a more orderly process of evaluation and programme development would lead to better outcomes for everybody. Further, Ofwat's methodology has become excessively complex, in large part as a response to the limitations of the five year fixed period. A simplified methodology under which Ofwat set price limits annually for the year that falls six years hence would automatically offer a good incentive framework, and would ensure that all stakeholders, particular investors and quality regulators, always had a secure five year regulatory "contract" to work with. This would improve the system's ability, for example, to accommodate significant new developments such as the Water Framework Directive without there being undue concerns about timing. It would smooth Ofwat's workload and provide greater continuity in their work. It would facilitate an ongoing and potentially more orderly involvement on the part of the quality regulators, and would enable the companies to plan their businesses on a rolling, and therefore more conventional, basis. Now is the time for the regulator and other stakeholders to give this reform serious consideration. A more detailed paper will be available on the Welsh Water website www.dwrcymru.com, or, on application, from the speaker.