



Office of Water Services
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I C R Byatt
Director General

MD 127

**TO ALL MANAGING DIRECTORS OF
WATER AND SEWERAGE COMPANIES AND
WATER ONLY COMPANIES**

20 March 1997

Dear Managing Director,

CAPITAL UNIT COSTS IN THE WATER INDUSTRY

I enclose a copy of the report *Capital Unit Costs in the Water Industry: The 1994 Cost Base*. This provides an account of how the capital unit costs of the water industry were used to inform judgements of the appropriate levels of capital expenditure in the 1994 Periodic Review.

One of the key distinguishing features of the water industry is its capital intensity and hence its requirements for capital investment to maintain and improve its networks of assets. Water industry capital expenditure was £2.6bn in 1995-96 and remains at historically high levels. Given the size of the industry's capex programme, capital investment judgements as to the size of capital programmes are central to both company and regulatory decisions. Companies also need to achieve an efficient balance between capital and operating expenditure.

Since the 1994 Periodic Review, companies have been reporting lower levels of capital expenditure than were assumed would be necessary when price limits were set and substantially lower than companies included in their strategic business plans. In many instances, companies report the savings as being the result of improvements in capital productivity arising from innovative solutions to problems without any reduction in outputs both now and in the future.

In developing a similar sized cost base to be used in the next Periodic Review Ofwat will wish to:

- demonstrate whether or not the claimed improvements in capital productivity by the industry or particular companies are real, by maintaining a common core of standard costs in each service area;

improve the coverage of standard costs to reflect the anticipated capital expenditure programme of the industry post 2000 so that robust comparative judgements can be incorporated into future price limits.

I am publishing this report now to clarify how the cost base information was used in the 1994 Periodic Review and as an aid to developing the approach to be used in 1999 Periodic Review. I would be pleased to receive comments on the report and suggestions for how the cost base could be developed for use in 1999. Such comments and suggestions should be addressed to Bill Emery, here, at Ofwat by Friday 30 May 1997.

Yours sincerely

Ian Byatt

I C R BYATT

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