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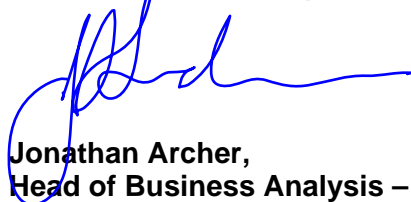
Ms. Rhiannon McHugh,
PR09 Planning Team,
Office of Water Services,
Centre City Tower,
7 Hill Street,
Birmingham.
B5 4UA

Dear Rhiannon,

Setting price limits for 2010-15: Framework and Approach – A Consultation Paper

Please find attached our brief response to your methodology paper. Our more detailed technical comments will be supplied in our response to the PR09 Reporting Requirements.

Yours sincerely,
for Atkins Limited Reporter Team,



**Jonathan Archer,
Head of Business Analysis – Regulation.**

Enc.

Setting price limits for 2010-15: Framework and Approach – A Consultation Paper

Ofwat indicated that it particularly wants our views on:

- whether the approach set out in its paper delivers Ofwat's objectives for the price review;

Ofwat's role is "to protect consumers, promote value and safeguard the future" and its objectives are stated as:

To set price limits that support and encourage a sustainable water and sewerage sector by:

- providing a structure that places responsibility on all stakeholders to contribute to minimising the impact on bills to customers;

While the objective is laudable, it is unclear how the methodology will achieve or confirm this.

- developing incentives for companies to deliver efficiency and give consumers value for money;

While the concept of menu regulation seems clear, its implementation has the potential to be open to wide ranging interpretation, unless restrained by the heavy regulation that menu regulation surely seeks to avoid.

- implementing a framework that will deliver long-term planning that balances local and global priorities; and

A long term framework seems likely to please all stakeholders, but the balance of local and global priorities may sit uncomfortably with customers who are reluctant to pay heavily for a collective green conscience.

- promoting the development of a competitive market.

At a theoretical level, a competitive market has the potential to provide value. Whether the level of "policing" required or the risk mitigation measures necessary would create an even more burdensome regulation by another name is open to question. It is an objective, as required by the act, but it is not clear that it is an objective that will support and encourage a sustainable sector.

- are there any issues to simplify, or issues where Ofwat are proposing to go into too much detail; and

We note that this document was far lighter on technical content than previous methodology papers and therefore lacking in some substance. However, we acknowledge the difficult balance between the document being accessible and being comprehensive.

- do respondents have views on any additional issues that respondents think we need to cover.

We give our opinion on the document in the relevant sections below.

Foreword

The challenges facing the water industry are real, but not new. The evidence of these challenges is stronger than before, which creates a dilemma for the economic regulator who is now less well placed to suggest deferral of expenditure on the basis of uncertainty and unquantifiable risk.

Vigorous competition will almost certainly drive dynamic innovation, as suggested. However, in the harsh world of fierce competition, companies at the frontier have a higher risk of failure. Failure of water and sewerage services is unacceptable, as is the cost of building-in the necessary redundancy by the organisation that is to provide the “safety net” in the event of failure.

Executive summary – Key Issues

Competition

Competition is cited as the first of the two key issues. We are not clear that competition is a priority in the eyes of all but a few of the industry stakeholders or even if government considers competition to be the most important issue for the water industry. Perhaps Ofwat could shift its focus from pursuit of competition to significant industry drivers such as flooding, security etc.

Competition is obviously something that the industry is moving towards, although there does not seem to be the consumer desire or pool of competitors that will be required to make competition successful. Accounting separation should be informative but we are aware that many in the industry question whether the perceived gains in terms of sub-service information will justify the cost of moving from the level of accountancy reporting that the industry currently reports against to true accounting separation. We would expect Ofwat to have carried out a regulatory impact assessment of this change to confirm that it is justified.

Promoting competition should impact on all parties. If this involves the relaxation of the requirement to have common tariffs across regions, consumer champions may cry foul.

Introduction: the framework and process for setting price limits

We consider the adoption of the long term view and the use of the Strategic Direction Statement to be positive steps. However, the requirement that the draft business plan be consistent with the Strategic Direction Statement precludes the further development of strategy despite a further 8 months out information gathering, analysis and scrutiny. The draft business plan should be consistent with the Strategic Direction Statement unless the need for a modified strategy can be clearly demonstrated.

Reporters

Where the text refers to the scrutiny and views to be provided by the company’s reporter, we believe the wording should be amended to emphasise the independence of the reporter. The

reporter's duty of care to Ofwat may not be apparent to stakeholders when the term "the company's reporter" is used.

On general note, the specific inclusion of reporter scrutiny in this section could be interpreted as implying that the reporters are not dealing with parts of the business plan where they are not specifically mentioned. We know this not to be the case. There should therefore be a general statement to say that all aspects of the business plan submission will be subject to scrutiny by Reporters (or auditors)

The right outcomes for consumers

Consumers

The document does not make it apparent whether the term 'consumers' refers to an anonymous mass or to clearly defined individuals or groups of individuals. While stakeholders reading the document could gain comfort from an assumption that individual consumers are being referred to, the scope remains for the wording to be interpreted in a less granular way with the needs of the masses taking precedent of those of the individual. We make no judgement, but believe the nature of the term consumer should be more evident.

Consultations

Consultations appear more central to Ofwat's thinking and although they have always been part of the process we consider that they are approached by the Company's at different levels, i.e. the questions asked by companies may not always be specific to inform willingness to pay.

Scenarios

The document refers to the need for only one scenario rather than the two or three required at the 2004 periodic review. By way of contradiction, it also refers to the need to each company's plan to take account of the 2008 UK climate change scenarios.

Innovation

The reference to the potential for innovation is refreshing. However, Ofwat's reaction to suggestions of innovation in business plans has broadly been one of incredulity, particularly where the companies have added a risk premium to capital costs on the basis of the uncertainty surrounding untried approaches.

Cost Benefit Analysis

Cost Benefit Analysis has been utilised for engineering projects for many years and from our experience has been applied within the water industry as "business as usual" . The change to the requirements will be the establishing a consistent approach and the need to be explicit in declaring the benefits rather than just the cost in the submission.

The requirement that the benefits of each proposal shall exceed the costs may prove difficult unless there is creative valuation of the consumer satisfaction. This would apply where the consumer research indicates that a high cost, low benefit (financial) scheme is welcomed.

We believe the requirement to maximise benefits and minimise cost as discussed later in the text is more pragmatic.

Asset Management

The Ofwat approach to good practice in asset management planning is now well established with the common framework in place since before the previous periodic review. The measurement of the adequacy of company capital maintenance submissions in a consistent manner is crucial.

We believe that the use of a transparently defined scoring approach will be a significant improvement on the approach used at the previous periodic review.

Metering

We note Ofwat's positive statements about metering, but note that absence of discussion about the means by which the "can't pay/won't pay" issues will be addressed. There is a strong lobby looking after the interests of low income high consumption consumers who might be worse off with the implementation of metering.

Quality Programme

In considering the scope of the quality programme, the balance between the polluter or the water company consumer paying is touched upon very lightly. In the context of a long term river basin management approach, the consideration of the funding of the treatment of diffuse pollution may be worth discussion within the document.

Change Protocol

We welcome the facility for companies to call upon the change protocol to amend assumption as the implementation of the Water Framework Directive unfolds.

Understanding the costs of delivery

Menu Regulation

We remain unsure as to whether menu regulation can deliver the hoped for benefits to all in the water industry. We are aware that it has been used in other industries where there has been insufficient data available and therefore we wonder if it might turn out to be a backward step. We are concerned that the setting of the baseline level of expenditure will be open to influence from or manipulation by the companies.

The setting of a baseline by Ofwat "after the event" is not, on the face of it, any more transparent than the old "take it or appeal it" approach. However, we understand the need for Ofwat to be able to make comparative judgements across all of the companies. We also accept the need to avoid an over prescriptive approach, which would encourage companies to furnish Ofwat with data that would lead to a high baseline.

The menu regulation approach appears to provide an open and transparent means of treating over/under-expenditure against the final determination. We remain unconvinced that the essence of the baseline setting approach differs significantly from the previous approach.

We are concerned that the use of different methodologies for the capex and opex parts of the submission will not deliver a cohesive outturn. The financial modelling of high or low capex solutions with low or high opex solutions may produce different outcomes than would be achieved by a pure whole life costing approach.

It is not apparent how the menu regulation approach sits with the capital maintenance planning common framework approach which we had understood Ofwat expects to be fully embedded within companies' capital maintenance planning. It appears that menu regulation is a step back from the common framework, being entirely focused on the delivery of economic efficiencies. We suggest that there must be balance in this area with appropriate drivers being introduced, perhaps through the refinement and development of the OPA.

We are concerned that the menu regulation approach is being discussed and introduced so late in the process. That it is so late in the process suggests that it may not be part of a coherent holistic approach to the regulation of the water industry.

Financial assumptions for setting price limits

We do not consider that indexing the cost of capital would necessarily be better for customers. The PR04 approach to WACC has resulted in an outturn WACC that has favoured the companies during the period and therefore customers have not benefited from any favourable movements in the market. But the PR04 approach does protect the customer from instability as the Company has all of the risk. Just because the markets have been such that the last period has favoured the companies should not unsettle Ofwat into changing the approach. The current uncertainty in the international finance markets is already affecting the real WACC faced by companies (particularly the cost of debt).