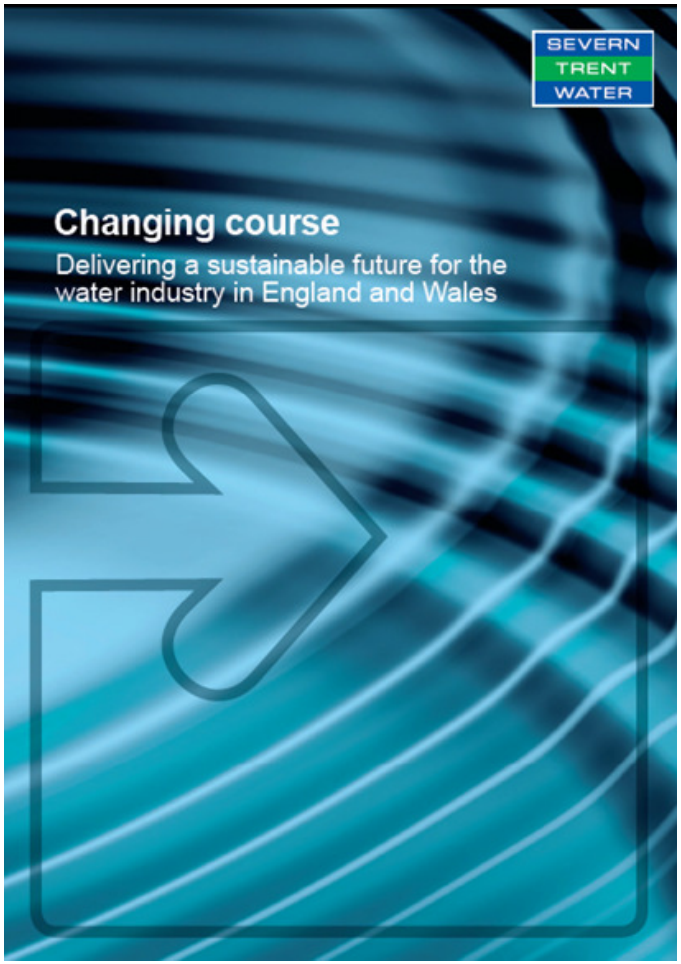
Changing course –
regulating for sustainability

Water and Environment 2010



Regulating for sustainability

- The water industry makes an important contribution to sustainable development
- The water industry has reached an important juncture. The framework has generally been successful but the industry faces new challenges, particularly adapting to and mitigating climate change
- Change need to be made to the regulatory and policy framework to ensure that the industry can meet future challenges

Sustainable development objectives

The objective of sustainable development is to enable people to satisfy their needs and enjoy a better quality of life, without compromising the quality of life of future generations.

We recognise that our activities can have a major impact on sustainability through our impact on the local economy and the environment, and we aim to make a contribution to all for of the government's five guiding principles:

- Living within environmental limits.
- Ensuring a strong, healthy and just society.
- Achieving a sustainable economy.
- Promoting good governance.
- Using sound science responsibly.

Context: the water industry has reached an important juncture

- **Challenges of the last 20 years have been met.** c.£70 billion of investment has been delivered, service levels have improved and opex efficiencies have kept bills lower.
- **But the industry faces new challenges**. Affordability of bills and climate change are key issues - is there an alternative pathway that will deliver better outcomes?
- **Momentum for change is growing:**
  - The independent Cave and Walker Reviews have proposed changes
  - The Council for Science and Technology has called for greater innovation
  - Ofgem, WICS and Postcomm are reviewing their approaches
  - Ofwat has announced it will do the same.
- **A limited window of opportunity for change exists.**
  - As one price review closes, now is the time to review how the next is carried out
  - The next WFD planning cycle can be carefully considered (2015 -2021)
- **We want to make a constructive contribution to the debate**

The last 20 years have delivered successes. But there have also been adverse consequences

Successes

Opex efficiency has improved – baseline opex has declined by 21%

Services have improved

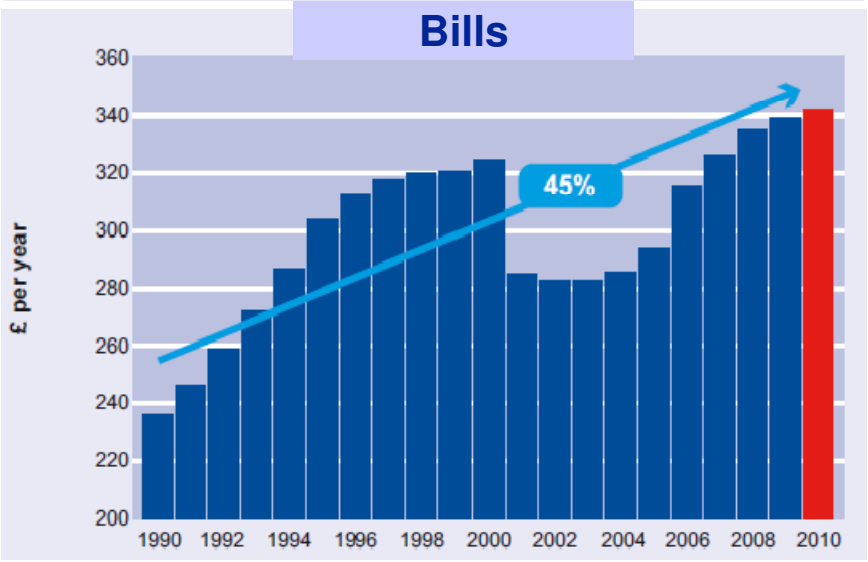
Environmental performance is substantially better

Consequences

Bills have exceeded RPI by 45%

Energy usage has increased by 113%

Debt has increased from 0 to £34bn – gearing from 0 to 75%



The industry is facing a new set of challenges

- A **new set of challenges** is likely to call the sustainability of the current regulatory framework into doubt
  - There needs to be more innovation to increase efficiency and meet new challenges
  - A large capital programme is likely to be required
  - 11% of customers pay more than 3% of their income in water bills, reducing the ability of consumers to absorb further price increases
  - A continuing large capital programme, financed by borrowing, will increase gearing in an already highly geared capital structure. This raises issues about whether it can be financed at reasonable cost.

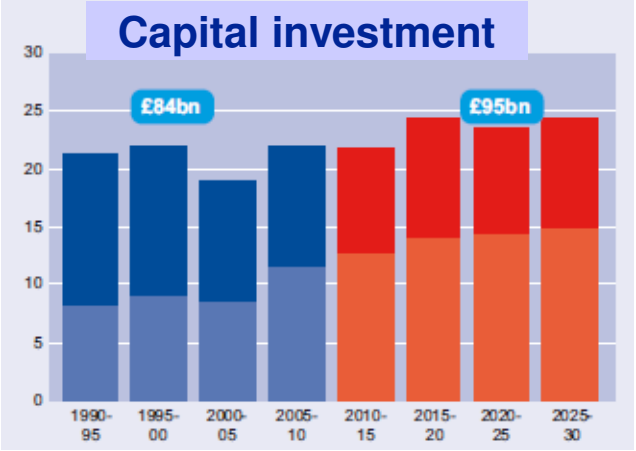
Over the next 20 years, the industry will be expected to deliver even more investment than in the last two decades.

Investment drivers

Environment	Higher environmental standards
Climate change	Renewable energy to mitigate climate change
	Demand from customers for more robust solutions
	Dealing with increased flooding
Customers	Adopting private sewers
	Increasing supply capacity to adapt to climate change
Regulation	Incentives to seek capital rather than operating cost solutions

Forecast impact

c.£95bn of investment required by 2030



Opex will need to increase by 15%.

We do not believe continuing these high levels of investment is sustainable.

For customers

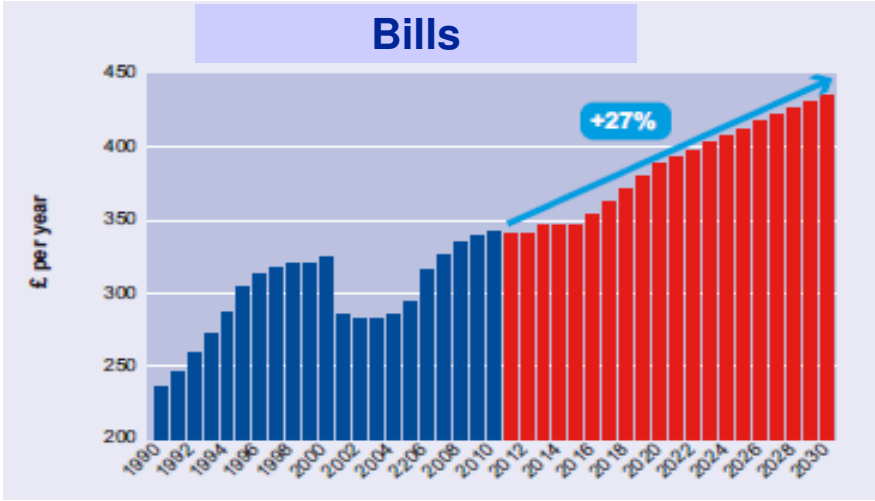
- Customer bills will increase by a further 27%.
  - ➡ **Is this affordable?**

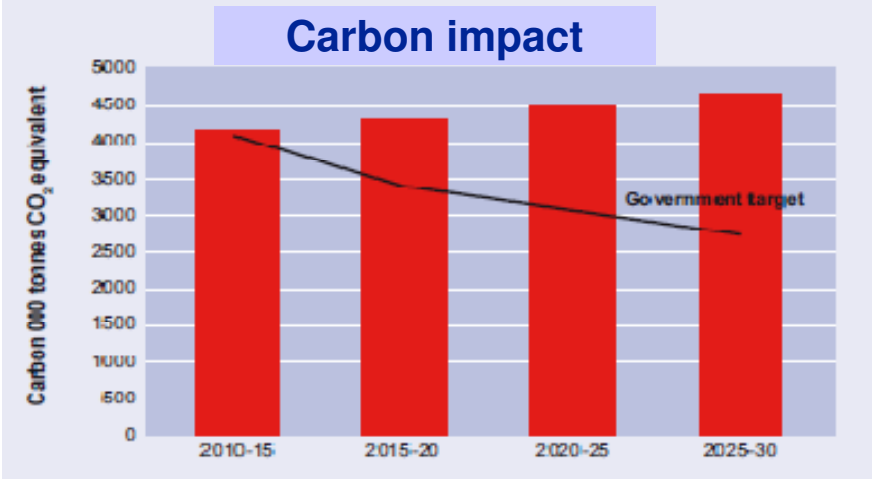
For the environment

- Carbon emissions will increase rather than meet the Govt's target for a 34% reduction.
  - ➡ **Is this acceptable?**

For investors

- Industry debt will increase by a further £27bn by 2030 – equity participation is at risk.
  - ➡ **Is this financeable?**





Changes in policy are needed

Two changes in policy are required:

- A new **market-based framework** for water trading would enable companies to optimise the use of resources nationally rather than just regionally.

- Flexible implementation of the **Water Framework Directive** to ensure a better trade-off between carbon emissions and costs by:
  - assessing whether costs are disproportionate to benefits and therefore if objectives should be revised or achievement phased; and
  - enabling more cost-effective approaches, such as catchment management, to achieve objectives.

Changes in approach are needed by both companies and regulators

Two changes in regulatory approach are required:

- The Environment Agency should transition from prescriptive point-based consenting to **a more flexible approach to consents**, widening the scope for more cost-effective approaches to meeting water environment objectives.
- Ofwat should improve the **price setting process** to provide greater incentives for innovation, sustainable solutions and more accurate business planning, and encourage equity investment in the sector.

Companies need to respond:

- Companies must change their approach to risk and take a leading role in driving **innovation** – both in terms of the strategic and technological solutions they pursue and in shaping the wider direction the industry takes.

And in order to effect these changes successfully:

Outcomes for the sector to deliver need to be prioritised and customers better engaged through a clearer role in deciding regional outputs.

More sustainable approaches to river quality

- Catchment management rather than further sewage treatment
- Improved approaches to consents
  - Catchment-based consents
  - Consents varying with state of the river
  - Company / Ofwat / EA review of approach to risk of failure – does the current approach cause too much risk-aversion, with additional costs and carbon impacts

Proposed improvements in economic regulation

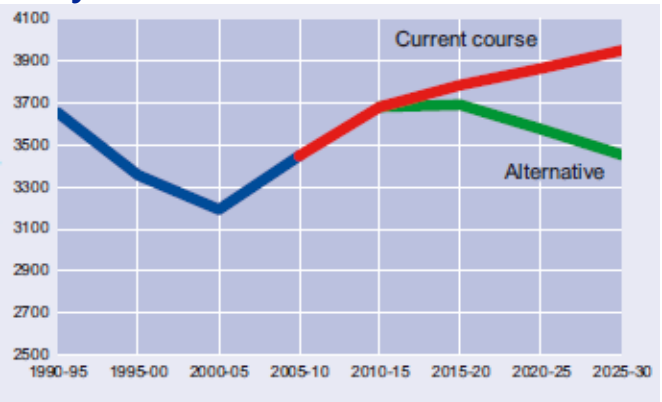
- Rewards and penalties should be rebalanced to encourage innovation
- A new approach to splitting expenditure between capex and opex could remove the incentive to invest in capital schemes rather than operating cost solutions
- Mechanisms should be developed to encourage accurate business planning and in turn increase regulatory confidence in company business plans
- Regulatory reporting requirements should be simplified to allow both regulators and water companies to focus on strategic issues
- Simplified approach to capital maintenance, supply / demand, income forecasts

Implementing these measures will bring down costs and deliver more sustainable outcomes for customers, investors and the environment.

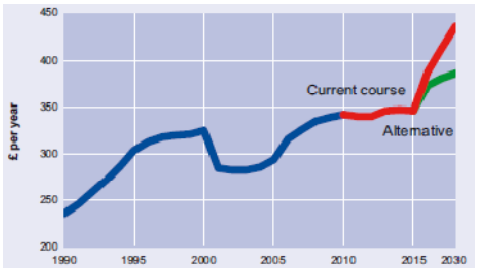
A lower cost base

Cumulative investment requirements would be £10bn lower

Operating costs would be £550m lower pa by 2030

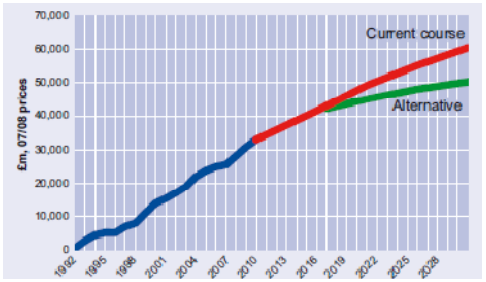


Better outcomes



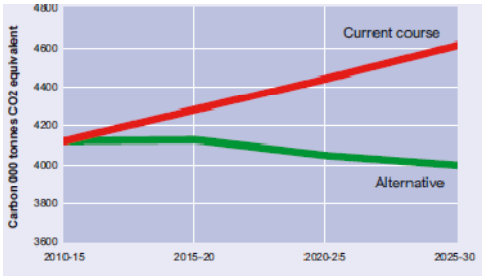
For customers:

Bills would be 11% lower.



For investors:

Debt would be £10bn lower



For the environment:

CO_2 emissions would be 0.6mt lower by 2030.