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RPI-X@20 consultation - Networks
Ofgem
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Dear Hannah

Regulating energy networks for the future: RPI-X@20 Principles, Process and Issues

We welcome the opportunity to comment on your consultation on RPI-X@20. Severn Trent Water is one of the largest ten privatised water and sewerage companies providing water to 7.4 million people, and sewerage services to 8.5 million people, in an area covering 21,100 square kilometres in the Midlands and mid-Wales. Since privatisation in 1989, we have invested over £10 billion in our assets and made major improvements to both water and sewerage services.

Whilst the RPI-X@20 project and review of energy network regulation does not directly impact on the water and sewerage sector, we are regulated using a form of RPI-X and would like to draw on our experience of the model where relevant. We have not answered the detailed questions the consultation poses, but rather focussed on some of the more strategic issues it presents, where we believe there are clear parallels between the energy and water sectors.

The RPI-X@20 project considers two broad themes: focussing on consumers and delivering a sustainable sector. These issues are not only very important to the energy sector, but also have direct relevance to the water sector.

We support the RPI-X@20 review and make the following key points.

- RPI-X has delivered real benefits to customers in the energy, water and other sectors.
- There is, however, scope for improvement in particular to help respond to new emerging challenges such as sustainability (including climate

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change and carbon reduction) and meeting customers' priorities (including delivering value for money).

- A better balance of outcomes for customers, the environment and investors could be delivered through greater co-ordination and further constructive regulatory engagement.

Rationale for the review

We support the rationale for the review. RPI-X regulation has brought demonstrable benefits to consumers over the last 20 years. However, if regulation is to continue to be effective, it is important to review whether the RPI-X model will deliver greater focus on consumers and promote appropriate behaviours from regulated companies in the future, particularly in the light of the changing outcomes they are expected to deliver.

We also welcome the suggestion that the review should consider the need for networks to finance their activities. Given the importance of borrowing to finance investment, if companies are to continue to attract the best possible rates it will be important that investor confidence is maintained.

We consider that investor confidence could be affected in the following ways:

- Changes to the regulatory framework could create uncertainty. Investors will seek reassurance about the framework's effectiveness and expect transparency over how it will work.
- If the scope of network regulation is to widen from incentivising greater efficiency towards sustainability and consumer focus, the perceived risks of investment could change. If investors are to be expected to take on any additional risks, they will want to be appropriately remunerated for it.

In this regard, we believe that the proposed guiding principles of the review, particularly consultation, transparency and 'no surprises' are important. Constructive engagement with all stakeholders throughout the process should ultimately lead to better outcomes for consumers and the sector.

Benefits of RPI-X and developing the approach

We agree that the RPI-X framework has brought about significant benefits for consumers in Britain's energy, water and telecoms networks. In particular RPI-X has helped to:

- provide a stimulus for improving efficiency, delivering greater value for money for customers;
- drive service improvements; and
- contribute to investor confidence.

However, we also recognise the potential for many of the legacy effects of RPI-X identified in your consultation.

- Developing methodologies as part of RPI-X to deal with water quality issues can make the regulatory framework more complicated. This not only increases the information burden on companies, but also reduces

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the perceived accessibility of regulation to general stakeholders and consumers.

- Regulated companies can become more risk averse, seeking to avoid failure on specific performance measures rather than taking a more balanced view of overall performance.
- Regulated companies may take a cautious approach to their plans for price reviews on the expectation that their regulator will make 'cuts'. Conversely, regulators may make 'cuts' on the expectation that regulated companies have been overly cautious.
- Short price review periods (relative to asset lifespans) and a focus on efficiency (reducing the scope for expenditure on research and development) can provide limited incentives for innovation.

We therefore believe that there is scope for improvements to be made.

Focusing on customer needs

We welcome your proposition that in deciding the future of the sector, regulators, policy makers and service providers will be expected to balance a range of different objectives including security of supply, environmental targets and social objectives. We support your view that focussing on meeting the needs of consumers, underpinned by an exploration of how consumers can be better engaged in regulation, will help an appropriate balance to be struck. However, our experience of the water industry suggests that the improvements that customers indicate that they are willing to pay for, or can afford to pay for, are not always consistent with statutory requirements and environmental priorities.

As part of our business planning for Ofwat's current price review (PR09) we aim to keep customers' bills as low as possible. We set ourselves challenging efficiency targets to keep our costs, and therefore bills for customers, down. However, these efforts will be largely offset by increasing costs beyond our control such as rising electricity charges, increasing rates, and delivering new environmental quality obligations. The impact of these uncontrollable costs over 2010-15 is around £55m, which adds around £7 onto a customer's bill (of circa £300). We believe there should be a greater focus on keeping these costs down and bills to customers affordable.

Delivering a sustainable energy sector

Your definition of a sustainable energy sector as one which promotes security of supply over time; delivers a low carbon economy and associated environmental targets; and delivers related social objectives, has obvious parallels to the water sector. A key challenge will be balancing these objectives whilst providing customers value for money.

A central issue for the water sector is the need to secure a sustainable profile for the industry over the short, medium and long term. The scale of industry investment programme since privatisation, together with the fact that customers typically pay for improvements over many years, has led to providers of debt,

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rather than customers, funding investment. We are concerned whether this position will be financially sustainable in the longer term, particularly if environmental obligations are to increase. We are also concerned that this suggests bills will need to continue to rise in the future to fund the repayment of debt.

Our experience in the water industry also suggests that improvements made towards one objective can often be offset by progress towards others. This issue of competing priorities has recently become apparent with regards to carbon reduction. There is a recognised need for water companies to play our part in meeting the Government's challenging carbon reduction targets. To deliver against these targets, we are industry leaders in generating our own electricity. We currently generate 17% of our own electricity and plan to increase this to 30% by 2013. In addition, we have set ourselves challenging energy efficiency targets for 2010-15. However, the carbon reduction delivered by these plans will be completely offset by major increases in energy use resulting from implementing statutory quality programmes such as the Water Framework Directive. Thus, by meeting one environmental objective, we are in danger of failing to meet another and we believe there needs to be a more balanced, holistic approach to ensuring sustainable outcomes in this area.

Conclusion

We believe there is scope for much greater constructive engagement between all stakeholders in regulation across both the energy and water sectors. We were pleased that in the final report of his independent review of competition and innovation in water markets (published on 22 April 2009), Martin Cave highlighted the potential role for 'negotiated settlements' in water regulation. In particular, he noted that regional customer representatives (specifically the Consumer Council for Water) could negotiate with companies to ensure that consumer priorities are reflected in price settlements.

If the best possible outcome is to be delivered for consumers, the environment and investors, it will be important that the regulation is less focused on driving specific outcomes and considers the wider, strategic picture. Your RPI-X@20 review is well-placed to begin these required developments in the regulatory framework.

Yours sincerely



Dr Tony Ballance
Director, Regulation and Competition