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Dear Regina

Natural England's response to Ofwat's Draft Determinations

Following publication of Ofwat's Draft Determinations on 23 July 2009, we are writing to confirm our views.

Overall we welcome the publishing of the Draft Determinations which are set to deliver real benefits for the natural environment and consumers.

We particularly welcome:

- the inclusion of more than 99% of the National Environment Programme
- the inclusion of all the catchment schemes and investigations proposed in final business plans

We remain concerned about whether PR09 will be able to deliver longer term planning needs and would like to see the following issues addressed in the Final Determinations:

- Inconsistencies between final business plans and company Strategic Direction Statements
- Inclusion of all necessary actions to enable companies to deliver their final Water Resource Management Plans
- Inclusion of water efficiency proposals that are currently excluded from Draft Determinations

We have some specific comments on the Draft Determinations and also include comments on approaches to economic analysis and decision-making for consideration at the next Price Review.

1) Inclusion of the National Environment Programme (NEP) and wider objectives for the natural environment.

We have worked closely with the Environment Agency and water companies to develop the National Environment Programme (NEP) which includes the schemes and investigations companies need to deliver to meet their environmental obligations. Of specific interest to Natural England are those needed to meet the requirements of:

- Natura 2000 sites, under the Habitats and Birds Directives
- Sites of Special Scientific Interest (SSSIs), under the Wildlife and Countryside Act, as amended by the Countryside and Rights of Way Act
- Habitats and species in the UK Biodiversity Action Plan (BAP), under the Natural Environment and Rural Communities Act

We welcome the inclusion of more than 99% of the NEP, which will address the statutory requirements for Natura 2000 sites and SSSIs, and a significant proportion of those required for BAP.

We expect companies to meet their environmental obligations through delivery of all these schemes and investigations and we expect them to work directly with you to address any specific challenges that the Draft Determinations may pose for their ability to deliver.

We have one specific comment regarding the presentation of information in your Draft Determinations. Tables 19 and 20 provide a very useful summary of the outputs under each driver of the quality programme. It would be very helpful if you would split the figures to show the numbers of *schemes* and the numbers of *investigations* under the relevant drivers in your Final Determinations. This would helpfully provide a little more information to consumers and wider stakeholders on the number of investigations.

We expect all the requirements for the NEP to be included in the Final Determinations and are working with Ofwat on some specific proposals that have been excluded from the Draft Determinations.

2) Catchment Schemes

Natural England strongly supports the catchment management proposals in PR09. We have worked closely with the Environment Agency, Ofwat and the Drinking Water Inspectorate to encourage water companies to develop catchment schemes for inclusion in PR09.

Catchment schemes will shift activity towards upstream land management based solutions to tackle raw water quality and water resource problems at source. Many of the proposals in the final business plans are likely to deliver a range of other public benefits such as improving the condition of Natura 2000 sites and SSSIs, improvements to landscape and biodiversity, improved carbon management, opportunities for access and recreation, better flood risk management and make an important contribution to climate change adaptation.

We have started to work with Ofwat, the Environment Agency, the Drinking Water Inspectorate, Water UK and water companies to develop mechanisms for capturing the outputs of catchment management and promoting good practice.

We are pleased that all the catchment proposals in the final business plans have been included in the Draft Determinations and we expect to see these included in the Final Determinations.

We believe it is important that the regulators continue to work with the industry to capture the outputs and the lessons learned from catchment management during the 2010-2015 delivery period in preparation for the next Periodic Review.

3) Risks around longer term planning

We welcome the long term planning framework that has been adopted in this Price Review. We believe it is important for companies to adopt a strategic approach towards sustainable development and climate change and to innovate in their approaches to these issues.

We believe that the Draft Determination demonstrates there are still inconsistencies between the approach adopted in PR09 and the need for longer term planning. We illustrate this by discrepancies between the final business plans and company 25 year Strategic Direction Statements and challenges made in the Draft determinations to longer term obligations that companies have already set out in their draft 25 year Water Resource Management Plans. Some environmental targets may be best achieved over the long term and we are still not clear how some of these will be achieved when delivery is set through a five year Price Review.

- **Strategic Direction Statements**

We welcome the introduction of Strategic Direction Statements (SDS) to help provide the long term planning framework, but not all company final business plans are consistent with their SDS and we

understand that Ofwat has no proposal in advance of the next five year Periodic Review to reconsider them.

It is essential that SDSs are used to help raise consumer understanding of the work companies deliver and where they are heading, particularly for the natural environment, which we believe cannot be achieved if they are not consistent with the final business plans. For these reasons SDSs are of limited value for many companies and their consumers.

We believe that if the longer term planning framework is to succeed, SDSs must be consistent with the business planning cycle and Ofwat should be instituting a formal review of the SDSs at the start of the 2010-2015 delivery period.

- **Water Resource Management Plans (WRMPs) and Climate Change**

The PR09 process has been running parallel to the statutory Water Resource Management Planning process and the Draft Determinations have been based on company draft WRMPs.

The Secretary of State has recently approved just under half of the company WRMPs in England for final publishing.

We expect Ofwat to include the actions in the plans, as approved by the SoS, in the Final Determinations to enable companies to implement their final WRMP.

The remainder of the WRMPs need to provide further information and decisions on these are unlikely to conclude before your Final Determinations.

We expect Ofwat to put the necessary mechanisms and processes in place to ensure that once the remaining final WRMPs are published there will be no delays to approving funding and subsequent delivery.

Climate change is one of the biggest challenges for the water industry and requires a focus on longer term planning. A number of water resources schemes are linked with actions around climate change adaptation. We acknowledge Ofwat's need to ensure that companies use the most up-to-date climate change projections and the delay to publishing these projections (UKCP09) has meant that the Draft Determinations do not include all the necessary work for climate change adaptation.

We expect Ofwat to ensure that the necessary mechanisms and processes are in place so there will be no delays to approving funding and subsequent delivery of company proposals for climate change adaptation.

- **Water Efficiency and Metering**

In our response to companies final business plans we highlighted that some companies provided a very clear focus and strong leadership on water efficiency, but that others had weakened their proposals because the reduced demand for water meant their original proposals were no longer cost beneficial.

Our concerns were centred around the risks associated with managing water resources over the next five years based on reduced demand. We are pleased the Draft Determinations include proposals to address growth in most areas, including allowances for additional expenditure where companies have not addressed growth. We are also pleased that the Draft Determinations ask companies to reconsider the wider benefits of their metering proposals before make Final Determinations are made.

We remain concerned that several companies, in the South East region in particular, have had their water efficiency proposals scaled back and others have largely abandoned their metering proposals, which is out of step with their Strategic Direction Statements and draft Water Resource Management Plans. The South East is designated an area of serious water stress and a step change in demand management is needed to address the legacy issue of environmentally

damaging abstraction licences, increase resilience to climate change, accommodate planned growth and reduce the carbon emissions from water and wastewater services.

We expect Ofwat to ensure the Final Determinations provide the level of investment in demand management needed to support a sustainable future for water resources, particularly in the South East.

- **Carbon Management**

We welcome Ofwat's support for investment in renewable energy, where relevant to company functions. We particularly acknowledge support for investment in sludge treatment plants to support newly designated Nitrate Vulnerable Zones.

4) Approach to economic analysis of schemes

We understand that Ofwat is committed to having regard to best regulatory practice. We maintain however, that there are two aspects of Ofwat's methodology for PR09 that were inconsistent with this. We raised these issues in our response to consultation on Ofwat's methodology for PR09 and are re-iterating them here as we believe they should be addressed for the next Price Review.

- **Schemes that address statutory requirements**

Requiring water companies to undertake cost benefit analysis (CBA) for schemes that address statutory requirements is not necessary or proportionate and poses an unnecessary burden on the water companies (in light of the Government's better regulation agenda). Cost effectiveness analysis (CEA) is a more appropriate and less expensive tool to use to identify the least cost way of meeting statutory requirements. CBA is not appropriate to use for these schemes as the decision about whether action should be taken has already been made as it is mandatory that statutory requirements are met. It is misleading to require the water companies to use CBA for these schemes as it implies that water companies may use the results to challenge whether they should meet statutory requirements. This could potentially have far reaching consequences: failure to comply with the Habitats and Birds Directives may risk infraction proceedings by the European Commission.

To enable selection of solutions that minimise the impact on customers' bills, we believe Ofwat's approach for the next Price Review should require CEA of schemes that meet statutory requirements.

- **All other schemes**

The CBA results for schemes in the companies' business plans were not transparent because of inconsistencies in the approach used for the analysis and for valuing the benefits. This made it difficult to interrogate the results. We are not clear how Ofwat has assessed the results: how it correctly identified schemes that needed to be challenged; assessed the validity of the CBA results and compared CBA results for comparable schemes proposed by different companies. We believe that the inconsistencies in approach pose a major risk to achieving outcomes that are in the best interests of consumers and to the environment.

The situation arose because Ofwat's approach to PR09 did not provide a common methodology for CBA; it gave water companies scope to adopt different approaches for the analysis and for valuing the benefits of schemes. We believe that it is unlikely that the benefit of company ownership of its own methodology outweighs the disbenefits of not using a common methodology. For the next Price Review, a common methodology is required to provide consistency, transparency and to enable comparison between companies.

We also believe that schemes that deliver benefits to UK society as well as to water customers should be analysed from the perspective of society as well as for customers. Conducting analysis only from the perspective of customers fails to recognise the wider benefits to society. For example, though the benefits of statutory schemes in the Norfolk and Suffolk Broads are likely to be of value to Essex and Suffolk Water customers, they are also likely to be of value to wider society. Also it is not consistent with application of the principles of the Green Book.

Natural England would welcome the opportunity to work with Ofwat, along with other stakeholders, on development of an appropriate methodology for economic analysis of schemes for the next Price Review.

5) Decision-making

In the future we want to see a more open and transparent process for assessing and challenging investment proposals made by the water companies. We suggest that a stakeholders' forum should be established to discuss the draft business plans. This will enable open discussion of:

- the economic analyses presented by the water companies,
- the balance between economic and other considerations in project selection,
- consideration of sustainable development as well as customers' priorities in project selection.

This debate will help inform water companies' investment decisions and future development of the approach for setting water company price limits. It could usefully be informed by peer review of the water companies' investment proposals.

We welcome the reporter scrutiny of business plans and costs. For this to be effective, it needs to be a transparent process that is available to stakeholders. We believe Ofwat should enable stakeholders to propose issues and topics for scrutiny and view the reported scrutiny.

6) Delivery of outputs during the AMP5 period

It is essential that Ofwat ensure there are sufficient mechanisms in place to monitor company progress and performance on the delivery of schemes and investigations during the 2010-2015 period, and that outputs are captured to inform the next Price Review.

Natural England will be working closely with the Environment Agency to make sure there are sufficient mechanisms in place to monitor company progress on delivery of outputs relevant to our interests. If we have any concerns regarding delivery and performance we will discuss these directly with the Environment Agency and yourselves.

We would like to work with you and the Environment Agency to ensure there is a clear and transparent process in place so that Natural England, and other relevant stakeholders, have access to relevant information, can track progress and raise any delivery issues.

Yours sincerely



Guy Thompson
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