An industry response to the
House of Lords Science and Technology Committee Water Management report

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[NOTE THE SLIDES FOLLOW THIS TEXT]

Firstly, I would like to thank the Foundation for giving me the opportunity to speak this evening.

Secondly, I would like to congratulate the House of Lords Science and Technology Committee on a thorough job and a thought-provoking report. Its recommendations, and there are many, will need to be carefully considered by all involved - government, regulators, customers and companies.

The report's publication is timely. Two dry winters with rainfall for the last 18 months at its lowest for 80 years. Hosepipe bans affecting 13 million people, non essential use of water prohibited by Sutton and East Surrey and powers granted to Southern Water and ourselves to do likewise.

At the same time, Folkestone and Dover have been granted water scarcity status enabling them to compulsory meter over the next 10 years to address longer term resource issues.

As part of the price setting process, all parties attempt to engage with their customers and seek views on what they want. This always seems to me to be a bit of a challenge and although a good piece of research involving all stakeholders was undertaken for the last price review, most of the time our customers express limited interest in the activities of the water industry. I think this is a good sign of an industry delivering an excellent service but also, lets be honest, our customers have many other more pressing worries on their minds.

However, when you have a drought, actively increase communication with your customers and impose restrictions on water use, customers' interest naturally increases and the media also plays its part.

That media coverage on many occasions, particularly from local press, is balanced and accurately stated but from time to time it is not and you will all have seen some strong headlines over the last few months.

The hot topics are:

- the unacceptability of hosepipe bans
- leakage

- excessive profits and
- the impact of new development

I would like to comment on each of these, particularly in the context of Mid Kent Water but also in relation to some of the recommendations made in the Committee's report.

When planning future resource requirements the Industry assumes a 1 in 10 year hosepipe ban. Too date, it has been viewed as an acceptable scenario for customers offering a cost effective solution to what should be a short term problem. However, in the wake of this drought, we may conclude that customers would like companies to plan for less frequent restrictions (say 1 in 50). Furthermore, we may conclude that climate change is starting to make current assumptions obsolete. Certainly, the Committee have recommended that the potential consequences of climate change and associated inherent uncertainties in relation to long term water resource planning, need to be more transparent and open to scrutiny.

One concern that has become clear from the media coverage and my post bag, is that the law defining what a hosepipe ban covers i.e. you cannot wash your car or water your lawn but you can use a hosepipe to fill your swimming pool, must be changed. Another observation is that domestic customers are becoming less tolerant of restrictions on them in advance of commercial activities e.g. golf courses. In fact, once we are out of this drought, it is my view that the full suite of restrictions and the process for implementation should be subject to review.

Leakage at times feels like the "leaves on the line" of the water industry. It is all too easy for the press to criticise the industry for allowing 23 % of supply to be lost and furthermore a number of my customers have written to me challenging the validity of imposing a hosepipe ban when they can see a leak somewhere in their village.

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The facts are:

- the industry has reduced leakage by a third over the last decade
- all companies bar two are operating at or below their economic level of leakage (ELL)
- leakage is planned to be reduced by a further 8% from current levels by 2010
- however, even then the loss from supply will still be c20%.

In the middle of a drought companies in the South East are rightly stepping up their leakage activity. We have increased find activity by some 25% and are responding to customer reported leaks more quickly.

The ELL is up for review in 2007 and should be subject to extensive scrutiny at that point. The Committee have recommended that Ofwat replaces ELL with a broader concept of "sustainable level of leakage" which embraces appropriate environmental considerations. Whatever the outcome of that review, customers will need to understand and buy in to the increased cost of any further leakage reduction and that the remaining water loss, whatever that figure is, is considered acceptable by all involved.

SLIDE

As I speak this evening, the Industry is in the middle of its reporting season of financial results for 2005/6 - the first year of the 2005-10 quinquennium. The media looks for substantial increases in profit figures and reports on the outrageous nature of these amounts. Two points come from this, firstly, to look at a water company's reported profit alone is totally inappropriate. These results are not like those for normal trading companies. Lets take Mid Kent Water's figures as an example. Turnover (sales) have increased by 11% - this is predominately the 9% k increase as per the price determination plus inflation which is required to cover operating costs, investment and return - it is not directly linked to operating cost - and as such we see a large part of that increased turnover flowing through to profit before tax, which as reported has increased by 75%. At the same time investment of £26m is a company record and cashout flow of £9m gives rise to gearing of 77%. Mid Kent Water and the industry will be cash negative throughout 2005-10 - reported profit figures do not reflect the true story.

Clearly we do not expect all of our customers to be financial experts but the capital investment programme of the industry needs to be better understood. The Industry has invested £50 billion since privatisation and has a programme of investment of £16.8 billion in the 2005-10 period. This is a very capital intensive industry and needs the appropriate support from Funders to ensure delivery. The Committee's report clearly highlights the lack of investment in the 80's and the inability of the industry at that time to meet European Standards. It is very pleasing to note the success of the industry some 17 years following privatisation.

Why do the media focus on these increases - partly it seems to me because they want to paint a picture of excessive profits whilst highlighting any customer service deterioration. The key measure used to demonstrate deterioration is invariably leakage - which brings me back to my earlier comments on the importance of customers' perception around the acceptability of water loss.

SLIDE

An issue that has been rumbling away for several years but has become heightened at this time of drought surrounds new development in the South East. For Mid Kent the growth in Ashford of some 30,000 houses by 2030 results in planned average demands for the company increasing from 163 ml/d in 2004 to 216ml/d by 2030. These resultant increases in demand are met by achieving 75% meter penetration, reducing leakage and with the introduction of new resources. You can see from the graph the raising of Bewl by 2014 and the commissioning of Broad Oak by 2019.

Although Mid Kent Water will achieve a significant level of meter penetration by 2030 we are pleased that the report recommends that the government should make it easier for companies in water stressed areas to impose compulsory metering.

As the only company funded for smart meters at the last price review we also welcome the reports support towards the roll-out of such technology.

Although we support the need for the introduction of tariffs going forward, we will need to give some thought as to whether we believe that rising block tariffs as an obligatory requirement of being granted the ability to introduce compulsory metering is in fact the correct way forward.

With a significant programme of resource development planned, we are very pleased that the Committee support the need for such developments as part of a twin track approach, supplied as sustainably as possible - an approach we completely endorse. Furthermore, we welcome the report's recommendation that Ofwat allows sufficient funding combined with long-term financial assurances to enable water companies to undertake this resource development over several price setting periods.

Moving away from the issues raised by the current drought, I was pleased to see that the report tackles the question of affordability. Water affordability is becoming an increasingly serious issue but I am personally not convinced that any form of "means tested" tariffs managed by individual water companies can possibly be the correct way forward. The report urges the government to help the most vulnerable households with the water bills through the benefits and tax credit system - we agree. I was staggered to read in the report that the winter fuel payment scheme costs £2.5 billion per annum - surely something appropriate and cost effective can be introduced for water.

The report also raises the somewhat thorny issue of limiting flows for those customers not willing to pay. This is a very difficult social issue and will raise many differing views for and against.

What cannot be ignored is that there are significant numbers of customers who can pay but will not and the problem is getting worse. Some solution will ultimately be required.

In conclusion, the report offers a substantial commentary on key issues facing the water industry. Its conclusions will not be unanimously agreed with, but all need very careful consideration.

Thank you.

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6 June 2006

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Mid Kent Water

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Industry leakage record

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Mid Kent Water
Financial results for year ending 31 March 2006

	2006 £m	2005 £m	
Turnover	48.1	43.2	+11%
Profit before tax	9.1	5.2	+75%
Capex	26.2		
Cashflow	(9.1)		
Net debt/regulatory asset value	77%		

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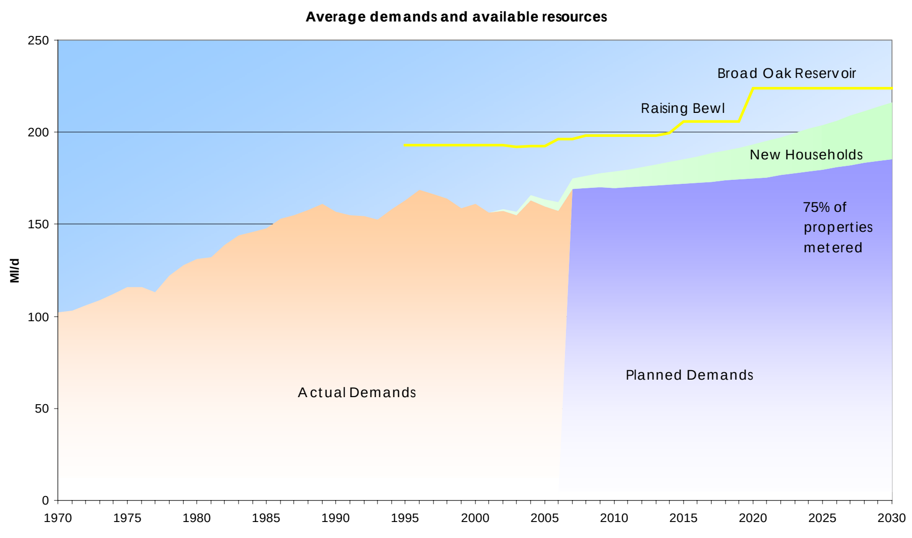

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