



Looking to the future



**Company strategy
North East version**

Northumbrian Water Limited: North East operating area



North East operating area

Northumbrian Water provides water and sewerage services to 2.6 million people in the North East of England.

The major population centres of Tyneside, Wearside and Teesside are in our area but we also serve large rural areas in Northumberland and County Durham.

Northumbrian Water also provides water services to 1.8 million people in its Essex & Suffolk operating area.

Foreword



Northumbrian Water is proud of the service it provides in the North East of England.

The quality of our drinking water is the best it has ever been and we have contributed to significant improvements in river and bathing water quality. For the third year running we scored highest of all water and sewerage companies for customer satisfaction in research undertaken by the Consumer Council for Water.

We are now planning the services we will deliver in 2010-15 and have used extensive customer research to find out what customers think about our current services and their priorities for improvements. In these times of economic difficulty it is especially important to ensure customers are willing to pay for improvements and we have, therefore, taken care to understand their views in this respect.

This document describes the services we plan to provide, taking on board the results of the customer research and the views of regulators and other stakeholders. Our plan, which includes important programmes to reduce flooding from sewers and alleviate discoloured water complaints, received high levels of customer support in the research undertaken after our draft plan was published.

There have been a number of significant and unavoidable changes since we published our draft plan, including increased tax liability and business rates. The economic recession is also having an impact, with reduced water use resulting in the requirement for higher charges to recover our costs.

Given these changes, it is inevitable that water and sewerage bills will be higher than we proposed in our draft plan. Whilst this will be unwelcome news for customers, we have done all we can to manage the impact of increased costs. We have used central estimates to ensure risk is shared fairly. We have also phased prices to avoid a large increase in 2010-11, which we believe would have been unacceptable.

Our bills in the North East will remain amongst the lowest in England and Wales. We believe our plan represents excellent value for money and will allow the company to continue to deliver top class services.

John Cuthbert

Managing Director

7th April 2009

A handwritten signature in dark ink, appearing to read 'J Cuthbert', followed by a long diagonal line and a small dot below it.

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INTRODUCTION

This is a summary of Part A of our Final Business Plan, which sets out our plans for water and sewerage services in the North East for the period 2010-15. A separate document describes plans for water services in our Essex & Suffolk operating area.

The Final Business Plan is an important document in the water industry price review 2009 (PR09). PR09 is the process by which Ofwat will set limits on the prices companies can charge their customers for the five years from 1 April 2010.

The final business plan will be used by Ofwat as the basis for setting draft price limits in July 2009. Customers and other stakeholders will have the opportunity to comment on draft price limits before they are finalised in November 2009.

DEVELOPING OUR PLANS

Our aim is to provide the services our customers want at a price they find acceptable. To understand our customers' needs, we carried out extensive customer research which established priorities for service improvement and willingness to pay for them.

As well as meeting the needs expressed by customers, our plan addresses a number of specific challenges:

- investing in services whilst also keeping bills at affordable levels
- responding to the impacts of the economic recession
- reducing carbon emissions to help prevent the damaging effects of climate change
- ensuring our assets are protected from sea and river flooding
- resolving significant flooding of properties from overflowing sewers
- maintaining a stable financial position

We have also liaised closely and effectively with the Consumer Council for Water (CCWater), the Drinking Water Inspectorate, the Environment Agency, Natural England and other stakeholders in producing our plans.

Our plans take us a significant step towards the goals and aspirations for the longer term set out in our Strategic Direction Statement published in November 2007, which can be found on our website www.nwl.co.uk.

RESPONDING TO CUSTOMERS' VIEWS

There are few areas where customers have indicated they want improvements to service. We believe this is because satisfaction with service is already very high. This was confirmed by the results of research by CCWater (the water industry watchdog) where, for the third year running, we scored the highest of all water and sewerage companies for customer satisfaction.

After publication of our draft plan, customer research was undertaken to establish the degree of support for our proposals. We found there was a high level of support for all aspects of our service offering, confirming that we had interpreted our customers' views appropriately. Our proposals for future services, therefore, remain substantially unchanged in the Final Business Plan.

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SUMMARY OF WHAT WE WILL DELIVER IN THE NORTH EAST 2010-15

Customer satisfaction

- Further improvements to satisfaction with service and value for money
- A significant reduction in billing and operational complaints
- Further development of payment methods including online payment facilities

Water Quality

- Reliable, safe water supplies, addressing risks through the 'Water Safety Plan' approach
- New standard for lead in drinking water achieved
- Further reductions in the risk of discoloured water
- Improvements in the taste and odour of drinking water
- Improved liaison with farmers and land managers to protect sources used to supply drinking water

Meeting future water needs

- Encouragement to customers to save water
- Manage leakage to achieve the revised, lower sustainable economic level of leakage
- Increases in water system capacity required to meet population growth and relocation

Keeping the water flowing

- Reductions to planned interruptions
- Maintain current level of unplanned interruptions of over six hours duration
- Maintain current low levels of properties at risk of low water pressure

Dealing with increasing flows in the sewerage system

- Develop an integrated long term drainage plan
- Major programme to address flooding from sewers
- Additional cleaning of sewers to reduce flooding from blockages
- Increases to sewerage system capacity to cope with new development and population movement
- Levels of sewer replacement increased to sustainable levels
- Increased 'real time' monitoring and management of the sewerage system to aid planning

Improving the water environment

- Achieve as near as possible to 100% discharge consent compliance by 2015
- Further significant reduction in pollution incidents by 2015
- Reduce sewage litter by customer campaigns and reducing system spills
- Further improvements to river & bathing water quality
- Undertake investigations into the impact of certain water abstractions on the environment

Encouraging biodiversity and catchment management

- Continue to encourage biodiversity on all our sites
- Development of our partnership initiative 'Branch Out' to help build habitat resilience
- Continuation of our involvement with the Tees Colour 'Peatscapes' project

Sustainable operation and resilience

- Development and implementation of a carbon reduction plan covering all our operations
- Production of 20% of our energy from self-generated renewable resources by 2015
- Aspiration to achieve a 50% reduction in operational carbon from 2007-08 levels by 2020
- Investment to protect our assets from flooding risk
- Update our assessment of operational resilience in the light of changing circumstances

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COSTS OF DELIVERY

Note: Operating costs and capital expenditure in this section reflect company-wide requirements (North East plus Essex & Suffolk).

Efficiency proposals

We aim to deliver the objectives in our plan efficiently and effectively, to ensure customers' bills are no higher than they need to be.

We intend to reduce base operating costs over the 2010 to 2015 period by 1% per annum for the water service and 2% per annum for the sewerage service. These challenging efficiency savings are in addition to major reductions made over the last 20 years and will help offset above inflation increases in some of our costs.

Changes since our draft plan

Since we submitted our draft plan, there have been a number of changes to forecast expenditure from factors mainly outside our control. Whilst there are movements in both directions, the net impact is a large increase in expenditure pushing bills upwards. The main changes are shown below.

Changes since our draft plan

Government driven changes

- Tax increases (removal of Industrial Building Allowances)
- Increased business rates
- Increasing customer debt as a result of the new Tribunals, Courts and Enforcement Act
- Cost of permits to work in highways from the new Traffic Management Act

Changes as a result of the Economic recession

- Reduced demand for services (our fixed costs have to be recovered from lower sales)
- Pensions deficit resulting from falling stock market prices

Other changes

- Energy price reductions (but still an increase on assumptions made at the last review)
- Revaluation of assets completed – higher Current Cost Depreciation
- Reduction in capital investment (some as a result of the recession)
- Reduced volume related costs due to lower demand
- Lower capital cost inflation (COPI)

Overall, the net effect of cost increases and efficiency savings result in a 9% increase in total operating costs from 2007-08 to 2014-15, excluding inflation.

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In line with Ofwat's guidance, we have not included either operating costs or capital investment in our plan resulting from the Government's decision to transfer certain private drains and sewers to company ownership in 2011. This is because of uncertainty over the costs that will be incurred. It is important to note, however, that is likely to bring a significant increase to sewerage bills in the future through an interim price review.

Capital investment

To meet our objectives we will need to invest a total of £1.27 billion (net of contributions) over the next five years, nearly 20% more than allowed at the last review but slightly less than our draft programme. Whilst investment in mandatory improvements to drinking water and environmental quality have continued to reduce, increases are required to deliver appropriate levels of asset maintenance and reduce sewer flooding.

Our proposed asset maintenance programme has been subject to rigorous internal challenge and reflects the minimum sustainable level required to maintain services. It is well founded on robust asset planning processes in line with the framework agreed with regulators. The company's proposals for future levels of capital maintenance investment at previous periodic reviews have been found to be appropriate and, as a result, we have considerable confidence in our planning capability.

We were concerned, therefore, to find that Ofwat had adjusted the scope of our capital maintenance proposals significantly downwards in its draft baseline document. We have carefully reviewed and refined our proposals since we submitted our draft plan and remain convinced that we have identified the right level of capital maintenance investment.

Financing the capital programme

It is essential that the company is able to raise the funds it requires to finance the future investment. A key financial assumption in this respect is the cost of capital and the current volatile financial climate makes it more problematic than usual to assess what this should be.

In our Draft Business Plan, we assumed a cost of capital of 4.7% real, post tax, significantly lower than at the last price review (5.1% real, post tax), partially offsetting the impact on bills of increased investment and higher operating costs. We have reviewed this assumption and have decided to retain 4.7% for our final plan. This is at the lower end of the possible range identified by NERA in a recent report on the cost of capital. Our approach will help keep bills down.

IMPACT ON PRICES AND CUSTOMERS' BILLS

Overall prices

We have modelled the impact of our proposals for 2010-15 on prices and customers' bills. Price limits are expressed as a percentage above or below inflation. This is called the 'K' factor. Ofwat sets separate indicative price limits for the water and sewerage services. The water price limit applies to both the North East and Essex & Suffolk.

The overall average annual price limit required by our plan is +3.4% comprising +4.3% for the water service and +2.1% for the sewerage service. This is higher than proposed in our draft plan because of the changes described above. We have phased price limits in AMP5 to avoid an overall K of +11% in 2010-11, which we believe customers would have found unacceptable.

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We considered spreading the price increases equally across the five years. However, we were unable to reduce the price increase in the early years whilst maintaining a satisfactory financial position. In any case, to maintain the same overall cashflow on this basis would have resulted in bills rising by over 4% more than with our proposed phasing by 2014-15. This would have meant bills in the North East rising by a further £6.50 and £7.60 for the water and sewerage services respectively.

Our policy of charging customers no more than is necessary was demonstrated by our decision not to use the full price limit allowed by Ofwat for 2007-08, 2008-09 and 2009-10. This has resulted in bills overall being around 2% lower than they otherwise would have been in 2009-10 but has the effect of making the price increases in AMP5 appear larger.

Application of price limits

The overall price limit for the water service denotes the average increase to prices in the North East and Essex & Suffolk. When setting tariffs, it is necessary to consider whether there are reasons why the price limit should be applied differentially to reflect any significant variations in costs in each charging area. This is to ensure customers' bills continue to reflect broadly the cost of providing the services they receive. For example, it would not be fair to expect customers in the North East to pay for improvements to service benefiting customers in Essex & Suffolk only.

Our plans include significantly more investment and other costs (per property) in Essex & Suffolk than in the North East. This includes investment in mains renewal to manage leakage and the Abberton water resource scheme. Other cost drivers, particularly EA abstraction charges, are also greater in Essex & Suffolk. We are, therefore, proposing to apply the water K factors to reflect differences in investment and costs between the two areas. This results in the following average annual increases in prices (not including inflation), phased to avoid a large first year increase.

Average price increases, not including inflation (%)

| North East | 2010/11 | 2011/12 | 2012/13 | 2013/14 | 2014/15 | Average |
|----------------------------|---------|---------|---------|---------|---------|---------|
| Water | 6.2 | 6.2 | 6.2 | 0 | 0 | 3.7 |
| Sewerage | 3.5 | 3.5 | 3.5 | 0 | 0 | 2.1 |
| Total | 4.6 | 4.6 | 4.6 | 0 | 0 | 2.8 |
| Essex & Suffolk | | | | | | |
| Water | 8.2 | 8.2 | 8.2 | 0 | 0 | 4.9 |

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Customers' bills

Our proposals result in average household bills as shown in the table below.

Average household bills (2007-08 prices)

| | Actual 1999-00 | Actual 2009-10 | Forecast 2014-15 |
|---------------------------------|-------------------|-------------------|---------------------|
| North East (water and sewerage) | £303 | £297 | £322 |

Despite investing some £4 billion in improving our assets, forecast bills in the North East for 2014-15 are only around 6% higher, in real terms, than those in 1999-00.

CONCLUSION – THE OVERALL OUTCOME FOR CUSTOMERS

We have produced an integrated, well founded plan which has been endorsed by our Board of Directors. We have placed our customers at the heart of the process and believe that our plan delivers the benefits they want.

The foundation of our plan is maintaining compliance with drinking water and environmental standards, maintaining high levels of customer service and ensuring our customers have sufficient water. In addition to this we will deliver a relatively small programme of quality improvements and a small number of carefully justified service enhancements.

Since we submitted our draft plan, a number of factors outside our control have pushed bills upwards. These include increases in taxation and rates and the impacts of the economic recession. In assessing the costs arising from these changes, we have taken a balanced view, incorporating in our plan central estimates of the costs we will incur.

We believe we have taken a balanced view of risk throughout our plan, ensuring bills are no higher than they need to be. As well as always including central estimates, there are a number of assumptions we have made with significant risk. These include our assumption about the impact of the economic recession on revenue, where reductions in industrial demand could easily be much greater than we have forecast, and our decision to use a cost of capital towards the lower end of the potential range.

Despite the increases, our bills in the North East will remain amongst the lowest in England and Wales. We believe our plan represents excellent value for money and will allow the company to continue to deliver top class services. By 2014-15 households will pay on average (2007/08 prices):

41p per day for water services in the North East

48p per day for sewerage services in the North East