



Society of British Water and Wastewater Industries

Can the water industry supply chain meet the PR04 challenge?

The SBWWI is an organisation whose membership is made up of contractors, manufacturers and consultants active in the water and wastewater industries. It is SBWWI members, working in partnership with the water companies, that will have the task of delivering the AMP4 capital maintenance and investment programmes authorised by Ofwat in the final price determinations published on 2nd December.

In the final determinations, a hefty document of some 281 pages, Ofwat states that its role in the water industry is to act as a surrogate for a competitive market¹. To achieve this objective Ofwat relies heavily on comparative competition, identifying the most efficient water companies in each area of activity and using their performance as a benchmark to which the less productive companies can aspire. This 'aspiration' is given teeth by what Ofwat refers to as a mixture of 'carrot' and 'stick'.

The efficiency 'stick' means that Ofwat assumes that water companies will 'catch-up' a proportion of the potential efficiency gains compared to the benchmark organisations – as well as out-performing efficiency gains in the economy as a whole. The 'carrot' comes from any efficiency gains made over and above the targets set for each company by Ofwat and which they can retain for five years before they are factored into the following price review. These efficiency gains are at the core of Ofwat's strategy. The immediate response of both suppliers – and I suspect the water companies – is, to paraphrase Winston Churchill, '.....some carrot, some stick!'

SBWWI's members are primarily concerned with the capital investment aspects of the final determinations. Ofwat has split capital investment into two distinct categories: capital maintenance and capital enhancement, which relates to new build and upgrading of existing facilities. Ofwat recognises that identifying efficiency gains in repetitive maintenance activities is harder to achieve than new capital works but has stated that it believes the water companies have the potential 'scope' to improve water services by 5% and sewerage services by 6% in this area over the five years of the AMP4 period (2005-2010). The capital enhancement figures for the same period are 6% and 8.8% respectively².

Challenging efficiency targets represent both an opportunity and a threat for those companies in the water industry supply chain. The 'threat' comes from the knowledge that water companies will put pressure on suppliers to lower prices, and may seek to source cheaper products overseas particularly if the British supplier is unable to demonstrate any added-value differentiators for its product or service. The 'opportunity' arises because the water companies, at this time more than any other, should be receptive to both technical innovations, and supply chain integration techniques that can improve service quality and deliver efficiency savings.

A problem voiced by smaller innovative suppliers, and a powerful reason for joining lobbying groups such as the SBWWI, is that they are finding it hard to influence the supply chain early enough in the cycle to make an impact. The tendency for water

companies to establish all-encompassing framework agreements with major contractors and to use their resources to manage this critical relationship with a view to achieving supply chain savings can, ironically, lead to delays in vital information being disseminated down the chain. The result is that suppliers frequently have to be reactive rather than proactive in their marketing and sales activities.

The final determinations document reports at an aggregated, industry level. Nevertheless, certain supplier 'growth' opportunities can be clearly identified; none more so than in water quality and environmentally-related consultancy and contracting.

Between 2005 and 2010 many 'new' European Directives should start to impact on the water industry in addition to existing legislation and government policies. Examples include the Water Framework Directive, Urban Waste Water Treatment Directive, Habitats Directive, the Countryside and Rights of Way Act 2000 and the UK Biodiversity Action Plan³. In total almost £3.5bn has been earmarked for the sewerage service quality programme in PR04 and the corresponding figure for the drinking water quality programme is over £2bn. With draft river basin management schemes to be published by 2008 and the target date to achieve the Water Framework Directive's environmental objectives set at 2015, the environment will continue to play a significant role in the next price review in 2010.

A second 'growth' opportunity is in the supply and installation of both optional and selective water meters. The determinations include capital expenditure of £206 million to provide over 1.2 million optional meters and £77 million for almost 354,000 selective meters. The figure for optional meters appears overly optimistic as there is little incentive for the water companies to install them. By law, they are obliged to install a meter free of charge when requested, often leading to both a fall in revenue and an additional operating cost in collecting meter readings. The targets for selective metering appear more achievable. Ofwat itself states that, 'Accelerated selective metering will increase meter penetration and the scope for demand management options in the future, in parts of the country where water resources are likely to be under pressure.'⁴ Folkestone and Dover Water even proposes to seek water scarce area status during the PR04 period.

The mainstream press has concentrated on the headline figures as far as water bills and capital expenditure are concerned. Ofwat makes it quite clear, however, that it assesses each water company against the delivery of output requirements, not on how much it spends⁵. According to the final determinations document, Ofwat states that it sets out in detail the output expectations for each company – often in a project specific format⁶. Unfortunately, these outputs are detailed in confidential supplementary reports not made available to water industry suppliers. This is an opportunity missed by Ofwat as the availability of such information would help clarify the goals which the supply chain has to meet and help identify projects which could generate multiple outputs combining, for example, water quality, security of supply and environmental objectives.

Previous comments on the environment and metering in this article should not detract from the fact that there is still a huge work programme on core water and sewerage infrastructure (underground) and non-infrastructure assets. Between 2005-2010 Ofwat indicates that it expects around 23,400km of water mains to be laid renewed or relined and, the replacement, renovation and laying of around 6,400km of sewers – including a staggering 1,200km of the London mains network alone being upgraded! Many of the nation's water treatment works and sewage treatment works will be refurbished or rebuilt.

(A note of caution - these figures should be treated prudently because of the way in which they are calculated. For example, the repair of a one metre long defect in a 100m section of sewer counts as 100m of sewer that has theoretically been renovated.)

In its draft determinations Ofwat admitted to the, ‘...inefficient ‘roller coaster’ pattern of investment seen at previous price reviews.’⁷ This terminology reflected that used in an earlier document, RD 42/03: ‘This investment roller coaster increases supply chains costs and risks loss of much-needed resources to the sector’.

To combat this destabilising trend, Ofwat established the ‘Early Start’ initiative which identified almost £1bn of specific projects well in advance of the beginning of AMP4. To many SBWWI members it appears, however, that water companies have not felt sufficient confidence in the Early Start process prior to the final determinations to instigate any meaningful programme that fully engages the supply chain. This unwillingness to clearly commit resources not only causes a fall off in volume and revenue but, more seriously for the long-term, leads to the loss of skilled and experienced manpower that will inevitably seek employment elsewhere. The knock-on effect is that, in the medium-term, project costs will increase as demand rises making it extremely difficult for the water supply chain to meet Ofwat’s efficiency targets.

Whilst the efficiency savings targeted by Ofwat are challenging, there can be few suppliers who would relish a return to the days before privatisation when water industry investment came from the same exchequer pot as education, health and defence. The experience of suppliers in the highways sector is testament to what can happen when investment decisions are subject to the stop-start vagaries of political and ideological expediency. The water industry knows that Ofwat has authorised a significant increase in capital expenditure over the next five years and the SBWWI and its members are ready and willing to take up the supply chain baton in what should be a hard but exciting race.

1 Future water and sewerage charges 2005-10: Final Determinations
Ofwat Periodic Review 2004 p52

2 Ibid p20 – ‘Table 20 Capital expenditure efficiency’

3 Ibid p203 – For a more detailed list see ‘Table 38 What the environment quality programme will deliver in 2005-2010’

4 Ibid p186

5 Ibid p21

6 Ibid p183

7 Draft determination summary document p36