

The Company recognises that increases to customer bills are unfortunate and must only be approved when essential. Initiatives have been pursued by the Company to minimise the price limits required. The huge efficiency drive in AMP3 will benefit customers, since our operating costs have been reduced to levels that represent leading efficiency in the industry. This drive reduces customer bills by 3.9%. Also, the Company has included an infrastructure renewals charge based on the average of 15 years expenditure, whereas previously this has always been based on a 5-year period. This reduces customer bills by 1.7%.

In terms of the overall 5-year impact of +19.4%, the following table illustrates the main components driving these price changes:

Principal Cost Drivers Over the 5-Year Period (2005-2010)	Impact on K
Increase to infrastructure renewals charge	+2.9%
Increase to overground asset renewal and subsequent impact of change in capital allowances	+2.0%
Quality Enhancements	+0.2%
SDB expenditure	+2.9%
Operating cost efficiencies	-5.1%
Base opex additions (including pensions, power and leakage costs)	+4.0%
Turnover reductions	+7.4%
Depreciation increases	+4.7%
End of roll-out of K abatements	-1.2%
Cost of capital uplift from 5.50% to 5.92%	+2.0%
Taxation changes	+1.1%
Other changes	-1.5%
Overall K Impact	+19.4%

These price limits do not include allowances for lane rental charges, any levels of service premium, increased abstraction charges to the EA, nor taxation changes arising should FRED29 be introduced. FRED29 would result in infrastructure renewals expenditure receiving 6% per annum capital allowances rather than full immediate tax relief.

#### Achieving the right balance for customers

The Company continues to receive favourable feedback from customers on both the quality of service provided and the overall value for money. The Company does not therefore intend to seek price increases to fund any service enhancements.

The single material cost driver under the Company's control relates to our need to uplift the level of mains renewal in 2005. This is the Company's priority for improvement. The impact on customer bills has reduced from +3.9% in the Draft Plan to +2.2% in the Final Plan due to the adoption of a longer-term accounting charge. The Company considers that this extra investment is essential, taking a long-term perspective of our infrastructure condition and its ability to maintain serviceability for customers.

#### Asset Performance and Risk

Although leakage cannot be forecast with certainty, the Company recognises that over the longer term, continued rising leakage and bursts are unsustainable and undesirable. Hence additional investment has been directed to this area (additional mains renewals, extended coverage of DMAs, PRVs etc.). There remains however a risk that leakage will rise in the short term, especially through very dry or very cold periods, although in the AMP4 period leakage levels should be kept at or below the new assessment of the short-run economic level of leakage.

A further high level risk relates to a length of single main from our Hampton Loade Treatment Works (shared with Severn Trent) that serves and hence could potentially interrupt supplies to more than half our customers (300,000 properties are served by HLTW). A scheme to duplicate the 9.3km of this trunk main has been agreed with Ofwat and is now proceeding.

The issue of the lead communication pipe replacement programme to meet the 10ug/l standard will remain an uncertainty. Unlike the Draft Business Plan, there is no provision for any strategic lead programme in the AMP4 period. However, if the phosphate optimisation activity is not as successful as we hope, some activity may become necessary before 2010 to ensure that we are on track to meet the standard of 10ug/l by the compliance date of 2013.

The Final Business Plan includes security-related expenditure of £5.5m, including schemes to improve the transfer of water around the network and measures to assist the prevention of security incidents, for example fencing, cameras and access control systems at key sources.

#### Key Outputs

Some of the key outputs in 2005-10 include:

- 338km of distribution and trunk mains replaced.
- A sustainability reduction of 2 MI/d abstraction by 2009/10.
- Maintenance of existing high levels of customer service and satisfaction.
- Refurbishment of five treatment works, ten pumping stations and two service reservoirs.
- Renewal of 30,000 customer meters and installation of 35,000 new customer meters.
- Extension of the DMA programme and maintenance of leakage at the economic level of 75.9 MI/d.
- Improvements to the customer contact telephone service so that fewer customers encounter an engaged tone.

#### Board Approval

This plan has received the full endorsement of the Board of Directors of South Staffordshire Water PLC.

**Dr Jack Carnell**  
**Managing Director**  
**May 2004**



# South Staffordshire Water FINAL BUSINESS PLAN



## 2004 PERIODIC REVIEW

## The Overall Strategy

The Company's overall objective is to continue to offer customers exceptional value for money through high levels of service and low water bills.

The Company's strategic objectives are to maintain existing high levels of service and satisfaction, supply security and water quality, whilst increasing asset renewal activity and continuing to offer one of the lowest bills in the industry.

The overall strategy has not materially changed from the Draft Business Plan. The Company's business plan remains focused on ensuring that there is adequate provision for asset maintenance, in particular underground assets due to issues of burst levels, leakage trends and condition assessments. The Board of Directors have sought to minimise price increases wherever possible, including sharing with customers the funding efficiencies of our recent bond issue, continued operating cost savings, spreading the cost of increased mains renewal and adopting a revised lower cost of capital.

## Asset Renewal

As was flagged five years ago in our AMP3 Business Plan, an uplift in asset renewal is required. The Company needs to increase infrastructure renewals activity by 40% (requiring only a 22% expenditure uplift to £7.5m per annum), to arrest both rising bursts and rising leakage, which has led to a serviceability assessment of "marginal". The Company has incurred significantly increased operating costs in the AMP3 period due to rising levels of bursts and background leakage, compounded by Ofwat setting mandatory leakage targets which are tougher than those contained in our AMP3 business plan and are below our economic level. Before the full benefits of this proposed increase in expenditure are realised, it is possible that leakage may rise slightly before returning to economic levels from 2006/07.

Additional maintenance expenditure is also needed for overground assets (circa 8% uplift compared to the long term average), partly resulting from the need to maintain shorter life assets installed during AMP3 such as leakage-related District Meters, pressure reducing valves and also customer meters. The Company has reviewed future levels of maintenance expenditure to ensure that only essential and economic maintenance has been included in the Business Plan.

## Supply/Demand Balance (SDB)

The Company has no significant supply demand balance issues to address in the AMP4 period. The additional investment included to control rising leakage leads to no new resource schemes being required in AMP4. The Environment Agency (EA) require a sustainability reduction at the end of AMP4 of 2 MI/d. Overall SDB capital expenditure of £32.3m in AMP4 is forecast to be 22% lower than AMP3 levels.

## Quality Enhancements

Having achieved some of the highest levels of water quality in the industry for several years, the quality investment programme is now very limited. The DWI have confirmed that the commencement of the strategic lead communication pipe replacement programme can be delayed until 2010. There are no requirements to install new water quality driven treatment

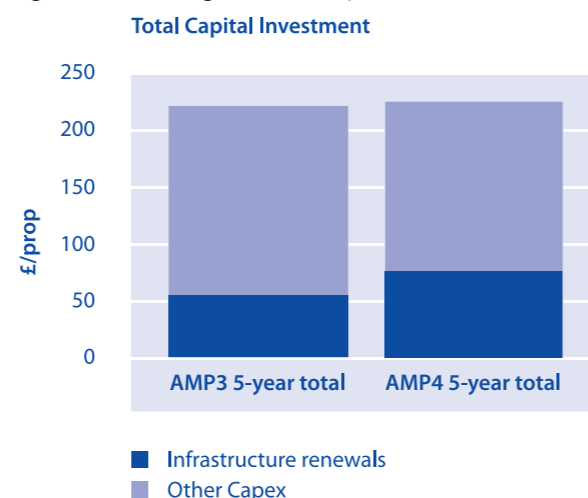
processes at sources in AMP4. Overall water quality capital investment in AMP4 is expected to be £4.5m, compared to AMP3 levels of £20m, representing a 78% reduction.

## Enhanced Services

There are no expenditure proposals for enhanced service levels, which is consistent with the fact that there is no observable customer demand for service improvement.

## Overall Capital Programme

The Company's Final Business Plan contains an overall capital investment programme of £120m (before capital contributions of £16m) that is 4% higher than the AMP3 Determination of £116m. The smaller water quality and supply demand balance programmes, together with further capital efficiencies, allow an essential increase to the capital maintenance programme (both underground and overground assets) to be accommodated.



The Company will invest £44 per property in capital schemes in each year of AMP4 - £220 per property over the 5 years in line with AMP3.

## Operational Efficiency

The Company has given considerable attention to the reduction of operating costs over the AMP3 period, progressively improving its relative operating cost efficiency ranking from 17th at the start of the review to 2nd in 2002/03 (Band A). The Company will continue to seek efficiency improvements, but stresses that further large savings in operating costs are not achievable.

The Final Business Plan includes an annual operating cost efficiency improvement of 0.35% in the AMP4 period. This is based on the Company actually achieving 0.7% per annum, with an appropriate 50:50 sharing between the Company and the customer. This is lower than previously envisaged and reflects the increasing cost pressures that the Company has witnessed in 2003/04 including real wage inflation and insurance. All of the cost savings achieved in 2003/04 estimated at 0.7% together with the 17% reduction achieved in the previous 5 years will result in lower charges for our customers.

The Company has taken the decision to declare some of the 2003/04 costs as atypical, since the dry summer led to unusually high pumping costs. This has the effect of reducing the costs going forward into the AMP4 period.

From April 2003 to the end of the AMP4 period this plan includes an efficiency reduction of 4%. This reflects a 50:50 sharing of cost savings between customers and the Company, hence customers will in time reap the full benefits of the efficiency drive that is projected to be 6% over the seven years, from April 2003 to 2009-10. These opex efficiencies include the benefit of the investment in IT and automation contained in the Company's plan that are essential if further operating cost efficiencies are to materialise.

## Future Operating Costs

The Final Business Plan includes allowance for additional future operating costs. The main uplifts are for pension and power costs. Pension contributions will return to long-term levels, as advised by the trustees following a recent actuarial valuation. The costs put forward only reflect the long-term contribution rate, they are not required to recover a pensions deficit. The increased power costs reflect material increases to wholesale electricity prices since the Company's current electricity contract was negotiated in January 2003. A new contract will commence in April 2005. There are smaller increases assumed for leakage repair costs, business rates and emergency planning. In total, additions to base operating costs are forecast to be £2m by 2009/10. However, due principally to the significant efficiencies already secured by the Company, future operating costs in the period 2005-10 will average £60 per property per year, which is lower than the Ofwat Determination for the current AMP period 2000-05, which was £66 per property each year.

## Cost of Capital

The required 5.92% post tax cost of capital (including a 0.67% small company premium) contained in the Company's business plan is a company-specific amalgam of actual debt costs for the issued bond, together with equity returns drawn from recent NERA analysis. The weighting between debt and equity is based upon the Company's actual projected gearing of 63.5% of RCV. This approach shares with customers the financially-efficient bond costs, whilst leaving sufficient headroom for realistic returns for new equity, including reinvested retained profits.

The Company's financial modelling shows that the level of retained profit will eliminate the requirement for new external funds for the AMP4 period (i.e. the Company will be broadly cash neutral overall) but this is because the current very prudent dividend cover of 1.8 times based on historic cost is assumed to continue for the whole of the AMP4 period. It would be unreasonable to expect existing shareholders to reinvest in the Company in this way if sufficient equity returns are not offered.

## Price Limits Proposed

The Company's business plan is based on requiring a K factor of plus 9.7% in 2005/06, followed by an average of 2.4% for the following four years. This profile reflects the timing of the key cost drivers.

## Proposed Price Limits

2005/06	9.7%
Average annual K for remaining 4 years	2.4%
Average annual K over 5 years	3.9%

## Impact of proposals on customer bills

The Company has for many years had one of the lowest bills in the UK. In 2004/05 the Company's average household bill is 21% (£25) less than the national average.

## Average Household Bills in 2002-03 prices (real)

	2004/05	2005/06	2009/10
South Staffs	£87	£95	£105
National Average	£112	N/A	N/A

## Issues Driving the Need for Higher Bills

The cost drivers are shown below.

## Principal Cost Drivers in 2005/06

	2005/06 Impact on K
Increase to infrastructure renewals charge	+2.2%
Increase to overground asset renewal and subsequent impact of change in capital allowances	-0.9%
Quality Enhancements	+0.4%
Operating cost efficiencies	-4.1%
Base opex additions (including pensions, power and leakage costs)	+3.0%
Turnover reductions	+5.7%
Depreciation increases	+2.4%
End of roll-out of K abatements from AMP2	-1.8%
Cost of capital uplift from 5.50% to 5.92%	+1.8%
Changes to taxation rules	+1.9%
Other changes	-0.9%
<b>Overall K Impact</b>	<b>+9.7%</b>

The Company's strategy is focused on uplifting capital maintenance activity, in particular the level of mains renewals in order to arrest the rising trend in bursts and leakage and thereby return to stable serviceability. However, this strategy only requires an uplift of 2.2% to prices from 2005/06, whereas the overall K factor is 9.7%. The table shows that rising operating costs in terms of pensions, power costs and leakage have a larger influence, contributing 3%. The Company has included what it considers to be a sensible and realistic assessment of the cost of capital of 5.92%, including a small company premium. This uplifts customer bills by 1.8% in 2005/06 (which offsets the impact of historic abatement) and there is a similar uplift arising from the introduction of new tax rules, which is being progressed by the Inland Revenue.

In meetings with Ofwat and in the Annual June Returns, the Company has highlighted at the highest level the discrepancies in terms of actual turnover and depreciation charges compared to assumptions made at the last review. In terms of turnover, the closure of Drakelow Power Station, that was previously our third largest user, together with other industrial decline is a factor leading to increased bills in AMP4 to re-dress this decline and ensure the revenue requirement is fulfilled.