

SUTTON AND EAST SURREY WATER PLC

Strategic Direction Statement

(December 2007)

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1 Summary

- This Strategic Direction Statement outlines our vision for the Company for the next 25 years. It takes into account the views of our customers and other stakeholders and addresses the challenges that will face the company in this period and beyond.
- We have carried out research which reveals that our customers expect:
 - Reliable supplies of water.
 - High quality water.
 - Less leakage.
 - Charges for water to be based on metered consumption.
 - Water efficiency schemes and education.
 - Infrastructure to be well maintained and robust.
- More importantly, it was also clear that customers do not want:
 - Standpipes or rota cuts, and would prefer there not to be bans on the non essential use of water, but will accept hosepipe bans.
 - Any improvements in customer service levels that would increase charges.
- We will meet our customers' expectations by:
 - Providing reliable supplies of water by a major extension of our Bough Beech works in the period to 2015; and
 - Participating with other water companies and the Environment Agency in any development of resources in the South East of England, including sharing of resources where appropriate.
 - Aiming to achieve 100% water quality compliance.
 - Meeting any new lead standards.
 - Introducing a programme to reduce our leakage.
 - Continuing our metering programme, initially at a rate of 12,500 meters per annum.
 - Carrying out a pilot study of metered tariffs in our Croydon area to determine how they might be applied to all our metered customers after 2020.
 - Introducing a tariff structure to be applied to new dwellings built in accordance with the Code for Sustainable Homes
 - Doubling our expenditure on water efficiency measures.
 - Replacing or renovating up to 2% of our mains network each year.
 - Maintaining the serviceability of our assets in a stable condition.
- We expect to have a large financing requirement and it is important that the cost of capital is at the appropriate level to attract finance.
- We will minimise our carbon footprint and CO2 emissions within a framework of increasing demand and existing assets. We will set targets to help achieve this.
- We will aim to carry out our activities in a sustainable manner with care for the environment, although this is not a major priority for our customers.
- We will also look to carry out our work in an innovative and efficient manner to achieve best value for our customers.

2 Introduction

2.1 Our vision

This document is designed to set out our vision for Sutton and East Surrey Water in the next 25 years and to place that in the context of customers' expectations and the broader requirements of the community and environment.

2.2 Our objectives

Put very simply, our strategic objectives for the next 25 years are:

- to maintain the supply of the highest quality water to our customers and to achieve 100% compliance with water quality standards;
- to maintain an adequate, continuous supply of water to our customers;
- to improve the resilience of our resources so that we can reduce the frequency of supply restrictions;
- to maintain very high levels of service to our customers;
- to carry out our operations in an environmentally friendly and sustainable way; and
- to maintain an appropriate level of return to our shareholders.

Implicit in achieving the above are the following:

- maintenance of our asset base;
- compliance with all relevant legislation and similar obligations;
- management of our water resources with a view to the future;
- ensuring our charges represent fair value-for-money;
- minimising our burden on the environment;
- continuing to innovate and make the most effective use of modern technologies;
- meeting new challenges and obligations;
- being an efficient and innovative Company;
- maintaining an appropriate level of security at all of our sites; and
- being a good and progressive employer.

This strategy is in accordance with the expectations of our customers whose clear priority is that we provide them with a reliable water supply that is of good quality.

It should be noted that throughout this document, we have not attempted to differentiate between 'customers' and 'consumers'. Generally our consultations have been with 'customers' who are all consumers, and our findings reflect this, however we recognise that some 'consumers' may have different opinions especially where they are not responsible for paying the bill for their water and sewerage.

2.3 Challenges and pressures

We have provided an essential service to the people living in our area of supply for around 160 years. Central to our vision is that we continue to supply our customers with an adequate supply of high quality water whilst maintaining high levels of service. However, we recognise that things cannot stay the same because the world is changing, in particular the environment in which we operate, and we will have to change too. Over the period covered by this statement, "business as usual" will not be an option.

External challenges and pressures that will affect the environment in which we will have to operate include:

- **Customers' expectations.** Customers' expectations are rising; in particular we believe that their tolerance of water supply restrictions in times of drought is reducing. It will be necessary for us to provide additional resources and to manage demand in order to meet that expectation.
- **Climate change.** The scientific evidence is that temperatures are rising and that our climate is changing. The indications are that the change in climate is likely to result in longer hotter drier summers. This will affect the demand that we will be required to meet, and the resources that we use to meet that demand;
- **Protection of the environment.** There is an increasing awareness of the environment in which we operate, and a need to protect that environment. Legislation is already in place to try and ensure that our environment is protected and we will be expected to operate in a sustainable manner, to reduce our carbon emissions and to improve our environmental performance. In particular, the Draft Climate Change Bill, the Water Framework Directive and other forthcoming European legislation, are likely to have an impact on the way we operate. We have not currently been asked to include for any sustainability reductions as part of our water resources planning;
- **Growth in population and properties.** An additional pressure on resources will be the adoption of the London Plan and the South East Plan, both of which will result in a large increase in the number of houses that will have to be supplied with water in the South East of England. We forecast approximately 50,000 new homes in our area of supply by 2035;
- **Competition and Financing.** We are conscious that it will be necessary for water bills to rise over and above inflation in order to meet the challenges outlined above, and our plan will require significant levels of capital expenditure. This will generate a substantial funding requirement and we will need to offer competitive funding rates to attract the necessary capital. Changes to an established regulatory regime, for example competition, may affect our ability to raise the necessary capital to finance our plan.

The remainder of this document sets out how we propose to meet these challenges and explores some of the issues in more detail.

2.4 Risks

In setting out our proposals to meet the challenges outlined above, it must be recognised that some of the circumstances are outside of our control. These risks include the following:

- Resources are not available to be shared in the South East.
- Sustainability reductions arising out of the Water Framework Directive, or other European legislation, are applied to our resources.
- The cost of capital allowed does not enable us to attract new capital.
- Changes in regulations or obligations are more significant than we have assumed.
- There is a lack of Government leadership on water efficiency measures (eg the Code for Sustainable homes is not made compulsory, and Building Regulations are not changed – these are required if the consumption of new homes assumed for our demand forecast is to be achieved).
- We are not funded to implement our proposed metering programmes and experimental tariffs.
- Prices are not at a high enough level to enable us to maintain our asset base satisfactorily. The danger in an industry with essentially long life assets, such as the water industry, is that under investment remains hidden for many years. However,

once assets start to fail, significant levels of investment are required to bring the systems back into good repair.

- Regulatory mechanisms designed to deal with uncertainties do not adequately recompense us for changes in our operating costs (eg in 2005-10 increases in electricity costs, and costs and decreased revenue arising out of the drought).

2.5 Board Approval

The Board have reviewed the development of this Statement during the summer and autumn and approved it at its meeting on 23 November 2007.

2.6 Consultation

We have conducted customer research through Accent (a specialist market research company); have had a Quadripartite meeting in July with CCWater, the Environment Agency (EA) and the Drinking Water Inspectorate (DWI); and have discussed the SDS with Natural England. We have had a second meeting with CCWater in October to explain how our thinking had progressed during the period. We have used these avenues to explore customers' expectations and requirements. We have developed a vision for the Company that takes into account the expectations and requirements of our customers and the views of our other stakeholders.

We had hoped to complete customer consultation before finalising this Statement. However, following an incident in July that resulted in us having to issue a 'Boil Water Notice' to 50,000 customers, Accent recommended that our customer consultation should be postponed as the incident might prejudice the responses of those interviewed. We now hope to complete our consultation, including a 'willingness to pay' survey, early in the New Year 2008. This will enable us to include its findings in our draft Business Plan.

Draft versions of the Statement were sent to CCWater, the Drinking Water Inspectorate, the Environment Agency, Ofwat, Natural England and our Reporter, for comment. We are very grateful for the positive and constructive feed back we received, and have tried to incorporate those comments into our final revision.

The Statement deals initially with what we perceive to be the important immediate issues the Company has to address to meet customers' and stakeholders' expectations. It then reviews the external factors that could affect its plans. Finally our long term aspirations for the Company are set out. We believe our proposals to deal with the immediate issues will be a start along the way to meeting those aspirations.

This Statement will be made available on our website for full public comment. We will also publish on our website a more customer friendly version designed for those who just want an overview of the key issues.

We will continue to develop our plan in response to comments from customers and other stakeholders, and consultations yet to be completed. The aim is to produce a strategy that is focused on, and supported by customers.

2.7 Ownership

Notwithstanding section 2.6, this is our vision for the Company and forms our view of the strategic direction the Company should follow.

3 Setting the Scene

3.1 The current position and recent history

Currently we are meeting the strategic objectives set out in our last Business Plan (PR2004) and fulfilling our obligations, despite extremes of weather experienced in the last few years. However, as set out above, things are changing and it is important that we recognise this and react accordingly. Two recent events illustrate the sort of climatic variations our assets and systems are going to have to deal with in the coming decades.

3.1.1 Summer of 2006

From November 2004 to July 2006 (inclusive) there was an exceptional shortage of rainfall – a relatively rare event (in the order of 1 in 75 years). As a consequence, in the spring of 2006, our resources (in particular our groundwater sources which supply about 85% of our water) were at very low levels. In order to protect supplies for essential use we applied to the Secretary of State for a Non-Essential Use Ban. The application had the support of the vast majority of our customers, CCWater, the Environment Agency and DEFRA. The Non-Essential Use Ban was granted and put in place in May 2006. It expired in November 2006.

The consequences of applying the ban were that peak and average demands reduced dramatically. Peak demands were up to 36% lower and average demand was 11% lower than an equivalent dry year. Customers responded well to requests to use water wisely, and recognised that we had managed our resources well. It has subsequently become apparent however that customers were aware that we are entitled to apply restrictions on the use of water, but were not aware that the amount of money they pay for their water is linked to the level of service we are required to provide. In other words, customers hadn't fully understood that we are funded through water bills to provide an uninterrupted supply of water except in the event of a 1 in 10 year drought when we are entitled to ban the use of hosepipes.

It was also evident that a Non-Essential Use Ban was not popular with customers and that we should try to find a way to reduce the risk of having to impose one in the future. The perceived wisdom is that with climate change, similar events are likely to become more frequent. A third dry winter might have resulted in the use of standpipes, or the need to impose rota cuts.

3.1.2 Summer of 2007

During this summer we experienced unusually high levels of rainfall. Similar rainfall patterns were experienced across much of England and Wales leading to flooding and operational difficulties for a number of water companies. Some customers in Severn Trent suffered loss of supply for a significant period of time. We were fortunate compared to many, but still suffered operational supply problems at one of our works for a short period of time. Climate change experts report that we can expect similar major events on a more frequent basis as the world's climate continues to change.

3.1.3 Consequence for the Company

The Company performed well in the events set out above, but in order to meet our customers' expectations, we propose to make the investment necessary to ensure that in all but the most exceptional conditions:

- our sources can be relied upon to give an adequate and reliable yield;
- our treatment works are robust enough to treat the raw water supplied without interruption; and

- our mains network is in a condition to deliver safely the treated water to our customers.

The point is that no customer wants to experience a loss of supply for any significant period of time. All customers want to turn on the tap and receive a reliable supply of high quality drinking water.

4 Customer expectations

In essence, we are required to provide:

- customers with a reliable supply of good quality water, and
- maintain the condition of our assets.

The vast majority of customers take our service for granted, as long as they receive good quality water, and we respond to enquiries and any supply problems in an efficient and effective manner.

However, customers do have other requirements and expectations. Over the years we and the industry have conducted many market research surveys and by and large they produce broadly similar results.

The recent research is consistent with findings from earlier surveys, and does not seem to vary significantly over time. Our customers have a very clear view of what they expect from us:

- **Reliable supplies of water.**
- **High quality water.**
- **Less leakage.**
- **Charges for water based on metered consumption.**
- **Water efficiency schemes and education.**
- **Infrastructure to be well maintained and robust.**

More importantly, it was also clear what customers do not want:

- **Standpipes or rota cuts, and would prefer there not to be bans on the non essential use of water, but will accept hosepipe bans.**
- **Any improvements in regulatory driven customer service levels that would increase charges.**

We believe that our longer-term market research will confirm these common sense and practical priorities. We also believe that they will be largely confirmed by national research that is being conducted by DEFRA, Welsh Assembly Government, Ofwat, CCWater, the Environment agency, the Drinking Water Inspectorate and Water UK. We had hoped to complete our customer consultation before finalising this Statement. However, following an incident in July that resulted in us having to issue a 'Boil Water Notice' to 50,000 customers, Accent (our market research consultant) recommended that our customer consultation should be postponed as the incident might prejudice peoples' responses. We now hope to complete our consultation, including a 'willingness to pay' survey, early in the New Year 2008. This will enable us to include its findings in our draft Business Plan.

5 Meeting Customers' Expectations

The way in which we intend to meet the expectations of our customers is discussed below. These are taken in the order of importance to our customers.

5.1 Reliable supplies

This is the major requirement of our customers. It has consistently been ranked highest throughout our market research projects over many years. Customers have now stated that the use of standpipes and/or rota cuts is generally unacceptable and that they would prefer not to be subject to non-essential use bans (NEUBs). This changes our levels of service as follows:

Level of service	Current	Future
Standpipes/Rota cuts	1:100 years	Unacceptable
Non-Essential Use ban	1:20 years	1:40 years*
Hosepipe bans	1:10 years	1:10 (or 20) years**

* Whilst customers have expressed the opinion that they would prefer not to be subject to NEUBs, a figure of 1:40 is considered appropriate for planning purposes.

** Subject to further customer research and water resource planning.

We currently supply around 160Ml/d with summer peaks up to 260Ml/d. We have sufficient resources to meet average and peak demands in a dry year and have a security of supply index of 100 for an average dry year and critical period. However, improving levels of service in accordance with customers' expectations will require additional resource development, together with demand management, particularly if we are going to remove the need for standpipes or rota cuts which (based on the experience of 2004-2006) could well be the consequence of a third dry winter. Additional resources and demand management will also be needed to meet growth in demand from new and existing customers, and to take into account the new 'risk based' headroom methodology that we did not use in our previous submissions. We are still developing our supply/demand forecasts, but initial results indicate that an increase in resources will be required.

Our resource development proposals in the short to medium term and the medium to long term are set out below. When balancing demand with supply, we are committed to the twin track approach and will aim to encourage the more efficient use of water alongside the development of new resources. Demand management proposals are dealt with later (see sections 5.3, 5.4, 5.5 and 5.6 below).

5.1.1 Short/Medium term

Our proposals to improve the resource situation in this period centre on making more effective use of our Bough Beech reservoir and treatment works. Bough Beech takes water from the River Eden to serve Gatwick airport and the nearby areas of Horley, Edenbridge and Lingfield. These facilities were built in the mid 1970's with a design throughput of 45Ml/d. Over the years there have been various modifications to the plant to accommodate new quality standards and the works currently has an effective capacity of around 38Ml/d.

Since the merger with Sutton District Water Company in 1995 we have increased interconnectivity around the extended area. The result is that we now export water from the East Surrey Water Resource Zone to the Sutton Water Resource Zone and therefore some of the water from Bough Beech is now blended with other sources and can be consumed in Reigate, Redhill, Tadworth and parts of Sutton and Cheam.

During the current quinquennium we are carrying out a major refurbishment project to update and up-rate the Bough Beech plant to the original design capacity of 45Ml/d. In the period between 2010 and 2015 we plan to increase the output from the works to 70Ml/d. We would like to explore with Ofwat the possibility of managing this project across the two asset management plan periods, 2005-10 and 2010-15 along the lines of the overlap programme described in the PR2009 consultation paper, this could possibly be used by Ofwat as a trial of the proposed approach.

An increase in the peak abstraction licence to 70Ml/d has already been granted by the EA subject to the up-rating being carried out by 2015. The increase in treatment capacity together with the associated up-rating of pumping stations, trunk mains and the distribution system will enable us to make better use of the surface water storage at Bough Beech and to rest ground water sources at critical times, and should increase peak deployable output by up to 25Ml/d. A modest increase in average deployable output may also be realised, although this will depend upon more strategic use of the reservoir. The overall cost of this project will be between £35-40m.

During this period we will continue our normal borehole development programme and we also intend to develop further our aquifer recharge scheme which should increase peak deployable output by an additional 5Ml/d.

5.1.2 Medium/long term

Once we have extended our Bough Beech facilities and implemented the other supply side options identified in our 2004 Water Resources Plan, we believe that we will have used all the available resources in our area. We expect that during this period our metering programme, water efficiency measures, new tariffs etc will have some impact on the level of demand and we will take account of this in the draft of our 2009 Water Resources Plan. Unfortunately, we expect that there will still be a deficit in deployable output to meet rising demand. Our current view is that sometime after 2020 we will require access to a bulk supply of up to 30Ml/d.

Water resources in south-east England are well developed and there is limited scope for further abstraction. It is important for the environment and sustainability that we make the best use of the resources that are available. We will work closely with other water companies and the Environment Agency to develop further resources in an environmentally sensitive and sustainable manner. We have therefore been fully participating in the modelling work being carried out by the Environment Agency, as a member of the Water Resources in the South East Planning Group. We understand that neighbouring companies are proposing to build reservoirs, in particular Thames Water's proposed Upper Thames Major Resource Development, and we have approached them to discuss access to these facilities, preferably by sharing the capital/operating costs. We have had initial discussions with Thames Water and other companies in the South-East, which need to be progressed further before we can include any proposals in our Business plans.

It is very important that all parties in the Water Resources in the South East Planning Group co-operate in a regional plan that is capable of distributing water throughout the South East. CCWater strongly support this position.

5.2 High Quality Water

5.2.1 General

Water of high quality is equally important to our customers. We currently produce water that is of consistently high quality. In 2006, our overall drinking water quality (as represented by mean zonal compliance for 40 parameters) was 99.95% (from Drinking Water 2006, a report by the Chief Inspector of the Drinking Water Inspectorate).

Our aspiration is to achieve 100% compliance during the period covered by this Statement. This will involve ensuring that our assets are properly maintained and our staff are well trained, and that appropriate operational procedures are in place. Greater emphasis will be placed on a risk based approach to management of water supplies, from source to tap. We will carry out all the improvements and integrated operational strategies identified by our Water Safety Plans. These are still being prepared, but currently we do not believe that strategies identified will be excessively costly.

We will also meet all the quality standards that are established during the currency of this Statement.

5.2.2 Taste and odour

The taste and odour of our treated water did not emerge from our PR2009 research as important issues for our customers. Research for JR2007 indicated that 98% of our customers were satisfied with the taste and odour of our water and that only 2% were very dissatisfied. We will continue to maintain our treatment process and distribution systems so that taste and odour issues are minimised. In the longer term, we will continue to review developments in disinfection that could further improve the taste and odour of our water.

5.2.3 Iron

We currently have a carefully managed and targeted programme that identifies mains with internal corrosion which are refurbished where necessary. Due to its localised nature, discolouration is not an issue for the large majority of our customers and therefore we intend to continue with our current approach.

5.2.4 Lead

We will continue with our currently agreed lead programme until 2010. This comprises conditioning of water with orthophosphoric acid, replacement of communication pipes that have been identified as failing the standard, and opportunistic replacement of communication pipes when other work is being carried out. Carefully controlled phosphate dosing appears to be keeping failures of the new lead standard of 10ug/l (which will apply from 2013) to a minimum. Guidance is required from the DWI to establish what action will be required when the standard is breached. This has the potential to trigger a major replacement programme, depending upon the course of action recommended, because we have around 110,000 lead communication pipes. We have worked on the assumption that the guidance will not significantly change the programme or costs from current levels.

This assumption is based on the premise that, in the short to medium term, dosing with orthophosphate will be allowed to continue. In the medium to long term, the environmental implications of the continued use of orthophosphate to reduce lead levels in treated water will need to be established, and a decision made by Government and the Regulators as to whether there should be a change to the current approach.

In the short to medium term, we will also continue with our policy of opportunistic replacement of lead communication pipes. This means replacing communication pipes when the water main they are connected to is replaced, or when a communication pipe is found to be leaking, or when a customer replaces their supply pipe. Over time this will result in the replacement of all lead communication pipes. Opportunistic replacement offers good value for customers because it can be more cost effective to replace communication pipes whilst similar work is being carried out in the area. However, there is limited benefit in replacing communication pipes as lead levels will not be significantly reduced unless the customers' lead supply pipes are replaced at the same time. In the medium to long term there is a strong argument that the Government should establish a programme of replacement of all lead supply and communication pipes. We are prepared to work with Government and the Regulators to try and establish how this could be best achieved at a rate acceptable to customers.

5.3 Demand management – general

As indicated in 5.1 above, we are committed to the twin track approach of balancing supply and demand. We will establish the most appropriate means of overcoming any deficit in resources to meet demand taking into account economics, willingness to pay, environmental impact and cost/benefit analysis, and will look for ways to improve the more efficient use of water alongside resource development.

5.4 Demand management – leakage

This is seen as an important issue by our customers. They are very aware of leakage because of the publicity associated with Thames Water but were not aware that our leakage level, at around 15%, was the third lowest level in England and Wales. Once they were aware of this their attitude changed slightly but they still strongly believed that leakage should be reduced.

Currently our economic level of leakage (ELL) is between 27.2MI/d and 31.2MI/d. We have a pragmatic target set by Ofwat of 24.5MI/d which we have consistently achieved. In 2006-07, during the drought, we reduced leakage by 0.3MI/d to 24.0MI/d. This marginal decrease was achieved at additional operating costs of £0.3m. This reinforces our view that reducing leakage is an expensive way of reducing demand. We understand that Ofwat is developing new methodologies for evaluating the ELL. We look forward to receiving and understanding these proposals so that they can be considered along with other demand management measures when looking at the economics of balancing supply and demand during the Business Plan process. Using the current ELL methodology, in the short/medium term we are proposing a modest reduction in leakage levels to 24MI/d. In the longer term, we will aim to reduce leakage to 12.5% of distribution input (see also 8.3.2). Once costs have been established, and cost benefit analyses have been carried out, we will reconsider more ambitious leakage targets taking into the alternatives which will include receiving supplies from other companies, and other demand management measures.

5.5 Demand management – Metering

Currently over 63,000 households are metered, which is 25% of the total number of those billed. By the end of 2010 we expect this to increase to over 89,000, or 35% of billed households. Our customers are convinced that the only equitable way to pay for water is by meter and that the level of metering should be increased substantially. We agree, and consider that metering offers a real opportunity to manage demand.

We believe that our customers are economically driven and the only signals that will have a lasting impact on behaviour are associated with price. To make any significant contribution to demand management we consider that at least 65-70% of households need to be metered.

5.5.1 Water Stress

In its consultation document on “water stress”, the Environment Agency has classified the Company as being in an area of “serious water stress”. The effect of this, assuming the new legislation is enacted, is that the Secretary of State will require us, in drawing up and consulting on our draft statutory water resource management plans, to formulate and include an assessment of the costs and benefits of compulsory metering alongside the costs and benefits of other water supply and demand measures. We will consider the option of compulsory metering.

5.5.2 Savings

Until such time as meter penetration has reached the level discussed above, the savings that can be made are limited to any reduction in consumption when a customer switches from an unmeasured tariff. In our affluent area we assume reduced consumption and supply pipe leakage will result in overall savings of 10% in an average household. This is line with our PR04 Business Plan and was accepted by Ofwat. As a consequence, it is unlikely that compulsory metering will be the most economic way of balancing supply/demand.

5.5.3 Proposed level of metering

Notwithstanding the economic arguments, we believe that we should be aiming for a meter penetration level of at least 70% by 2020 when supply side options will be limited. To achieve this we propose to install 12,500 meters per annum from 2010 by a combination of metering on change of occupancy, providing free meters to optants, and compulsory metering. We are funded to install 9,500 meters in the last year of the current quinquennium (2009/10). We consider 12,500 meters per annum to be an achievable step up from that level. The proposal to move towards charging on a metered basis is strongly supported by customers and the Environment Agency. We are aware that it will be necessary to put in place measures that safeguard vulnerable customers.

5.5.4 Tariff development

The level and structure of tariffs that will be required to manage demand are not known yet. We are aware that some companies are carrying out, or proposing to carry out trials, and look forward to seeing the results.

We propose to investigate the impact of new tariffs by carrying out a pilot study using various tariffs in our smallest charging zone - Northern 2 (Croydon). This zone currently has 23,000 domestic customers of which 4,500 are metered. We propose to meter the remainder of these between 2010 and 2015. We then have a discrete charging area where we can begin to trial various metered tariffs in the 2015-2020 period, to see if these have any impact on consumption behaviour. The Northern 2 trial will form part of that overall meter programme.

5.6 Demand management – water efficiency

5.6.1 General

We fully recognise our obligation to promote water efficiency and we fully support our customers’ views that we should promote schemes and educational facilities.

To date it has not been possible to demonstrate that water efficiency is an economic means of balancing supply and demand. Nevertheless, we consider water efficiency to be an important tool in the management of demand. We believe that key areas for us in achieving water efficiency savings are: the education of our customers, assisting customers to reduce household consumption, reducing business use, and working with Local Authorities and Housing Associations to reduce the consumption of their housing stock and business premises.

In the short term, we plan to build on the initiatives we have developed this year (including a trial of a dual flush retrofit device) and double our spending in the next quinquennium to £1m pa.

5.6.2 Code for sustainable homes

We are prepared to work with Government and Local Authorities to help oversee the introduction of the Code for Sustainable Homes, and assist with the monitoring of consumption. For this initiative to have long term benefit, it will be necessary for the Code to be statutory, and for Building Regulations to be updated to ensure that any changes made to properties at a later date will not increase water consumption. It will also be necessary for someone to police the scheme.

We propose that new homes are built to a certain standard with regard to water consumption, and that a target level is set for each property based on bed space. We then propose that we introduce a rising block tariff that is applied to each of those properties where consumption exceeds the target level. Customers with larger families will be able to claim an increased volume of water for essential use as will those with special medical needs. Alternatively, a target could be set against occupancy, but we believe that this would be more difficult to manage.

5.6.3 Water efficiency savings

Customers need to make a behavioural change if we are really to be successful in reducing their consumption, especially in existing homes. Water efficiency in buildings relies heavily upon legislation and Building Regulations. Any real inroads into the reduction of consumption will require the support of Local Authorities, Central Government, developers, white goods manufacturers, bathroom fittings manufacturers etc. For this reason we believe that it would be imprudent in the short/medium term to rely upon any meaningful water savings from this source.

Longer term we believe that improvements in the water use of white goods and toilet cisterns will help to counter the increase in demand that will arise out of increases in appliance ownership (eg power showers and dishwashers). This has been allowed for within our microcomponent analysis of demand.

5.6.4 Water efficiency targets

We do not agree with the imposition of water efficiency targets on water companies when we can only, at best, be an influence on consumer behaviour. If, however, Defra, or the regulator, is minded to introduce water efficiency targets, then we would like to agree how the savings are to be measured. One approach may be to allocate and agree a theoretical saving attributable to each water efficiency device or measure adopted. On this basis, it may be possible to agree a longer term targets, see 8.3.4.

5.7 Maintaining our Networks

5.7.1 General

One of the clear priorities of our customers is that we should keep our networks in good order. In particular they are keen that pipes are replaced at a rate that reflects the life of the pipe.

5.7.2 Maintenance - Infrastructure

As a result of the Determination made by Ofwat our current five year mains replacement/refurbishment programme is:

Problem with Pipework	Solution	Mains Length (km)	% of mains network (pa)
Structural Failure	Replace Mains	140	0.82
Water Quality Failure	Replace Mains	40	0.23
Water Quality Failure	Refurbish Mains	64	0.37

The current programme of work was developed through the application of the Capital Maintenance Planning Common Framework (CMPCF). We will continue to develop this approach to capital maintenance planning and the outputs will play an integral part in our Business Plan submission. Our aim is to maintain 'Stable' serviceability of our infrastructure assets.

It should be noted that:

- Over 48% of the pipes in our mains network are more than 70 years old.
- Over 15% of the pipes are more than 100 years old.
- 67% of the pipework in our network is highly vulnerable unlined iron.
- Over 51% of our mains are subject to pressure management (59% of properties).

We believe that the CMPCF analysis results in a replacement rate that is too low because of the cost effectiveness principle embedded in it. Pressure management does not stop deterioration of a main, only temporarily delays the point at which a pipe will fail. Climate change is likely to make the situation worse by causing greater variation in ground movements. We propose that, as a minimum, no less than 1% of mains should be replaced each year for structural failure reasons.

67% of the mains in our network are aged, unlined iron. We propose that a further 1% of our mains should be replaced or relined per annum for water quality failure reasons.

5.7.3 Maintenance - non-infrastructure

During the current period (2005-10), we are committed to completing the refurbishment of Cheam water treatment works, and commencing the refurbishment of Bough Beech treatment works. The serviceability of our above ground assets is rated as Stable.

Customers expect us to maintain our assets in good condition so that serviceability does not deteriorate. Our non-infrastructure capital maintenance proposals will be determined accordingly using a forward looking risk based approach in accordance with the principles of the Common Framework. This will rely upon the Capital Maintenance Planning Common Framework (CMPCF) models that are currently being developed.

In the short to medium term we anticipate major refurbishment at our Bough Beech, Elmer, Godstone and Kenley water treatment works. In the medium to long term, we anticipate major refurbishment at the remaining five water treatment works. We do not anticipate any significant increase in the base level of expenditure in this area, however, over time the base level may have to rise as more recent assets, with shorter asset lives (eg ICA), require replacement.

5.8 Other Customer Service indicators

Customers have clearly indicated that these are perfectly satisfactory and do not require any particular improvements. Our objective is to continue to provide the highest levels of DG service indicators and achieve at least 95% in the OPA levels of service.

5.9 Sustainability and the Environment

Our customer research indicates that our customers have an interest in sustainability and the environment, but it is not one of their top priorities. Nevertheless, customers expect the Company to act sustainably and in an environmentally responsible way, and they are therefore important issues that we need to address. We already carry out Environmental Impact Assessments on a number of our major projects, and look for ways to carry out our works more sustainably (for example, the use of recycled material for trench backfill). We will endeavour to meet our customers' expectations in these areas especially where solutions can be found at little or no extra cost.

6 Financial Impact of Meeting Customers Expectations

Capital and operating expenditure for future periods is driven by the proposals discussed above. All costs included are in the early stages of estimation.

6.1 Capital expenditure – short term

The largest driver of future prices is capital expenditure. We currently anticipate that a significant increase in capital expenditure will be required in 2010 to 2015 (compared to the period 2000 to 2005) if we are to address all of our priorities. A large part of the increase would arise from the following:

- Our proposed uprating of Bough Beech water treatment works;
- Improvements to the distribution system associated with increased output from Bough Beech;
- The increased metering programme; and
- Increased infrastructure renewals (mains replacement).

6.2 Capital expenditure – longer term

We currently expect capital expenditure to remain high up until 2020 with slight reductions after that.

One of the biggest unknowns is the likely cost of access to additional supplies from the assets put in place as a consequence of the modelling being carried out by the Water Resources in the South East Planning Group, whether those costs be capital or revenue.

6.3 Affordability

This is an issue raised by Ofwat and CCWater. It is clear that our customers do not perceive affordability as an important issue except for a few large/low income families moving to meters.

Analysis of the CACI data for our Company is shown in the Table below.

CACI category	SESW area % of households	National % of households	SESW difference
Wealthy achievers	33.9	25.4	1.33x
Urban prosperity	14.7	11.5	1.28x
Comfortably off	31.1	27.4	1.14x
Moderate means	10.8	13.8	0.78x
Hard pressed	3.9	7.9	0.49x
Struggling families	5.6	14.0	0.40x

This table shows that our customer base is significantly more affluent than the national average. We have a much higher percentage of wealthy achievers, urban prosperity and comfortably off customers than the national averages, and less than half the national average struggling families. We also have one of the lowest levels of bad debt.

The Government has reviewed water charges and compared them to disposable incomes in DEFRA's 2004 *Cross Government Review of Water Affordability*. Unfortunately, this only provides data at the level of Water and Sewerage Companies (ie Thames), but it should be

noted that in the Thames Area water and sewerage charges were expected (in 2009/10) to be 0.8% of disposable income, and for the poorest quintile of customers it was only 2.2% of disposable income. It is also worth noting that only 6.5% of customers in this area were expected to spend more than 3% of their disposable income on water charges

Any detached look at our current charges of £150pa (approx) i.e. 41p/day (less than a litre bottle of mineral water) will show that this is a small amount compared to the disposable income for what is a very affluent consumer base. Therefore, even though our charges may have to increase significantly, this is still de minimis for the vast majority of our customers. The comparison with bottled mineral water also shows that tap water is exceptionally good value for money.

However, we are aware that there is a small minority of customers where payment of water charges is an issue. We will continue to work closely with these customers and the appropriate agencies to ensure that they can pay their water charges.

6.4 Cost benefit analysis and menu regulation

We will develop a cost benefit methodology that can be used to make decisions on expenditure more transparent and to justify expenditure now that will have benefits in the future. We do not however believe that it should be the only driver for expenditure.

We will investigate how 'Menu Regulation' might help incentivise and inform our expenditure proposals.

7 External Factors

In the introduction to this statement we identified a number of external challenges and pressures that will affect the environment in which we will have to operate during the period 2010 to 2035. These are explored in a little more detail below.

7.1 Population Growth/Demand

We are working on our draft Water Resources Plan (WRP) that will be available for public consultation in the spring. This work also has to be finalised but currently we are forecasting:

- A change in target headroom resulting from using the risk based methodology. This will probably result in lower headroom in the early years of the plan but a significant increase towards the end of the plan.
- An increase in new properties to over 2000 pa by 2015 and then declining to 1000ish by the end of the period (we are not expecting any significant new developments in our area, except that Reigate has been given new growth point status).
- Modest growth in per capita consumption – despite water efficiency measures.
- Significant increase in the level of domestic meters so that all properties that can be effectively metered should be converted by 2025.

These factors require a large shift in the supply/demand balance requiring significant increases in expenditure in this area.

7.2 Financing

We are conscious that our plans will require significant levels of capital expenditure. For the last ten years we have spent on average around £18m pa on capital projects. We are predicting that this will increase significantly in the period 2010 to 2015 and will reduce slightly after that. It will not however return to the levels we have recently been allowed.

This level of expenditure will require significant external financing. The capital markets have had many years experience of providing finance for water companies. They have an excellent understanding of the regulatory regime and are well qualified to assess the merits of any financing proposals. We envisage being able to borrow from the debt markets at competitive rates in the short to medium term. This view is built on the assumption that the consistency of regulatory regime that has been developed over the past 15 years is maintained. Crucial to this is that risks to the regulatory capital value (RCV) are not increased, for example by competition, separating assets between supply and distribution etc.

The view also assumes that the wider economic, financial and political climate remains generally benign. There is clearly a risk that a continuation of the current “credit crunch” or a similar event would impact on our ability to raise external finance at competitive rates, even though we are a relatively low risk industry.

We are currently considering its options for financing the business going forward.

We have assumed that the bond markets can fund significant amounts of our programme. There is a natural ceiling to the levels of gearing that any water company will bear. In PR04, Ofwat suggested this was between 55-65% of the RCV. Some companies, such as ourselves, have gone beyond that level, by innovative financing techniques, to take advantage of favourable debt market conditions. However, whatever the sustainable level of gearing is, there

will always be a requirement for equity funding. This means that the capital programme will need to be funded from a mixture of debt and equity.

The additional equity finance required can be provided through one of two routes, retained earnings or capital injection. It is vital that the rate of return allowed is sufficient to encourage equity finance into the industry, i.e. to encourage new equity investors to invest and/or to encourage existing shareholders to defer dividend income.

In summary, the only way to attract debt or equity investment is for there to be a sensible cost of capital typical of a reasonably efficient Company. We will be in a cash negative position for many years and will require access to external sources of finance. Therefore, a realistic rate of return is a fundamental factor that underpins this Statement.

7.3 Legislation/Regulation

We have incorporated into this Statement our understanding of the impact of recent legislation and/or directives. We currently believe that the Water Framework Directive will not have any significant impact upon our operations. We await the guidance for lead that will apply from 2013, but have assumed that it will be achievable and will not require a significant increase in expenditure.

Any new directives or standards that we become aware of before 2009 will be incorporated into our Final Business Plan. Beyond that we are expecting that any new/changed requirements will be dealt with by the existing price adjustment mechanism.

7.4 Climate Change and Sustainability

The water industry is inextricably linked with the environment. We cannot operate effectively unless the environment works. We are very aware of the debate surrounding climate change and carbon emissions. We fully support the work of Ofwat and Water UK to derive a methodology to measure the impact of climate change and our current levels of emissions and carbon footprint. We understand the necessity to minimise our energy consumption and carbon emissions and will work to achieve that. We have engaged consultants to work with the Carbon Trust to advise us on our current emissions and to develop an action plan to reduce them. We will use the action plan to set carbon reduction targets for the Company in line with Government policy (eg Draft Climate Change Bill). We await the consultant's report and will incorporate its conclusions, including targets, in our Business Plan.

We need to be aware however that we have a growing population to serve, increasing property numbers etc which will inevitably require more water and therefore require greater energy costs. We also have an asset configuration that will take some years to replace so that we have a legacy energy requirement that will be difficult to change in the short/medium term.

Sustainability is about planning and operating in a socially, environmentally and economically responsible manner. We already carry out Environmental Impact Assessments on a number of our major projects. We will investigate the development of a sustainability strategy and targets against which we can monitor our environmental performance.

Our customers understand the climate change and water sustainability issues, and the need to improve water efficiency. We fully accept our responsibility to promote and facilitate this amongst our customers. But, customers need to make a behavioural change if we are to successfully improve water efficiency. This will require the support of local authorities, central government, developers, white good manufacturers, bathroom fittings manufacturers etc before

any significant changes can be made. For this reason we believe that it would be imprudent in the short/medium term to expect any significant water savings from this source.

7.5 Competition

Competition did not appear to be a driver for our domestic or business customers. Our position is that we support competition provided that it benefits all of our customers. We do not support cherry picking of large industrial/commercial customers which then receive lower prices at the expense of domestic customers who may have to pay more.

8 Long Term aspirations

Our long term aspirations are as follows:

8.1 Resources

To be part of a shared water resource strategy for the south-east of England. Our preference is to have part ownership of new reservoir schemes being planned by neighbouring water companies.

8.2 Water quality

To achieve 100% compliance. This is an aim that relies on a number of other aspirations being achieved in addition to responding to any new water quality challenges:

- Maintaining “stable” serviceability will not be enough to achieve 100% compliance. Serviceability will need to improve to the highest level. Plant failures will need to be eliminated (or where duty/standby plant is available, changeovers must be seamless, without interruption).
- All lead communication and supply pipes will need to be replaced. It will probably not be practicable or cost effective to do this by 2035 because of the number of lead pipes in our area. In the meantime, we will continue to minimise the risk of failure of the lead standard by dosing with orthophosphate while it is environmentally acceptable to do so. We will seek opportunities to replace lead communication pipes where this can be done whilst undertaking related work (eg mains replacement). Ultimately we would like to see the replacement of all lead communication and supply pipes and are prepared to work with Government and the Regulators to try to achieve this at a rate acceptable to customers. Opportunistic replacement will of course, over time, result in the replacement of all lead communication pipes, but not supply pipes.
- All unlined iron mains will need to be replaced or lined. 67% of our mains network is vulnerable unlined iron. We propose that all of our unlined iron pipes should be replaced or relined by 2045.

To achieve zero taste and odour complaints. This will probably require chemical free treatment and a trouble free distribution system and is unlikely to be achieved within the planning period. As a first step it will be necessary to find suitable alternatives to chlorine for disinfection.

8.3 Demand management

8.3.1 General

To manage demand so that there is no underlying growth in consumption. This will be achieved through a combination of leakage reduction, metering, and water efficiency measures. In addition a programme of work will be put in place to minimise treatment works losses and to eliminate outages.

Ofwat has indicated that compulsory water efficiency targets will be introduced from 2010. Whilst we have issues with these (see 5.6.4), we would like to work together with Government and the Regulators to agree targets that can be measured and achieved. These may need to become more challenging in the longer term. We will consider the reductions in demand that could be achieved and take these into consideration within our 2009 Water Resources Plan.

8.3.2 Leakage

To reduce leakage to 12.5% of distribution input by 2035. Reducing leakage is a clear priority for our customers. To achieve a 2.5% reduction we will need to:

- Continue to replace our ageing mains network at a level equivalent to 1% to 1.5% per annum. Mains replacement is a key element of any leakage reduction strategy.
- Intensify leak detection and repair.
- Identify supply pipe leakage, and repair or replace. Nearly 40% of our leakage is attributed to unmeasured supply pipe leakage. The proposed increase in meter penetration should help with the identification of leaks on supply pipes.

8.3.3 Metering

a) meter penetration

To be 90% metered by 2025.

b) rising block tariffs

To manage demand by utilising some form of rising block tariff by 2025 and by encouraging water efficiency measures. Tariffs will be designed to achieve reductions in peak and average demand with perhaps medium and long term targets. Basic rising block tariffs can be achieved using ordinary meters read twice a year, however customers will respond better if they understand consumption patterns. This will require the use of intelligent meters that can be read and interrogated easily and frequently. Ultimately, the customer should be provided with a read out in the house.

8.3.4 Water efficiency

a) Non-household demand

To reduce non-household demand. Initially this will be achieved through proactive water efficiency advice given at byelaws inspections, and through water audits. At some point after 2025 it may be necessary for legislation to be introduced that would impose targets on businesses based, for example, on production and number of staff. Our plan assumes no growth in non-household demand.

b) Household demand

To manage demand by the active promotion of water efficiency measures. Significant savings were achieved during the 2004 to 2006 drought by using a well targeted and persuasive media campaign. In the longer term education will still be important, but it will be necessary to go beyond relying on the good will of customers and the installation of a few cistern displacement devices. Houses will need to be modified to use less water (eg installation of very low flush toilets, rainwater harvesting, and greywater recycling). We will investigate the most efficient ways of achieving the savings that will need to be made, and will be in a position to make any modifications required. It should be recognised, however, that to achieve the level of savings that will be required will need legislative and behavioural change.

8.4 Maintaining our networks

8.4.1 General

To improve the serviceability of our assets. In the short to medium term, as set out above we will maintain our infrastructure and non-infrastructure assets to achieve “stable” serviceability. However, longer term, as indicated in “water quality” above, we do not believe that stable serviceability will be enough and it will be necessary to improve the reliability and performance of our assets. We will aim to do this in a sustainable manner using best practice asset management.

8.4.2 Infrastructure

To improve the serviceability of our mains network, while minimising disruption of road traffic, by employing new and innovative techniques for replacing, repairing and reinforcing pipes. The programme will be designed to reduce leakage and improve water quality as outlined above, and to reduce the number and duration of supply interruptions.

8.4.3 Non-infrastructure

To improve the serviceability of non-infrastructure assets. In particular, we will seek to reduce taste and odour complaints, to eliminate plant failures and works outages.

8.5 Research

To work together with partners like UKWIR and WRc to determine how our longer term business needs will benefit from targeted investment in research and innovation. In particular to support UKWIR's 20-20 vision for the future which was published in June 2007 as the UKWIR R&D Roadmaps with 5 major themes:

- Energy Management;
- Underground Assets;
- Leakage;
- Intelligent Metering; and
- Chemical Free Treatment.