

Appendix 11

MD 203 Interim determinations



Office of the Director General of Water Services
 Centre City Tower, 7 Hill Street, Birmingham B5 4UA
 Switchboard: 0121 625 1300
 Direct Tel: 0121 625 Direct Fax: 0121 625

MD 203

**TO ALL MANAGING DIRECTORS OF
 WATER AND SEWERAGE COMPANIES
 AND WATER ONLY COMPANIES**

10 May 2005

Dear Managing Director,

INTERIM DETERMINATIONS 2005

This letter sets out our intended approach to any interim determinations which we are requested to make or we initiate in 2005, in terms of principles, methods and process. These reflect the requirements of part IV of Condition B of the licence and in some cases build on our experience of earlier interim determinations. This letter does not cover applications under the 'substantial effect clause'. This letter provides guidance on how we will approach the following key issues in 2005:

- i) changes up or down in the number of meter plants;
- ii) increases in bad debt and the costs of managing debt;
- iii) increases in charges for abstractions and discharges to controlled waters;
- iv) charges for lane rental/traffic management;
- v) increases in the taxation of infrastructure, expenditure arising from the introduction of International Financial Reporting Standards (IFRS);
- vi) changes in the construction price index (where applicable);
- vii) new enhancement expenditure;
- viii) other relevant changes of circumstance; and
- ix) counter-notices.

As price limits for 2005-10 were set in December 2004, we do not anticipate receiving many, if any, interim determination applications this year. However, we will apply the provisions of the licence as set out. In addition, we believe that all parties will benefit from early discussions to consider the issues and processes to be followed. If your company is contemplating an application please contact Kieran Duffy (0121 625 1446), who is our Project Manager for interim determination applications. Your Ofwat Board lead contact will also be involved in overseeing the IDoK process and issues for your company.

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A. PROCESS

There are two important, general points.

1. Interim determinations can only deal with the impact of relevant items (relevant changes of circumstance and notified items). An interim determination is not a mini-periodic review.
2. The procedure is also available to us – that is, we can decide, regardless of whether you have applied for an interim determination, that we ought to take action.

The minimum timetable for interim determinations is set out in Condition B of the licence as follows:

- Following the licence modification in April this year, to change prices in the 2006-07 charging year either you or we must trigger an interim determination process by no later than 15 September 2005.
- Where this happens the other party may issue a counter-notice within 14 days.
- We must make an interim determination decision within three months of a request.

For several years now we have issued and consulted on draft interim determinations. This enables us to consider stakeholders' views and take representations from the relevant WaterVoice Committees. Early discussion of a potential application with us will assist this also. We encourage companies to inform their relevant WaterVoice Committee about any potential interim determination application.

In recent years most companies have involved their Reporters from the start of the process. Their scrutiny and opinion is very useful to you and to us. Consequently, we encourage you to invite your Reporter to attend any early discussions with us and involve them in the subsequent development of the proposed application.

Any application for an interim determination must be submitted by Thursday 15 September 2005. Your supporting documentation and Reporter's report should be submitted on the same date. If this deadline is met we will announce determinations no later than Thursday 15 December 2005. If we decide to trigger an interim determination we will inform the company by 15 September and announce determinations by 15 December.

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We believe that customers' interests are best served by operating an open and transparent approach to regulation. Therefore, we believe it would be beneficial for a company that requests an interim determination of price limits to inform its customers when it makes an application. We will publicly announce any interim determination we decide to initiate.

I attach at annex A the timetable we intend to follow this year. Please tell us of any difficulties you foresee with this.

In previous years we made the electronic spreadsheet that underpins our interim determination calculations available to all companies. The version that we will use for 2005 is now available to download from the Ofwat website (www.ofwat.gov.uk). It includes table formats that we use to summarise our interim determination. The spreadsheet automates the assessments of triviality and materiality and calculates the annual allowable amount and the K adjustment required.

If a company believes that there has been a change in the obligations placed on it since price limits were last set, but its valuation of the changes does not exceed the materiality threshold of 10%, these will not be dealt with by the process set down in this letter. Companies have the opportunity to use the procedures set down in MD197, the AMP4 change protocol. Where companies use these procedures we will indicate the items to be logged up or down at the next price review. We aim to respond to a request for approval/confirmation within six working weeks of receipt of all the relevant material from the company.

B. METHOD OF CALCULATION SET OUT IN CONDITION B

We will issue any counter-notices no later than 14 days after receipt of a company's application. Where possible we will indicate our intention to do so during any early discussions that we have with individual companies.

We will examine each application against the list of questions set out in Condition B paragraph 13/14.2¹. The determination will either be a revision to price limits, or no revision to price limits because the materiality threshold has not been met.

¹ Where a number appears such as 13/14, the first one is the paragraph in the water companies' licences and the second is the number in the water and sewerage companies' licences.

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1) Relevant change of circumstance and notified items

Interim determinations may be available, provided that each of the matters at issue is a relevant item; that is either a relevant change of circumstance (RCC) or a notified item.

The relevant changes of circumstance are defined in Condition B. The standard ones are:

- RCC(1): a new or changed legal requirement (each of these is also defined);
- RCC(2): differences in the proceeds of land disposals from that assumed when price limits were last set; and
- RCC(3): failure to achieve some output, funding for which was provided at the last price setting.

A few companies have a fourth – RCC(4) – changes in the construction price index (CPI) from what was assumed at the last price setting.

Notified items are anything which, at a price setting, we have recorded specifically as having not been allowed for (either in part or at all).

There are currently five. A difference from the assumptions made when price limits were last set in:

- i) changes up or down in the number of meter optants;
- ii) increases in bad debt and the costs of managing debt;
- iii) increases in charges for abstractions and discharges to controlled waters;
- iv) charges for lane rental/traffic management; and
- v) increases in the taxation of infrastructure expenditure arising from the introduction of International Financial Reporting Standards (IFRS).

2) Materiality

The materiality threshold and its arithmetic are set out in Condition B. This is calculated using the appropriate discount rate (see below). The costs, savings and changes in revenue used in the arithmetic will reflect our judgements of what is reasonably attributable to the relevant item(s) in question.

3) Triviality

We will only take non-trivial changes into account in price limits. Following our proposal in 'Setting water and sewerage price limits for 2006-10: Framework and approach' (March 2003) to amend the definition of triviality (at para 9.12) we will use the following approach.

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If the net present value (NPV) of the change is less than 1% of the relevant service turnover (water or sewerage) to which it, in our view, relates exclusively, then it would not normally be carried forward to the materiality test included in any reassessment of price limits. Where it appears to us that a change does not relate exclusively to either the water service or the sewerage service, triviality will be assessed with reference to 1% of the combined water and sewerage turnover.

When assessing triviality, we group together all schemes in response to a single relevant change of circumstance. For example, all the work necessary to comply with a cryptosporidium notice will be considered together (both monitoring and additional treatment costs).

4) Discount rate

For the majority of companies, Condition B states that the investment allowed for in the interim determination should be remunerated using the current rate of borrowing. In these cases the value used will be pre-tax cost of debt. For all other companies the discount rate will be the pre-tax rate of return reflecting the weighted average cost of capital.

The actual value will be assessed during the interim determination period. We will confirm the value we are using for each company. In the meantime, you should assume the discount rate will be the same as the value used at the last price setting.

5) Annual allowable amount and revised price limits

Condition B requires the determination of an annual allowable amount and prescribes the method of calculating the revised price limits.

These items will be calculated in accordance with Condition B using the discount rate (see above) and our judgements on the costs and revenue losses as used in the materiality calculation. We will provide details of our calculation of these items in the format and at the level of detail which will be set out in the spreadsheet.

6) Licence matters

The current licence for all companies incorporates the changes set out in MD194, 5 August 2004. In MD194 we said that we would consult further on a package of the more contentious changes to the interim determination mechanism during 2005-06, to apply from 2010 onwards. We will take this forward during the current year.

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C. OPTIONAL METERS

1) Optant numbers

In the final determination our revenue forecasts for 2005-10 used assumptions about optant numbers in 2004-05. In assessing the impact of changes in the uptake of optional metering on 2005-10 revenues, we will use out-turn figures for numbers of optants in 2004-05, in place of the assumed figures used for the final determination.

To arrive at assumptions about the number of meter optants expected by 2009-10, we will consider company-specific evidence and trends. However, we will be cautious in drawing conclusions from the level of metering observed during the first months following significant shifts in bills in April 2005.

2) Meter location

For the 2004 final determination, companies' assumptions on meter location, as presented in the Final Business Plans, were generally accepted. We would expect you to continue to adopt the Final Business Plan assumptions on meter location unless you provide compelling evidence supporting changed assumptions.

3) Optant characteristics

For the 2004 final determination, company-specific assumptions were applied based on Final Business Plan information and other available evidence. We will continue to adopt this approach:

We will expect all companies to present updated evidence on optant characteristics. This should be based on out-turn evidence, for example from billing data. Companies should set out evidence for successive cohorts of optants showing:

- post-switching demand (in the first year after opting and subsequent years);
- the rateable value of optants' homes; and
- the change in water consumption associated with the move to measured charging (to date we have normally assumed a figure of 5%).

We will assess the robustness of evidence provided by companies in reaching judgements about the likely characteristics of future optants.

We will assume that optants have average characteristics in terms of supply leakage (both when unmeasured and subsequently when measured), unless compelling evidence is presented to the contrary.

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4) Other

In assessing incremental investment requirements relating to the supply/demand balance, we will take account of any impact on demand expectations arising from out-turn trends in optional metering. This could reduce growth expenditure needs or operating costs.

D. BAD DEBT

At the 2004 Periodic Review, Ofwat retained the operation of a one-way Notified Item for increases in bad debt and debt management costs where these relate to private dwellings or to premises where any part constitutes a private dwelling.

As companies are required to show how costs have increased in each full year of the current period (2005-10) we consider it unlikely that this notified item will be triggered in 2005.

However, for information, the basic methodology when calculating the annual allowable amount will follow the same principles as used in previous years' interim determinations.

Firstly, companies will be required to demonstrate that costs have increased above those reported in 2003-04. The net change between the base year (2003-04) and each full year of the 2005-10 period will be determined for the total of four components:

- Financing costs associated with increases in revenue outstanding.
- Outstanding revenue written-off.
- Operating costs involved in managing outstanding revenue.
- Capital expenditure due to investment in debt management systems.

Secondly, companies must show that:

- 1) their debt management activities are undertaken in an efficient and cost-effective manner using good practices established by other service providers; and
- 2) any increase experienced is in general terms due to the disadvantageous conditions under which water and sewerage undertakers are required to operate as compared with other service providers.

If any company would like further detail on this Notified Item, additional guidance will be available from Sally Inett in our Service and Performance Team.

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E. ABSTRACTIONS AND DISCHARGES TO CONTROLLED WATERS

At the 2004 Periodic Review, Ofwat assumed there would be no real increase in unit rates of charging for abstractions and discharges to controlled waters above those reported in 2003-04.

The costs associated with any net increase in the total charges payable for existing abstractions or discharges, arising from real changes in unit rates above the charges reported for 2003-04 is a notified item.

As only five months of 2005-06 will have elapsed by the date of any application, we consider it is unlikely that this notified item will be triggered.

We would expect companies to demonstrate the real change in unit rates above the 2003-04 level with actual invoices raised and payable by the company.

In addition, we expect companies to demonstrate that the final amount payable has been determined following a period of negotiation between the company and the controlling authority and the amount paid by the company represents best value.

F. LANE RENTAL AND TRAFFIC MANAGEMENT

At the 2004 Periodic Review, Ofwat set price limits assuming that there will be no change in the charges payable to highway authorities for occupying the highway. The Secretary of State for Transport has not approved any proposals to introduce charges payable to highway authorities for occupying the highway. As a result, this notified item would not be relevant for any interim determination applications in 2005.

G. INCREASES IN THE TAXATION OF INFRASTRUCTURE EXPENDITURE ARISING FROM THE INTRODUCTION OF IFRS

We do not believe this notified item will be relevant for interim determination applications in September 2005.

A number of companies have requested clarification on the treatment of tax for the purposes of calculating materiality as the current drafting in Condition B of the licence does not specifically address this point. For materiality purposes we intend to regard tax in a similar way to changes in operating costs and revenue (ie over fifteen years). We will make the necessary licence amendments to formally reflect this in time for 2006 Interim Determination decisions.

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H. CONSTRUCTION PRICE INDEX

A few companies have clause RCC(4) in Condition B of the Licence. This allows for an interim determination arising from changes to the notified index if different from that assumed at the last periodic review. The notified index is the index of national construction costs (COP1) relative to the retail price index.

However, by September 2005, no complete charging year will have elapsed since price limits were set in December 2004, as required by Licence Condition B. As a result, it will not be possible to trigger RCC(4) in 2005-06.

I. ENHANCEMENT EXPENDITURE

1) New enhancement expenditure

We expect companies and others to have used the AMP4 change protocol (MD187) during the year. Any changes to enhancements included in the formal application for an IDoK must already have been confirmed using the principles and where appropriate the procedures set down. If this process has not been completed by 15 September the enhancement will not be considered at an IDoK this year.

2) Failure to deliver expected quality outputs on time

The DWI and the Environment Agency will report to us in June 2005 on your progress with delivering the quality outputs included at the 1999 Periodic Review, as amended by any subsequent interim determination for the AMP3 period.

In each of the cases below where changes are non-trivial we will consider whether to issue a counter-notice or trigger an interim determination under RCC(3).

- The Environment Agency reports each year on progress on the five-year National Environment Programme (NEP). If you have failed to deliver the expected outputs set down in the NEP and have not agreed changed priorities with the Environment Agency, we will take account of any shortfalls.
- The DWI will report on progress with improvements to treatment works to comply with regulations. We will take into account shortfalls in delivery from the programmes of work assumed when we last set price limits.

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- The DWI will also report on progress with delivering the programme of mains renovation started in 1989 to improve quality at the tap. If the milestones for the lengths of mains to be renovated have not been delivered to the satisfaction of the DWI, we will value the renovation not carried out. We will treat this as a shortfall.

We will assess the change in revenue needed to deliver the outputs to the delivery dates now expected, compared with that assumed when we last set prices. We will value any change using the assumptions made when we last set price limits.

J. LICENCE TERMS

The following expressions set out in this letter are terms as defined in the licence (Condition B):

- relevant item
- charging year
- relevant change of circumstance
- notified item
- appropriate discount rate
- net present value
- annual allowable amount



PHILIP FLETCHER

(1) Where a number appears such as 13/4, the first one is the paragraph in the water companies' licences and the second is the number in the water and sewerage companies' licences.

ANNEX A

INTERIM DETERMINATIONS 2005 – INDICATIVE TIMETABLE

10 June	June returns submitted for report year 2004-05.
May-July	Company to submit change protocol requests to Ofwat for approval/confirmation in time for inclusion in this year's IDoK.
June/July/August	Company/Ofwat/Reporter dialogue about scope and context of potential interim determinations/supporting information.
August	Company involves Reporter in preparation for submission/ supporting information.
No later than 15 September	Company informs WaterVoice of potential IDoK application.
No later than 15 September	Company completes change protocol procedures with Ofwat, quality regulators and Defra/Welsh Assembly Government.
15 September	Company/Ofwat triggers an interim determination process. Supporting information provided.
15 September	Reporter's report submitted.
29 September	Ofwat/company issues any counter-notices.
Sept/Oct	Queries raised with companies and Reporters. Working level meetings with companies.
3 November	Draft interim determination issued to company and published.
3-24 November	Public consultation on draft interim determination.
17 November	Company written response to draft interim determinations.
29 Nov – 2 Dec	Representation meeting with Director and Ofwat senior staff.
No later than December 15	Final interim determination issued to company and published.

