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8 November 2001

INTERIM DETERMINATION – provisional response

On 14 September 2001 Brynley Bellis made an application for an interim determination of your company's price limits under Part IV of Condition B of the licence. Your Reporter, John Holmes of Montgomery Watson submitted his report on your application on 19 September 2001.

Your application covers the additional costs and loss of revenue resulting from the following three items:

- a greater numbers of customers taking up the free meter option than was allowed for in the final determination (notified item);
- cryptosporidium monitoring requirements placed upon your company by the Drinking Water Inspectorate (Relevant Change of Circumstance); and
- the effects of the loss of power to disconnect domestic customers for non-payment of charges (notified item).

Annex A summarises your estimates of the effect of these changes on your costs and revenues.

In addition to the changes you have claimed we have identified a change to the work to be undertaken by your company to meet the new lead standards. We have taken this into account when determining your application as set out in my letter to you of 28 September 2001.

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We have completed our initial assessment of your application. Our approach and our initial findings, judgements and conclusions are summarised in Annex B attached to this letter. We have provided you with some explanatory notes expanding on Annex B. Our provisional views on the impact of the changes on your costs and revenues are set out in the summary table (Annex A).

Our initial assessment of the total impact of the relevant items on your costs and revenues is sufficient to exceed the materiality threshold set down in Condition B of your licence. The revised price limits set out on the attached table would apply from April 2002. In the final determination in 1999 we anticipated that the average household bill could decrease by £8.44 in real terms between 2001-02 and 2004-05. We now consider that it will need to increase by £0.77 in real terms over the same period.

In MD169 we indicated that companies seeking an interim determination should expect a licence modification to extend the scope of the notified item to allow for both losses and gains. This means that, in future, an interim determination can be triggered by Ofwat if our revised metering assumptions turn out to be too generous. A copy of the proposed licence modification is attached at Annex C.

Please could we have your written representations on our draft determination by Thursday 22 November 2001. We shall be meeting on Wednesday 28 November 2001 to hear first hand your representations.

Written representations are sought from other interested parties by Thursday 29 November 2001.

We shall issue our final determination of your application by 14 December 2001.

We are placing this draft determination in the Ofwat library and announcing our decision to the London Stock Exchange.

This letter and enclosures have been copied to John Ballard (DEFRA), Michael Rouse (DWI), Roger Thomas (Environment Agency), John Ford (Chairman of CSC for Wales), to all the members of the Welsh Assembly, your local Members of Parliament and Members of the European Parliament.

PHILIP FLETCHER

DEE VALLEY WATER PLC
DRAFT INTERIM DETERMINATION – Autumn 2001 – SUMMARY TABLE

Description		Company's Assessment (September 2001)		Ofwat's Assessment (November 2001)		
Item 1 – Additional meter optants						
1.1	Total additional meter optants in period to 2004-05 (AMP3) over and above the November 1999 assumptions.	+ 4,237 (water)		+ 2,594 (water)		
1.2	Estimated net additional capital expenditure over the AMP3 period	£0.72m		£0.58m		
1.3	Estimated net additional operating expenditure over the AMP3 period	£0.15m		£0.03m		
1.4	Estimated loss in revenues over the AMP3 period	£1.77m		£0.71m		
1.5	Materiality amount (NPV of total net additional costs and losses)			£2.39m		
1.6	Contribution towards materiality threshold			14.7%		
Item 2 – Cryptosporidium – Additional requirements for continuous monitoring.						
2.1	Estimated net change in capital expenditure to 2004-05	£0.13m		£0.08m		
2.2	Estimated net change in operating expenditure to 2004-05	£0.94m		£0.71m		
2.3	Materiality amount (NPV of total net additional costs and losses)			£1.57m		
2.4	Contribution towards materiality threshold			9.6%		
Item 3 – Bad Debt						
3.1	Estimated net change in operating expenditure over the AMP3 period.	£0.14m		£0.14m		
3.2	Materiality amount (NPV of total net additional costs and losses)			£0.32m		
3.3	Contribution towards materiality threshold			1.9%		
Item 4 – Counter notice – Lead – Changes to the compliance programme						
4.1	Estimated capital expenditure on plumbosolvency control to 2004-05 additional to that assumed in the 1999 final determination	£0.28m		£0.19m		
4.2	Estimated operating expenditure on plumbosolvency control to 2004-05 additional to that assumed in the 1999 final determination	£0.28m		£0.11m		
4.3	Materiality amount (NPV of total net additional costs)			£0.50m		
4.4	Contribution towards materiality threshold			3.1%		
4.5	Reduction in capital expenditure on lead communication pipe replacement compared with that assumed in the 1999 final determination	-£0.94m		-£0.94m		
4.6	Materiality amount (NPV of total net reductions)			-£0.90m		
4.7	Contribution towards materiality threshold			-5.5%		
OVERALL ASSESSMENT						
5	Materiality amount (NPV of total net additional costs and losses)			£3.88m		
6	Dee Valley turnover for 2000-01 used in materiality test			£16.32m		
7	Materiality test			23.8%		
PRICE LIMITS		2000-01	2001-02	2002-03	2003-04	2004-05
8	Current price limits (as set in November 1999)	-10.6	-2.6	-3.0	-3.0	0.0
9	Draft revised price limits	-10.6	-2.6	1.1	1.0	1.0
Notes:						
1. Additional costs and revenue losses shown as positive, savings and revenue gains shown as negative.						
2. The appropriate Discount Rate used is 4.95%.						
3. Materiality Test – Result must be greater than +10% or less than –10% to trigger a change in price limits.						
4. All monetary values are stated in September 2001 prices. Totals may not add due to rounding.						

**DEE VALLEY WATER PLC
DRAFT INTERIM DETERMINATION – Autumn 2001
SUMMARY OF OFWAT'S INITIAL ASSESSMENT**

1. We have followed a four stage assessment of your application in accordance with the terms of Condition B of your company's licence.
2. You included three changes in your application:
 - a greater number of customers taking up the free meter option;
 - the cryptosporidium monitoring requirements placed upon your company by the Drinking Water Inspectorate (DWI); and
 - the effects of the loss of power to disconnect domestic customers for non-payment of charges.
3. Our initial assessment of your application and the counter notice is set out in summary terms below.

STAGE 1 – CONFIRMATION THAT THE CHANGED REQUIREMENTS ARE RELEVANT CHANGES IN CIRCUMSTANCE OR ARE COVERED BY SPECIFIC NOTIFIED ITEMS

Item 1 – Additional meter optants

4. A special notified item was set out in the 1999 price determination to protect the company from some of the implications of a greater number of customers taking up the free meter option than had been assumed by Ofwat.
5. We confirm that the rate of meter uptake is faster than we assumed in the final determination and has triggered the notified item.

Item 2 – Cryptosporidium - additional requirements for continuous monitoring

6. In 1999 the extent of the new requirements to deal with the risk from cryptosporidium was uncertain. Provision in price limits was only made for that work which had been identified and received technical support from the DWI. The outcome of risk assessments was not known, and hence no provision was made in price limits for any requirements to carry out continuous monitoring.
7. The DWI issued a notice dated 31 July 2000 under regulation 23A of The Water Supply (Water Quality) (Amendment) Regulations 1999 which set out the steps you must take to comply with the requirements of regulation 23B. The DWI has confirmed that the work set out in your application is necessary to meet your obligations under the cryptosporidium regulations.
8. We confirm that these cryptosporidium requirements qualify as a Relevant Change of Circumstance. We are content that the scale of the work set out in your

application is appropriate and additional to what has been assumed in price limits set in 1999.

Item 3 – Bad debt

9. A notified item was set out in the 1999 price limit determination to protect the company from the consequences of increased levels of bad debt and costs of debt recovery arising from the loss of the power to disconnect domestic customers.

10. We confirm that the increases in your bad debt and costs of debt have triggered the notified item.

Item 4 – Counter notice – Changes to the lead compliance programmes

11. Provision was made in price limits in 1999 for a work programme to deal with the new lead standards. This was based on a lead communication pipe replacement programme and plumbosolvency control. During the 1999 periodic review the DWI clearly stated that it would review the most effective means of delivering compliance after receiving further information from each company. Plumbosolvency control is now the preferred initial approach.

12. The DWI has confirmed that the provision for lead assumed in the final determination was only for the purpose of setting prices, and the revised statement of intent dated 30 March 2001 replaces the letter of support provided for the periodic review process. This statement of intent sets down that you are required to install plumbosolvency treatment at three sites, and investigate the need for treatment at another three sites.

13. We have taken advice from the DWI on the timescale of any subsequent lead communication pipe replacement which may be required. The effectiveness of plumbosolvency control will need to be assessed before it is possible to determine whether further action may be required to achieve full compliance with the lead parameter.

14. We consider that the change in the lead compliance programmes is a Relevant Change of Circumstance.

STAGE 2 – ASSESSING THE APPROPRIATE NET ADDITIONAL COSTS/REVENUE LOSSES ATTRIBUTABLE TO EACH CHANGE

Item 1 – Additional meter optants

15. We have carefully assessed the information contained in your application and, where appropriate, we have requested further clarification from both yourselves and the Reporter. Our assessment is set out below.

Numbers of optants

16. In assessing the evidence most weight has been attached to confirmed outturn information and the extent to which this indicates a divergence from the assumptions made in the final determination.

17. In the final determination we assumed that 10% of unmeasured water customers would choose to change to measured charging between April 2000 and March 2005. And that switching would follow a pattern whereby each year a constant proportion of the remaining unmeasured customer base took up the free meter option.

18. Your application presents evidence relating to confirmed free meters installed by the company up to September 2001. Your submission does not contain other evidence to support your projections of future meter optant numbers.

19. For the purpose of this draft interim determination we are required to take a forward-looking view of the likely uptake of optional metering for the remainder of the quinquennium. In doing so we have had regard to the high degree of sensitivity of calculations to alternative extrapolations.

20. We accept that the number of optional meters you have installed since April 2000 will have a material impact on the cost and revenue assumptions made for the 1999 periodic review. However, we do not agree with your projections for the future rate of uptake.

21. We have assumed that, in each remaining year of AMP3, 2.7% of your remaining unmeasured customers will take up the free meter option. In reaching this view we have taken account of your experience with a free meter option since 1997, and the apparent downward trend in meter requests.

22. Our revised projections of revenue also take account of variations between the level of meter optants assumed in the final determination for 1998-99 and 1999-2000 and the outturn numbers of meter optants during that period.

Meter optant characteristics

23. You have presented limited evidence to support your revised assumptions regarding the likely characteristics of meter optants, in terms of average rateable value, and average pre and post-switching consumption. This evidence relates to data collected from existing meter optants.

24. Our assumptions take account of your view on average post switching consumption and average meter optant rateable value to date. However, our projections assume that the average consumption of the remaining unmeasured customers with an incentive to switch will increase over time. The draft interim determination assumes that optant's pre-switching water delivered will be 60% of the average unmeasured household water delivered in 2000-01 rising to 68% by 2004-

05. In addition, we have continued to assume that those taking the free meter option will reduce their consumption by 5% on average.

Meter Unit Costs

25. For the capital cost of installing meters, we have used the same industry standard unit costs as at the 1999 final determination. We have assumed the mix of meter location adopted by the Competition Commission in its determination of price limits for Mid Kent Water and Sutton and East Surrey Water.

26. Your submission uses operating unit costs per meter based on a policy of four meter readings per year. We have examined other companies' meter reading policies and found that four readings per year is an outlier in terms of standard practice. You have not presented any evidence in support of a meter reading policy that involves such a high operating cost. We have continued to assume the unit operating costs adopted for the 1999 final determination.

Meter location

27. Ofwat has considered evidence put forward by the company regarding meter location, and taken account of the Competition Commission's opinion that the level of funding allowed in the 1999 final determination will have the effect of pushing companies towards an internal meter policy. Therefore the capital and operating cost allowances for meters have been calculated assuming that 23% of new meters will be installed in existing boundary boxes, and that 75% of the remaining new meters will be installed externally.

Item 2 – Cryptosporidium - additional requirements for continuous monitoring

28. You have chosen to deal with the requirements at three sites by carrying out continuous monitoring. The Reporter has commented that the decisions you have made are reasonable.

29. We have reviewed your projected costs for meeting the requirement for cryptosporidium monitoring and considered the Reporter's report. We have also looked more widely at experience elsewhere, and in particular at market prices for this type of work already included in price limits for other companies.

30. We consider that your submission of the additional operating costs of carrying out continuous monitoring for cryptosporidium are high in comparison with other companies. The operating costs for cryptosporidium monitoring should be broadly similar for all sites. Therefore our assessment has been based on the benchmark established elsewhere.

31. Continuous monitoring and testing for cryptosporidium is still in its infancy. It is reasonable to assume that as experience is gained there will be decreases in the unit costs of materials and increases in efficiency for this labour intensive procedure. We judge that a continuing efficiency of 2.5% per annum is a reasonable expectation.

32. We note that you revised your estimate of the additional capital investment associated with continuous monitoring in your response to our follow-up question. You included the 'up-front' contribution for laboratory equipment within the additional operating costs in your initial application. You transferred this cost to additional capital investment in your response to our question. In response to another question you state that a partial refund is being made on this 'up-front' contribution. Your Reporter gives the value of the refund.

33. After the adjustment to the associated capital costs, the residual capital costs were higher than the benchmark for the equipment to carry out continuous monitoring on site. The costs of installing cryptosporidium monitoring equipment should be broadly similar for all sites. Consequently we have reduced the costs by 75% of the difference between the adjusted company expenditure and the benchmark cost.

Ofwat's view of the likely costs of cryptosporidium monitoring

34. You assessed the net present value over 15 years of the operating costs and the capital costs of complying with the new requirement as £2.3m at September 2001 prices, with £0.94m net additional operating costs and £0.13m net additional capital costs incurred over the period to March 2005.

35. We assess the net present value over 15 years of these costs to be £1.57m, with £0.71m net additional operating costs and £0.08m net additional capital costs over the period to March 2005.

Item 3 – Bad debt

36. We have carefully assessed the information submitted in your application. Where appropriate we have requested further clarification from yourselves and your Reporter.

37. We accept your evidence that the level of debt and the operating costs of collecting debt have increased since the implementation of the Water Industry Act 1999.

38. You set out the changes to the company's procedures for recovering debt from customers. Prior to the Water Industry Act 1999 you used the threat of your power to disconnect domestic customers widely. You established contact with many non-paying customers as a result and obtained payment. Having lost this power, you now make increased use of other court procedures which do not secure payment or contact as quickly.

39. We accept that as a result of these changes it now takes the company longer to recover customer debt and that a financing cost arises from this.

40. You also set out that changes in your procedures have caused your operating costs to rise. This is largely through the necessity for an additional debt counsellor

and the wider use of third party agencies. We also accept that these costs have increased.

41. We have compared your costs and the level of debt which you have outstanding as a proportion of household revenue with figures for the rest of the industry. As both your costs and debt levels are low, we have not applied any benchmarking adjustments to your figures.

42. You have not claimed for any increase in capital expenditure.

43. You assessed the difference between your operating costs and financing of outstanding debt in 1998-99 and in 2000-1 to be £0.03m. We accept this calculation and assess the net present value over 15 years of the increased operating costs of collecting debt from customers and financing higher levels of outstanding debt as £0.32m in 2001 prices. The 15 year period begins in 2000-01 when the notified item took effect.

Item 4 – Counter notice – Changes to the lead compliance programmes

44. The letter of support from the DWI for the purpose of price setting, dated 10 March 1999, set down that provision should be made for the replacement of 1,797 lead communication pipes, and plumbosolvency control at Boughton, Llwyn Onn and Oerog Springs.

45. In your response to the lead counter notice, you include the costs of plumbosolvency treatment at Boughton and Llwyn Onn, and at Plemstall where investigations revealed the need to install first time treatment.

46. Although the installation of plumbosolvency treatment at Boughton and Llwyn Onn was assumed in the last price setting, you are now required to treat a greater volume of water than was previously assumed. Accordingly, our assessment is based on the expenditure necessary to treat the additional volume requirements for these works. And on the additional expenditure associated with the new requirement for plumbosolvency treatment at Plemstall.

47. We note that the requirement to install first time treatment at Oerog Springs has not yet been confirmed. At this stage we have assumed that this will still be necessary, and have not adjusted the provision made for plumbosolvency control at this site at the final determination. If further progress is made on the investigation, this will be incorporated into the interim determination in December.

48. We consider that your additional operating costs for plumbosolvency are high in comparison with other companies. Sufficient information is available to compare your estimate of the cost for plumbosolvency treatment with those of other companies. We have compared your cost estimate with cost information from other companies likely to have similar qualities of water to Dee Valley. The costs for the benchmark company have been compared with yours. As a result we have reduced your costs by 75% of the difference between your estimate and the benchmark.

49. We have assumed that future efficiencies of 1.4% a year are reasonable for plumbosolvency control operating costs.

50. We judge there to be uncertainty in the additional capital investment required to install plumbosolvency treatment at Plemstall, and have reduced your estimate by 10%. We have applied the same future efficiency assumption of 1.4% to capital expenditure.

Ofwat's view of the likely costs of changes to lead compliance programme

51. The DWI has confirmed that the formal statement of intent has replaced the letter of support which was provided only for the purposes of the periodic review. The final determination in 1999 included financial provision for dealing with the lead parameters, some of it linked for the purpose of the review to a programme of lead communication pipe replacement. No lead communication pipe replacement has yet been confirmed by the DWI, and the timescale and extent of any such replacement is not yet known. We have considered separately the costs of complying with the programme now confirmed by the DWI and the savings arising from the changed work programme.

52. The net present value over 15 years of the operating costs and the capital costs additional to those assumed at the 1999 price setting for plumbosolvency control, put forward by the company, of installing plumbosolvency control was £1.17m, with £0.28m net additional operating costs and £0.28m net additional capital costs over the period to March 2005.

53. We assess the net present value of these costs to be £0.50m, with £0.11m additional operating costs and £0.19m additional capital costs over the period to March 2005.

54. The allowance in price limits for lead communication pipe replacement has been offset. The net present value of this is £0.90m.

55. You considered the net effect of these two changes and estimated the net present value over 15 years of the additional operating and capital costs to be £0.10m.

56. For the purposes of calculating materiality we have considered these changes as two separate amounts of costs and savings, as set out in your licence.

STAGE 3 – MATERIALITY TEST – IN AGGREGATE DOES THE SUM OF ALL THE CHANGES EXCEED THE MATERIALITY THRESHOLD SET DOWN IN THE LICENCE?

57. Condition B of the licence sets a materiality threshold for consideration of interim determinations. If the present value of the net additional costs and revenue losses (calculated up to the start of the next charging period for capital costs and over 15 years for operating costs and revenue losses) arising from the changes is greater than 10% of the turnover of the Appointed Business in the latest financial

year for which accounting statements have been delivered to Ofwat, then a revision of price limits is triggered.

58. Our analysis, based on the revised assumptions set out above, are summarised in Annex A. This shows that the materiality threshold has been satisfied.

STAGE 4 – IMPLICATIONS FOR PRICE LIMITS IF THE MATERIALITY THRESHOLD IS EXCEEDED

59. Because the materiality threshold is exceeded we are required by Condition B of your licence to review and revise your price limits. Our provisional assessment of your company's application is that the price limits for the charging years 2002-03 to 2004-05 should be revised as set out in the table in Annex A.

60. We propose to adopt the symmetrical notified item model used by the Competition Commission, together with the new projections of meter optants as amended by the numbers set out in Annex A. The licence modification and revised notified item are attached at Annex C.

DRAFT

WATER INDUSTRY ACT 1991 s.13(1) MODIFICATION OF CONDITION B OF THE CONDITIONS OF APPOINTMENT OF []

Made on []
Coming into effect on [1 April 2002]

1. In Condition B, in place of paragraph 13.2(6) there shall be inserted –

“13.2(6)(a) where any Base Cash Flows under (5) consist of items to which (b) below does not apply, what is the Net Present Value of those Base Cash Flows calculated up to the start of the first of the Charging Years for which the next periodic review falls to be carried out;

(b) where any Base Cash Flows under (5) consist of¹ revenue and/or Operating Expenditure, what is the Net Present Value of those Base Cash Flows calculated over 15 years –

and what is the aggregate of those Net Present Values calculated under (a) and (b) (“**the Materiality Amount**”);”.
2. Paragraph 12.3 (Definitions of Costs and Receipts in paragraph 13 and in the definition of a ‘Relevant Change of Circumstance’) shall be amended as follows –
 - (i) after the semicolon at the end of (1), delete “and”; and
 - (ii) at the end of (2), delete the full stop and insert –
“;and

(3) without prejudice to subparagraph (1) above, “Operating Expenditure” in subparagraph 13.2(6) includes those items currently so identified in Regulatory Accounting Guidelines 3 and 4 and in the July Return 1999 Reporting Requirement, line 22 in table 21 and line 23 in table 22. For the avoidance of doubt, depreciation, the write-down/off of assets, the profits/loss on disposal of assets and infrastructure renewals expenditure or charges are excluded.”.

Philip Fletcher

¹Deletion of the words ‘loss of’ from previous version

NOTIFIED ITEM

For the purpose of this determination Ofwat has assumed that the cumulative increase in the numbers of measured household customers arising from the exercise of the free meter entitlement under s.144A(1) of the Water Industry Act 1991 will be as specified for each year in the following table.

Numbers of Household Meter Optants between 1 October 2001 and 30 September in the Year		
2002	2003	2004
2,007	3,958	5,857

Any difference between the assumed cumulative number and the actual, cumulative number at 30 September in the year in question is a notified item.

The costs attributable to the notified item shall be interpreted to comprise:

- (i) the difference in capital expenditure to be attributed to the provisions and installation of a different number of meters;
- (ii) the difference in annual operating expenditure to be attributed to the provision of measured charging for a different number of customers;
- (iii) the extent to which annual revenues accruing to the company from standard charges are different as a result of the cumulative number of household optants varying from the numbers specified above.

1 November 2001