

Mr A Parsons  
Managing Director  
Bristol Water Plc  
PO Box 218  
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Bristol  
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14 December 2007

Dear Alan

### **13.2 INTERIM DETERMINATION – decision**

On 14 September 2007 Bristol Water plc made an application for an interim determination of its price limits under Part IV of Condition B of the licence. Your Reporter, Wendy Staden of Atkins and your Auditor, Stuart Woodward of Deloitte & Touche, submitted their reports on your application on 19 September 2007 and 18 September 2007, respectively.

Your application covered the additional costs and/or loss of revenue resulting from the following three items:

- a greater number of customers taking up the free meter option than was allowed for in the 2004 final determination (Notified Item);
- increases in bad debt and the costs of managing bad debt (Notified Item); and
- increases in charges for abstractions from and discharges to controlled waters (Notified Item).

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

We sent you our provisional decision on 5 November. You sent us your representations on 15 November. We have considered your representations and those of CCWater Western. We received no other representations.

You made a number of specific points relating to bad debt and the costs of managing bad debt. You reiterated your view that your proposed approach was more appropriate than our existing methodology but, pragmatically, accepted our position.

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You suggested that we should not apply efficiency assumptions to abstraction charges as these costs were unavoidable. You also provided further information on outturn meter optant numbers and questioned whether the Notified Item allowed us to update data in years prior to 2005-06 as part of the interim determination.

However, you said that you were willing to accept our provisional decision given consideration of affordability for customers.

CCWater Western raised a number of points specific to your determination. It felt that we should not make a greater allowance for bad debt than you requested in your application. CCWater Western asked whether the forecast meter uptake should be lower than we assumed in 2008-09 and 2009-10 because K factors for both Bristol Water and Wessex Water Services (which supplies sewerage services to your customers) reduce markedly in these years.

We have considered these representations in reaching our final decision on your application. Annex A sets out the impact of our decisions on your application. Our approach, judgements and conclusions are summarised in Annex B attached to this letter. We have also provided you with some confidential explanatory notes expanding on Annex B.

Our final decision retains the key elements of our provisional decision. We have continued to:

- disallow costs associated with a change in meter location mix;
- use our established methodology for calculating costs associated with increases in bad debt; and
- use 'reprofiled' levels of household debt written off which are intended to reflect a more 'typical' level of write-offs.

However, we have revised forecast meter optant data to take into account the actual number of meter optants for September 2007. We have continued to update data in years prior to 2005-06 when we calculate costs associated with meter optants. We believe this is appropriate within the terms of your licence and is consistent with our publicly stated approach at previous interim determinations. We have not adjusted meter optant forecasts in the manner suggested by CCWater Western because the evidence does not suggest that the rate of uptake is sensitive to such changes in K factors.

Although we fully understand CCWater Western's concerns in relation to bad debt, it would not be appropriate to follow the approach they advocate. We need to ensure that our approach to interim determinations is consistent and predictable. Such an approach would be a departure from the methodology we have applied to other companies who have submitted a claim under this Notified Item.

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You suggested that it was not appropriate to apply efficiency assumptions to abstraction charges. We do not accept this argument. Our approach is consistent with our policy at the 2004 final determination where efficiency factors were applied to total operating costs.

CCWater Western noted that as Bristol Water was now part of a much wider group the cost of capital should no longer include an allowance for the small company premium.

In 'Setting price limits for 2010-15: Framework and approach – a consultation paper' we have said that going forwards we doubt the need for a small company premium within the cost of capital.

We thought carefully about the appropriate cost of capital to apply to your application even though the capital element of your application is very small. There are indications that the cost of capital may be lower than when it was last set at the 2004 final determination. However, we note that we are only halfway through the five year period. For this year we have decided to use a cost of capital consistent with that assumed at the 2004 final determination. We may however revise the cost of capital for future interim determinations if we feel this to be necessary.

Our assessment is that 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 in Annex A will apply from April 2008.

Both your representation and CWater Western's favoured smoothing the K profile (to provide a more stable profile). Our decision reflects these views. Our final K profile, set out below has been smoothed. We have ensured that you receive no more revenue than you would have done from an unsmoothed profile.

In calculating revised price limits we have used the calculation set out in Condition B of your licence. This produced an unsmoothed K profile of 4.6 in 2008-09 and of -1.9 in 2009-10. Following smoothing your final revised K profile is 3.6 in 2008-09 and 0.0 in 2009-10.

In the 2004 final determination we anticipated that the average household bill would reduce by £2 in real terms between 2007-08 and 2009-10. The revised price limits mean that average household bills will increase by £3 in real terms over the same period.

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

This letter and enclosures have been copied to Martin Hurst (DEFRA), Jeni Colbourne (DWI), Tricia Henton (EA) and Tony Smith (CCWater).

Yours sincerely

**Regina Finn**  
**Chief Executive**

## Annex A

**BRISTOL WATER PLC**  
**INTERIM DETERMINATION – Autumn 2007 – SUMMARY TABLE**

Description	Company's Assessment (September 2007)	Ofwat's Assessment (December 2007)	
<b>Item 1 – Additional meter optants</b>			
1.1	Estimated net change in <b>capital expenditure</b> over the period 2005-10	£3.7m	£2.2m
1.2	Estimated net change in <b>operating expenditure</b> over the period 2005-10	£0.3m	£0.3m
1.3	Estimated loss in <b>revenues</b> over the period 2005-10	£2.1m	£1.9m
1.4	<b>Materiality amount</b> (NPV of total net change in costs)	<b>£11.1m</b>	<b>£8.9m</b>
1.5	Contribution towards <b>materiality threshold</b>	13.3%	10.6%
<b>Item 2 – Increases in bad debt and the costs of managing debt</b>			
2.1	Estimated net change in bad debt and the costs of managing debt over the period 2005-10	£2.4m	£2.9m
2.2	<b>Materiality amount</b> (NPV of total net change in costs)	<b>£5.7m</b>	<b>£6.4m</b>
2.3	Contribution towards <b>materiality threshold</b>	6.8%	7.7%
<b>Item 3 – Charges for abstractions</b>			
3.1	Estimated net change in <b>operating expenditure</b> over the period 2005-10	£1.6m	£0.5m
3.2	<b>Materiality amount</b> (NPV of total net change in costs)	<b>£3.9m</b>	<b>£1.1m</b>
3.3	Contribution towards <b>materiality threshold</b>	4.7%	1.3%
<b>OVERALL ASSESSMENT</b>			
4	<b>Materiality amount</b> (NPV of total net change in costs)	<b>£20.7m</b>	<b>£16.4m</b>
5	Bristol Water turnover for 2006-07 used in materiality test	£83.6m	£83.6m
6	<b>Materiality test</b>	<b>24.8%</b>	<b>19.6%</b>

<b>PRICE LIMITS</b>		2005-06	2006-07	2007-08	2008-09	2009-10
7	<b>Current price limits</b> (as set in December 2004)	13.8	2.8	1.5	0.7	-2.3
8	<b>Revised price limits</b>	13.8	2.8	1.5	3.6	0.0

- Notes:**
- Additional costs are shown as positive, savings and revenue gains are shown as negative.
  - The appropriate discount rate used is 8.21%.
  - Materiality test** – Result must be greater than  $\pm 10\%$  to trigger a change in price limits.
  - All monetary values are stated in September 2007 prices. Totals may not add due to rounding.
  - Bristol Water proposed a different methodology for calculating the increase in bad debt costs, which Ofwat has not accepted (item 2). A direct comparison between Bristol Water's application and Ofwat's assessment is therefore not possible.

**Bristol Water plc**  
**Interim determination – autumn 2007**  
**Summary of Ofwat’s 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 (Notified Item);
  - increases in bad debt and the costs of managing bad debt (Notified Item); and
  - increases in charges for abstractions from and discharges to controlled waters (Notified Item).
3. Our assessment of your application is summarised below.

**Stage 1 – Confirmation that the changed requirements are Relevant Changes in Circumstances or are covered by specific Notified Items**

**Item 1 – Additional meter optants**

4. A Notified Item was set out in the 2004 price limit determination to take account of the uncertainty in the number of customers likely to take up the free meter option.
5. We confirm that the rate of meter uptake is greater than we assumed in the 2004 final determination and has triggered the Notified Item.

**Item 2 – Bad debt**

6. A Notified Item was set out in the 2004 price limit determination in recognition of the uncertainty in future levels of bad debt and costs of debt management.
7. We confirm that the increases in your bad debt and costs of debt management have triggered the Notified Item.

**Item 3 – Increases in charges for abstractions from and discharges to controlled waters**

8. A Notified Item was set out in the 2004 price limit determination to take account of the uncertainty in the charges to be levied by the Environment Agency and British Waterways for abstractions from and discharges to controlled waters.
9. We confirm that the charges levied are greater than we assumed in the 2004 final determination and have triggered the Notified Item.

## Counter-notices

10. We did not identify any counter-notices.

## Stage 2 – Assessing the appropriate net additional costs/revenue losses attributable to each change

### Item 1 – Additional meter optants

11. 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

12. In assessing the evidence, we have attached most weight to confirmed outturn information and the extent to which this indicates a divergence from the assumptions we made in the final determination.
13. In the final determination we accepted your forecast of optional metering and included a total of 18,511 optional household meters for 2005-10.
14. Your application and subsequent representations present evidence relating to the actual number of free meters installed by the company up to September 2007.
15. For the purpose of this 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 fact that the calculations are highly sensitive to alternative extrapolations.
16. You have forecast that 30,703 customers will opt for a free meter during the 2005-10 period. This is based on actual experience to date, with the average switching rate for 2005-06 to 2006-07 projected forward. This results in an average annual rate of metering over the 2005-10 period of 1.9% of the unmeasured base. Your estimates of the future rate of uptake appear reasonable as revised by your latest experience of meter optants in September 2007.
17. CCWater Western asked whether the uptake should be lower than we assumed in later years because K factors for both Bristol Water and Wessex Water, which supplies sewerage services to your customers, reduce markedly for these years. However, econometric analysis indicates that the level of the bill, rather than the K factor, is the driver for customers to opt. The level of the bill in 2009-10 will be higher, because of the increase in K in 2008-09. CCWater Western also sought assurance that we would monitor your future progress on optional metering against these new assumptions. We will do this.

18. We accept that the number of optional meters you have installed since April 2005 will have a material impact on the cost and revenue assumptions made for the 2004 final determination.
19. We have taken account of the difference between the level of meter optants we assumed in the final determination for 2003-04 and 2004-05 and the outturn numbers of meter optants during that period.
20. You suggested that the Notified Item did not allow us to do this. We believe that our approach is consistent with the terms of your licence.

**Meter optant characteristics**

21. You have stated that the actual characteristics of optants differ only slightly from those forecast at the 2004 final determination, and have therefore chosen to adopt the 2004 final determination figures. We continue to believe that these assumptions remain appropriate.

**Meter unit costs**

22. For the capital cost of installing meters, we have used the same unit costs and mix of meter location as at the 2004 final determination, which was based on data in your 2004 business plan.
23. Your application applied the same unit operating costs as assumed for the 2004 final determination. We continue to believe that these assumptions remain appropriate.

**Meter location**

24. We considered the evidence you put forward in relation to meter location. We have maintained the assumptions on meter location at the levels assumed in the 2004 final determination where we accepted your proposed location mix of 50% external meters and 50% internal. We note that it was a policy decision by you to install a greater proportion of external meters than you had proposed in your business plan in 2004. We do not believe that customers should have to fund additional costs due to this change in approach. We also remain unconvinced that any proposed savings in operating costs resulting from the change to a more external meter focused policy is at least as great as the associated capital cost.

**Item 2 – Bad debt**

25. In your application you explained that despite undertaking debt management activities in an efficient and cost effective manner, you have experienced an increase in bad debt. You explain that the increase relates in general terms to the disadvantageous conditions under which you are required to operate.
26. We carefully assessed the information submitted in your formal application and supplementary paper "Additional information on bad debts" and where appropriate requested further clarification from yourselves and your Auditor.

27. In your submission you challenged the approach that Ofwat uses to assess changes in the level of unrecoverable revenue. You calculated the increases using changes in the levels of residual debt, rather than our established methodology which considers changes to the level of household revenue written off. Whilst your representation to our provisional decision reiterated your view that your proposed approach was "robust and pragmatic", you understood our preference to retain the existing methodology.
28. Therefore, the final determination is based on the same methodology as used in our provisional response (ie based on write-offs).
29. Write-offs are definitive and final amounts that have been formally recognised by the company as unrecoverable. Residual debt, whilst based on historical experience, can change over time. The Notified Item we allowed for bad debt is a one-way item, which means that we cannot recover any increases allowed in residual debt, which may be recovered by the company subsequently.
30. Our methodology also allows companies to recover the financing costs of carrying any increased levels of revenue outstanding. This ensures that companies are compensated for any loss of cash flow and reduces the incentive for companies to write-off debt prematurely.
31. In your application you explained that the trends in your levels of write-offs were distorted because you had undertaken a specific exercise to clear unrecoverable debt when you moved to joint billing. At our request you resubmitted data, reprofiling write-offs between years to reflect more 'typical' levels of write-offs. We acknowledge that the exercise undertaken was a theoretical assessment of what the trends *would* have been in a more steady-state environment. Having considered the work undertaken, we accept that whilst the numbers are not "actuals", they have been calculated in a logical and robust manner.
32. We have assessed your claim using our established methodology, set out in RD 12/01 and subsequently used in five previous interim determinations. This calculates the net increase of:
  - loss of revenue (defined as household revenue written off);
  - financing costs associated with increases in household revenue outstanding; and
  - debt management costs.

It also considers any capital expenditure incurred directly on debt management systems.

33. We have applied our methodology in a consistent manner with previous determinations and in line with our provisional decision. This has resulted in a slightly higher amount for bad debt costs than included in your application.

CCWater Western suggested that the allowance awarded for bad debt costs should be capped at the level included in your submission. We understand their concern that by not doing so, customers will view the company as gaining more than they requested.

Having considered CCWater Western's views, we believe that it would not be appropriate for us to take such action. In the long term customers benefit from regulation that is consistent and predictable. When setting price limits it would not be good practice to deviate from our established methodology.

34. We have calculated changes in loss of revenue and financing costs using your re-profiled numbers. We have used outturn prices rather than adjusting the numbers in each year to the same price base as set out in your application. This has resulted in an allowance for loss of revenue and financing costs which is slightly higher than the amount included in your application.
35. Debt management costs reported in 2005-06 and 2006-07 are lower than those reported in 2003-04. You explain that this is due to the investment in the joint billing company with Wessex Water Services and the efficiencies that have subsequently been made in consolidating the previously separate debt activities. We note the point you raised in response to our provisional decision and acknowledge that references to staffing numbers included in your submission relate to the total position for dealing with both Wessex Water Services and Bristol Water debt.
36. To calculate the change in debt management costs we have inflated all numbers to a constant price base and applied efficiency assumptions at a rate of 2.49% p.a. This is consistent with the 2004 final determination assumptions for your company and includes both continuing and catch-up efficiency.
37. The cost savings that have been made in this respect have been offset against the increases in write-off and financing costs.

CCWater Western suggested that in order to give companies an incentive to improve debt recovery performance that future assumptions on the level of bad debt costs should be reduced.

However, the level of debt management costs reported since 2003-04 have reduced and as explained earlier, this reduction has already been taken into account to offset increases in other areas of the calculation. Additionally our current methodology assumes that write-off and financing costs will be maintained at 2006-07 levels and will not increase. We believe this approach provides a strong incentive on companies to manage bad debt.

Therefore we have not altered our existing methodology (as used in our provisional decision) to include reductions in costs going forward.

38. You did not include additional capital expenditure costs in your claim. We have not made any allowance in this respect.

39. We explained in MD224 that when considering a claim under the bad debt Notified Item we would consider the broad consistency in the movement between key debt measures since 2003-04. We have also compared your debt levels and debt management costs with other water only companies.
40. This showed that your debt management costs were significantly below the water only company average, whilst your revenue outstanding as a proportion of revenue billed was around average.
41. Your submission provided evidence which you believed demonstrated that your debt management is undertaken in an efficient and cost effective way. You confirmed that whilst debt management costs have reduced since 2003-04 this is due to efficiencies made rather than a reduction in activity. As an example, since 2003-04 the number of staff involved in debt management (across the joint billing company) has increased from 33 to 59.
42. Finally, you included evidence to demonstrate that you operate in disadvantageous conditions compared to other service providers. For example you compared household and non-household debt levels to illustrate how the domestic disconnection ban has affected you. You provided evidence from debt advice agencies that confirms that indebted clients will typically be aware of the disconnection ban, and a comparison with debt levels in the energy sector.
43. Having considered the evidence we accept that the amount of household debt that the company is unable to collect has increased, and that where debt is recovered it can take longer to do so. We accept that this is despite your best efforts in debt management which you have undertaken in an efficient and cost effective manner.
44. You provided evidence to show how you have managed your debt collection processes. This included for example, increasing the use of direct debit as a payment option and increasing the number of staff employed in debt related activity.
45. We also accept that the increase in bad debt has arisen due to the disadvantageous conditions under which you are required to operate. You provided evidence to demonstrate this such as information on the pockets of high income deprivation within your operating area, comparison between non-household and household recovery rates and letters from advice agencies which show that many customers with multiple debts are aware that companies no longer have the power to disconnect for non-payment.
46. Further information on how we have assessed your claim and the basis of costs included is provided in the confidential explanatory notes.

**Item 3 – Increases in charges for abstractions from and discharges to controlled waters**

47. When we set price limits in 2004 we assumed that there would be no real increase in unit rates for abstraction charges above those reported in 2003-04. In our assessment, we have compared your actual costs of abstraction licenses obtained from the invoices you provided to the costs included in our price determination.
48. We have excluded the costs of licenses no longer held from our analysis.
49. We have applied efficiency assumptions to your actual reported costs and the costs included in the 2004 final determination at a rate of 2.49%. This is equivalent to the continuing and catch-up efficiency assumptions applied at the 2004 final determination.
50. We consider our approach of applying efficiency appropriate, as we apply efficiency to the whole of base operating expenditure at the 2004 final determination, which includes abstraction charges. In previous interim determinations, which included British Waterways' charges, we applied efficiency and catch-up assumptions in the same way. CCWater Western supports our approach.

**Stage 3 – Materiality test – in aggregate does the sum of all the changes exceed the materiality threshold set down in the licence?**

51. 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.
52. Our analysis, based on the revised assumptions set out above, is summarised in Annex A. This shows that the materiality threshold has been exceeded.

**Stage 4 – Implications for price limits if the materiality threshold is exceeded**

53. 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 2008-09 and 2009-10 should be revised as set out in the table in Annex A.