

Mr B Bellis
Managing Director
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14 December 2007

Dear Bryn

13.2 INTERIM DETERMINATION – decision

On 11 September 2007 Dee Valley Water plc made an application for an interim determination of its price limits under Part IV of Condition B of the licence. Your Reporter, Nigel Kent of Montgomery Watson Harza and your Auditor, Simon Venables of KPMG, submitted their reports on your application on 11 September 2007 and 18 September 2007, respectively.

Your application covered the additional costs and/or loss of revenue resulting from the following four 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);
- increases in charges for abstractions from and discharges to controlled waters (Notified Item); and
- additional expenditure for the protection of assets (Relevant Change of Circumstances).

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 and we discussed these at our formal meeting on 30 November. We have considered your representation and those of CCWater Wales. We received no other representations.

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You argued that we should have used either all your revised meter optant consumption data or none at all. You felt that using an alternative approach which used some elements of the revised data was inappropriate. You provided revised data for household debt written off and set out your view as to why we should make an allowance for debt management costs. You accepted our proposals on charges for abstraction and discharges and the protection of assets.

CCWater Wales was unconvinced that your wider financial position warranted an application for an interim determination. It felt it was more appropriate for any variance from the 2004 final determination to be dealt with as part of the 2009 determination. CCWater Wales supported our decision not to allow costs that we were not convinced were robust.

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:

- Continues to disallow increases in debt collection costs arising from the termination of a collection agreement with Wrexham County Borough Council. Despite your further arguments we are not convinced that you could demonstrate that the increased costs relate solely to your circumstances as a water undertaker.
- Allows for net changes in household debt written off, disallowed in our provisional decision. Since our provisional decision you submitted data for write-offs which we consider to be more representative of the likely levels of household bad debt written off in 2003-04.
- Includes changes to metering data disallowed in our provisional decision. Since our provisional decision you have provided us with further information on the proposed changes. Your Reporter has also provided more details in response to our questions. However, we have modified your proposed changes. We believe that your assumptions did not fully account for the likely reduction in the number of council tenants who will switch.

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 we 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.

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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 CCWater Wales' suggested that you would prefer that the K profile was not smoothed because of the impact on the average household bill at the end of the period.

However, when we met on 30 November you explained that if we were to accept your arguments and, consequently, price limits increased above the levels set down in our provisional decision, you would not wish to ask customers to pay more than around 5% in real terms, in 2008-09. We are also mindful that, in reaching its view on K smoothing, CCWater Wales could only reach its view based on our provisional decision, not our final decision.

An alternative to smoothing the K profile would be for you to defer a proportion of K in 2008-09, to be used in 2009-10. However, such an approach would be less transparent for customers than if we smoothed K factors as part of the interim determination process. Taking all factors into account we have therefore decided to undertake a limited amount of smoothing to your K factors. We have ensured that you receive no more revenue than you would have done from an unsmoothed profile.

In calculating the revised price limits we have used the calculation set out in Condition B of your licence. This produced an unsmoothed K profile of 5.8 in 2008-09 and of -0.3 in 2009-10. Following smoothing your revised K profile is 5.0 in 2008-09 and 1.3 in 2009-10. In the final determination in 2004 we anticipated that the average household bill would not change in real terms between 2007-08 and 2009-10. The revised price limits mean that average household bills will increase by around £4 in real terms over the same period.

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

This letter and enclosures have been copied to Claire Bennett (Welsh Assembly Government), Jeni Colbourne (DWI), Tricia Henton (EA) and Tony Smith (CCWater).

Yours sincerely

Regina Finn
Chief Executive

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Ofwat – Protecting consumers, promoting value and safeguarding the future

DEE VALLEY WATER
INTERIM DETERMINATION – Autumn 2007 – SUMMARY TABLE

Description	Company's Assessment (September 2007)	Ofwat's Assessment (December 2007)	
Item 1 – Additional meter optants			
1.1	Estimated net change in capital expenditure over the period 2005-10	£0.7m	£0.7m
1.2	Estimated net change in operating expenditure over the period 2005-10	£0.1m	£0.2m
1.3	Estimated loss in revenues over the period 2005-10	£1.1m	£1.0m
1.4	Materiality amount (NPV of total net change in costs)	£4.5m	£4.3m
1.5	Contribution towards materiality threshold	24.4%	23.4%
Item 2 – Increases in bad debt and the costs of managing debt			
2.1	Estimated net change in bad debt and the costs of managing debt over the period 2005-10	£0.8m	£0.2m
2.2	Materiality amount (NPV of total net change in costs)	£2.0m	£0.7m
2.3	Contribution towards materiality threshold	11.0%	3.6%
Item 3 – Charges for abstractions and discharges			
3.1	Estimated net change in operating expenditure over the period 2005-10	£0.3m	£0.3m
3.2	Materiality amount (NPV of total net change in costs)	£0.9m	£0.8m
3.3	Contribution towards materiality threshold	4.9%	4.1%
Item 4 – Protection of assets			
4.1	Estimated net change in capital expenditure over the period 2005-10	£0.7m	£0.6m
4.2	Estimated net change in operating expenditure over the period 2005-10	>£0.1m	-
4.3	Materiality amount (NPV of the net change in costs)	£0.7m	£0.5m
4.4	Contribution towards materiality threshold	3.6%	2.9%
OVERALL ASSESSMENT			
5	Materiality amount (NPV of total net change in costs)	£8.1m	£6.3m
6	Dee Valley Water turnover for 2006-07 used in materiality test	£18.5m	£18.5m
7	Materiality test	43.8%	34%

PRICE LIMITS		2005-06	2006-07	2007-08	2008-09	2009-10
9	Current price limits (as set in December 2004)	5.7	-1.4	0.2	0.6	-0.7
10	Revised price limits	5.7	-1.4	0.2	5.0	1.3

Notes:

1. Additional costs are shown as positive, savings and revenue gains are shown as negative.
2. The appropriate discount rate used is 4.81%.
3. **Materiality test** – Result must be greater than $\pm 10\%$ to trigger a change in price limits.
4. All monetary values are stated in September 2007 prices. Totals may not add due to rounding.

Dee Valley 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 four 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);
 - increases in charges for abstractions from and discharges to controlled waters (Notified Item); and
 - additional expenditure for the protection of assets (Relevant Changes in Circumstances).
3. Our initial 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.

Item 4 – Protection of assets

10. Since the 2004 price limit determination, the Welsh Assembly Government has issued guidance which clarifies the level of work required during 2005-10 to ensure the ongoing protection of assets. This work was not anticipated in your business plan for 2005-10, and was accepted by Ofwat as additional work under the Change Protocol on 10 July 2007. This is a Relevant Change of Circumstances.

Counter-notices

11. 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

12. 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

13. 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.
14. In the final determination we did not accept your forecast of optional metering for households. Instead we made judgements based on the statistical evidence available to us and provided for 9,384 optional meters for the period 2005-10.
15. Your application presents evidence relating to confirmed free meters installed by the company up to September 2007.
16. 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.
17. You have forecast that 12,647 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 2002-03 to 2006-07 projected forward. This results in an average annual rate of metering over the 2005-10 period of 3.9% of the unmeasured base. Your estimates of future rates of uptake appear reasonable.
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 at the 2004 final determination.

19. Our projections of revenue also take account of differences between the level of meter optants assumed in the final determination for 2003-04 and 2004-05 and the outturn numbers of meter optants during that period.

Meter optant characteristics

20. In your application you 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 comprised data collected from existing meter optants. Since then, both you and the Reporter have provided further clarification about post-consumption figures.
21. In your representations you argued that pre-switching consumption was linked to post-switching consumption. You had completed your application based on observations from households in your unmeasured consumption monitor that had opted to have a meter. We have maintained the same assumption as in your application that pre-switching consumption is a proportion of post-switching consumption. This does not have a material impact on our determination.
22. We have retained your assumption about the level of post-switching demand for 2005-06 that you originally submitted in your application. For 2006-10 we have taken into account your expectation that there will be a lower proportion of meter optants from low consumption, low RV council properties. You forecast that the average RV of meter optants would increase as the proportion of low RV properties reduced. However, we believe that this expectation should equally apply to the consumption of meter optants. We have therefore assumed that the relative difference in consumption between council tenant meter optants and other meter optants will remain constant, although consumption for both groups of optants will increase in line with average unmetered household consumption.

Average household demand after optionally metered (l/prop/d)					
	2005-06	2006-07	2007-08	2008-09	2009-10
Company interim determination submission	203	203	204	204	205
Ofwat assumption for final interim determination	203	200	207	212	216

Average household demand before optionally metered (l/prop/d)					
	2005-06	2006-07	2007-08	2008-09	2009-10
Company interim determination submission	325	325	326	327	328
Ofwat assumption for final interim determination	325	318	330	338	344

Meter unit costs

23. We cannot reconcile your profile for additional capital expenditure with your stated unit cost. For the capital cost of installing meters, we have used the same unit costs and mix of meter location as assumed in your submission and at the 2004 final determination.

24. Your application states that you have adopted the same unit operating costs assumed for the 2004 final determination. We cannot reconcile your additional operating expenditure profile with this unit cost. We have used the same unit operating cost as at the 2004 final determination and we continue to believe that these assumptions remain appropriate.

Meter location

25. Your submission adopts the same assumptions on meter location as assumed in the 2004 final determination where we accepted your proposed location mix of 83% external meters and 17% internal. We see no reason to deviate from this.

Item 2 – Bad debt

26. In your application (dated 11 September 2007) you explained that bad debt levels and associated debt management costs had increased significantly, primarily due to the transfer of Wrexham County Borough Council (WCBC) tenants to direct billing.
27. We carefully assessed the information submitted in your application. Where appropriate we requested further clarification from yourselves and your Auditor.
28. The approach adopted in your submission followed Ofwat's established methodology first set out in RD12/01 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.
29. It also considers any capital expenditure incurred directly on debt management systems.
30. Numbers included in your submission differed from those included in your 2007 June return in all areas. Consequently we sent you a number of queries so that we could understand these differences. Where necessary we sought confirmation from your Auditor. Where appropriate, we accepted the data changes and amended your June return to reflect this.
31. Because of the data changes, and because we felt that you failed to demonstrate that bad debt costs had risen due to the disadvantageous conditions in which you are required to operate, after detailed consideration, our provisional decision excluded two of the three elements requested in your claim.

32. Your representation to our provisional decision provided further information to support your claim, including re-profiled write-off data and additional arguments explaining why you believed that the debt management costs element should be included.
33. We have considered your representation and also comments received from CCWater Wales. We set out our final decision below.
34. Financing costs associated with revenue outstanding have been included using the same methodology as our provisional response. Your submission restated 2006-07 data to include revenue outstanding under payment plans which allowed us to compare it to 2003-04 revenue outstanding data. In response to our provisional decision you provided revised information on the level of revenue outstanding in 2003-04. This reflected the effect on revenue outstanding of the reprofiled write-off data. As a result of this change, the 2003-04 total household revenue outstanding used in our calculation reduced from £1.166m to £1.004m.
35. We have applied our methodology in a manner consistent with previous determinations. This has resulted in a slightly higher amount for this element than included in your application.
36. Firstly, the interest rate we have used is based on the pre-tax cost of capital for your company, which is higher than the rate included in your calculations.
37. Secondly, our calculation was based on outturn prices. The net effect of this is that the financing cost is higher than the amount included in your application.
38. Your representation on our provisional decision accepted this element of our calculation.
39. The increase in household revenue written off was not included in our provisional decision. This was because we were not convinced that the data was robust. You were also unable to explain the extent to which debt written off in 2004-05 as part of a 'catch up' exercise should have been written off in previous years.
40. In response to our provisional decision you provided information which re-examined the 2004-05 write-offs and allocated these to previous years. This re-profiled data showed what the level of write-offs would have been had it not been for the suspension of write-offs caused by the implementation of the new billing system in 2003-04.
41. The methodology used to re-profile write-offs is sensible and has been confirmed by your Auditor. As we consider the revised write-off data to be more representative of the likely levels of household bad debt written off in 2003-04 we have allowed this element of your claim in our final decision.

42. Debt management costs initially reported in 2005-06 and 2006-07 were lower than those reported in 2003-04. You explained that this was due to the way in which the WCBC commission was reported. Your submission explained how the figures had been re-calculated and requested the restatement of 2003-04 debt operating costs to exclude the element of commission relating to non-debt related activity.
43. As a result of this data change, debt collection costs in 2003-04 reduced by around £130k. Comparing the restated numbers showed that there had been an increase in costs.
44. However, these costs were excluded from our provisional decision as we felt that the termination of an agreement or contract (such as the one you had with WCBC) is a risk that all companies face, and cannot be considered to relate to disadvantageous conditions specific to the water industry.
45. In response to our provisional decision you explained that despite the transfer of Wrexham tenants to direct billing being well managed, that debt levels increased and that this can only be attributable to the false belief by WCBC tenants that their water charges were part of the rent and that if they were unpaid it could lead to eviction. As you are not able to withdraw the water service for the non-payment of bills these tenants are choosing not to pay. Therefore, you argued that the inability to disconnect is a disadvantageous condition under which you are required to operate when compared to other service providers.
46. Additionally you argued that the savings made by no longer paying commission to WCBC have been utilised in other areas of customer service and provided data to show that your total customer service costs increased between 2003-04 and 2006-07.
47. Having considered your representation we continue to believe that termination of the agreement is a normal business risk. We do not believe that sufficient evidence has been included to demonstrate that the increased costs relate solely to your circumstances as a water undertaker.
48. Neither do we feel that sufficient detail has been provided to show where the savings gained from the termination of the agreement have been utilised. Due to the wide range of activities included within customer service costs the increase discussed in your representation could be due to a number of reasons unrelated to debt management or the termination of the agreement.
49. We have therefore continued to exclude the debt collection element of your claim in our final decision.
50. We explained in MD224 that when considering a claim under the bad debt Notified Item that we would consider the broad consistency in the movement between key debt measures since 2003-04. We have also compared your debt levels and other debt management costs with other water only companies.

51. This showed that your debt management costs are now above the industry average whilst revenue outstanding as a proportion of revenue build is less than average.
52. Your submission provided evidence to show how you had managed the transfer of WCBC tenants to direct billing – including various examples of communication to explain the change in billing arrangements and attempts to sign as many as possible to payment plans.
53. You also provided evidence through a number of case studies to show how a number of WCBC tenants have already accumulated significant amounts of debt. We accept that despite these efforts, many of these customers are not paying and therefore the level of revenue outstanding to the company has increased. We have therefore allowed the financing costs and write-off elements of your claim.
54. No request was included in your claim for additional capital expenditure costs.
55. 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

56. Your representation did not challenge our approach for this item. CCWater Wales supported the application of efficiency assumptions. Our position remains as it was for the provisional decision.
57. 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.
58. In our assessment, we have compared your actual costs of abstraction and discharge licenses obtained from the invoices you provided to the costs included in our price determination.
59. We have excluded the costs of new licenses and licenses no longer held from our analysis.
60. We have applied efficiency assumptions to your actual reported costs and the costs included in the 2004 final determination at a rate of 1.21%. This is equivalent to the continuing and catch-up efficiency assumptions applied at the 2004 final determination. We consider this to be appropriate because we applied efficiency to the whole of base operating expenditure at the 2004 final determination, which included abstraction charges.

Item 4 – Protection of assets

61. Your representation did not challenge our approach for this item. Our position remains as it was for the provisional decision.

62. We have reviewed your estimate of the costs to undertake work to protect assets and considered the Reporter's report. We have reduced the capital expenditure by 13.5%, equal to the combined catch-up and continuing efficiency challenge for water non-infrastructure. This is consistent with the challenge applied at the 2004 final determination for your water non-infrastructure programme. We are also applying the same level of efficiency challenge to the operating expenditure as we did at the 2004 final determination.
63. In your application and the associated documentation you set out the capital work that you plan to carry out. We have assumed that all of this work will be completed by 31 March 2010 and that any operating costs are incurred after this date.

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

64. 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.
65. Our analysis, based on the revised assumptions set out above, is 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

66. 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.