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11 December 2003

14.3 INTERIM DETERMINATION

Your application

You applied on 11 September 2003 for an adjustment to your company's price limits under Part IV of Condition B14.3, the substantial effect or 'shipwreck' clause, of your licence. Your reporter, David Arnell of Black and Veatch Ltd submitted his report on your application on 16 September 2003.

We sent you our provisional decision on 5 November. You sent us your representations on 18 November and we discussed these at our formal meeting on 28 November. We have considered your representations and those from others, including WaterVoice Northumbria, WaterVoice Eastern and members of the public.

Licence Condition B14.3 allows you to refer to the Director General for determination by him the issue of whether a circumstance (other than a relevant Change of Circumstance) has occurred which has or will have a substantial adverse effect on the Appointed Business or on its assets, liabilities, financial position, or profits or losses. Provided a company could not have avoided this circumstance through prudent management action, Ofwat must then consider what change, if any, should be made to your price limits.

In your application you stated that:

- Northumbrian Water has "suffered a substantial adverse effect, namely loss of revenue relative to that assumed by Ofwat at the time of the Final Determination made by the DGWS at the last periodic review in 1999."

…./….

- "The primary (but not sole) circumstance causing this effect is a declining level of demand for water by large users, which has fallen significantly below Ofwat's assumptions underlying the 1999 Final Determinations for Northumbrian Water and Essex and Suffolk Water."

- You believed Northumbrian Water could not have foreseen or avoided, by prudent management action, the substantial adverse effect.

We have set out the broad principles that we believe we must apply when considering a claim under Licence Condition B14.3 at Annex A. In reaching a determination we also considered the circumstances specific to your case.

You calculated that the loss of revenue, under the terms of your licence, was equivalent to 28% of the appointed business' turnover for 2002-03. You included small offsetting amounts for cost savings linked to the circumstance and competition.

Ofwat determination

The outcome of our analysis, which is set out in detail below, is that we consider an adjustment to the 'K' factor of 10 in 2004-05 for tariff basket customers will allow you sufficient revenue to finance the proper carrying out of your functions in 2004-05.

We have written under separate cover setting out our conclusions on your Licence Condition B14.2 application. This generates a K of 6.8 for 2004-05. Therefore an additional K of 3.2 is attributable to your Licence Condition B14.3 application.

Overall, in September 2003 prices, the average water and sewerage bill for a Northumbrian Water customer will increase by around £21 from £212 in 2003-04 to £233 in 2004-05. The average water bill for an Essex and Suffolk Water customer will increase by around £11 from £117 in 2003-04 to £128 in 2004-05.

This means that customers' bills will still have reduced by around £36 for Northumbrian Water customers and around £13 for Essex and Suffolk customers in real terms for the whole of the period 2000-05.

Challenges applied to your application

We challenged your initial application because we did not believe it fully accounted for the savings that would result from a lower than forecast demand for water. You submitted a revised application on 1 October that took account of our queries and included a fuller provision for offsetting operating cost (opex) savings and reduced supply/demand balance capital expenditure (capex).

We challenged the calculations in your submission in the following manner:

- We believe that the offsetting operating cost savings attributable to delivering lower volumes of water than expected are greater than those you included in your application.

- We believe that because of the lower demand you are investing substantially less capital expenditure than expected under supply/demand balance drivers. We are not convinced that these savings would be reversed in 2003-04 and 2004-05 and have assumed capital expenditure in line with the 1999 final determination assumptions for these years (ie we assume there is no erosion or addition to the 2002-03 cumulative capital expenditure saving).

- We considered whether you could have raised tariffs to large user customers. In view of the relatively low level of discount that you offer we have not made any adjustment for this item, although we consider that it may be relevant in other cases.

- We have adjusted for the loss of revenue you experienced that is attributable to the management action of offering lower relative tariffs to customers in the 100 – 250 Ml/year range. We query whether this was prudent in your circumstances where you faced falling non-household revenues.

Details of these adjustments are set out in the confidential annex B sent to you alongside this letter. In your representations to us you outlined a number of technical issues that you believed we should take into account when calculating any additional K for 2004-05. We also respond to these points in annex B.

In considering your case we note the following exclusions:

- We have not taken account of your underspend on optional metering.

- You excluded any revenue variance arising in the ‘other revenues’ category on the grounds that these may not represent true revenue shortfalls.

- You adjusted your figures to exclude a part of the revenue shortfall which was due to the loss of a customer to an alternative supplier.

We have calculated the overall materiality of your claim, in accordance with your licence. That is, the net present value of revenue losses, calculated over 15 years, that result from the declining level of demand. We have also taken into account those offsetting cost savings reasonably attributable to the demand shortfall outlined above. In calculating this amount we have taken account of:

…./….

- the operating cost savings attributable to the lower demand; and
- the supply/demand balance capital expenditure that will no longer be incurred for the period 2000-2005 due to the reduction of actual demand against forecast demand.

Alternative approaches not pursued

We also considered, but did not pursue, other options that we believe could in certain circumstances be open to management action. In particular there might have been some flexibility to increase charges to non-tariff basket customers. This might be through a moderate reduction in the level of the discount offered to large users. While these charges are subject to Condition E, they are by definition not subject to direct price control.

We might wish to pursue such issues with other companies in the event of similar applications.

Key issues from representations

In response to our consultation you agreed that it would be reasonable to recover the additional revenue attributable to the Licence Condition B14.3 application from the whole of your customer base. You made representations that one small group of customers should be excluded. You consider that these customers receive a markedly different level of service from all others.

WaterVoice Northumbria acknowledged the adverse effect that you set out. WaterVoice Eastern raised some concerns over the application. But they noted that if Ofwat were to allow an increase they would prefer it to be implemented from 1 April 2004 as this would provide a more stable price profile by offsetting the increase currently being proposed by the company for the first year of the next review period.

Outcome of your claim

We calculate your claim to be equivalent to 25% of your appointed business turnover in 2002-03 and therefore the materiality threshold of 20% is exceeded.

In your discussions with us you acknowledged the significant impact your Licence Condition B14.2 and Licence Condition B14.3 applications might have on customers' bills in 2004-05. You stated that applying Licence Condition B14.2 principles to a Licence Condition B14.3 application might yield an increase in K of 14 points in 2004-05 for the Licence Condition B14.3 application. When combined with your licence condition B14.2 application this might produce an overall increase in K of 21 points. However in your application you have considered the wider implications of such an increase.

…./….

You noted that the Licence Condition B14.2 principles for calculating a change in the Adjustment Factor do not apply in calculating the appropriate change under Licence Condition B14.3.

As a result, you set out a proposed remedy, which you believe provides a balanced outcome between shareholders and customers. You consider that an adjustment, which allows you to finance your functions, until prices are set again in April 2005 would be appropriate. You acknowledged the discretion that the Director General has under Licence Condition B14.3 in contrast to Licence Condition B14.2 applications as regards what change is made to the Adjustment Factor.

Because you have, in parallel, applied for an interim determination under Licence Condition B14.2 you believed that a combined increase in K of 12 in 2004-05 in aggregate for your B14.2 and B14.3 applications would be sufficient to achieve this. In your representation to us you revised this to a K of 11.4.

We welcome your acknowledgement of the balance that needs to be achieved between stakeholders. Our starting point when we consider what change should be made to the Adjustment Factor for a material application under Licence Condition B14.3 is the Director General's duties under Section 2 of Water Industry Act 1991.

Our view of the amount needed for Northumbrian Water to finance the proper carrying out of its functions until April 2005 is that which will enable the company to raise sufficient revenue such that the company achieves an appropriate return on capital and that the financial indicators used at the 1999 review are satisfied. That is, a return on your Regulatory Capital Value (RCV) and the appropriate cash interest cover indicator for 2004-05.

We consider that this approach is warranted in this instance, as the substantial adverse effect is the primary cause of the deterioration in Northumbrian Water's financial performance.

We have targeted a slightly higher return than in our provisional decision, which takes account of your representations on the modelling process used for the provisional decision.

In your determination we have assumed that the additional revenue attributable to the 14.3 application that you need to recover to enable you to finance the proper carrying out of your functions is recovered from all of your customers except the small group that you identified.

This has resulted in the K factor of 10 set out above.

…./….

Future application of the substantial effect clause

In our provisional decision letter we noted that your application is the first such application under the substantial effect clause. We explained that in light of this we believed that we should consult on possible amendments to the substantial effect clause along with other possible amendments to Licence Condition B in advance of the 2004 final determination.

We have received some comments from you and from WaterVoice on this Licence Condition. We also listened to stakeholders' views informally at the Forward Programme Workshop on 13 November 2003.

We still hold the view that the substantial effect clause, in its current form, has the effect of altering the balance of risk for unavoidable material events between customers and shareholders in a way that was not envisaged. We will consult on possible amendments to the substantial effect clause and other aspects of Licence Condition B in early 2004. We will incorporate views received when we commence our consultation.

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

This letter and its enclosures have been copied to Richard Bird (DEFRA), Jeni Colbourne (DWI), Graham Tate and David Gallagher (Environment Agency), Andrea Cook (Chairman of WaterVoice Northumbria), Catherine Harvey (Chairman of WaterVoice Eastern), your local Members of Parliament and Members of the European Parliament.

PHILIP FLETCHER

Annex A

Licence Condition B14.3 of Northumbrian Water's licence, the substantial effect clause states:

All of the following:

(1) whether any circumstance (other than a relevant Change of Circumstance) has occurred which has or will have:

(a) a substantial adverse effect on the Appointed Business or on its assets, liabilities, financial position, or profits or losses, not being one which would have been avoided by prudent management action taken since the transfer date; or

(b) a substantial favourable effect on the Appointed Business, or on its assets, liabilities, financial position, or profits or losses, being one which is (i) fortuitous and (ii) not attributable to prudent management action; and

(2) if so, what change should be made to the Adjustment factor.

For this purpose:

(i) what constitutes "prudent management action" shall be assessed by reference to the circumstances which were known or which ought reasonably to have been known to the Appointee at the relevant time;

(ii) an effect shall not be regarded as a substantial adverse effect or a substantial favourable effect in any case unless, if the questions set out in sub-paragraph 14.2 were to be asked in relation to the circumstance giving rise to it, the answer to that in 14.2(7) (taking the reference in it to ten per cent as a reference to twenty per cent) would be in the affirmative.

The substantial effect clause differs from a standard interim determination under Licence Condition B14.2.

The standard **interim determination** process allows companies to ask us to review their price limits in certain specific conditions set down in the licence. These are:

- Relevant Changes in Circumstances (such as a change in legal obligation); and
- Notified Items: items agreed at the previous price review to allow companies, or Ofwat to recover costs in areas where considerable uncertainty remained at the time of price setting around forecasts in relation to those items.

Under Licence Condition B14.2 the process and method of calculating the change to the Adjustment Factor are clearly set out in the licence.

The **substantial effect** clause allows a company to ask us to consider what change should be made to the Adjustment Factor where a circumstance has occurred which has, or will have, a substantial adverse effect on the Appointed Business or on its assets, liabilities, financial positions or profits or loans which could not have been avoided by prudent management action. On receipt of an application under Condition B14.3 we will therefore consider two questions:

- **Does the company have a material case that we must consider?**
- **If the company has a material case what change do we consider should be made to the Adjustment Factor?**

Each of these questions is considered below.

Does the company have a material case that we must consider?

We will apply a staged approach to applications.

1. We will consider each application under Licence Condition B14.3 on its own merits. For each case we will consider, within the terms of the licence:

- what circumstance has occurred; and
- whether this has or will have a substantial effect.

We will consider whether, in each individual case, the company's definition of the circumstance and substantial effect are reasonable. We may decide that the definition that the company applies is not appropriate. In such a case we would set out our view and the effect of this on the company's claim.

2. We will consider whether the company has demonstrated that:

- in Net Present Value terms the net extra costs or losses are equivalent to greater than 20% of the appointed business turnover; and
- the net extra costs or losses could not have been avoided by prudent management action.

An application by a company for an adjustment under Licence Condition B14.3 must satisfy these two tests. Whether an application is material is calculated in accordance with Licence Condition B14.2 (1) – (7).

The licence states that 'prudent management action shall be assessed by reference to the circumstances which were known or which ought reasonably to have been known to the Appointee at the relevant time'.

The concept of 'prudent management' will depend to an extent on what we believe the 'circumstance' that leads to the 'substantial effect' to be in a particular application. We will consider what prudent actions would have been within management control and what impact we might have expected this to have on the 'substantial effect'.

The company must also demonstrate, to our satisfaction, that it:

- fully considered the cost savings associated with the change in circumstances that it is seeking redress for; and
- included in the materiality calculation the net effects of the circumstance.

We would expect a company's Reporter and/or Auditor to be closely involved in the preparation of its application. The exact role will depend to an extent on the specific circumstances of the application.

Generally a company would need to reconcile any data with the June Return data, explaining why they might differ. We would also expect a company to refer to actuals wherever possible and justify the assumptions underpinning any forecasts.

If the company has a material case what change do we consider should be made to the Adjustment Factor?

Once materiality is established we have discretion in determining what change should be made to the Adjustment Factor. Licence Condition B14.3 is not mechanistic in calculating the change to the Adjustment Factor in the way that Licence Condition B14.2 is for standard interim determinations because Condition B14.3 must be capable of dealing with a range of unforeseen events. It allows greater flexibility when considering what change should be made in the specific circumstances that a company believes are causing a substantial adverse effect.

We will first consider the impact of a substantial effect on a company's ability to finance the proper carrying out of its functions, with reference to the Director's duties under Section 2 of the Water Industry Act 1991.

For example, in determining what change should be made to the Adjustment Factor we will look to ensure that it strikes the appropriate balance between:

- ensuring the financing of proper carrying out of functions;
- protecting customers' interests; and
- promoting economy and efficiency.

It may be that following detailed analysis and proper consideration of all of the Director's Section 2 duties we might decide that a material application should not result in any change to the Adjustment Factor.

Alternatively we might apply a smaller adjustment than that claimed by a company, if we were satisfied that, on the facts, a company would still be able to finance its functions with the smaller than proposed change to the Adjustment Factor.