

**ANGLIAN WATER SERVICES LIMITED  
INTERIM DETERMINATION – December 2000  
SUMMARY OF OFWAT'S ASSESSMENT AND DETERMINATION**

- 1 Ofwat has followed a four-stage assessment in accordance with the terms of Condition B of the company's licence.
- 2 The company cited two changes in its application; (1) greater numbers of customers taking up the free meter option (additional meter optants) and (2) the continuous monitoring requirements for cryptosporidium required by the Drinking Water Inspectorate (DWI).
- 3 Ofwat's assessment and determination of the application is set out in summary terms below for each of the stages and items.
- 4 In the draft determination Ofwat included a counter-notice; an offsetting adjustment for planned quality enhancement work which had been funded in price limits but was no longer required. After reconsideration of the issue this adjustment has not been included in this determination.

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

**Item 1 – Additional Meter Optants**

- 5 A special notified item was set out in the 1999 price limit 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.

**Item 2 – Cryptosporidium – Continuous monitoring**

- 6 In 1999 the extent of the new requirements to install equipment and to carry out continuous monitoring for cryptosporidium oocysts was uncertain. No provisions were made in price limits for these requirements.
- 7 Following your application Ofwat sought and has obtained confirmation from officials at the DWI that the company's assessment of the requirements under regulation 23B of The Water Supply (Water quality) (Amendments) Regulations 1999 was appropriate and necessary.
- 8 Ofwat confirms that the Cryptosporidium requirements do qualify as a Relevant Change of Circumstance.

## STAGE 2 – ASSESSING THE APPROPRIATE NET ADDITIONAL COSTS

### Item 1 – Additional Meter Optants

<sup>9</sup> Ofwat has assessed carefully the information contained in the company's application and, where appropriate, Ofwat has requested further clarification from both the company and the Reporter. Ofwat's assessment is set out below.

#### *Numbers of Optants*

<sup>10</sup> 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.

<sup>11</sup> The 1999 final determination assumed that from a position where 44.7% of the company's water customers were metered 15% of unmeasured water customers would choose to change to measured charging between April 2000 and March 2005. Furthermore it was assumed that switching would follow a pattern whereby each year a constant proportion of the remaining unmeasured customer base took up the free meter option. In the case of Anglian Water, Ofwat's final determination assumptions included those customers situated in the region formerly served by Hartlepool Water.

<sup>12</sup> The 1999 final determination also contained assumptions about the number of optants among unmeasured sewerage customers who receive water supplies from other water suppliers.

<sup>13</sup> The company's application presented evidence relating to confirmed free meter requests received by the company up to 25 August 2000. The company has since provided information on numbers of free meter requests received by the company up to 24 November 2000. In addition, the company submission contained evidence intended to support your projections of future meter optant numbers.

<sup>14</sup> For the purpose of this determination Ofwat is required to take a forward-looking view of the likely uptake of optional metering for the remainder of the quinquennium. In doing so Ofwat has had regard to the high degree of sensitivity of calculations to alternative extrapolations.

<sup>15</sup> Ofwat has also taken account of any differences between the final determination assumptions and the outturn numbers of meter optants between 1997-98 and 1999-2000. Ofwat has noted that the number of optional meters installed between 1997-98 and 1999-2000 were significantly less than indicated in the company's business plan and therefore had been assumed when price limits were set in 1999. The company's interim determination application shows that the current overall meter penetration achieved by Anglian Water as at September 2000 has not reached the level assumed in price limits for that date, notwithstanding the increase experienced so far in 2000-01.

16 The company has argued that Ofwat should discount the actual position on meter penetration. It advocates a narrow interpretation of both the Notified Item and its licence conditions, on the grounds that the final determination should be treated as a total package within which individual items should not be distinguished. We are not persuaded. Both the items (meter optancy and quality) are specifically identified in the final determination as areas of uncertainty that could, if significant changes in requirements arise or outputs not delivered to programme, lead to consequential changes in price limits. Moreover it is important that any re-determination of prices arising from loss of revenue following changes in the number of customers opting for a meter should also take account of the actual starting position at the start of the quinquennium. To do otherwise would require Ofwat to project future revenues on the basis of assumptions that are known to be wrong, at the expense of customers.

17 Ofwat's assessment is that Anglian Water has yet to incur any costs or revenue losses associated with optional metering that have not already been allowed for in the final determination. This is in accordance with the provision in Licence Condition B 14.2(3)(i)(D) that requires the Director to take no account of

*“ . . . any amounts attributable to matters allowed for in making a Relevant Determination, except to the extent that such amounts otherwise fall to be taken into accounts as amounts reasonably attributable to, or connected with, the Relevant Item . . . ”*

18 Ofwat considers that it is still appropriate to assume that the decline in the rate of free meter uptake observed between 1997-98 and 1999-2000 will continue. This determination assumes a take up rate of 4% in the year to September 2001, levelling out at a constant rate of 3.5% per annum thereafter. This forward-looking assumption appears consistent with historical trends, and the cumulative level of meter penetration in the Anglian Water region.

19 In the case of customers that receive sewerage services from Anglian Water, but receive water supplies from other suppliers, the company's submission assumes that the Notified Item should be judged against a lower number of optants than was allowed for in the final determination. Ofwat's assessment of revenue losses and costs is based on the numbers of optants allowed in the final determination. However, Ofwat accepts the company's forecast of sewerage only optant numbers for the quinquennium. The forecast made by the company appears reasonable in the light of available evidence from the relevant water only companies, and is actually less than the number of sewerage service only optants that were assumed in the final determination.

#### *Meter Optant Characteristics*

20 Anglian Water has presented a range of evidence to support revised assumptions regarding the likely characteristics of meter optants, in terms of average rateable value, and average pre and post-switching consumption. Much of this evidence relates to data collected from existing meter optants and does not necessarily apply to future meter optants. Ofwat's assessment is that the assumptions about the

average rateable value of optants' properties used for the 1999 final determination remain appropriate. However, Ofwat considers that assumptions about optant average pre and post-switching water delivered should be revised. The assumed reduction in demand associated with switching continues to be set at 5% of pre-switching water delivered. The average pre-switching water delivered for 2000-01 is assumed to be 58% of average unmeasured household water delivered rising to 72% in 2004-05. These assumptions take account of the likely trend in optant characteristics, as fewer low use customers remain in the unmeasured base, and of the need to ensure that assumptions are plausible in the context of the overall water balance.

### *Meter Unit Costs*

21 The company has presented evidence to support its assessment that the unit capital costs of metering are higher than those allowed for in the final determination. Ofwat considers that there is no reason not to expect further efficiencies, and that the unit cost assumptions used in the final determination remain appropriate.

### *Meter Location*

22 Ofwat has also considered evidence presented relating to meter location, in particular Anglian Water's view that external metering carries a range of advantages. Ofwat has also taken account of the Competition Commission's views that the level of funding allowed in the 1999 final determination will have the effect of pushing companies towards an internal meter policy. Capital and operating cost allowances assume that 75% of meters will be installed externally at properties where there is no existing boundary box.

## **Item 2 – Cryptosporidium – Continuous Monitoring Requirements**

23 Ofwat has reviewed the company's projected costs for meeting this requirement and considered the Reporter's report. Ofwat has 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. Ofwat considers that the company has over-estimated significantly the operating costs of carrying out the continuous monitoring. Therefore Ofwat's assessment has been based on a benchmark established by other companies and current market prices.

24 Continuous monitoring and testing for cryptosporidium is in its infancy. As the level of this monitoring increases it is reasonable to assume there will be an increase in efficiency for this labour intensive procedure as well as a decrease in the costs of materials as the development of this assay progresses. This is a new area of technology and routine high levels of work have yet to be carried out in commercial laboratories. Analogies can be drawn with other developments where unit costs have reduced sharply following introduction of new requirements.

25 Your company made representations concerning the Ofwat view in the provisional response on the rate at which efficiencies may be demonstrated in this area. Ofwat has reconsidered its view, revisiting two aspects of the judgement. Firstly, it is not certain how far the benchmark supplier had moved down the learning

curve; it is possible that there had been a rapid acquisition of expertise and the costs had decreased accordingly in the first year or so after the wide deployment of this type of monitoring. Secondly, the level of continuous monitoring over the next 15 years is subject to possible change. Sufficient oocysts might be found at a number of sites for it to be considered prudent to fit treatment. Conversely, continuous monitoring might be terminated at some sites if the risk classification changes. In either event the number of sites requiring monitoring would decrease, and there would not be the current level of incentive for innovative new techniques to be employed and for significant efficiencies to be delivered. Ofwat has judged that 2.5% per annum continuing efficiency may be a more reasonable expectation than that originally proposed. This projection will still provide a balance both in terms of a continuing stimulus to the company to seek cheaper ways of delivering the obligation and an incentive to go even further, which will benefit the company initially and its customers in the longer term.

26 The company assessed the net present value over 15 years of the operating costs of complying with the new requirement as £8.0m at 2000-01 prices, with £3.5m net additional operating costs being incurred over the period to March 2005.

27 Ofwat's view is that the appropriate net additional costs of meeting this change will be £1.7m over the period to March 2005. Over a 15 year period Ofwat assesses the net present value of meeting the requirement to be £3.5m.

28 In the company's representation on Ofwat's provisional determination on the company application, the case was put forward for the triviality criterion to be applied at the service and not company level. Ofwat has considered your points. The mechanism for the calculation of materiality and other issues relating to the interim determination procedures refer to the single licence for provision of water and sewerage service, and hence in this case is it also appropriate to base the triviality criterion on the company turnover.

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

29 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 at least 10% of the turnover of the Appointed Business in the latest financial year for which accounting statements have been delivered to the Director, then a revision of price limits is triggered.

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

30 As the materiality threshold has not been exceeded there can be no revision to price limits using the approach set out in Condition B of Anglian Water Services Limited's licence.

<sup>31</sup> Therefore, Ofwat's final assessment of the company's application is that the current price limits for the charging years 2001-2 to 2004-5 should not be changed.

Ofwat - 19 December 2000