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8 November 2001

### **INTERIM DETERMINATION – provisional response**

On 14 September 2001 you made an application for an interim determination of your company's price limits under Part IV of Condition B of the licence. Your Reporter, Robin Clark of Halcrow Management Sciences submitted his report on your application on 18 September 2001.

Your application covers the cryptosporidium monitoring requirements placed upon your company by the Drinking Water Inspectorate. Annex A summarises your estimate of the effect of the requirement on your costs.

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 view on the impact of the change on your costs are set out in the summary table (Annex A).

Our initial assessment of the total impact of the relevant item 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 would need to increase by £1.62 in real terms between 2001-02 and 2004-05. We now consider that it will need to increase by £5.34 in real terms over the same period.

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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 metering assumptions for the final determination in 1999 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 have a provisional meeting arranged for Thursday 27 November 2001. I would be grateful if you could confirm whether you would like to take this opportunity to discuss 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 has been copied to John Ballard (DEFRA), Michael Rouse (DWI), David Jordan and Richard Cresswell (Environment Agency), Sheila Reiter (Chairman of Wessex CSC), your local Members of Parliament and Members of the European Parliament.

**PHILIP FLETCHER**

## ANNEX A

### BOURNEMOUTH & WEST HAMPSHIRE WATER PLC DRAFT INTERIM DETERMINATION – Autumn 2001 – SUMMARY TABLE

Description		Company's Assessment (September 2001)		Ofwat's Assessment (November 2001)		
<b>Item 1 – Cryptosporidium – Additional requirements for continuous monitoring.</b>						
1.1	Estimated net additional capital <b>expenditure</b> for AMP3	£0.08m		£0.08m		
1.2	Estimated net additional <b>operating expenditure</b> for AMP3	£1.5m		£1.28m		
1.3	<b>Materiality amount</b> (NPV of total net additional costs and losses)			£2.72m		
1.4	Contribution towards <b>materiality threshold</b>			10.3%		
<b>OVERALL ASSESSMENT</b>						
2	<b>Materiality amount</b> (NPV of total net additional costs and losses)				£2.72m	
3	Bournemouth & West Hampshire turnover for 2000-01 used in materiality test				£26.46m	
4	<b>Materiality test</b>				10.3%	
<b>PRICE LIMITS</b>		2000-01	2001-02	2002-03	2003-04	2004-05
5	<b>Current price limits</b> (as set in November 1999)	-3.0	-1.7	-1.7	0	1.7
6	<b>Draft revised price limits</b>	-3.0	-1.7	1.2	1.2	1.2
<b>Notes:</b>						
1. Additional costs and revenue losses shown as positive, savings and revenue gains shown as negative (-ve).						
2. The appropriate Discount Rate used is 4.95%.						
3. <b>Triviality criterion</b> – If NPV of specific change is less than 1% of company turnover then normally deemed trivial and not carried forward into materiality test.						
4. <b>Materiality test</b> – Result must be greater than $\pm 10\%$ to trigger a change in price limits.						
5. All monetary values are in September stated in 2001 prices. Totals may not add due to rounding.						

**BOURNEMOUTH AND WEST HAMPSHIRE 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 one change in your application, namely the cryptosporidium monitoring requirements placed upon your company by the Drinking Water Inspectorate (DWI).
3. Our initial assessment of your application is set out in summary terms below.

**STAGE 1 – CONFIRMATION THAT THE CHANGED REQUIREMENT IS A RELEVANT CHANGE OF CIRCUMSTANCE**

**Item 1 – Cryptosporidium - additional requirements for continuous monitoring**

4. 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.
5. The DWI issued a revised 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.
6. We confirm that these additional 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.

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

7. You have chosen to deal with the requirements at six sites by carrying out continuous monitoring. The Reporter has commented that the decisions you have made are reasonable.
8. 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.

9. We consider that your estimate of the initial additional operating costs of carrying out continuous monitoring for cryptosporidium includes some opportunity costs and overheads that are not additional costs. These costs have not been taken into account in our assessment. Once these costs have been excluded your costs compare favourably with our benchmark.

10. 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.

11. Your estimate of the additional capital investment associated with continuous monitoring for cryptosporidium is lower than the benchmark established elsewhere. Consequently we have not reduced your estimate of these costs.

#### Ofwat's view of the likely costs of cryptosporidium monitoring

12. You assessed the net present value over 15 years of the operating costs and the capital costs of complying with the new requirement as £2.9m at September 2001 prices, with £1.5m net additional operating costs and £0.08m net additional capital costs incurred over the period to March 2005.

13. We assess the net present value of these costs to be £2.72m, with £1.28m net additional operating costs and £0.08m net additional capital costs over the period to March 2005.

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

14. 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.

15. The results of our analysis, based on the revised assumptions set out above, are summarised in Annex A. This shows that the materiality threshold is satisfied.

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

16. 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.

17. We propose to adopt the symmetrical notified item model used by the Competition Commission. 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 of<sup>1</sup> 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**

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<sup>1</sup>Deletion 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.

<b>Numbers of Household Meter Optants between 1 October 2001 and 30 September in the Year</b>		
<b>2002</b>	<b>2003</b>	<b>2004</b>
2,744	5,430	8,060

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