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15 January 2004

13.3 INTERIM DETERMINATION – PROVISIONAL RESPONSE

Your application

You applied on 26 November 2003 for an adjustment to your company's price limits under Part IV of Condition B13.3, the substantial effect clause, of your licence. Your reporter, Robin Clark of Halcrow Management Sciences, submitted his report on your application on 19 December 2003.

Licence Condition B13.3 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 your claim relates wholly to a revenue shortfall, which consists of two components:

- lower than expected revenue from households, arising from the assumptions adopted during the 1999 price review (and specifically those concerning the effects on water use of household metering);

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- lower than expected revenue from non-households, caused primarily by business closures.

You believe Bournemouth and West Hampshire Water could not have foreseen the substantial adverse effect and has acted in a prudent manner.

We set out the broad principles that we believe we must apply when considering a claim under the substantial effect clause in our 11 December 2003 letter to Northumbrian Water which we have restated at Annex A of this letter. Your application results from similar circumstances and we have applied these criteria to your application and have considered all the circumstances specific to your case.

Ofwat's draft determination

The outcome of our provisional analysis, which is set out in detail below and in the confidential Annex B sent to you, is that a K factor of 4.3 in 2004-05 would allow you sufficient revenue to finance the proper carrying out of your functions. This represents an increase of 3.8 on the previous K factor of 0.5 which was set following your interim determination in 2001.

The revenue loss that forms the basis of your application is the result of circumstances across your business as a whole. In this draft determination we assume that the additional revenue that you need to raise to enable you to finance the proper carrying out of your functions is recovered from all your customers.

Overall, the average water bill for a Bournemouth and West Hampshire Water household customer would increase from £102 (£104 in November 2003 prices) in 2003-04 to £109 in 2004-05 This is an increase of £5. This compares with an average bill in 1999-00 of £111, when expressed in November 2003 prices. Average household bills would therefore remain broadly constant between 1999-00 and 2004-05.

Analysis of your application

i) Materiality calculation

You calculated that the present value of the loss of revenue over 15 years, under the terms of your licence, was equivalent to 78% of the appointed business' turnover for 2002-03. In your application you considered a number of offsetting amounts for:

- all other revenues received by the appointed business;
- a reduced operating cost of supplying less water;
- the reduced long-term costs of meeting demand; and
- lower operating and capital expenditure due to lower levels of meter installation count than assumed at the last periodic review in 1999.

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In calculating the overall materiality of your claim we have therefore considered, in accordance with your licence, the net present value of revenue losses, calculated over 15 years, that result from the lower than expected demand from measured customers. We have also taken into account those offsetting cost savings associated with the demand shortfall outlined above. These are:

- the operating cost savings attributable to the lower demand;
- capital and operating cost savings due to lower levels of meter installation than assumed at the 1999 Final Determination.

We calculate your claim to be equivalent to 38% of your appointed business' turnover in 2002-03 and therefore the materiality threshold of 20% for a claim under Licence Condition B13.3 is exceeded.

ii) Calculation of change to the adjustment factor

Licence Condition B13.3 does not set out how the Director General calculates any change to the adjustment factor if there is a material substantial effect. Consequently, he has, as you acknowledge, more discretion (in contrast to interim determinations under Licence Condition B13.2) as regards what change should be made to price limits.

Our starting point when we consider what change should be made to the Adjustment Factor for a material application under Licence Condition B13.3 is the Director General's duties under Section 2 of Water Industry Act 1991.

We discussed your application in further detail at our meeting with you on 12 December 2003. We challenged the calculations in your submission. Where your arguments did not convince us we have adjusted your figures as follows:

- We have adjusted the offsetting cost savings attributable to delivering lower volumes of water included in your application.

- We have made an adjustment to your revenue forecasts for the remainder of the 2000-05 period.

- 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.

- You included revenue variance arising in the 'other revenues' category as an offsetting item. We have adjusted this figure and included it within the revenue calculation for modelling purposes.

- We have adjusted the amount of savings you considered were due to lower levels of meter installation than assumed at the 1999 Final Determination.

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You consider that Bournemouth and West Hampshire Water has acted in a prudent manner by continuing its policy of metering on change of occupancy in spite of the related shortfalls in revenue. You argued that the policy on metering is part of a prudent long-term strategy to maintain supply/demand balance in your area. You maintain that selective metering, pursued on change of occupancy, has a significant impact on demand, particularly peak demand. You have told us that reversing, or modifying, your policy could have wider implications for your business.

In the context of likely pressures on supply/demand balance in your company's area of supply, we doubt that it would have been prudent for management to change the established metering strategy, simply to reduce the short-term impact on turnover. By following this demand management strategy, which has some short-term cost, you expect to be in a position to defer costs associated with water resource development which will be to the benefit of customers over the longer term. We expect that your Final Business Plan for the 2004 Periodic Review will demonstrate that you continue to follow this preferred approach.

Our provisional view of the amount needed for Bournemouth and West Hampshire 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 once the revenue forecasts and related cost changes for 2004-05 have been revised. All other assumptions from the last periodic review, as modified by the 2001 interim determination, remain unchanged.

This approach produces a required K in 2004-05 of 4.3. This would ensure that key financial indicators, particularly cash interest cover (FFO), remain above adequate levels.

You predict that costs will increase to maintain base services but that the company will have outperformed the efficiency assumptions set at the last review.

Our provisional assessment makes no allowance for such outperformance nor potential cost increases in 2004-05 that do not directly relate to the substantial effect. These will be considered as part of the overall review of prices for 2005-10.

The objective of the substantial effect clause is to mitigate the effects of material, unanticipated circumstances that have adversely affected the business. In doing so, it is important to balance the interests of customers and other stakeholders in an even way.

The proposed change in price limits should increase shareholders' returns to the level anticipated at the last review after adjusting for the decline in revenues. Customers' bills will increase but should do so by no more than necessary and should not increase further to preserve outperformance. We do not believe that such an approach would reduce the incentives on companies to become more efficient.

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Future application of the substantial effect clause

We stated in our decision on Northumbrian Water's substantial effect application that we intended to revisit the clause as part of our wider consultation on licence modifications. The nature and content of your application underline the need for Ofwat to consider how the balance of risk between shareholders and customers has potentially been altered in a way that was not envisaged. We will issue our consultation paper shortly.

Next steps

I invite your written representations on this draft determination by 29 January 2004. We will then meet you on 2 February 2004 to discuss your representations. You discussed your application with Watervoice Wessex at the time that you submitted this to Ofwat. We invite views on our provisional decision, from Watervoice Wessex and other interested parties by Wednesday 5 February 2004.

We will issue our final interim determination of your application on 19 February 2004. We are placing this draft 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), David King (Environment Agency HQ), Sheila Reiter (Chairman of WaterVoice Wessex), Andy Rogers (EA South West) and your local Members of Parliament.

PHILIP FLETCHER

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Annex A

Licence Condition B13.3 of Bournemouth and West Hampshire 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 13.2 were to be asked in relation to the circumstance giving rise to it, the answer to that in 13.2(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 B13.2.

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 B13.2 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 B13.3 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 B13.3 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 B13.3 must satisfy these two tests. Whether an application is material is calculated in accordance with Licence Condition B13.2 (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 June Return data and other relevant information submissions, 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 B13.3 is not mechanistic in calculating the change to the Adjustment Factor in the way that Licence Condition B13.2 is for standard interim determinations because Condition B13.3 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.