



Mr R J Baty  
Chief Executive  
South West Water Ltd  
Peninsula House  
Rydon Lane  
Exeter EX2 7HR

14 December 2001

## **INTERIM DETERMINATION**

You applied on 14 September 2001 for an interim determination of your company's price limits under Part IV of Condition B of your licence. Your reporter, Roger Sawdon of W S Atkins, submitted his report on your application on 14 September 2001.

Your application covers the additional costs and loss of revenue resulting from the following four items:

1. More customers taking up the free meter option than was allowed for in the final determination.
2. Cryptosporidium monitoring and treatment requirements placed upon your company by the Drinking Water Inspectorate.
3. Changes to the lead compliance programme.
4. The costs associated with the Climate Change Levy.

In addition to these changes, your application identified delays to two major wastewater projects.

We agree that items 1 – 3 above qualify for changes in costs to be considered at an interim determination. The Climate Change Levy is not a relevant change of circumstance and we have not taken it into account. Our reasoning is set out in Annex D. We have taken into account the changes to the wastewater projects noted above and to a number of smaller projects.

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We sent you our draft decisions on 8 November and corrections to the draft price limits on 20 November. You sent us your representations on 26 November and we discussed these on 30 November. Following your representations and those from others, including the Customer Service Committee, we have looked again at the costs and revenues and made some changes to our determination:

- an increase in the annual rate of take up of optional meters to 6% of the remaining unmeasured customer base from September 2001;
- a reduction in the costs for the delayed schemes because the work at Sidmouth is now complete; and
- a small increase in costs associated with cryptosporidium monitoring.

In reaching our final decisions about take up of meters we took particular note of the comments of the Customer Service Committee and of the interaction between your already high bills and incentives for customers to switch to a meter.

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 Ofwat can trigger an interim determination if our revised metering assumptions turn out to be too generous and this is shown to be material in either 2002 or 2003. Alternatively, if materiality is breached by 2004 I intend to take the value of your gains during this quinquennium into account in resetting your price limits for 2005-10. I attach a copy of the proposed licence modifications at Annex C.

Annex A summarises your estimates of the changes to your costs and revenues, our final view of your costs and revenues and the new price limits. Our decisions are summarised in Annex B. We are sending explanatory notes expanding on Annex B separately.

The total impact of the relevant items on your costs and revenues is enough to exceed the materiality threshold set out in Condition B of your licence. These revised price limits will apply from April 2002. The effect of this change for customers is that average household bills will increase by £29 in real terms between 2001-02 and 2004-05 rather than £14 as anticipated at the final determination in 1999.

We are placing this determination in the Ofwat Library and announcing our decision to the London Stock Exchange.

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This letter and its enclosures have been copied to John Ballard (DEFRA), Michael Rouse (DWI), Richard Cresswell (Environment Agency), Noel Olsen (Chairman of South West CSC), your local members of Parliament and members of the European Parliament.

**PHILIP FLETCHER**

## ANNEX A

**SOUTH WEST WATER LIMITED**  
**INTERIM DETERMINATION – December 2001 – SUMMARY TABLE**

Description		Company's Assessment (September 2001)		Ofwat's Assessment (December 2001)		
<b>Item 1 – Additional meter optants</b>						
1.1	Total <b>additional meter optants</b> in period to 2004-05 (AMP3) over and above the November 1999 assumptions.	+ 55,011 (water) + 53,750 (sewerage)		+ 44,994 (water) + 43,007 (sewerage)		
1.2	Estimated net additional <b>capital expenditure</b> over the AMP3 period	£9.3m		£10.9m		
1.3	Estimated net additional <b>operating expenditure</b> over the AMP3 period	£2.3m		£1.1m		
1.4	Estimated loss in <b>revenues</b> over the AMP3 period	£42.3m		£36.5m		
1.5	<b>Materiality amount (NPV of total net additional costs and losses)</b>			£126.7m		
1.6	Contribution towards <b>materiality threshold</b>			52.0%		
<b>Item 2 – Cryptosporidium – additional requirements for continuous monitoring and treatment.</b>						
2.1	Estimated net change in <b>capital expenditure</b> to 2004-05	£3.1m		£2.7m		
2.2	Estimated net change in <b>operating expenditure</b> to 2004-05	£2.6m		£2.4m		
2.3	<b>Materiality Amount (NPV of total net additional costs and losses)</b>			£8.0m		
2.4	Contribution towards <b>materiality threshold</b>			3.3%		
<b>Item 3 – Lead – changes to the compliance programmes</b>						
3.1	Estimated capital expenditure on confirmed lead programme to 2004-05	£6.7m		£4.1m		
3.2	Estimated operating expenditure on confirmed lead programme to 2004-05	£2.9m		£2.2m		
3.3	<b>Materiality amount (NPV of total net additional costs and losses)</b>			£10.5m		
3.4	Contribution towards <b>materiality threshold</b>			4.3%		
3.5	Reduction in <b>capital expenditure</b> on lead communication pipe replacement compared with that assumed in the 1999 final determination	-£9.5m		-£11.9m		
3.6	<b>Materiality amount (NPV of total net reductions)</b>			-£11.4m		
3.7	Contribution towards <b>materiality threshold</b>			-4.7%		
<b>Item 4 – Climate Change Levy – not a relevant change of circumstance</b>						
<b>Item 5 – Counter Notice – Torbay, Cornborough, AMP 3 schemes</b>						
5.1	Estimated net change in <b>capital expenditure</b> to 2004-05	-£0.2m		0		
5.2	Estimated net change in <b>operating expenditure</b> for AMP3	-£2.6m		-£1.9m		
5.3	<b>Materiality amount (NPV of total net additional costs and losses)</b>			-£5.6m		
5.4	Contribution towards <b>materiality threshold</b>			-2.3%		
<b>OVERALL ASSESSMENT</b>						
6	<b>Materiality amount (NPV of total net additional costs and losses)</b>			£128.2m		
7	South West turnover for 2000-01 used in materiality test			£243.5m		
8	<b>Materiality test</b>			52.7%		
<b>PRICE LIMITS</b>		2000-01	2001-02	2002-03	2003-04	2004-05
9	<b>Current price limits</b> (as set in November 1999)	-12.2	0.0	2.0	2.0	2.0
10	<b>Revised price limits</b>	-12.2	0.0	4.4	4.4	4.4
<b>Notes:</b>						
1. Additional costs and revenue losses shown as positive, savings and revenue gains shown as negative.						
2. The appropriate Discount Rate used is 4.2%.						
3. <b>Materiality test</b> – Result must be greater than ±10% to trigger a change in price limits.						
4. All monetary values are stated in September 2001 prices. Totals may not add due to rounding.						

**SOUTH WEST WATER LIMITED  
INTERIM DETERMINATION – 14 December 2001  
SUMMARY OF OFWAT'S INITIAL ASSESSMENT**

1. We followed a four stage assessment of your application in accordance with the terms of Condition B of your company's licence.
2. You included five changes in your application:
  - more customers taking up the free meter option;
  - the additional requirements placed on your company by the Drinking Water Inspectorate (DWI) – to deal with cryptosporidium;
  - changes to the lead compliance programme;
  - the costs associated with the Climate Change Levy; and
  - some delays to projects in your quality programme (Torbay and Cornborough).
3. We issued a counter notice identifying delays in the schemes you identified and in other aspects of your quality programme.
4. Our assessment of your application and the counter notice is set out below.

**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. The 1999 price determination included a notified item to protect the company from some of the implications of more customers taking up the free meter option than we had assumed.
6. We confirm that the rate of meter uptake is faster than we assumed in the final determination. This has triggered the notified item.

**Item 2 – Cryptosporidium - additional requirements for continuous monitoring and treatment**

7. When we set price limits in 1999 the extent of the new requirements to deal with the risk from cryptosporidium was uncertain. Only that work which had been identified and received technical support from the DWI was included in price limits. This did not include any requirement to carry out continuous monitoring.
8. The statement of intent issued by the DWI on 30 November 1999 set down the programme of improvement works you are required to carry out at three sites. These improvements to washwater facilities are necessary in order to meet 'Badenoch and Bouchier' requirements.

9. On 7 September 2000 the DWI issued a revised notice under regulation 23A of The Water Supply (Water Quality) (Amendment) Regulations 1999. This set out the steps you must take to comply with the requirements of regulation 23B. Since then the DWI has agreed the need for continuous monitoring at Bratton Fleming when the river source is used. The DWI has confirmed that the work set out in your application is necessary to meet your obligations under the cryptosporidium regulations.
10. These additional cryptosporidium requirements qualify as a relevant change of circumstance. The scale of the work set out in your application is appropriate and additional to that assumed in price limits set in 1999.

### **Item 3 – Lead – changes to the compliance programmes**

11. In 1999 we allowed in price limits for a work programme to deal with the new lead standards. This assumed a lead communication pipe replacement programme and plumbosolvency control. During the 1999 periodic review the DWI clearly stated that it would review the most effective means of delivering compliance after receiving further information from each company. Plumbosolvency control is now the preferred initial approach.
12. The DWI has confirmed that the provision made in the final determination for lead was only for the purpose of setting prices. The programme of work set down in the DWI's letter to the company dated 27 July 2001 'Water Supply (Water Quality) Regulations 2000: Regulation 41 – Approval of Programmes of work' replaces the letter of support provided for the periodic review process. This programme of work requires you to install plumbosolvency treatment at 18 sites and investigate the need for first time treatment at another eight sites.
13. The DWI advises that the effectiveness of plumbosolvency control will need to be assessed before it is possible to determine whether any further lead communication pipe replacement may be required to achieve full compliance with the lead standards.
14. We consider that the change in the lead compliance programme is a relevant change of circumstance.

### **Item 4 – Climate Change Levy**

15. We have carefully considered your request, but have not included any allowance for it in this determination. The reasoning is explained in Annex D.

### **Item 5 – Capital investment deferrals**

16. You report delays to wastewater schemes at Torbay and Cornborough. In discussions with the Environment Agency we have also noted the revised completion dates for nine other schemes.
17. We consider that the non-delivery of these quality outputs by the required dates is a relevant change of circumstance.

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

### **Item 1 – Additional meter optants**

18. We have carefully assessed the information contained in your application and subsequent correspondence. Where appropriate, we have requested further clarification from you and your reporter.

#### *Numbers of optants*

19. 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.
20. In the final determination we assumed that 15% of unmeasured water customers would choose to change to measured charging between April 2000 and March 2005. We also assumed that a constant proportion of the remaining unmeasured customer base would take up the free meter option each year.
21. Your application presents evidence relating to free meter installations in the period 1 April 2000 to September 2001. This includes 5,655 optional meters installed free of charge before 1 April 2000, but not used as the basis for charging until that date. Your submission also presents evidence to support your forecast of meter optants up to March 2005.
22. For this 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 considered both the sensitivity of calculations to alternative extrapolations, and the limited quantity of outturn data.
23. We accept that the number of optional meters you have installed since April 2000 will have a material impact on the cost and revenue assumptions made for the 1999 periodic review. We also accept that the future rate of uptake is likely to be affected by increases in bills that are already among the highest in England and Wales. In your case it is reasonable to assume, therefore, that the future rate of uptake will be higher than that observed since April 2000. We have assumed from September 2001 that each year 6% of remaining unmeasured customers will take up optional meters. This assumption also takes into account the views of the Customer Service Committee about the desirability of reducing the risk of a further interim determination on this item before the next periodic review in 2004.
24. Our revised projections of revenue also take account of differences between the number of meter optants assumed in the final determination for 1998-99 and 1999-2000 and the outturn numbers of meter optants during that period.

#### *Meter optant characteristics*

25. You estimate that the characteristics of meter optants will be different from those assumed in the final determination.

26. Our assumptions take account of your view on average post switching consumption and average switcher rateable value to date. However, because we believe that optants with low demand will tend to switch first, our projections assume that optants' average pre-switching consumption will increase over time. This determination assumes that optants' pre-switching water delivered will be 60% of the average unmeasured household water delivered in 2000-01 rising to 68% by 2004-05. In addition, we have continued to use the 1999 periodic review assumption that optants will reduce their consumption by 5% on average. Our assumptions are for the average annual optant water delivered over the AMP3 period and not just the period immediately after switching.

*Meter unit costs*

27. For the capital cost of installing meters, we have used the same industry standard unit costs as at the 1999 final determination. For internal meters we have continued to assume the unit operating costs adopted for the 1999 final determination. For external meters we have applied the Competition Commission's views regarding the opex savings associated with external meters resulting in a unit cost of £4.35 per annum before efficiencies.

*Meter location*

28. We have considered your evidence about meter location, and taken account of the Competition Commission's opinion that the level of funding allowed in the 1999 final determination will have the effect of pushing companies towards an internal meter policy. For meters that will not be installed in existing boundary boxes we have assumed the mix of meter location adopted by the Competition Commission in its determination of price limits for Mid Kent Water and Sutton and East Surrey Water. Therefore, the capital and operating cost allowances for meters have been calculated assuming that 14% of new meters will be installed in existing boundary boxes and that 75% of the remaining new meters will be installed externally.
29. For the draft determination we calculated 2000-01 meter capex based on optants during the period October 1999 to September 2000. We have corrected the metering capex allowance for 2000-01 so that it is now based on actual numbers of optants for the period April 2000 to March 2001. For this determination we have also used the proportion of meters installed in existing boundary boxes as set out in your application.
30. For the draft determination we applied the Competition Commission's views regarding the opex savings associated with external meters only from 2001-02 onwards. For this determination we have applied this approach in calculating opex allowances for 2000-01 onwards. Our calculations now also use the proportion of meters installed in existing boundary boxes as set out in your application for 2000-01 onwards.

## **Item 2 – Cryptosporidium - additional requirements for continuous monitoring and treatment**

31. You have chosen to deal with the requirements by carrying out continuous monitoring at 14 sites, providing a process and commencing continuous monitoring at another three sites, and shutting down three others. Your reporter has commented that the decisions made are reasonable.
32. We have reviewed your submitted costs for cryptosporidium monitoring and treatment, and considered the reporter's report. We have also looked at market prices for this type of work reported by other companies. We used this information to develop our view of the reasonable impact of the new requirement.
33. We compared your estimate of the additional operating costs of carrying out continuous monitoring for cryptosporidium with a benchmark and found them to be reasonable. The only adjustment we made to your submitted operating costs was to reduce the expenditure for 2000-01 to reflect the number of samples collected and analysed relative to subsequent years.
34. Continuous monitoring and testing for cryptosporidium is still in its infancy. We expect decreases in the unit costs of materials and increases in efficiency for this labour intensive procedure as experience develops. We judge that a continuing efficiency of 2.5% per annum is a reasonable and conservative expectation.
35. You included within the additional capital expenditure for cryptosporidium monitoring the cost of modifying your laboratory to carry out the analysis of cryptosporidium to DWI requirements. We have assumed that your company's relative efficiency for capital procurement has not changed significantly since the last price setting in 1999, and so we reduced the laboratory expenditure by 3%. This was the catch-up adjustment factor used for non-infrastructure quality enhancements.
36. You also included within the additional capital expenditure for monitoring the cost of replacing laboratory centrifuges at a future date. We have not included this capital maintenance expenditure in our assessment. You also included within the capital expenditure the cost of carrying out risk assessments. You indicated that a proportion of this cost represents in-house labour costs. We did not include these costs in our initial assessment.
37. In your response to our initial assessment you argued for the inclusion of these in-house labour costs. We have amended our assessment to include half of these costs. We believe this is a satisfactory reflection of the component of the in-house labour costs that is additional company expenditure.
38. As a result of representations by others we increased by 15% the benchmark for installing on site monitoring equipment. Your additional capital expenditure for this equipment is higher than the benchmark. The costs of installing cryptosporidium monitoring equipment should be similar for all sites. In our

assessment we reduced the costs by 75% of the difference between the adjusted company expenditure and the benchmark cost.

39. You are also installing additional treatment at some works and improving filter washwater facilities at a number of others in order to meet cryptosporidium requirements. The costs of some of these improvements were included in the 1999 final determination. But the membrane plant at Houndall and the washwater improvements at Prewley, Delank and St Cleer were not included, and so have been included in this assessment.
40. The annual operating cost for the membrane plant at Houndall is higher than the benchmark. Our assessment at this site has been based on the benchmark. We do not have sufficient comparative data on the operating costs associated with the three 'Badenoch and Bouchier' washwater upgrades to establish a benchmark. Our assessment has been based on reducing your estimated operating costs for these works by the same proportion as those of the membrane plant at Houndall.
41. In the past companies have been able to deliver much greater efficiencies in dealing with such new standards and new processes than either they or Ofwat expected. Accordingly we have assumed an efficiency gain of 2.8% per annum in operating costs for both the membrane installation and the washwater upgrades.
42. We have reduced the additional capital expenditure for the membrane plant at Houndall by 3%, consistent with the catch-up improvement assumed for capital enhancement procurement derived from the cost-base in the final determination.
43. We have also reduced the additional capital expenditure in 2000-01 for the three washwater upgrades by 3% to incorporate this catch-up. There is significant uncertainty about the additional capital costs of this work in subsequent years and we have reduced the company estimates by 10% for 2001-02 and 2002-03
44. We have not assumed any efficiency in 2002-03 for the additional capital expenditure associated with cryptosporidium treatment.

### **Item 3 – Lead – changes to the compliance programmes**

45. The DWI stated in Information Letter 13/98 that the provision made for meeting the new lead standards was solely for the purpose of estimating costs for the periodic review. The Information Letter made it clear that allowance in price limits was subject to companies agreeing specific programmes of work with the DWI once the criteria for action was agreed. After the 1999 final determination, the DWI set out in Information Letter 12/2000 the criteria for action, which put more emphasis on treatment to reduce plumbosolvency than was assumed in the final determination. The DWI stated that financial provision for the quality elements was to be used only for treatment, and that lead communication pipe replacement would not qualify for funding as a quality improvement unless prior written approval was given by the DWI.

46. The DWI has not given such approval to your company and so we have not included in our assessment the expenditure you have reported on lead pipe replacement.
47. DWI Information Letter 3/2001 states that companies wishing to carry out opportunistic lead pipe replacement should submit their proposals to the DWI for consideration. All proposals must be agreed in advance by the DWI before we will consider whether it should be quality driven work for price limit purposes.
48. The DWI has not approved opportunistic lead pipe replacement for your company, and we have not included your cost estimates for this activity.
49. We consider that your initial estimate of additional operating costs for plumbosolvency treatment are high in comparison with those reported by other companies. We have compared your cost estimate with cost information from other companies likely to have similar qualities of water. The costs for the benchmark company have been compared with yours, and we have reduced your cost estimate by 75% of the difference in costs.
50. We have assumed that future efficiencies of 1.4% a year are reasonable for plumbosolvency control operating costs.
51. Your reporter has indicated that the additional capital costs of plumbosolvency control for the eight sites scheduled for completion next year have not been worked up to the same degree of detail as those of the other sites. We consider that this indicates a significant level of uncertainty about these costs. In view of this we have reduced your estimate of the additional capital expenditure by 10%.
52. We have assumed future efficiencies of 1.4% a year are reasonable for this capital work.
53. For the purpose of calculating materiality in Annex A we have considered the changes to the lead programme separately, as additional costs and as savings. This meets the requirements of your licence.

**Item 4 – Climate Change Levy** – This is not a relevant change of circumstance – see Annex D.

#### **Item 5 – Capital investment deferrals**

54. You have provided us with information on the actual or expected completion dates of a number of schemes including Torbay and Cornborough. We have also discussed these completion dates with the Environment Agency and considered your reporter's comments on the expected completion dates for a number of projects.
55. We then considered the difference between the amount allowed in price limits for the original completion dates and that for the new dates. The financial

assumptions made were the same as those used in the 1999 price setting, taking account of the revised completion dates.

56. Since our draft interim determination you have informed us that the scheme at Sidmouth is complete and the Environment Agency has confirmed this. We have amended our assessment accordingly.

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

57. Condition B of the licence sets a materiality threshold for consideration of interim determinations. A revision of price limits is triggered if the present value of the net additional 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. For the purpose of this calculation, capital costs are calculated up to the start of the next charging period and operating costs and revenue losses are calculated over 15 years.
58. The results of our analysis, based on the revised assumptions set out above, are summarised in Annex A. This shows that the materiality threshold has been met.

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

59. 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.
60. We propose to adopt the symmetrical notified item model used by the Competition Commission, together with the new projections of meter optants as amended by the numbers set out in Annex A. The licence modification and revised notified items 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>
25,316	49,113	71,483

Any difference between either or both of the assumed cumulative numbers and the actual, cumulative numbers 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.

14 December 2001

**Climate Change Levy – Director’s decision**

The Director General (the Director) disallowed your claim based on the obligation to pay the Climate Change Levy (“CCL”), because he is satisfied that this general fiscal obligation, which applies to a wide variety of business users of electricity, gas and certain other sources of energy, does not qualify under the Interim Determination provisions of Condition B in your conditions of appointment.

The definition of a ‘legal requirement’ in condition B13.2 (1)(a) includes – “any enactment or subordinate legislation to the extent that it applies to the Appointee in its capacity as a water undertaker or sewerage undertaker ...”.

It has been suggested, first, that this applies to all and any requirements that the Appointee must meet in the conduct of its regulated business, and so will catch the CCL. Under this broad interpretation, the condition would also catch, presumably, general changes in such areas as taxation, health and safety, and employment protection. The Director firmly considers that this broad interpretation is at odds with the structure and purpose of the mechanisms for controlling charges in Condition B. In particular:

(1) Condition B generally (like all the other Conditions of Appointment) is concerned with the regulation of the Appointed Business, i.e., the carrying out of the functions of a water or sewerage undertaker. The point of the particular specification in condition B13.2(1)(a) (that any qualifying legal requirement should apply to the Appointee “in its capacity as a water undertaker or sewerage undertaker”) is precisely to show that the provision relates to water-specific legislation, i.e., concerning the handling or treatment of water or waste water. This accords with the tenor of the subsequent paragraphs within condition B13.2(1), notably (c), (d) and (f). It does not mean that the only legislation that will necessarily qualify is legislation applying only to the water and sewerage companies.

(2) The system for reviewing the company charging limits established under Condition B envisages periodic reviews - currently once every five years. The underlying legislative intention is that any interim adjustments to the charging limits should be exceptional and closely defined events. (In 1989, there were 8 specified kinds of Relevant Changes in Circumstance (“RCCs”). In 1993-94, that was reduced to either 3 or 4 specified kinds, depending on the company concerned).

(3) If the suggested broad interpretation were right, the sorts of legislation that would be covered would include a host of general obligations that have nothing to do with the companies “in their capacity as water or sewerage undertakers”.

(4) Nor can it be claimed that a broad interpretation was intended to deal with developments generally that might have a substantial adverse effect on the companies’ ability to finance their functions between periodic reviews. Condition B14.3 in the original version of Condition B was designed precisely to deal with such general eventualities (This is the so-called “shipwreck clause”. When the 8 RCCs were reduced in number to 3 or 4, the then Director offered each company the opportunity to retain the shipwreck clause provided that it was made reciprocal, so that he could tighten price limits, should a company enjoy some windfall).

(5) It should be remembered that changes in legal requirements can confer benefits on companies as well as operating to their disadvantage. Accordingly, under the suggested broad interpretation, the Director would have an increased power (and probably a duty) to reduce, as well as increase, a company's K factor allowance on an interim basis. Yet, in an industry such as the water and sewerage industry where planning for long term investment is important, there is a high premium on achieving certainty in the intervals between periodic reviews.

(6) Also under the wide interpretation, and for the same reasons, he would almost certainly have to increase his ongoing information requirements from the companies, in order to be able to determine the source of any changes in company costs and take effective steps to reduce K factors where appropriate. For example, he might need to create additional entries for the companies to complete in their annual June returns. The net result would undoubtedly be more detailed (and intrusive) regulation between periodic reviews, contrary to the spirit of the legislation. He believes that this would be unlikely to be welcomed by many of the water and sewerage companies.

(7) The argument that there is no necessary reason why water-specific legislation should have a greater practical impact than general legislation is of limited weight. It is rational to have assumed that water-specific legislation should be more likely to have a greater impact on the water and sewerage activities of the companies.

A second, more limited, interpretation of condition B13.2(1)(a) has also been advanced to support a claim based on the CCL. This is that the provision covers legislation which, although of general application, has disproportionate effects in practice on water or sewerage companies, i.e. greater than those which apply to other types of company. The Director considers that this interpretation is similarly misconceived. In particular:

(1) The B13.2(1) definition of a "legal requirement" is not written so as to relate to legislation that has disproportionate, or "special", effects on water and sewerage undertakers. Additional language needs, artificially, to be read into the provision.

(2) This interpretation would be entirely vague and indeterminate in its scope. It may be unclear whether the impact on water and sewerage undertakers of a certain piece of legislation is sufficiently "special" or "disproportionate" for it to count as an RCC. Moreover, the impact of a piece of legislation on companies may vary from time to time depending on the circumstances, leading to the possibility that its status as an RCC may fluctuate through time.

Recently, a third argument has been raised to support a claim for an allowance based on the CCL. This argument accepts the basic premise that the relevant change of circumstance is only triggered by water-specific legislation but contends that the CCL is nevertheless still caught. The argument is that: (a) companies in other energy-intensive sectors (currently, those covered by the IPPC regime) are entitled to an 80 per cent. discount from the levy in return for entering into energy saving agreements with the Secretary of State; (b) the only reason why companies in the water industry have been excluded from the possibility of arranging for similar discounts is that they have special obligations by virtue of the Urban Waste Water Treatment Directive ("UWWTD"), which is clearly water-specific legislation; and (c)

accordingly, the obligation to pay the full CCL rate arises as a result of the application of water-specific legislation.

This third argument cannot be correct. Even assuming the accuracy of (b), the source of the obligation to pay the CCL at the rate applicable to many other descriptions of businesses is not water-specific legislation

By contrast new obligations deriving from the UWWTD would qualify as “legal requirements” for the purpose of the interim determination provisions of Condition B, if they were not taken into account at periodic reviews.