

16. Dealing with uncertainties

- We recognise that there are uncertainties when we set price limits.
- We have proven mechanisms to deal with significant changes when they arise.
- We have identified particular uncertainties that require notified items:
 - the number of meter optants;
 - bad debt and debt management;
 - charges for abstractions and discharges to controlled waters;
 - charges for lane rental/traffic management; and
 - changes in the taxation of infrastructure expenditure arising from the introduction of International Financial Reporting Standards.

16.1 Dealing with uncertainties

The price limits we set should be sustainable over a five-year period. However, we must allow for significant changes (both up and down) that are outside the control of an efficient company. These fall into three categories:

- changes in costs and outputs that affect industry in general;
- changes in costs and outputs that specifically affect the water industry; and
- changes in costs and outputs that we acknowledge to be too uncertain at the time of price setting to be included in price limits in full or in part.

Water companies are protected from the first of these changes because they are allowed to raise their price limits in line with general inflation (measured by a change in the RPI). The business risk inherent in the water industry, which is relatively low compared with other industries, is reflected in the cost of capital and we do not include any general allowance for unforeseen costs. The five-year price review process ensures that water companies do not carry risks for more than five years.

The following mechanisms protect the industry between reviews from material changes in costs that affect the water industry differentially.

- Interim determinations. These allow the companies, or Ofwat, to seek revised price limits if specified changes occur in the period since price limits were last set which have a total impact on the company amounting to at least 10% of a company's turnover (the materiality threshold).
- Logging up and down. This takes account, at the start of the next price limit period, of changes in outputs required of the companies during the previous price limit period.

As a further protection companies' licences allow for substantial effect determinations. These allow companies, or Ofwat, to seek revised price limits if a circumstance beyond a prudent

company's control changes so that the total adverse or beneficial impact on the company amounts to at least 20% of a company's turnover.

These mechanisms have worked well over the past 15 years and we will continue to use them. The mechanisms include the use of our change protocol (a procedure for dealing with changes in outputs between price reviews) published in MD197 'AMP4 change protocol'.

The interim determination process is set out in each company's licence. The factors that can trigger an interim determination are set out in full in Condition B. Broadly, they are:

- Notified items. These are items not allowed for, in full or at all, in price limits because the uncertainty surrounding them is too great.
- Relevant changes of circumstance (RCCs) which fall into four categories:
 - RCC(1): The application or change to specified legal requirements. These include changes to discharge consents and abstraction licences, and changes to legislation to the extent it applies to water companies in their capacity as a statutory supplier of water or sewerage services.
 - RCC(2): A change in the value received or expected from sales of land.
 - RCC(3): A change where a company has not delivered an output assumed when price limits were set.
 - RCC(4): Four companies (Anglian, United Utilities, Yorkshire and Cholderton) can trigger an interim determination if changes in the construction output price index (COPI) are significantly different from changes in the retail price index (RPI).

Since we set price limits in 1999, there have been nine interim determinations and two substantial effect determinations. The net effect of these redeterminations on price limits has been an increase in the annual average price limit of 0.5% for the industry as a whole. The issues that have triggered these determinations have been wide-ranging. They included:

- rate of uptake of free meters (a notified item); and
- bad debt and debt management costs (a notified item).

And the following were accepted as relevant changes in circumstances:

- Cryptosporidium – continuous monitoring requirements at water treatment works;
- additional sewage treatment required to comply with new consents issued by the Environment Agency after confirmation through the change protocol;
- lead – changes to the compliance programme confirmed by the DWI;
- measures to address deteriorating raw water quality;
- changes to the programme for improving unsatisfactory intermittent discharges from the sewerage system, confirmed by the change protocol;
- protection of assets;

- changes to national requirements to implement the Waste Incineration Directive;
- British Waterways discharge consents (included in a notified item for 2005-10);
- land disposals RCC(2); and
- changes in the notified index RCC (4).

We would expect similar issues where they involve new changes (and where they are not notified items) to qualify as relevant changes of circumstance should they arise again in 2005-10.

Companies have made claims in their business plans for other items which they consider place a disproportionate degree of uncertainty on the industry. We have considered these carefully. Those that meet the criteria set out in the companies' licences for relevant changes of circumstance and apply directly to the water or sewerage companies in their capacity as undertakers are likely to be treated as such in any interim determination, so long as they pass the triviality threshold and satisfy the licence conditions.

We can confirm that changes arising from the adoption of private sewers will be a relevant change of circumstance on the assumption that the regulations supporting the Water Act 2003 come into force. Should there be a change to the Guaranteed Standards Scheme payments, for example in respect of sewer flooding, then this would also be a relevant change in circumstance. Changes in discharge consents affecting the environmental programme or changes to the drinking water quality programme will also count as relevant changes of circumstance as explained in the change protocol.

Companies are concerned that the definition of relevant change of circumstance is confined to matters having a direct impact on them. Some have suggested a notified item to allow us to consider any issues that might be unforeseen at a price review but, if known at that time, might have warranted one. We have concluded that it is appropriate that companies continue to bear a proportion of the risk arising from uncertainty and if a single issue outside prudent management control is sufficient to have a serious impact on the company then a substantial effect determination may be applicable.

It is natural that companies should seek protection from as many changes as possible. However we have concluded that some of the changes they propose are adequately dealt with in the price setting mechanism, for example power costs and pensions. Others will be reflected in changes in the RPI. Others are simply business risks that need to be accepted by water and sewerage companies as for any other company, for example loss of customers through competition. We have reviewed all of the issues raised by the companies carefully and we judge that the risks are small and even if they appeared, companies should use their management skills to minimise the effects. The cost of capital takes account of this and other forms of business risk.

16.2 Notified items

A few issues are too uncertain to be included in our price limits. For these issues we set 'notified items' so that if the issues do arise and have a material impact on a company's costs then they can be considered as a reason for resetting that company's price limits between reviews. Companies put forward many issues in their business plans and representations.

After assessing the companies' proposals and representations we have set notified items for:

- Changes up or down in the number of meter optants. The Water Industry Act 1999 allows customers to change to a metered charge, without being charged for the installation of the meter. Most customers who opt for a meter do so because they expect to save money. The rate at which customers switch to a meter has a significant impact on a company's revenue but depends on decisions by customers. We recognise that the assumptions we make about future rates of optional metering may be too high or too low. These assumptions can be revised at an interim determination initiated either by the company or Ofwat. This was a notified item at the 1999 price review (at that time it only applied if our metering assumptions were too low, for most companies) and four companies have used it to trigger an interim determination since then.
- Increases in bad debt and the costs of managing debt. The Water Industry Act 1999 also prohibited the disconnection of domestic premises for non-payment of bills. We created a notified item at the 1999 review to address the uncertainty this caused. Since then, five companies have triggered an interim determination for bad debt and debt management costs. Companies have now had five years since the change in legislation to improve their debt management processes. Good practice is being shared across the industry and latest data shows that not all companies are reporting increases in bad debt. This suggests that the position may be stabilising. However, this uncertainty remains and we will include a one-way notified item for the period to the 2009 review to allow for rises in levels of household bad debt and debt management costs.

In their representations on our draft determinations, companies claimed that the link to the loss of power to disconnect would be increasingly difficult to demonstrate. Our revised text for this notified item acknowledges that the loss of the power to disconnect is only one element of the disadvantageous conditions under which water and sewerage companies operate. We do not expect this notified item to be necessary after 2009.

- Increases in charges for abstractions and discharges to controlled waters. The costs of abstractions and discharges are more uncertain in the next five years than in the past for a number of reasons. Companies claim that abstraction charges have historically increased by more than inflation. In addition, the Environment Agency has consulted on changes to its water abstraction charges scheme, including its recovery of costs associated with environmental improvements ('Review of the water abstraction charges scheme', Environment Agency, January 2004), and published a summary of its responses under the same title in November 2004 but it has not reached conclusions.

Final ministerial guidance, in October, confirmed that compensation payments to holders of abstraction licences revoked or amended to deliver environmental improvements, would be funded through Environment Agency abstraction charges.

Another issue covered by the consultation was the proposal to remove the discount available to British Waterways (BWB), and hence to the companies who abstract water from BWB's canals. As a result of a ruling by the Court of Appeal in March 2001, BWB (and other owners of watercourses) can now charge sewerage companies for discharges. Some companies have reached agreements with BWB and these costs are included in their price limits. Other companies may face changes in charges in future.

We have set a notified item to protect water companies facing material increases in their net abstraction and discharge costs.

- Charges for lane rental/traffic management. At this stage we do not know what impact the provisions in the Traffic Management Act 2004 will have on water companies or what the Government will decide following the conclusion of two trials of a lane rental system in Middlesbrough and Camden. We have included a notified item to enable companies to seek a revision to price limits if the impact of either of these issues on efficient companies is significant.
- Increases in the taxation of infrastructure expenditure arising from the introduction of International Financial Reporting Standards (IFRS). It is not clear how the introduction of IFRS may interact with the UK tax framework, the corporation tax liabilities of water companies or the views of the Inland Revenue on particular cases in respect of the taxation of infrastructure renewals expenditure. Nor has any timetable yet been established for the implementation of any Financial Reporting Standard (FRS) based on FRED29 'Property, Plant and Equipment; Borrowing Costs' which may have similar impacts to IFRS. In these circumstances, Ofwat is not in a position to make any assumption on whether and when unavoidable additional taxation costs may arise for the water and sewerage companies from these causes. We have included a notified item to protect companies should a significant change in taxation costs arise from this change during the period. This approach is designed to maintain the incentive for companies to behave in a tax efficient way and to pursue the solution best designed to minimise the impact of IFRS and/or any FRS based on FRED29 on customers' bills. This issue is discussed in section 15.10.

At our draft determinations, we identified notified items covering four of the issues above – meter optants, bad debt and the costs of managing debt, some aspects of abstraction and discharge costs, and lane rental/traffic management. As stated in section 15.10, we were undecided at the draft determination stage about the need for a notified item on taxation but, following representations, we have concluded that one is required. We have also widened the scope of the notified item on abstraction charges and discharges and refined the one for bad debt and the costs of managing debt.

16.3 Licence modifications

In April 2004, we consulted on a number of modifications to companies' licences in MD189 'Proposed licence modification consultation'. Our proposed modifications covered a number of areas, most significantly in respect of interim determinations. The package of modifications sought to clarify the changes in costs and revenues that could trigger an interim determination or a substantial effect determination, and also included the extension of RCC(4) to all companies.

On the substantial effect determination we proposed revising the modifications that we made in 2000 and restoring the substantial effect clause to its original form. In their responses to our consultation the companies disagreed with our proposed approach. They argued that our proposal made it significantly more difficult to trigger a substantial effect determination, adding to the risk that companies face. We will not make the proposed change now but we will review this issue again before we set price limits in 2009.

For a standard interim determination the materiality threshold is 10% of the regulated company's turnover. At the last price review the calculation mechanism was extended to

15 years for assessing changes to operating costs and revenue losses. In practice we found that there were some difficulties with this approach. In particular, changes in the early part of the 15-year period could have a disproportionate effect when extrapolated over the full period. We therefore proposed a modification to the materiality calculation to base it on twice the present value of changes in revenue or operating expenditure over the five-year price review period. Most companies agreed with the proposal to change to a five-year period, but considered that twice the present value was insufficient and that we should use a larger multiplier. We will reconsider how best to modify the materiality calculation and will consult further on this after the current price review.

Our proposed extension to all companies of RCC(4) would have allowed us to review price limits either at our or the companies' initiative if the notified index rose at a different rate to that assumed at the last price review. The notified index reflects the difference between the construction output price index and the retail price index. Most companies welcomed this modification in their responses to the consultation.

In MD189 we said that we would set out with our draft determinations the licence modifications we proposed taking forward. We viewed the changes to interim determinations, substantial effect determinations and the extension of RCC(4) as a package. However, as companies have rejected some of the above modifications, we have decided to handle them separately from the price review process. Our assessment of risk and the cost of capital has, consequently, been made on the basis of the current licence conditions. We have, however, in setting the final price limits, assumed that construction prices will rise by slightly more than the general rate of inflation for those companies that do not have protection against this in their licences.

We will look to take all these modifications forward after the current price review and we expect to make any licence modifications ahead of the price review in 2009.

The other modifications we proposed in MD189 – the modification to remove the tariff basket headroom effect under certain circumstances, the definition of large users, amending the interim determination mechanism to cover revenue gains as well as revenue losses, and the proposed modification to Licence Condition H – were uncontroversial. We consulted on these aspects in MD194 'Proposed licence modifications: Conclusions' in August 2004.

We have written to each company setting out the changes we will be making to its licence and we will issue formal notices under section 13 of the Water Industry Act 1991 in the New Year to put these modifications in place by 1 April 2005.