

Mr Brian Duckworth  
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6 November 2002

## **INTERIM DETERMINATION – PROVISIONAL RESPONSE**

On 12 September 2002 you made an application for an interim determination of your company's price limits under Part IV of Condition B of the licence. This was altered by your supplementary submission of 22 October 2002. Your Reporter, Jon Bateman of Halcrow Management Services Limited submitted his report on your application on 13 September 2002 and has commented on your responses to our queries.

Your application covers the additional costs resulting from the following seven items.

- Increased operating costs, additional capital expenditure and uncollected revenue resulting from the ban on disconnection.
- Changes to the requirements for treatment and monitoring for cryptosporidium.
- Additional costs arising from the EC Nitrates Directive affecting sludge disposal in nitrate vulnerable zones (NVZs).
- Measures to ensure continued protection of assets.
- A proposed programme for tackling sewer flooding problems.
- Charges levied by British Waterways Board (BWB) for discharges to canals.
- Additional costs of providing first time rural sewerage.

Annex A summarises your estimates of the effect of these changes on your costs and revenues.

Your application also takes into account changes to requirements on plumbosolvency control and lead communication pipe replacement which have reduced your costs. We have taken account of this when determining your application.

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We have completed our initial assessment of your application and your supplementary submission. Our provisional views on the impact of the changes on your costs and revenues are set out in the summary table in Annex A. Our approach and our initial findings, judgements and conclusions are summarised in Annex B. We have provided you separately with some confidential explanatory notes expanding on Annex B.

Our initial assessment of the total impact of the relevant items on your costs and revenues is that they do not exceed the materiality threshold set out in Condition B of your licence. We therefore find no basis for changing the price limits we set in November 1999.

Please could we have your written representations on this draft determination by Wednesday 20 November 2002. We shall be meeting you on Tuesday 26 November 2002 to hear your representations. Written comments are sought from other interested parties by Wednesday 27 November 2002. We will take account of any new relevant information and the views of all interested parties in reaching our final conclusions.

We shall issue our final determination of your application by 12 December 2002.

We are placing this draft determination in our library and also announcing it to the London Stock Exchange.

This letter and enclosures has been copied to John Ballard (DEFRA), Bob Macey (Welsh Assembly Government), Michael Rouse (DWI), Steve Morley (Environment Agency), Sir James Perowne, (Chairman of WaterVoice Central), your local Members of Parliament, Assembly Members and Members of the European Parliament.

**PHILIP FLETCHER**

## ANNEX A

<b>SEVERN TRENT WATER LIMITED</b>			
<b>DRAFT INTERIM DETERMINATION – Autumn 2002 – SUMMARY TABLE</b>			
Description		Company's Assessment (October 2002)	Ofwat's Assessment (November 2002)
<b>Item 1 – Loss of disconnection</b>			
1.1	Estimated net change in <b>capital expenditure</b> over the AMP3 period	£3.8m	£1.6m
1.2	Estimated net change in <b>operating expenditure</b> over the AMP3 period	£3.3m	-
1.3	Estimated net change in <b>uncollectable revenue</b> over the AMP3 period	£25.9m	£27.0m
1.4	<b>Materiality amount</b> (NPV of total net change in costs)	<b>£74.3m</b>	<b>£61.1m</b>
1.5	Contribution towards <b>materiality threshold</b>	8.3%	6.8%
<b>Item 2 – Cryptosporidium – additional requirements for continuous monitoring and treatment.</b>			
2.1	Estimated net change in <b>capital expenditure</b> over the AMP3 period	£6.2m	£7.0m
2.2	Estimated net change in <b>operating expenditure</b> over the AMP3 period	£4.0m	£1.7m
2.3	<b>Materiality Amount</b> (NPV of total net change in costs)	<b>£15.2m</b>	<b>£10.8m</b>
2.4	Contribution towards <b>materiality threshold</b>	1.7%	1.2%
<b>Item 3 – Nitrate Vulnerable Zones</b>			
3.1	Estimated net change in <b>capital expenditure</b> over the AMP3 period	£7.3m	-
3.2	Estimated net change in <b>operating expenditure</b> over the AMP3 period	£7.5m	-
3.3	<b>Materiality amount</b> (NPV of total net change in costs)	<b>£43.8m</b>	-
3.4	Contribution towards <b>materiality threshold</b>	4.9%	0.0%
<b>Item 4 – Protection of assets</b>			
4.1	Estimated net change in <b>capital expenditure</b> over the AMP3 period	£14.4m	£11.6m
4.2	Estimated net change in <b>operating expenditure</b> over the AMP3 period	£0.4m	£0.4m
4.3	<b>Materiality amount</b> (NPV of total net change in costs)	<b>£16.3m</b>	<b>£12.1m</b>
4.4	Contribution towards <b>materiality threshold</b>	1.8%	1.4%
<b>Item 5 - Sewer flooding</b>			
5.1	Estimated net change in <b>capital expenditure</b> over the AMP3 period	£25.2m	£11.0m
5.2	Estimated net change in <b>operating expenditure</b> over the AMP3 period	-	-
5.3	<b>Materiality amount</b> (NPV of total net change in costs)	<b>£22.9m</b>	<b>£10.0m</b>
5.4	Contribution towards <b>materiality threshold</b>	2.6%	1.1%
<b>Item 6 – British Waterways Board discharge consents</b>			
6.1	Estimated net change in <b>capital expenditure</b> over the AMP3 period	-	-
6.2	Estimated net change in <b>operating expenditure</b> over the AMP3 period	£14.1m	-
6.3	<b>Materiality amount</b> (NPV of total net change in costs)	<b>£24.6m</b>	-
6.4	Contribution towards <b>materiality threshold</b>	2.8%	0.0%

<b>Item 7 – Lead – changes to the compliance programmes</b>						
7.1	Estimated <b>capital expenditure</b> on confirmed lead programme over the AMP3 period	£10.3m	£7.4m			
7.2	Estimated <b>operating expenditure</b> on confirmed lead programme over the AMP3 period	£3.1m	£2.2m			
7.3	<b>Materiality amount</b> (NPV of total net change in costs)	<b>£19.3m</b>	<b>£13.6m</b>			
7.4	Contribution towards <b>materiality threshold</b>	2.2%	1.5%			
7.5	Reduction in <b>capital expenditure</b> compared with that assumed in the 1999 final determination	(£50.2m)	(£46.2m)			
7.6	Reductions in <b>operating expenditure</b> compared with that assumed in the 1999 determination	(£0.9m)	-			
7.7	<b>Materiality amount</b> (NPV of total net change in costs)	<b>(£53.5m)</b>	<b>(£46.5m)</b>			
7.8	Contribution towards <b>materiality threshold</b>	(6.8%)	(5.2%)			
<b>Item 8 – First time rural sewerage schemes</b>						
8.1	Estimated net change in <b>capital expenditure</b> over the AMP3 period	£4.2m	-			
8.2	Estimated net change in <b>operating expenditure</b> over the AMP3 period	£0.1m	-			
8.3	<b>Materiality amount</b> (NPV of total net change in costs)	<b>£4.5m</b>	-			
8.4	Contribution towards <b>materiality threshold</b>	0.5%	0.0%			
<b>OVERALL ASSESSMENT</b>						
5	<b>Materiality amount</b> (NPV of total net change in costs)	£167.4m	£61.1m			
6	Severn Trent Water turnover for 2001-02 used in materiality test	£893.2m	£893.2m			
7	<b>Materiality test</b>	<b>18.7%</b>	<b>6.8%</b>			
<b>PRICE LIMITS</b>		2000-01	2001-02	2002-03	2003-04	2004-05
8	<b>Current price limits</b> (as set in November 1999)	-14.1	-1.0	-1.0	0.0	1.0
9	<b>Draft revised price limits</b>	-14.1	-1.0	-1.0	0.0	1.0
<b>Notes:</b>						
1. Additional costs are shown as positive, savings are shown as negative.						
2. The appropriate Discount Rate used is 6.79%.						
3. <b>Materiality Test</b> – Result must be greater than $\pm 10\%$ to trigger a change in price limits.						
4. All monetary values are stated in September 2002 prices. Totals may not add due to rounding.						

**SEVERN TRENT WATER LIMITED  
DRAFT INTERIM DETERMINATION – AUTUMN 2002  
SUMMARY OF OFWAT'S INITIAL ASSESSMENT**

**INTRODUCTION**

1. We have followed a four stage assessment of your application in accordance with the terms of Condition B of your licence.
2. You included eight changes in your application:
  - Increased operating costs, additional capital expenditure and uncollected revenue resulting from the ban on disconnection.
  - Changes to the requirements for treatment and monitoring of cryptosporidium.
  - Additional costs arising from the EC Nitrates Directive affecting sludge disposal in nitrate vulnerable zones (NVZs).
  - Measures to ensure continued protection of assets.
  - Additional costs of providing first time rural sewerage.
  - A proposed programme for tackling sewer flooding problems.
  - Charges levied by British Waterways Board (BWB) for discharges to canals.
  - Changes to the requirements on plumbosolvency control and lead communication pipe replacement.
3. We issued a counter notice in respect of changes to the requirements for lead communication pipe replacement which you reflected in your application.
4. Our initial assessment of your application and the counter notice is summarised below. This does not include the additional costs of providing first time rural sewerage. Condition B of your licence requires us only to consider non-trivial items. We explained in MD178 Interim Determination 2002 that we will only include additional provision in price limits if the net present value (NPV) of a specific change is greater than 1% of the company's turnover for the last reporting year. As the additional costs in your application of providing first time sewerage fall below the triviality limit, we have not considered these further.

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

**Item 1 – Loss of disconnection**

5. We set out a notified item in the 1999 price determination to protect you from the consequences of increased levels of bad debt and costs of debt recovery arising from the loss of the power to disconnect domestic customers for non-payment of bills.

6. We confirm that the increases in your bad debt and costs of debt recovery have 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 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 but did incorporate work to satisfy the recommendation of two expert committees (the Badenoch and Bouchier recommendations).
8. The DWI issued a programme of regulatory monitoring dated 31 July 2000 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. The DWI has since written to you on 7 August 2002 updating the programme of work to meet the cryptosporidium regulations.
9. The statement of intent issued by the DWI on 30 November 2000 set out the agreed AMP3 programme of improvement works you were required to carry out under regulation 41 of the Water Supply (Water Quality) Regulations 2000. This included activity towards satisfying Badenoch and Bouchier recommendations, particularly turbidity monitoring and control improvements, and the installation of particle analysers.
10. We have received confirmation from the DWI that the work set out in your application, with the exception of continuous monitoring at one site (Llanwrin) and your proposals for two additional sites (Bigwell and Newent), is necessary to meet your obligations under the cryptosporidium regulations.
11. In the letter to your company dated 26 October 2002 the DWI has confirmed that it considers the revised risk assessments for the Bigwell and Newent sites have been carried out satisfactorily. Your assessments concluded that there is now a significant risk of cryptosporidium oocysts in water supplied from these works. The DWI has not given approval for your proposal to install membrane treatment at these two sites. However, we have included these in our draft determination on the assumption that you will receive confirmation from the DWI before we make our final determination.
12. We made allowance when we set price limits in 1999 for some of the work that you have included in your application to satisfy Badenoch and Bouchier recommendations. This work, relating to five sites, is not therefore a relevant change of circumstance. We consider that the remaining monitoring and treatment requirements are a relevant change of circumstance under Condition B paragraph 13 of your licence.

### Item 3 – Sludge disposal in nitrate vulnerable zones

13. The European Council adopted the Nitrates Directive (Directive 91/676/EEC) on 12 December 1991. The objective of the Nitrates Directive is aimed at “reducing water pollution caused or induced by nitrates from agricultural sources, and preventing further such pollution”. For the purposes of realising this objective, member states had to establish action programmes in respect of designated vulnerable zones (NVZs).
14. The Nitrates Directive was originally implemented in England and Wales by The Protection of Water Against Agricultural Nitrate Pollution (England and Wales) Regulations 1996 (S.I. 1996 No.888) (“1996 Regulations”) and The Action Programme for Nitrate Vulnerable Zones (England and Wales) Regulations 1998 (S.I. 1998 No.1202) (“1998 Regulations”). The 1996 Regulations set out 68 NVZs, which represented approximately 8% of the land area in England. The 1998 Regulations impose legal requirements on the occupiers of any farm all or part of which is in a NVZ. Such occupiers of farms have to ensure that a detailed action programme is implemented in relation to any land which is part of the farm and in the NVZ. The action programme in particular places restrictions on the amount of nitrogen fertiliser which can be applied to the farmland, and when this can happen. Nitrogen fertiliser is defined to include sewage sludge and other organic wastes.
15. Following infraction proceedings initiated by the European Commission, the European Court of Justice ruled in December 2000 that the UK Government had failed to correctly implement the Nitrates Directive. The Nitrate Vulnerable Zones (Additional Designations) (England) Regulations 2002 (S.I. 2002 No.2525) (“2002 Regulations”) were therefore introduced. The 2002 Regulations set out additional NVZs, which now represent approximately 55% of the relevant land area. Under the 2002 Regulations, approximately 90% of your authorised area will be affected by the restrictions placed on occupiers of farms within NVZs. You have explained that this will translate into increased costs relating to, for example, transporting sludge cake over a longer distance to new agricultural sites.
16. Paragraph 13.2(1)(a) of Licence Condition B states that a legal requirement 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 [...]”. Similarly, the relevant sub-paragraph of the definition of a relevant change of circumstance in paragraph 13.1 refers to “*the application to the Appointee* of any legal requirement”. But the relevant Regulations (together “Nitrates Regulations”) apply to agricultural producers who occupy all or part of a farm. The operative legal requirement under the 1998 Regulations is regulation 3, which provides:
  - “(1) The occupier of any farm all or part of which is in a nitrate vulnerable zone shall ensure that the action programme set out in the Schedule hereto is implemented in relation to any land comprised in the farm and in the nitrate vulnerable zone.

“(2) For the purposes of paragraph (1) above, the occupier of a farm shall not cease to be the occupier of the whole of the farm by reason of another agricultural producer using part of the land comprised in the farm”.

17. The Nitrates Regulations may apply to certain farmers on whose land you dispose of sludge. This may well affect your business. But they do not apply to you in your capacity as a water undertaker or sewerage undertaker. The Nitrates Regulations do not therefore represent a relevant change of circumstance under Condition B paragraph 13 of your licence.

#### **Item 4 – Protection of assets**

18. DEFRA has recently instructed companies to accelerate planned programmes of work to ensure the ongoing protection of assets. This brings forward work which is required under the existing code of practice.

19. Such a change is a relevant change of circumstance under Condition B paragraph 13 of your licence.

#### **Item 5 – Sewer flooding**

20. In March this year we published a consultation paper ‘Flooding from sewers: A way forward’. As part of our consultation we invited views on proposals for tackling sewer flooding in the period up to 2005. We confirmed in MD180 ‘Flooding from sewers’ (September 2002) that we are willing to consider proposals for companies to address more problems.

21. Where as a result of a proposal from a company we establish a revised set of regulatory outputs to deal with sewer flooding and a company is making an application for an interim determination (because of other changes to its costs and revenues), we believe it is appropriate to take account of the increased costs to deal with sewer flooding in any interim determination.

#### **Item 6 – British Waterways Board discharge consents**

22. Following a ruling by the Court of Appeal on 21 March 2001, British Waterways Board can, for the first time, charge sewerage companies for surface water discharges to its canals.

23. The Court of Appeal’s ruling includes a reinterpretation of law. This change is a relevant change of circumstance under Condition B paragraph 13 of your licence.

#### **Item 7 – Lead – changes to the compliance programmes**

24. In 1999 we allowed in price limits for a work programme to comply with the new lead standards. This assumed a lead communication pipe replacement programme and a plumbosolvency control programme. During the 1999 periodic review the DWI stated that it would review the most effective means of delivering compliance. Plumbosolvency control is now the preferred initial approach.

25. The DWI has confirmed that the provision made in the final 1999 determination for meeting the new lead standards was only for the purpose of setting prices. The programme of work set down in the DWI's letter to you dated 12 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. The DWI wrote to you on 6 August 2002 setting down a modified programme of work.
26. The DWI has advised that it will not be possible to determine whether a programme of lead communication pipe replacement will be required until the effectiveness of plumbosolvency control has been assessed.
27. We have received confirmation from the DWI that the work set out in your application is necessary to comply with the new lead standards. We consider that the change in the lead compliance programme is a relevant change of circumstance under Condition B paragraph 13 of your licence.

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

### **Item 1 – Loss of disconnection**

28. We have carefully assessed the information submitted in your original application and your supplementary submission. We have also requested further clarification from yourselves and your reporter.
29. In your application you explained that:
- the amount of debt which you cannot collect; and
  - the costs of collecting debt
- have increased since the implementation of the Water Industry Act 1999. We accept that overall, your costs have increased.
30. Your application sets out changes to your procedures for recovering debt from customers. Prior to the Water Industry Act 1999 you used the threat of your power to disconnect domestic customers widely. You established contact with a significant number of non-paying customers as a result and obtained payment from most of those customers. Having lost this power you have undertaken a review of your credit management system and introduced a number of new initiatives including tailoring your approach to meet the circumstances of individual customers, use of dedicated teams focused on credit management and increased use of external credit agents. These do not secure payment in as many cases. Where payment is secured it is not recovered as quickly.
31. We accept that as a result of these changes:
- the amount of debt which the company is unable to collect has increased; and
  - where debt is recovered it now takes the company longer on average to do so. Financing costs increase because of this.

32. In order to assess the impact of the ban on disconnection on companies' financial positions we look at the changes in levels of debt and costs of debt recovery since 1998-99 (the last year in which companies could disconnect domestic customers for non payment of bills).
33. In your supplementary submission you assessed the amount of revenue which you are unable to collect based on an analysis of the change in revenue outstanding which is between 36 and 48 months old
34. We set out our methodology in RD12/01 'Notified Item for bad debt' (August 2001). This looks at the change in the level of debt written off over the same period. We have followed the approach we set out in RD12/01. This accounts in part for the difference between your claim and our assessment.
35. You also argued that changes in your procedures have caused your operating costs to rise over the period from 1998-99 to 2000-01. These costs are mainly the result of higher employee and outsourced debt recovery costs. In 2001-02 however your operating costs associated with debt recovery fell from the level you reported for 2000-01 to a level comparable with 1998-99. We have, therefore, assumed no increase in the level of debt recovery costs going forward.
36. In addition, you explained that the actions taken as a result of your review of your credit management system required additional capital expenditure. We have reduced your claim where we are not persuaded that the investment is related to debt recovery or would not have been undertaken by your company as part of your normal programmes to maintain an effective information technology system.

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

37. You have chosen to deal with the requirements of the cryptosporidium regulations by carrying out continuous monitoring at thirteen sites and improving the treatment process at one other site (Campion Hills). The reporter has commented that your decisions are reasonable.
38. You informed us on 21 October 2002 of your intention to install membrane treatment at Bigwell and Newent. The DWI has confirmed your risk assessments for these sites but has not yet supported your proposed actions. Because the DWI has confirmed your risk assessments you will have to carry out action at these sites. We have therefore included your cost estimates for the proposed work in our draft determination. In order for us to include these costs in the final determination we will require confirmation that the DWI supports your proposals.
39. Your estimate of the costs for installing membrane treatment at these two sites is not included in your assessment of additional expenditure set out in Annex A.
40. We have reviewed your costs for meeting the requirements 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.

41. We compared your additional operating costs for carrying out continuous monitoring for cryptosporidium with a benchmark and found them to be high. We reduced your submitted costs to the benchmark. This is consistent with the approach we have taken for interim determinations in the past.
42. Continuous monitoring and testing for cryptosporidium is still in its infancy. We believe that the unit costs of materials will fall and there will be increases in efficiency for this labour intensive procedure. We have assumed a future efficiency of 2.5% per annum for operating expenditure.
43. Your additional capital expenditure for continuous monitoring equipment is higher than the benchmark. The costs of installing this equipment should be broadly similar for all sites. In our assessment we reduced these costs by 75% of the difference between your submission and the benchmark cost. This is consistent with the approach we have taken for interim determinations in previous years.
44. You have also included in your submission the capital cost of turbidity monitoring and control improvements and providing particle analysers at 13 sites. We made an allowance in the 1999 final determination for Badenoch and Bouchier improvements at five of these sites, Bamford, Draycote, Frankley, Melbourne and Trimley. We did not therefore include the expenditure at these works in our assessment.
45. We reduced the capital expenditure for turbidity and particle size monitoring at the other eight sites by 11%. This reflects our assumptions about efficiency for capital expenditure at the 1999 review.
46. We reduced by 20% your submitted capital expenditure for treatment enhancements at Campion Hills and for installing new treatment at Bigwell and Newent. This includes our view of efficiency for capital expenditure at the 1999 review.
47. We have assumed a future efficiency of 2.1% for the additional operating expenditure associated with cryptosporidium treatment at Campion Hills, Bigwell and Newent.

### **Item 3 – Sludge disposal in nitrate vulnerable zones**

48. This is not a relevant change of circumstance. Please see paragraphs 13 to 17 above.

### **Item 4 – Protection of assets**

49. We have reviewed your estimate of the costs of accelerating the programme of work to ensure ongoing protection of assets, and considered the reporter's report. We have reduced your estimate of operating costs by 10%, and assumed a 2.1% future efficiency for operating expenditure. We reduced your estimate of the capital expenditure by 20%. This reflects your reporters' comments.

### **Item 5 – Sewer flooding**

50. We said in MD180 that we would consider proposed programmes for additional work to address sewer flooding where these are based on a system for prioritising schemes that has been developed in consultation with the relevant WaterVoice Committee. The prioritisation process must be based primarily on an overall assessment of the severity and frequency of the problems faced by the customers concerned. WaterVoice Central supports more work to reduce sewer flooding. You have provided a proposal for the completion of 73 schemes at a projected cost over £25m.

51. We have considered your proposal and concluded that there are 16 schemes at a total cost of £8.7m which should be excluded. This is because either:

- the schemes have high projected costs compared to their projected benefits; and/or
- the schemes are driven by the delivery of environmental benefits rather than sewer flooding alleviation.

52. Further work to understand these problems, and development of the likely solutions and costs, could provide a clearer interpretation of the cost and benefits for these schemes, and they could be included if better information is provided. Otherwise, they could be suitable for consideration within an application for to log-up additional expenditure at the 2004 review.

53. We have adjusted the proposed costs for a further 42 schemes where scheme costs are derived from a unit cost of solving a problem.

54. Your application does not appear to correctly apply unit costs to calculate the scheme costs you have included. We have made adjustments to correct this where we think it is appropriate.

55. We have also considered the unit costs you have provided as part of your application. We have applied a lower unit cost of £59,500 per problem alleviated. This is based on the benchmark we used at the 1999 periodic review updated to take account of changes in the construction output price index.

56. The proposed programme which we have included consists of 56 schemes with an average cost of around £60,000 per problem addressed. (Total cost £11m). The programme will alleviate:

- 63 problems where customers' properties are flooded; and
- 135 problems where customers' gardens are flooded.

This programme will also alleviate 134 internal or external flooding problems that are at risk of occurring less frequently than once in 10 years.

## **Item 6 – British Waterways Board discharge consents**

57. You are currently negotiating with British Waterways Board (BWB) about the charges to be made by BWB for discharges to its canals. In your application you

have explained that the total costs associated with discharges to BWB's canals are made up of two elements:

- the number of discharges which you make; and
- the charge levied for each discharge.

58. While a large number (in excess of 460) of discharges have been agreed with BWB, there are a significant number (up to 540 more) which have yet to be confirmed. The level of charges which BWB can make is subject to the outcome of your negotiations. You have explained in your application that these negotiations are not yet complete. The range of possible outcomes which you have presented in your application is very wide.

59. Given that the total number of discharges is still to be confirmed and the level of charges remain highly uncertain until your negotiations are complete, we have concluded that the costs attributable to this item are not sufficiently certain at present for us to make an allowance in price limits.

#### **Item 7 – Lead – changes to the compliance programmes**

60. 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 financial provision was subject to companies agreeing specific programmes of work with the DWI once the criteria for action had been agreed. After the final determination, the DWI set out in Information Letter 12/2000 the criteria for action, which resulted in more emphasis on treatment to reduce plumbosolvency than was assumed in the final determination.

61. You have chosen to install new treatment at 43 sites. You are also optimising existing treatment at four other sites.

62. The methodology we used for separating the costs and savings in expenditure arising from the confirmed lead programme differs from yours. Consequently the costs and savings for lead set out in Annex A should only be compared on a combined basis.

63. In our assessment we compared the volumetric output of the works in the notional plumbosolvency programme assumed at the 1999 final determination (around 20% of total output) with the volumetric output of the works in the confirmed programme (around 70% of total output). We have taken into account only the proportion of the costs associated with the net additional volumetric output of the confirmed programme.

64. We compared your operating costs with cost information from other companies. We consider that your additional operating costs for plumbosolvency treatment are reasonable, and we have made no adjustment to your submitted operating costs. And we have assumed no future efficiency reduction in operating costs.

65. We used your submitted capital costs for plumbosolvency treatment in our assessment. But we have assumed an estimate of 1.4% per year for future efficiency. This is consistent with the approach we have taken at interim determinations in previous years.

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

66. 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 31 March 2005 and operating costs and revenue losses are calculated over 15 years.

67. 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 not been satisfied.

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

68. Because the materiality threshold has not been met based on our preliminary view of the impact of changes included in your application, there can be no revision of price limits using the approach set out in Condition B of your licence.

69. Therefore our preliminary assessment of your application is that the current price limits for 2003-04 and 2004-05 should not be changed.