

Mr J Roberts
Chief Executive
United Utilities Water PLC
Dawson House
Great Sankey
Warrington WA5 3LW

11 December 2003

14.2 INTERIM DETERMINATION

You applied on 11 September 2003 for an interim determination of your company's price limits under Part IV of Condition B of your licence. Your reporter, Chris Turner of Halcrow Management Sciences, submitted his report on your application on 23 September 2003. Your application covered the additional costs resulting from the following six items:

- Changes to the requirements for treatment and monitoring for cryptosporidium.
- A proposed programme for tackling additional sewer flooding problems.
- Differences in the rate of change of the construction output price index relative to RPI compared with our final determination assumptions.
- Increased operating costs, additional capital expenditure and uncollected revenue resulting from the ban on disconnection of domestic customers.
- Additional expenditure for protection of assets.
- Changes to requirements under the Urban Wastewater Treatment Directive.

Your application also takes into account two changes that have reduced your costs or resulted in extra income:

- changes to the requirements for plumbosolvency control and lead communication pipe replacement; and
- proceeds from disposals of land.

We have taken all of these changes into account in making our determination.

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We sent you our provisional decision on 5 November. You sent us your representations on 19 November and we discussed these at our formal meeting on 26 November. We have considered your representations and those from others, including WaterVoice North West and members of the public.

In your representations, you highlighted a number of items in our provisional decision that you believed we needed to revisit. You also accepted our decision for a number of items. We have considered the points you raised and set out our decision in the company confidential explanatory notes that accompany this letter.

WaterVoice North West also raised particular concerns about increasing customer debt and associated costs relating to the ban on the disconnection of domestic properties. WaterVoice North West questioned whether the link between the loss of the threat of disconnection and companies' ability to recover debt has yet been conclusively demonstrated. WaterVoice North West wished Ofwat to be certain that United Utilities Water's failure to halt rising debt is solely attributable to the ban on disconnection and is in spite of their best efforts.-

We have reviewed the initiatives that you have undertaken to tackle the increases in domestic debt. We note that you have extended your efforts to manage this issue. It is clear that, despite this, the level of debt attributable to domestic customers has increased materially. This is in contrast to the level of debt attributable to non-domestic customers, which has not increased following the introduction of these initiatives. We accept that this difference is due to the implementation of the ban on disconnection of domestic customers.

My statutory duties require me to make sure that a well managed company can finance the services it provides to its customers. No specific allowance had been made at the 1999 periodic review for the additional costs that relate to the ban on disconnection but a notified item was specified to take account of such costs.

However it is important that companies manage the problem of rising debt in an effective and efficient manner. We will continue to apply and refine comparative analysis tools so that I can be satisfied that companies are making every reasonable effort to manage debt.

We discussed the issues surrounding the counternotice for Unsatisfactory Intermittent Discharges (UIDs) in detail with you and colleagues at the Environment Agency and DEFRA. I am pleased that these meetings produced a sensible way forward that will strike the right balance between environmental benefits and value for money. The counternotice relating to UIDs stands. We note:

- Appropriate action is still required to comply with Ministerial guidance issued in 1999;

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- EA and United Utilities Water will work towards an appropriate programme for these catchments to be delivered within an agreed timeframe;
- The reasonable net additional costs of the new programme will be accepted for logging up in United Utilities Water's final business plan.

Taking into account all representations received, our assessment of the total impact of the relevant items on your costs is that they are sufficient to exceed the materiality threshold set out in Condition B of your licence.

Annex A summarises your estimates of the effect of all the changes on your costs in your application and also our final assessment of your application. Our approach and our findings, judgements and conclusions are summarised in Annex B. We have provided you separately with some confidential explanatory notes expanding on Annex B.

The revised price limits set out in the attached table will apply from 1 April 2004. In calculating our revised price limits we have used the calculation set out in Condition B of your licence. This has resulted in a revised K of 8.9 in 2004-05. This represents an increase of 4.4 on the K of 4.5 set at the 1999 final determination.

Overall, in September 2003 prices, the average water and sewerage bill for a United Utilities customer will increase by around £21 from £252 in 2003-04 to £273 in 2004-05. This means that customers' bills have remained broadly constant in real terms for the whole of the period 2000-05.

We are placing this 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), Robert Runcie (Environment Agency), Maurice Terry (Chairman of WaterVoice North West), your local Members of Parliament and Members of the European Parliament.

PHILIP FLETCHER

ANNEX A

UNITED UTILITIES WATER PLC INTERIM DETERMINATION – December 2003 – SUMMARY TABLE

Description	Company's Assessment (September 2003)	Ofwat's Assessment (December 2003)	
Item 1 – Cryptosporidium – Additional requirements for continuous monitoring and treatment			
1.1	Estimated net change in capital expenditure over the AMP3 period	£43.1m	£34.4m
1.2	Estimated net change in operating expenditure over the AMP3 period	£6.6m	£6.5m
1.3	Materiality amount (NPV of total net change in costs)	£60.4m	£49.4m
1.4	Contribution towards materiality threshold	6.3%	5.1%
Item 2 – Protection of assets			
2.1	Estimated net change in capital expenditure over the AMP3 period	£10.8m	£9.9m
2.2	Estimated net change in operating expenditure over the AMP3 period	-	-
2.3	Materiality amount (NPV of total net change in costs)	£11.1m	£9.9m
2.4	Contribution towards materiality threshold	1.2%	1.0%
Item 3 – Lead – changes to compliance programme			
3.1	Estimated net change in capital expenditure on lead communication pipe replacement over the AMP3 period	(£97m)	(£160.4m)
3.2	Materiality amount (NPV of the total net change in costs)	(£103m)	(£175.8m)
3.3	Contribution towards materiality threshold	(10.7%)	(18.2%)
3.4	Estimated net change in capital expenditure on plumbosolvency control over the AMP3 period	£15.4m	£7.8m
3.5	Estimated net change in operating expenditure on plumbosolvency control over the AMP3 period	£4.1m	£2.4m
3.6	Materiality amount (NPV of total net change in costs)	£37m	£16.7m
3.7	Contribution towards materiality threshold	3.8%	1.7%
Item 4 – Sewer Flooding			
4.1	Estimated net change in capital expenditure over the AMP3 period	£18.2m	£16.0m
4.2	Estimated net change in operating expenditure on plumbosolvency control over the AMP3 period	£0.3m	£0.32m
4.3	Materiality amount (NPV of total net change in costs)	£19.3m	£17m
4.4	Contribution towards materiality threshold	2.0%	1.8%
Item 5 – Land Disposals			
5.1	Net receipts (50% of total) from disposals of land	(£9.0m)	(£8.9m)
5.2	Materiality amount (NPV of total net change in costs)	(£10.6m)	(£10.7m)
5.3	Contribution towards materiality threshold	(1.1%)	(1.1%)
Item 6 – Changes in the Notified Index			
6.1	Estimated net change in capital expenditure over the AMP3 period	£109.5m	£108.5m
6.2	Materiality amount (NPV of total net change in costs)	£123m	£121.6m
6.3	Contribution towards materiality threshold	12.7%	12.6%
Item 7 – Loss of disconnection			
7.1	Estimated net change in capital expenditure over the AMP3 period	£2.9m	£2.9m
7.2	Estimated net change in operating expenditure over the AMP3 period	£12.7m	£10.1m
7.3	Estimated net change in unrecoverable revenue over the AMP3 period	£46.9m	£31.0m
7.4	Estimated net change in financing costs over the AMP3 period	£4.9m	£13.4m

7.5	Materiality amount (NPV of total net change in costs)	£163.7m	£140.2m			
7.6	Contribution towards materiality threshold	17.0%	14.5%			
Item 8 – Urban Wastewater Treatment Directive						
8.1	Estimated net change in capital expenditure over the AMP3 period	£9.4m	-			
8.2	Estimated net change in operating expenditure over the AMP3 period	-	-			
8.3	Materiality amount (NPV of total net change in costs)	£13.7m	-			
8.4	Contribution towards materiality threshold	1.4%	-			
Item 9 – unsatisfactory intermittent discharges						
8.1	Estimated net change in capital expenditure over the AMP3 period	-	(£326.6m)			
8.2	Estimated net change in operating expenditure over the AMP3 period	-	-			
8.3	Materiality amount (NPV of total net change in costs)	-	(£331.7m)			
8.4	Contribution towards materiality threshold	-	(34.4%)			
OVERALL ASSESSMENT						
8	Materiality amount (NPV of total net change in costs)	£314m	(£163.3m)			
9	United Utilities Water turnover for 2002-03 used in materiality test	£965.1m	£965.1m			
10	Materiality test	32.5%	(16.9%)			
PRICE LIMITS		2000-01	2001-02	2002-03	2003-04	2004-05
11	Current price limits (as set in November 1999)	-9.3	-1.0	0.0	4.0	4.5
12	Revised price limits	-9.3	-1.0	0.0	4.0	8.9
Notes:						
8. Additional costs are shown as positive, savings and revenue gains are shown as negative.						
9. The appropriate discount rate used is 6.8%						
10. Materiality test – Result must be greater than +10% or less than –10% to trigger a change in price limits. In this instance there is a negative materiality but a positive price increase due to the different impact that capital items have on price limits as compared to operating and revenue items.						

**UNITED UTILITIES WATER PLC
INTERIM DETERMINATION – DECEMBER 2003
SUMMARY OF OFWAT'S ASSESSMENT**

INTRODUCTION

1. We have followed a four stage assessment of your application in accordance with the terms of Condition B of your company's licence.
2. You included eight changes in your application.
 - Changes to the requirements for treatment and monitoring for cryptosporidium.
 - Changes to requirements on plumbosolvency control and lead communication pipe replacement.
 - A proposed programme for tackling additional sewer flooding problems.
 - Proceeds from disposals of relevant land.
 - Differences in the rate of change of the construction output price index (COPI) relative to retail price index (RPI) compared with our final determination assumptions.
 - Increased operating costs, additional capital expenditure and uncollected revenue resulting from the ban on disconnection.
 - Additional expenditure for protection of assets.
 - Changes to requirements under the Urban Wastewater Treatment Directive.
3. We issued counter notices in respect of changes to the requirements for lead communication pipe replacement and for proceeds from disposals of land, both of which you reflected in your application. We also issued a counter notice for likely changes to your Unsatisfactory Intermittent Discharge programme.
4. Our assessment of your application and the counter notices is summarised below.

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

Item 1 – Cryptosporidium - additional requirements for continuous monitoring and treatment

5. When we set price limits in 1999 the extent of the requirements to deal with the risk from cryptosporidium was uncertain. Only work that had received technical support from the Drinking Water Inspectorate (DWI) was included in price limits. This did not include any requirement to carry out continuous monitoring.

6. The letter sent from the DWI to United Utilities Water on 31 July 2000 set down the programme of work you were required to carry out to meet the requirements of regulation 23B of the Water Supply (Water Quality) Amendment Regulations 1999. The DWI has since written to you updating the programme required to meet the cryptosporidium regulations. The most recent letter was sent on 19 November 2003.
7. We have received confirmation from the DWI that the work set out in your application for cryptosporidium monitoring is necessary to meet your obligations under the cryptosporidium regulations. This is a relevant change of circumstance.
8. At the final determination in 1999 we allowed for work at Rivington and Prescott in relation to cryptosporidium. But we are content that this was for different outputs from those in your application.
9. We have received confirmation from the DWI that the work set out in your application for dealing with cryptosporidium at the twelve sites in your application is necessary to meet your obligation under the cryptosporidium regulations. This is a relevant change of circumstance.

Item 2 – Protection of assets

10. In November 2001 DEFRA instructed water companies to accelerate the planned programmes of work to ensure the ongoing protection of assets. This brought forward work that was required under the existing code of practice. This is a relevant change of circumstance.

Item 3 –Plumbosolvency treatment to reduce lead levels in drinking water

11. In 1999 we allowed in price limits a programme to comply with the new lead standards. This assumed both lead communication pipe replacement and plumbosolvency control. During the 1999 periodic review the DWI stated that it would review the most effective means of delivering compliance, and plumbosolvency control is now the preferred initial approach.
12. 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 19 August 2003 'Water Supply (Water Quality) Regulations 2000: Regulation 41 – Approval of Programmes of Work' replaces the letters of support provided for the periodic review process.
13. 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.
14. We have received confirmation from the DWI that the plumbosolvency control programme set out in your application is necessary to comply with the new lead standards. This is a relevant change of circumstance.

15. The DWI has provided copies of the regulatory programmes of work for pilot lead pipe replacement projects in eight water supply zones. These are:

Altrincham (WSZ 295);
Northern Moor (WSZ Z300);
Ringway (WSZ Z301);
Burnley Road (WSZ 103);
Sharston (WSZ Z303);
Crossacres (WSZ Z261);
Childwall (WSZ Z187); and
Warbreck Tower (WSZ Z068).

And the DWI has confirmed that it is currently finalising a further programme of work for a lead pipe replacement scheme to be carried out in conjunction with your section 19 distribution system renovation programme.

16. The DWI has informed us that it has not put in place regulatory programmes of work for other lead pipe replacement.

17. We have included in the interim determination the lead pipe replacement programmes supported by the DWI and subject to regulatory programmes of work. In your application these are entitled 'pilots profile' and 'early delivery of agreed AMP4/5 outputs'. These two programmes represent a relevant change of circumstance.

18. In line with the approach taken at previous interim determinations, we do not consider the other lead pipe replacement programmes in your application constitute a relevant change of circumstance.

Item 4 – Sewer flooding

19. In March 2002 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.

20. 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 consider it is appropriate to take account of the increased costs to deal with sewer flooding in any interim determination.

Item 5 – Land disposals

21. When we set price limits in 1999 we assumed that there would be no disposals of relevant land in the period 2000-05. You have made a number of such disposals in 2000-01, 2001-02 and 2002-03.

22. These proceeds are a relevant change of circumstance under Condition B of your licence.

Item 6 – Changes to the Notified Index

23. You can request an interim determination of price limits where the Notified Index is different from our assumptions when we last set price limits. The Notified Index measures the rate of change in national construction costs compared to the rate of change in general inflation. The movement in the COPI compared to the movement in the RPI is different from the movement we assumed when we set price limits in 1999.
24. This difference is a relevant change in circumstance under Condition B of your licence.

Item 7 – Loss of disconnection power

25. 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.
26. We confirm that the increases in your bad debt and costs of debt recovery have triggered the notified item.

Item 8 – Urban Wastewater Treatment Directive

27. Where companies seek to have changes in the quality programme reflected in price limits, we expect the provisions in Appendix E of 'Future water and sewerage charges 2000-2005' to be followed. Companies should test fully the implications of the changes by challenging them. In this instance, the procedures were not followed. Alternatively, you have not consolidated these changes into your programme of work under the National Environment Programme using the change protocol. As a consequence, the changed consents at 12 works in your submission do not constitute a relevant change of circumstance and have not been included in the interim determination.
28. The Government has not come to a decision on how to proceed in light of the judgement of the Court of Justice on case C-396/00, the Commission v Italy (the Milan case). As a result work at one other works in your application is not a relevant change of circumstance.
29. We consider the certification of flow measurement systems and the development of data handling and reporting systems is good operational practice and does not constitute a relevant change of circumstance.

Item 9 – Intermittent discharges- change in the work programme and outputs expected

30. We set price limits in 1999 to allow you to deliver the National Environment Programme, as specified by the Environment Agency, and confirmed by Ministers. After price setting, the programme you were required to deliver was published as version 3.2 (19 April 2000) as an Annex to the EA publication 'Achieving the Quality' in June 2000. There were also minor changes to this programme agreed in 2002.

31. Since then you have been carrying out this work programme, and the Environment Agency has reported to us each year on your progress. For improvements to the sewerage service, you have explained to us that you resolved the simplest unsatisfactory intermittent discharges first.
32. In June 2003 you informed us that you were experiencing problems in planning and hence completing your programme by the end of March 2005. You were not able to deliver them according to the assumptions you had used to draft and submit your Business Plan in 1999. The EA confirmed at our joint meeting in September 2003 that you were discussing significant revisions to your programme. You have also raised these issues with DEFRA
33. You have told us there are uncertainties, and they are unresolved.
34. We consider that you have not taken the steps we assumed you would take when we set price limits in 1999. You have not confirmed with the EA the improvements needed, and therefore the work you will carry out to deal with unsatisfactory intermittent discharges from the sewerage system in a number of catchments. These steps were needed to complete the expected programme of work by March 2005.
35. This is a relevant change of circumstance under Condition B of your licence.

STAGE 2 – ASSESSING THE APPROPRIATE NET ADDITIONAL COST ATTRIBUTABLE TO EACH CHANGE

Item 1 – Cryptosporidium - additional requirements for continuous monitoring and treatment

36. You have included in your application 41 sites where you have chosen to deal with the requirements of the cryptosporidium regulations by carrying out continuous monitoring. You have also included eight sites that will be closed, and another four where treatment will be enhanced. The reporter has commented that the decisions made by your company are reasonable.
37. 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.
38. We compared your additional operating costs for carrying out continuous monitoring for cryptosporidium with a benchmark and found them to be reasonable. Consequently we have not reduced the operating expenditure in your submission.
39. Your additional capital expenditure for continuous monitoring equipment is higher than the benchmark, and we have reduced it half way to the benchmark. This is a smaller reduction than we have made in other interim determinations, and takes into account the reasonable additional operating expenditure in your application.
40. We have reduced the capital expenditure in your application for dealing with cryptosporidium at 12 sites by 7%. We consider this is a reasonable reduction that reflects the saving in capital maintenance that we expect to result from closing eight treatment works.
41. In assessing the remaining costs in your application for the twelve treatment works we employed the reference assumptions set out in RD 28/03. We reduced a portion of the remaining capital expenditure by 8%, the capital enhancement catch-up factor for water non-infrastructure, and the other portion by 16%, the infrastructure catch-up factor. And we assumed a continuing capital enhancement efficiency of 0.75% pa. We reduced the operating expenditure by 1.5% pa, the catch-up factor for enhancement operating expenditure, and we assumed a continuing efficiency of 0.75% pa.

Item 2 – Protection of assets

42. We reduced the capital expenditure in your application by 8%, which is the capital enhancement catch-up factor for water non-infrastructure in RD 28/03. We assumed a continuing capital enhancement efficiency of 0.75% pa.

Item 3 – Plumbosolvency treatment to reduce lead levels in drinking water

43. 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.
44. You have included in your application 46 sites where you have installed new treatment, and 51 where you have optimised existing treatment.
45. In our assessment we compared the total volumetric output of the works in the notional plumbosolvency programme assumed at the 1999 final determination with the total volumetric output of the works in the confirmed programme. We took into account only the proportion of the costs assumed at the 1999 final determination associated with the net additional volumetric output of the confirmed programme.
46. Our approach, as generally applied in other interim determinations, was to include the outputs now required in the same manner as we would have at the 1999 Periodic Review, if we had been aware of the present facts. The information you provided in 1999 showed the volumetric output of the confirmed programme to be less than that of the notional programme. Consequently we have allowed no additional costs for the 46 sites where you have installed new treatment.
47. But we have allowed the expenditure associated with optimising existing treatment and other expenditure not directly associated with phosphate dosing but still required for plumbosolvency control which was not included at FD99. We reduced the relevant capital expenditure by 8%, which is the capital enhancement catch-up factor for water non-infrastructure in RD 28/03. We assumed a continuing efficiency of 0.75%. We reduced the relevant operating expenditure by 1.5% pa, the catch-up factor for enhancement opex, and we assumed a continuing efficiency of 0.75% pa.
48. We deducted the FD99 assumption for the lead pipe replacement programme. But we allowed 44,300 pipe replacements using the unit costs assumed at FD99.

Item 4 – Sewer flooding

49. 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 established 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. You originally submitted a proposal for an additional £18.2m that, together with your allowance at the 1999 final determination, would have resolved problems at 1,278 properties between 2000-2005.

50. We have considered your proposal and your representations following our provisional decision and have taken account of comments from WaterVoice North West. We have concluded that outputs with a total value of £16m should be included within the interim determination. When added to your 1999 final determination we expect your revised sewer flooding programme for 2000-2005 to resolve problems for around 1120 properties. We have adjusted your application to take account of the following points:

- Your Reporter has raised some concerns about your ability to deliver a programme of this size by March 2005 given the other commitments on the company in this period.
- It is not clear, on the information available at present, that some of the schemes included offer sufficient benefits to customers. We do not consider that it is appropriate to include these schemes within the interim determination.

Item 5 – Land disposals

51. Under the terms of Condition B of your licence, at an interim determination, we take into account 50% of proceeds from disposals of relevant land. You report to us the value of any such proceeds each year. This forms part of your audited June return submission.

52. We have taken our figures from Table 39 of your June return submissions for 2000-01, 2001-02 and 2002-03. This is consistent with the approach you have taken in your application.

Item 6 – Changes in the Notified Index

53. When we set price limits in 1999, we made assumptions about the movement in the Notified Index over the period 2000-05. This index represents the movement in COPI relative to RPI. We assumed that COPI moved in line with RPI over the period to 2005. In practice COPI has increased at a greater rate than RPI and the Notified Index is, consequently, greater than we assumed.

54. We have assessed the change in your capital costs from those we assumed in the 1999 periodic review to take account of the actual movements in the Notified Index in 2000-01, 2001-02 and 2002-03. This is consistent with the approach you have taken in your application.

Item 7 – Loss of disconnection power

55. We have carefully assessed the information submitted in your application. Where appropriate we have requested further clarification from yourselves and your reporter.

56. In your application you explained that:

- the amount of debt which you cannot collect;
- the cost of financing outstanding revenue; and
- the costs of collecting debt

have all increased since the implementation of the Water Industry Act 1999. We accept your evidence.

57. Your application set out the changes made to your procedures for recovering debt from customers. You have explained that as a result of the Water Industry Act 1999 prohibiting the disconnection of domestic properties for non-payment of water charges you can no longer use the threat of disconnection against domestic customers, and therefore you have introduced new debt recovery procedures. You have set out in detail the new initiatives. These include increased use of debt collection agents, increased resources to target persistent non-payers and the use of dedicated teams to follow up and renegotiate failed instalment arrangements. These do not secure payment in as many cases and, where payment is secured, it is recovered less quickly.

58. We accept that as a result of these changes:

- the amount of debt which you are unable to collect has increased; and
- where debt is recovered it now takes you longer on average to do so. Financing costs increase because of this.

59. You also stated in your application that the changes in your procedures have caused your operating costs to rise. These include the increased costs associated with the new debt recovery procedures and additional staff exclusively employed in debt recovery activities. We accept that these costs have increased.

60. You explained that the introduction of a new debt management system to accommodate new methods of debt recovery required additional capital expenditure. We accept that these are costs that would not have arisen during this period if it were not for the ban on household disconnection.

61. You have assessed the change between 1998-99 and 2002-03 in both the level of unrecoverable revenue, and financing costs of outstanding debt following the general approach we set out in RD12/01 'Notified Item for bad debt' (August 2001).

62. There is one point of detail where our calculations differ. You challenged the approach that Ofwat uses to assess changes in the level of unrecoverable revenue. Your submission calculates the increases in unrecoverable revenue using changes to the household bad debt charge, rather than the methodology used by Ofwat which considers changes to the level of household revenue written off. You reiterated your views on this point in your representation to us following our provisional decision. We have followed this approach consistently for interim determinations in 2001 and 2002. We consider that this policy is appropriate as actual write-offs are a definitive and final amount and are subject to less management interpretation.

Our methodology allows companies the financing costs of carrying increased levels of revenue outstanding. The notified item is a one-way item and there is no scope to claw back revenue allowed for changes to the bad debt charge, which may not subsequently be realised.

63. These differences in methodology are reflected in the numbers as set out in Annex A. Further information is provided in the explanatory notes.

Item 8 – Urban Wastewater Treatment Directive

64. This is not a relevant change of circumstance. Please see paragraphs 27 to 29 above.

Item 9 – Intermittent discharges- change in the work programme and outputs expected

65. We have recovered the costs of the work you had planned in the 29 catchments you identified as not having consents and outputs confirmed, and which you believed did not offer reasonable benefits compared with either your Business Plan cost estimates or your revised costs.

66. You explained the basis for your concerns and reported the results of your valuation of the benefits of carrying out the original plans. You used the RPA valuation methodology developed by the EA for appraising projects for AMP4, and applied it to your outstanding AMP3 improvements. You valued the environmental benefits at between £50m and £70m.

67. We have removed the costs attributed to schemes in these catchments.

68. We have not included costs for carrying out any revised programme of works to deliver environmental improvements in these catchments. You have not yet defined the programme of work for completion in March 2005. The Environment Agency will be setting the environmental improvements needed, including spill frequencies, any criteria for solids removal, or pass forward flows. These substantial amendments and their delivery dates must be confirmed by DEFRA and Ministers. You will then need to set down the engineering solutions, including storage requirements, timescale and costs, to deliver these outputs.

69. We expect that the scope and costs of carrying out the environmental improvements programme, confirmed with the EA, will be in line with the valuation of the environmental benefits for the programme.

70. You will then be able to put forward a programme of work to deliver these environmental benefits. We will consider the costs of this programme at your next price setting. If the consents and engineering proposals are finalised in time for your 2004 business plan in April 2004, we will incorporate it into the logging-up procedure at the periodic review. You would then be remunerated for the programme of work from April 2005.

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

71. 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. The licence also allows for price limits to be adjusted in instances where the net present value of the materiality calculation is less than minus 10% of turnover. 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.
72. The results of our analysis, based on the revised assumptions set out above, are summarised in Annex A. In this instance, the materiality amount is minus 16.9% of turnover, so in accordance with Condition B, the materiality threshold has been exceeded.

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

73. Because the materiality threshold is exceeded we are required by Condition B of your licence to review and revise your price limits. Although the materiality calculation is a negative figure, the interim determination model indicates that an increase in price limits in 2004-05 is necessary. This illustrates the different impact that capital items have on price limits as compared with operating expenditure and revenue items. Capital expenditure is funded over a longer period of years and therefore its impact on price limits in any single year is less. Our provisional assessment of your company's application is that the price limits for the charging year 2004-05 should be revised as set out in the table in Annex A.