

23 November 2012

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Jonson Cox
Ofwat
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7 Hill Street
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Dear Jonson,

Consultation on Ofwat's section 13 proposals to modify company licences

I am writing to respond on behalf of Northumbrian Water to Ofwat's recent proposals to modify company licences.

We recognise that Ofwat has modified the original proposals made in December 2011, following the concerns that we and others expressed, and welcome the constructive engagement that has taken place between Ofwat and companies in that regard. We have been actively engaged in seeking to find an acceptable formulation that provides Ofwat with an appropriate and proportionate degree of flexibility. We welcome, in particular, the application of RPI to wholesale price controls within the licence and the commitments Ofwat has provided, albeit outside the licence, to the continuation of an RCV-based approach to setting wholesale price limits.

However, although Ofwat's revised proposals represent a welcome step towards seeking to address the considerable uncertainty created by the previous proposals, I regret that Northumbrian Water is unable to accept the modifications that have been proposed. Given the constructive dialogue that has taken place concerning the proposals to date, it may be helpful if I briefly indicate our principal remaining concerns.

The significant degree of flexibility that will be provided for activities to be transferred outside the scope of the wholesale price review remains a key concern. The current proposals provide for activities representing up to 20% of revenue to be transferred outside wholesale activities in any single price control period up to a cumulative total of 40% of revenues. Both of these thresholds are substantially higher than we envisaged when Ofwat initially referred to requiring flexibility regarding "non-material" changes.

Proposals that potentially affect up to 40% of revenues are clearly highly material, both to us and to investors in the sector generally. We cannot agree that making transfers at this level represents only "modest and evolutionary change". On the contrary, it seems to us that transfers at this level would represent a fundamental shift from RCV-based regulation. The current proposals provide no detail concerning what form of regulation would apply to activities that are transferred out of wholesale activities. This level of discretion inevitably continues to create significant uncertainty regarding the future regulation of the industry and is therefore also a key remaining concern.

We are aware that economic modelling conducted on behalf of companies following the publication of the revised proposals continues to indicate that they would be likely to give rise to an increase in the cost of capital across the sector. We are concerned that this would result in an unjustified and unwelcome increase in customers' bills.

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We note that independent analysts have commented negatively on the current proposals due to the increased level of discretion and regulatory uncertainty that they would cause. We also note that the share price of quoted water companies fell by 5-10% following publication of the proposals against a broadly flat market.

DEFRA has also made clear that the impacts of any potential changes to the regulatory framework must, as a matter of priority, seek to avoid regulatory uncertainty. DEFRA in particular points out the need for a very thorough impact assessment of any proposed reforms, a process that I am advised Ofwat has not yet undertaken.

In these circumstances, my Board cannot ignore its own concerns, and the evidence of wider industry and investor concerns, and is therefore unable to support the proposals as currently drafted.

Having said this, there are aspects of Ofwat's proposals that we do support, in particular introducing an ability to set separate price limits for water and sewerage services and an ability to set separate retail and wholesale price controls.

We continue to believe that it should be possible to devise modifications that provide Ofwat with appropriate flexibility without creating the undue uncertainty that would arise under the current proposals. I am sure you recognise that Northumbrian Water has adopted a constructive approach to discussions to date and we are keen that these discussions should continue.

You will be aware that all companies are willing to accept licence amendments that would allow separate wholesale and retail price controls to be set, and that a revised draft of licence Condition B that would enable this change has been drafted on behalf of companies. We recognise that you do not consider that this provides Ofwat with sufficient flexibility and we would like to explore how by building on this proposal appropriate flexibility could be achieved.

The areas of concern have narrowed since the original proposals, but more work is required to achieve an outcome that is acceptable to all stakeholders. I understand you may be available for a meeting on the 27th November. I would greatly appreciate it if this proves to be the case, as I would welcome the opportunity to explore with you in person whether there remains any scope to reach an agreed position concerning proportionate licence modification.

Yours sincerely,

A handwritten signature in blue ink, consisting of a stylized 'A' followed by a horizontal line that tapers to a point on the right.

ANDREW J HUNTER
Chairman