

Our ref R13274

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Dear Keith

**Consultation on proposed modifications to conditions B and C of the company's licence**

I refer to your letter dated 26 October 2012 and formal notification to our company of modifications to conditions B and C of our licence.

Our directors have considered this matter carefully and taken into account the balance of a need for change against the important objective of preserving the benefits, ultimately to customers, of the current structure and stability of the industry. We also note that the Government has published for consultation its draft strategic policy statement in which, amongst other matters, it stresses the importance of the strengths and stability of the current regime, efficient integrated water companies which can earn a reasonable return on their investment, and the need for predictable regulatory frameworks.

Until further detail is derived it remains unclear precisely how competition and the regulation of activities will work side by side within an appointed business and across contestable and non-contestable customers.

Given the above drivers, we believe that a better approach to evolution of the licence (which we support) would have been to take only those steps now which are required to remove redundant references in the licence and to enable the specific changes that are anticipated as being necessary for PR14, such as enabling retail competition for business customers. We proposed such an approach in our response to the previous proposals published in December 2011.

We also note that the draft conditions B & C contained in the notice are illustrative only and are subject to correction for any technical errors, inconsistencies, and tailoring to the specific circumstances of individual companies.

Notwithstanding this, our Board has decided to accept the proposed licence changes in principle, subject to a small number of clarifications and requests that our executive directors and chairman discussed with Regina Finn on 20 November and for which we received an encouraging response.

We would therefore expect to review and comment on the final wording before incorporation into our licence and will welcome any further dialogue that is necessary in this respect.

As discussed with Regina Finn, we propose that the following points be included in the final licence draft.

1. The potential for up to 40% of revenues on an industry wide basis being removed from the wholesale price control could create a greater risk to water only companies than to water & sewerage companies as we do not participate in the full range of activities and revenues across the two services. We therefore consider that the materiality ratio referred to should be applied (in the licence) to water and sewerage revenues separately, as this should largely avoid any unintended disproportionate impact on a water only company. We understand that the intention is that these activities would remain within the Appointed Business and be subject to Ofwat's duty to secure the financing of the functions of the Appointed Business as a whole.
2. We take some comfort in the short term from the consultation's intent that approximately 90% of assets by current cost value will remain in the wholesale price control. However, we understand that the intention is that 90% of assets by most measures (including by RCV) are expected to remain within the Wholesale price control, not just on a current cost value. Given that this intent is not currently included in the draft licence, our stakeholders cannot rely on this expectation to inform their perception of risk. We therefore suggest that the benchmark of 90% of assets (without specific reference to current cost value) is included in the licence condition itself. We acknowledge that the RCV is a regulatory construct and therefore do not expect the licence to refer to it directly, but investors have placed great store in its existence and its stable basis.
3. We are concerned that investors may be reluctant to invest in assets which may or may not be compensated post 2015. In order to ensure that such investment is not delayed, any efficiently incurred investment in assets up to any point of change in the regulatory model for that asset should remain as part of the Appointed Business for which Ofwat has a statutory duty to ensure that an efficient company can finance its functions. We understand from discussions with Ofwat that the possibility of applying some other form of price control to some activities does not mean that they would be removed from the Appointed Business and therefore would remain in principle subject to Ofwat's statutory financing duty. In the event of a proposed change, Ofwat should clearly set out in advance and through consultation how capital would be remunerated.
4. We want to help Ofwat to ensure that any changes to regulation or moves towards more competition are successful. In order to enable and encourage both incumbents and new entrants to invest time and money in competitive activities, Ofwat should take measured and well consulted steps in both removing activities from regulation and in bringing them back into the regime (if it is clear that it is appropriate to do so). This would be assisted if there were a requirement within the licence for the regulator to consult before moving activities either out of or back into a specific form of regulation. Again these activities would remain subject to the statutory financing duty on Ofwat, being within the Appointed Business.

We look forward to further dialogue with Ofwat in respect of the above in order to arrive at an appropriate final wording of conditions B & C.

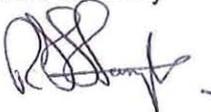
As a general observation, Government policy statements have indicated a potential for new approaches to upstream markets which we understand to be referring to water resources activities. Although we are of the view that de-regulation is not necessarily needed in order to achieve benefits of better use of the resources, we acknowledge that it may be an appropriate way forward in due course. However, we have serious concerns about any potential for water treatment to be in any way de-regulated or for any assets involved to be stranded. Most stakeholders place great store in the current vertically integrated nature of the water supply service where accountability for safe and reliable supplies of drinking water are very clear. Confidence must not be undermined and there will be a real risk of this if there is ever any confusion as to accountability or if it is not fully aligned with the ability to manage the risks.

Finally we would like to outline some areas where we specifically support the intentions of the illustrative licence:

- We were pleased to see that it is proposed to retain the explicit linkage to the Retail Prices Index in the wholesale part of the business.
- We support the setting of separate price limits for PR14 in respect of wholesale and retail activities.
- We concur that retail price limits may be set on some other basis than return on capital, and that the definition of retail activities may need to change in the light of emerging experience in the future, subject to progressive steps and to consultation.
- We support the deletion from the licence of the requirement to submit an annual Principal Statement, which we believe is consistent with what Ofwat has already signalled in its recent approach to lighter touch regulation and targeted enforcement.
- We also welcome the tidying up of redundant clauses.

We reiterate that we wish to work with Ofwat in successfully creating measured and evolutionary regulatory change in the water industry, in the best long term interests of customers. We therefore look forward to further and on-going discussion with Ofwat.

Yours sincerely



Roger Harrington  
Managing Director

cc Jim McGown  
Peter Bridgewater  
Alison Ramsey  
Tracey Legg