



YorkshireWater

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22 November 2012

Dear Keith,

**Water Industry Act 1991 (WIA9), Section 13 proposals by Ofwat to modify the conditions of appointment of all water only and water and sewerage companies**

**Introduction and Summary**

Thank you for the opportunity to respond to the proposals contained in the revised notice issued under Section 13 (S13) of the Water Industry Act 1991. We acknowledge that Ofwat has sought to address the concerns raised in response to the previous S13 notice of December 2011, by the reintroduction of RPI indexation for the wholesale price control and by attempting to limit the degree of flexibility for change. However, our concerns about the proposals remain.

We support the policy aims of the Water White paper which is aligned to the company's vision of "taking responsibility for the water environment for good", in which the needs of customers, the environment and investors are balanced. We welcomed the draft Water Bill as a vehicle for the introduction of greater competition.

Whilst we support reforms to the sector we believe that the success of the sector is built on phased evolution in the interest of all stakeholders rather than any revolutionary change. We consider that is important to continue with a considered approach to change in order to protect the necessary stability of the industry. Increasing risks to investors directly affects financing costs and will have a detrimental impact on customer bills.

For all the reasons which are set out below we do not consider that it would be in the public interest to accept the S13 notice put forward and therefore Yorkshire Water does not accept the proposals to modify the conditions of its licence.

We would, however, be willing to work with you to discuss other options if that were to be considered possible in the light of the responses that you receive.

**Commentary**

Our primary concerns are that the proposals:

- risk destabilising the industry and increasing cost to customers;
- seek to pre-empt legislation and direct government policy; and
- seek to pre-empt the outcome of the forthcoming Price Limits methodology consultation and Business Plan consultation.

The proposals contain many clauses which raise further questions and require further definition and clarification. We, along with others in the industry, have sought to clarify details of the proposals, but to date the responses from Ofwat have not satisfied our concerns.

We do not consider that it is appropriate to amend the conditions of appointment in an unspecified manner.

As with the previous S13 notice, the proposed licence amendment seeks flexibility for Ofwat to vary four key aspects of the licence, all of which are currently clearly defined;

1. Number of price controls
2. Form and scope of the price control(s)
3. Duration of the price control(s)
4. Indexation of the price control(s) for non-wholesale activities

In our letter of 29 February 2012, (copy attached), we commented on each of the above and we repeat the comments made in that letter. Whilst we welcome Ofwat's reinstatement of indexation to RPI for the wholesale price control, no reference is made to indexation for controls outside of the wholesale price control. This is unacceptable, given Ofwat's requirement for flexibility to move activities out of the wholesale control. We also refer to our response to the Consultation on Retail Controls, dated 24 August 2012, in which we explained the risks associated with no use of indexation, particularly with regard to default tariffs.

The key factors above introduce significant uncertainty for our business. Our business is a long term business, with long lived, capital intensive assets. We deliver a vital service to customers which cannot be put at risk through short term planning or views. Uncertainty over the future regulatory treatment, including uncertainty about the shape, form, control and timescale of the next, or each, price control, risks our ability to manage our business in a resilient and sustainable manner. This is to the detriment of all stakeholders and in particular risks increasing costs for customers unnecessarily.

Our priority is to maintain high levels of services for our customers and to do this in the most efficient and cost effective manner. In our estimation the proposals will have a detrimental impact on this objective. The total exposure to the cost impact created by the flexibility of the proposed licence conditions will result in an increased cost of debt that will inevitably result in higher customer bills than would otherwise be the case.

We consider that the revised proposals confer an unnecessarily broad discretion. We consider that separate wholesale and retail price controls could be implemented by making much more modest changes to the licence, under which the form and duration of the price controls applicable to wholesale and retail could be clearly defined.

In summary, the proposals provide no certainty as to the nature, form or duration of the controls; they do not make clear whether the controls are to take the form of a revenue cap or a price cap, and they provide Ofwat with significant discretion as to how different types of activities are to be categorised, and whether they will remain part of the RCV.

The proposals would remove a key element of certainty and predictability that is important in maintaining investor confidence. Ofwat would have the ability to change the price control framework at each periodic review without the requirement of another S13 consultation process, thereby undermining an important procedural safeguard which is contained in the WIA91. For such wide-ranging proposals, we would have expected Ofwat to have carried out an impact assessment to accompany the consultation.

However, we are particularly keen to continue to discuss alternatives with Ofwat which could address the needs of PR14, together with principles for future licence changes when deemed necessary by legislation or other factors.

As you are aware, both in their responses to the December 2011 consultation and in subsequent discussions with Ofwat, companies have consistently stated their willingness to implement such licence modifications as are required to allow Ofwat to set separate wholesale and retail prices at PR14.

In order to demonstrate the feasibility of amending the licence in this way, the industry has worked together with its advisers to develop an alternative set of modifications to Condition B. The attached draft represents the industry's preferred approach to implementing only such licence changes as are required for PR14.

While further work is required on some of the detail of the draft, it commands wide support within the industry as a starting point for discussion with Ofwat.

## **Conclusion**

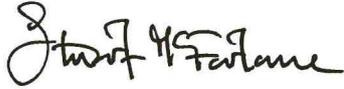
We, and other companies, remain committed to further discussions with Ofwat on such further changes to the licence as may be needed to implement future reforms to price limits, once these have been consulted on in the normal way. We are not averse to further changes which would be required in order to implement legislation once the appropriate consultation, impact assessment and cost benefit analysis has taken place.

We consider that the water industry in England and Wales is one of the most mature and advanced in the world, and as such, we (the companies and the Regulator) should be able to pool our combined and significant expertise to develop a regulatory structure which is fit for purpose to meet the challenges ahead, whilst continuing to ensure that our customers receive the best service at the lowest possible price.

We welcome the clarification that was released on 20 November as it does aid our understanding, however it does not allay the concerns expressed above. As you will appreciate it is difficult to respond at short notice in any detail to the suggestions in the "Next Steps" section but we remain willing to explore other options that you may wish to put forward that would avoid a reference to the Competition Commission as we believe this would be an unnecessary distraction for both the regulator and the industry in the period leading to the next Price Review. If it was considered, having taken account of the responses received to the consultation, that such an outcome was possible we would be committed to working with you intensively to arrive at a solution by the end of February 2013 in order to assist in meeting the timetable for PR14. Given our concerns on the breadth of flexibility and the breadth of the assets which would be subject to the proposed modifications it would be essential for you to provide further clarity and assurance on the four issues identified in the "Next Steps" section of your clarification document to aid any such further discussions.

It is therefore with regret that we reject the S13 notice as drafted and hope that you would be prepared to discuss and consider the adoption of the alternative proposal drafted by members of the water industry that is contained with this letter.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Stuart D McFarlane". The signature is written in a cursive style with a large initial 'S'.

Stuart D McFarlane  
Company Secretary

**Yorkshire Water's response to December 2011 section 13 consultation, 29 February 2012**

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29 February 2012

Dear Chris,

**Water Industry Act 1991, Section 13 proposals by Ofwat to modify the conditions of appointment of all water only and water and sewerage companies.**

Thank you for the opportunity to respond to the proposals contained in the notice issued under section 13 of the Water Industry Act 1991.

**Yorkshire Water's response to the consultation on proposals to modify the price review elements of the conditions of appointment (licences)**

Yorkshire Water welcomes the opportunity to respond to proposals to modify the conditions of appointment in the light of potential changes arising from Ofwat's current activities in its Future Price Limits (FPL) work-stream.

We place great importance on the terms of our licence as, together with the Water Industry Act 1991, and the relevant Final Determination, it effectively forms our contract of operations. In particular, the stability of the licence gives us and our investors certainty when we seek the vital investment needed to continue to deliver our core services of provision of clean water and sanitation to the population of our area. This stability and the value of investment is recognised by the Government in the recent Water White Paper<sup>1</sup>.

As a result we have significant concerns about the proposals as they have been put forward. Our primary concerns are that they:

- Risk destabilising the industry, and
- Seek to pre-empt the outcome of both the FPL Framework consultation and the subsequent FPL methodology consultation.

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<sup>1</sup> Water White Paper: 5.33 'We will not introduce changes that risk unsettling investor confidence in the stability of the water sector, particularly at a time when new investment will be essential and as competition for capital gets tougher. The water sector must remain an attractive proposal for long-term investors if the cost of capital, and the cost to customers, is to remain affordable. It must also remain able to deliver key Government objectives on future resilience...'

In doing so, the proposals are vague and non-determinate. We do not consider that it is appropriate to amend the conditions of appointment in an unspecified manner.

Our response focuses on four key aspects of the proposals, all of which are currently clearly defined within our licence:

5. Number of price controls
6. Form and scope of the price control(s)
7. Duration of the price control(s)
8. Indexation of the price control(s) (by use of RPI)

To amend the licence to allow Ofwat to have unlimited scope in determining the four key areas introduces significant uncertainty for our business. Our business is a long term business, with long lived, capital intensive assets. We deliver a vital service to customers which cannot be put at risk through short term planning or views. Uncertainty over the future regulatory treatment, including uncertainty about the shape, form, control and timescale of the next price control, risks our ability to manage our business in a resilient and sustainable manner. This is to the detriment of all stakeholders and in particular risks increasing costs for customers unnecessarily.

We make specific comment on each of the key areas below.

## **1. Number of price controls**

We note that Ofwat seeks to implement Option 3 of its FPL consultation. In this we recognise that a licence change would be required to enable two price controls; for wholesale and retail.

However, in our response to the FPL consultation, we demonstrated that the existing regulatory framework has not hindered our ability to focus on the customer, balance the needs of the environment and all stakeholders and make the best decisions for all whilst operating an efficient and responsible company. We therefore do not conclude that the single price control is a restriction.

We recognise the need for change for the market for business customers however in our response to the FPL consultation we identified an Alternative Option which enables the market for business retail customers but does not require separate price controls (i.e. does not require licence change). This allows a continuation of the current system whereby customers who are enabled by legislation to switch retailer are removed from the regulated monopoly price control framework.

We therefore comment, that, in the absence of a conclusion of the FPL framework consultation, and given our view on the Alternative Option, we are not able to accept a proposal of a modification to allow any number of price controls to be determined in the future by Ofwat.

We consider that the licence should state the number of price controls which are to be determined by Ofwat, and the number should only be changed in future by agreement (by licence change) and for appropriate reasons.

## **2. Form and scope of the price control(s)**

As above, we note that Ofwat seeks to implement Option 3 of its FPL consultation. In this we recognise that a licence change would be required to enable the form and scope of the price control to be redefined to enable wholesale and retail activities to be reflected separately.

However, as described above, and articulated in our response to FPL, we do not believe that this is necessary. Again we note that, in the absence of a conclusion of the FPL framework consultation, and given our view on the Alternative Option, we are not able to accept a proposal of a modification to allow the form and scope of the price controls to be determined in the future by Ofwat.

We consider that the licence should state the form and scope of the price control(s), and that this should only be changed in future by agreement (by licence change) and for appropriate reasons.

## **3. Duration of the Price Control(s)**

Ofwat has not proposed a specific change to the duration of the Price Control.

In our response to the FPL consultation we comment that a period of around five years is appropriate. We consider that a move to align the timing and duration of the Price Review process with that of the Water Framework Directive should be considered in future to improve certainty and enable efficiencies to be generated. We make these statements in consideration of managing risk over the duration of the price control. A long price control period increases uncertainty and risk to be managed by the company, and a short price control period increases uncertainty and risk associated with the action of the Regulator. In both cases, the impact on investors is the same i.e. a change in certainty of investment.

We do not consider that the licence should be changed without valid reason and full and proper consultation. Given that Ofwat does not propose a change in duration, and we believe that changes away from the current arrangement increase uncertainty, we are not able to accept a proposal of a modification to allow the duration of the price control to be determined in the future by Ofwat.

We consider that the licence should state the duration of the price control(s), and that this should only be changed in future by agreement (by licence change) and for appropriate reasons. We also consider that the ability to re-open determinations by both companies and Ofwat through the IDoK mechanism should be retained to address significant issues within a price control period.

## **4. Indexation of the price control(s) by use of RPI**

The success of the water companies in England and Wales since privatisation has largely been attributed to the ability to raise capital at affordable levels to facilitate necessary investment whilst keeping prices affordable for customers. This ability to attract investment is based on a stable and clear legal and regulatory framework, which has given investors confidence in the industry.

A substantial proportion of our debt financing is directly referenced or hedged to RPI. Both debt and equity investors have invested in our company on the specific understanding that the indexation of the asset base and income is linked to RPI through the licence conditions. Similarly, potential investors will regard their investment in the context of the certainty which the prescribed link to RPI provides. Access to debt markets is critical to fund, amongst other areas, current and future capital programmes. It should be noted therefore that removal of the link to RPI would remove a set of specific investment groups from the available pool of investor funding for the industry. This could significantly destabilise the industry, lead to a rise in the cost of capital and ultimately result in higher bills for customers.

We also reference the recent UKWIR project<sup>2</sup> which examined the appropriate index for use in regulation of the water industry. This project concluded that RPI was the appropriate index.

Therefore, we are unable to accept a modification to allow the indexation of the price control(s) to be determined in the future by Ofwat.

We consider that the licence should continue to state the indexation of the price control to be RPI, and that this should only be changed in future by agreement (by licence change) and for appropriate reasons.

As you will see, from the discussion above, we feel strongly that it is inappropriate to risk instability by attempting to implement licence changes which seek to address an outcome which has yet to be defined for the 2014 Price Review. It is furthermore unnecessary to attempt to implement licence changes which, at the same time, seek to enable a range of different unknown outcomes at subsequent price reviews.

We would be willing, and feel it is appropriate, to discuss the extent and detail of any necessary modifications to our conditions of appointment when the FPL framework consultation process has been duly completed. However, we note that even at this point, there may be aspects of water company licences which require review at the point of the FPL methodology consultation. Any such modifications must support a framework for setting prices within a stable and transparent regulatory environment where obligations and rewards are clear to customers, companies and investors.

In this respect we urge Ofwat to engage fully with companies about the proposals at the earliest opportunity and to maintain a constant dialogue. It is important to ensure that all risks and requirements are fully recognised, and that both the companies and Ofwat have appropriate time to reflect on the implications. Given the significant importance of our conditions of appointment, it is entirely appropriate and necessary that due consideration is given to any amendments, such that the stability and sustainability of the companies are preserved. Our vision is one of "Taking responsibility for the water environment for good". In doing so we place economic, environmental and social sustainability at the heart of our operations. To help to achieve this we must be in a position to retain and maintain investor confidence to enable us to continue to provide key public services now and in the future.

We look forward further engagement and discussion to help shape the next Price Review as the FPL methodology develops.

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<sup>2</sup> Alternative Measures of Inflation in the Regulatory Framework (12/RG/07/24), UKWIR 2012.

**Yorkshire Water's response to the Notice under Section 13 of the Water Industry Act 1991**

In the light of the above Yorkshire Water does not accept the proposed amendments to our conditions of appointment.

Yorkshire Water does not accept Ofwat's reasons for making modifications under Section 13; The rationale for changing the conditions of appointment has not been tested; Ofwat has not determined the outcome of its FPL consultation; Significant investor uncertainty will be generated by the proposed modifications; and additionally, from a procedural aspect we consider that the proposed modifications are not detailed or specific to ourselves.

Yours sincerely,

Liz Barber  
Director of Finance and Regulation

**Alternative set of modifications to Condition B**



## Condition B: Charges<sup>1</sup>

### Part I. *Explanatory Provisions*

#### 1. *Introduction*

The purposes of this Condition are set out in the following sub-paragraphs.

- 1.1 To enable the Water Services Regulation Authority to determine, with effect from the Charging Year starting on 1st April 2015, and thereafter at five-yearly intervals, separate Price Controls for Wholesale Activities and Retail Activities.
- 1.2 To limit increases in Standard Charges made by the Appointee in carrying out its Wholesale Activities and to control increases in [charges made, or as the case may be revenues generated,] by the Appointee in carrying out its Retail Activities.<sup>2</sup>
- 1.3 The Weighted Average Charges Increase for Wholesale Activities shall be limited to the sum of the movement in the Retail Prices Index and an Adjustment Factor, called K.<sup>3</sup>

As regards Wholesale Activities, changes in metered charges are calculated by reference to actual consumption in a Weighting Year (a financial year of the Appointee). Changes in unmetered charges are calculated by reference to changes in average revenue per Chargeable Supply calculated by reference to the number of premises supplied as at the preceding 1st December. Changes are weighted in proportion to the contribution which each type of charge makes to total revenue in the Weighting Year.

As regards Retail Activities, any limit on increases in [charges or revenues] shall be indexed by the movement in the Retail Prices Index [or using such other indexation mechanism as the Water Services Regulation Authority, after prior consultation with the Appointee, may determine having regard to its duties under section 2 of the Water Industry Act 1991].

Charges to customers for the supply of water and the provision of sewerage services will equal the sum of charges for Wholesale Activities and charges for Retail Activities.

These matters are dealt within Part II under the heading "Price Controls".

- 1.4 To provide for a review of the Appointed Business to be carried out by the Water Services Regulation Authority at five-yearly intervals, so that the Water Services Regulation Authority can determine whether the Price Controls should be changed. This is dealt with in Part III under the heading "Periodic Reviews."
- 1.5 To enable the Appointee:

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<sup>1</sup> This Condition has been drafted on the basis that it will not come into effect until 1 April 2015. This means that, until then, the existing version of Condition B will remain in effect. Transitional provisions will need to be added to the current version of Condition B, taking effect once the consent of the companies has been obtained, to enable the Water Services Regulation Authority to carry out separate price control reviews for wholesale and retail at PR14.

<sup>2</sup> Subject to outcome of consultation on price control methodology.

<sup>3</sup> The Price Control for Wholesale Activities is intended to be separate from any determination of wholesale access prices made pursuant to sections 66A to F of the Water Industry 1991.

- (1) to refer to the Water Services Regulation Authority for determination from time to time the question of changing one or more of the Price Controls to allow for Notified Items and Relevant Changes of Circumstance;
- (2) to refer to the Water Services Regulation Authority for determination at any time the question of changing one or more of the Price Controls where circumstances have a substantial adverse effect on the Appointed Business; and
- (3) where notice to terminate either or both of the Appointments has been given, to refer to the Water Services Regulation Authority for determination the question of what the Price Controls should be in the future, on the assumption that the relevant Appointment or, as the case may be, the Appointments were to continue in force, for the purpose of facilitating consideration of the terms on which a new appointee could accept transfers of property, rights and liabilities from the Appointee, as provided in section 9(4) of the Water Industry Act 1991.

These matters are dealt with in Part IV under the heading "Interim Determinations."

- 1.6 To provide for the Water Services Regulation Authority to initiate changes to the Price Controls to allow for Notified Items and Relevant Changes of Circumstance. This is also dealt with in Part IV.
- 1.7 To enable the Appointee to require the Water Services Regulation Authority to refer to the Competition Commission matters arising out of determinations by the Water Services Regulation Authority referred to in sub-paragraphs 0 and 1.6 and references referred to in sub-paragraph 1.5. These matters are dealt with in Part V under the heading "References to the Competition Commission."
- 1.8 To require the Appointee to give Information to the Water Services Regulation Authority to enable it to make determinations under this Condition. This is dealt with in Part VI under the heading "Provision of Information to the Water Services Regulation Authority."
2. *Defined Terms which apply for the purpose of all parts of this Condition*

In this Condition:

references to "**the Appointed Business**" shall be construed as if the Appointed Business included the management and holding by the Appointee of any protected land for so long as it is not transferred under paragraph 7 of Condition K;

"**Average Charge per Chargeable Supply**" means, in respect of a specified Unmeasured Basket Item for a specified year, the amount  $R/N$  where:

R is the annual revenue (exclusive of VAT) which would accrue to the Appointee in respect of the specified Unmeasured Basket Item if all Standard Charges (other than Excluded Charges) made or to be made in respect of that Unmeasured Basket Item in the specified year were applied to all Chargeable Supplies of the Appointee which would have been subject to those Standard Charges as at 1st December preceding the specified year; and

N is the number of Chargeable Supplies as at such 1st December for which the Appointee would have been entitled to make those Standard Charges, provided that, where the specified year is a Prior Year,

- (a) there shall be included in N the number of any additional Chargeable Supplies which the Appointee would have made as at such 1st December if the Standard Charges to be made in respect of the Unmeasured Basket Item in the relevant Charging Year had applied; and
- (b) there shall be excluded from N the number of any Chargeable Supplies which the Appointee would not have been entitled to make as at such 1st December if the Standard Charges to be made in respect of the Unmeasured Basket Item in the relevant Charging Year had applied.

**"Basket Items"** are

- (1) unmeasured wholesale water supply,
- (2) unmeasured wholesale sewerage services,
- (3) measured wholesale water supply,
- (4) measured wholesale sewerage services, and
- (5) reception, treatment and disposal of trade effluent

where

- (a) a measured supply or service is one where all or some of the charges for that supply or service are based on measured quantities of volume and an unmeasured supply or service is any other; and
- (b) sewerage services includes sewage treatment and disposal and excludes reception, treatment and disposal of trade effluent;

**"Chargeable Supply"** means any wholesale supply of water or any wholesale provision of sewerage services for which charges are payable;

References in this Condition to the **"Competition Commission"** shall include any successor body to which the functions of the Competition Commission are or may be transferred, and accordingly all such references to the "Competition Commission" following the entry into force of section 19(4) of the Enterprise and Regulatory Reform Act 2012 shall be deleted and replaced with the words "Competition and Markets Authority";

**"Contestable Customers"** means any customers who are permitted by law to choose their water supplier [or provider of sewerage services] but for the avoidance of doubt shall not include customers occupying, or otherwise seeking a supply in respect of, household premises and shall not include Non-Contestable Customers;

**"Excluded Charges"** unless and until otherwise agreed between the Water Services Regulation Authority and the Appointee, are

- (1) amounts payable in respect of an unmeasured supply of water by means of stand-pipes or water tanks and in respect of the erection or maintenance of stand-pipes or water tanks;
- (2) charges for a supply of water provided by the Appointee under section 59 of the Water Industry Act 1991;

- (3) charges for the reception and disposal by the Appointee, or other person specified by the Appointee of matter delivered to the Appointee or such other person by a collection authority in pursuance of section 14(9) of the Control of Pollution Act 1974;
- (4) charges for unmeasured supplies of water to cattle troughs;
- (5) charges for unmeasured building water supplies;
- (6) amounts payable in respect of an unmeasured supply of water by means of bowsers or water tankers;
- (7) charges for unmeasured supplies of water to farm taps and other agricultural water points; and
- (7A) Charges in any Charging Year for supplies of water (or for the provision of sewerage services or for the reception, treatment and disposal of trade effluent) to premises where the premises were supplied in the relevant Weighting Year with not less than such quantity of water as is specified from time to time under section 7(5)(a) of the Water Industry Act 1991

AND, for the avoidance of doubt, but without prejudice to the meaning of Standard Charges in respect of Basket Items, shall also include

- (8) charges payable for any such connection as is described in section 146 of the Water Industry Act 1991;
- (9) charges for a supply of water in bulk to another water undertaker;
- (10) amounts payable under any such agreement as is described in section 20 (1)(b) of the Water Resources Act 1991, (including any such agreement entered into by the Water Authority under section 158 of the Water Resources Act 1991, with respect to any of the matters referred to in section 158(1)(b) and 158(1)(d) of the Water Resources Act 1991, as, by virtue of paragraph 29(1) of Schedule 26, has effect on and after the transfer date as a thing done by the Appointee); and
- (11) charges payable under any agreement for any unmeasured supply of water or unmeasured sewerage services which are calculated by reference to the rateable value of hereditaments, occupied by the person to whom the supply or services are provided, fixed in accordance with section 32, 33 or, as the case may be, 34 of the General Rate Act 1967 or, as the case may be, fixed in accordance with section 54 of the Local Government Finance Act 1988

**"Measured Basket Items"** means items (3), (4) and (5) in the definition of Basket Items;

**"Non-Contestable Customers"** means any customers who are not permitted by law to choose their water supplier [or provider of sewerage services] but for the avoidance of doubt shall not include Contestable Customers;

**"Non-volumetric Charge"** is a charge which is not based on measured quantities of volume;

**"Price Control"** means any of the following:

- (1) a determination by the Water Services Regulation Authority of the Adjustment Factor relating to Standard Charges for Wholesale Activities;
- (2) a determination by the Water Services Regulation Authority of the [maximum charges permitted to be levied, or maximum revenue permitted to be earned,]<sup>5</sup> by the Appointee from carrying out its Retail Activities relating to Contestable Customers; and
- (3) a determination by the Water Services Regulation Authority of the [maximum charges permitted to be levied, or maximum revenue permitted to be earned,]<sup>6</sup> by the Appointee from carrying out its Retail Activities relating to Non-Contestable Customers.

**"the Relevant Charging Year"** means a Charging Year starting on 1st April 1995 or on the fifth anniversary of the first day of the first of the Charging Years in respect of which the last Periodic Review was carried out;

**"Retail Activities"** means the following activities, to the extent that such activities relate to Contestable Customers and Non-Contestable Customers: billing, payment handling, non-network calls, debt management, meter reading and such other activities that are incidental to any of the foregoing as the Water Services Regulation Authority may from time to time designate, after prior consultation with the Appointee, pursuant to sub-paragraph 4.9 below, but for the avoidance of doubt, shall not include any of the following activities: abstraction, treatment, distribution and supply of water, collection, treatment and disposal of waste water, meter ownership, maintenance or installation;

**"Standard Charges"** means

- (1) wholesale charges fixed under any such charges scheme as is referred to in section 143 of the Water Industry Act 1991;
- (2) charges payable under any such agreement as is referred to in section 142 of the Water Industry Act 1991, (including any such agreement made or entered into by the Water Authority under section 30 of the 1973 Act as, in accordance with a scheme under Schedule 2, is transferred to the Appointee) under or for which all the charges payable are in accordance with standard charges published or fixed by the Appointee or, as the case may be, the Water Authority;
- (3) charges payable where a discharge is made in pursuance of a consent given by the Appointee for the purposes of Chapter III of Part IV of the Water Industry Act 1991 under or for which all the charges payable are in accordance with standard charges published or fixed by the Appointee;
- (4) charges determined by agreement in respect of a supply of water provided by the Appointee for non-domestic purposes where all the charges so determined in respect of that supply are in accordance with standard charges published or fixed by the Appointee;

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<sup>5</sup> Subject to outcome of consultation on price control methodology.

<sup>6</sup> Subject to outcome of consultation on price control methodology.

- (5) charges fixed under any such charges scheme made by the Water Authority under section 31 of the 1973 Act as, by virtue of paragraph 16(1) of Schedule 26, has effect on and after the transfer date as if it were a charges scheme made under section 143 of the Water Industry Act 1991, by the Appointee;
- (6) charges payable under any such consent or agreement under Chapter III of Part IV of the Water Industry Act 1991, has effect on and after the transfer date as if it were given or entered into by the Appointee under which all the charges payable are in accordance with standard charges published or fixed by the Water Authority or, as the case may be, the Appointee;
- (7) charges in respect of any such supply which the Water Authority was under a duty to make under section 27 of the 1945 Act as, by virtue of paragraph 8 of Schedule 26, is a supply which the Appointee is under a duty to make on and after the transfer date where all charges in respect of such supply are in accordance with standard charges published or fixed by the Water Authority or, as the case may be, the Appointee; and

Provided that no part of this definition shall apply to any charge which is for the time being an Excluded Charge by virtue of (7A) of the definition of Excluded Charges;

In this definition references to standard charges published or fixed by the Appointee or the Water Authority are to such charges, whether published or fixed under a charges scheme or otherwise;

**"Termination Notice"** means a notice given in accordance with Condition O;

**"Unmeasured Basket Items"** means items (1) and (2) in the definition of Basket Items;

**"Weighted Average Charges Increase"** means the sum calculated as follows:<sup>7</sup>

$$W_t = \sum_i \left( \frac{A_t(i)}{A_{t-1}(i)} \cdot r(i) \right) + \sum_j \left( \frac{B_t(j)}{B_{t-1}(j)} \cdot r(j) \right) - 1$$

where

$W_t$  is the Weighted Average Charges Increase for the Charging Year

$i$  is an index identifying the two Unmeasured Basket Items

$j$  is an index identifying the three Measured Basket Items

$\sum_i$  requires summation over the two Unmeasured Basket Items

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<sup>7</sup> Although the formula under this draft Condition is the same as the formula which appears in the current licence, there are some changes in the way certain components of the formula have been defined (Basket Items, Chargeable Supply), both of which have been amended to refer explicitly to wholesale. The changes to these definitions have a knock-on effect on the definitions of Average Chargeable Supply and Weighting Year Revenue. The purpose of making these changes is to ensure that the formula only applies to Wholesale Activities. However, in determining the Price Control for Wholesale Activities for the Charging Year commencing on 1 April 2015, the Water Services Regulation Authority will need to determine the Average Charge per Chargeable Supply for the previous Charging Year, commencing on 1 April 2014 and the Weighting Year Revenue for the Charging Year commencing on 1 April 2013.

$\Sigma$  requires summation over the three Measured Basket Items  
j

$A_t(i)$  is the Average Charge Per Chargeable Supply in respect of Unmeasured Basket Item i for the Charging Year

$A_{t-1}(i)$  is the Average Charge Per Chargeable Supply in respect of Unmeasured Basket Item i for the Prior Year

$B_t(j)$  is the Weighting Year Revenue in respect of Measured Basket Item j for the Charging Year

$B_{t-1}(j)$  is the Weighting Year Revenue in respect of Measured Basket Item j for the Prior Year

$r(i)$  or  $r(j)$  is the revenue (exclusive of VAT) which accrued to the Appointee in the Weighting Year from all Standard Charges other than Excluded Charges (including, in the case of Measured Basket Items, any Non-volumetric Charge) in respect of Unmeasured Basket Item i or Measured Basket Item j (as the case may be), divided by the aggregate of such revenues for all five Basket Items;

**"Weighting Year"** means the financial year of the Appointee ended last before 7th October in the Prior Year;

**"Weighting Year Revenue"** means the revenue (exclusive of VAT) which would have accrued to the Appointee in the Weighting Year in respect of the specified Measured Basket Item, if all Standard Charges other than Excluded Charges (including any Non-volumetric Charge) made or to be made in respect of that Measured Basket Item in the Charging Year or, as the case may be, the Prior Year had applied;

**"Wholesale Activities"** means all activities forming part of the Appointed Business which are not Retail Activities.

3. Where the calculation of the Weighted Average Charges Increase requires reference to be made to circumstances existing at any time or during any period prior to the transfer date references to the Appointee shall include references to the Water Authority.

## Part II. Price Controls

### 4. *Price Controls for Wholesale Activities and Retail Activities*

- 4.1 The Price Control relating to Standard Charges for Wholesale Activities shall take the form of a Wholesale Charges Limit.

- 4.2 The Wholesale Charges Limit is the percentage calculated as  $RPI + K$ , where:

RPI is the percentage change (expressed, in the case of an increase, as a positive number, in the case of a decrease, as a negative number and, in the case of no change, as zero) in the Retail Prices Index between that published for the month of November in the Prior Year and that published for the immediately preceding November; and

K is the Adjustment Factor determined by the Water Services Regulation Authority or, as the case may be, the Competition Commission.

- 4.3 The Appointee shall ensure that the Weighted Average Charges Increase in any Charging Year (beginning with the Charging Year starting on 1st April 2015) when expressed as a percentage does not exceed the Wholesale Charges Limit.
- 4.4 If the Weighted Average Charges Increase in any Charging Year is less than the Charges Limit then the Wholesale Charges Limit for the following Charging Year shall be increased by the amount of such deficiency. The Wholesale Charges Limit for the Charging Year starting on 1st April 2015 and each subsequent Charging Year shall only be increased by virtue of this sub-paragraph 4.4 to the extent that such deficiency is not attributable to any Charging Year ended three years or more previously.
- 4.5 The Price Controls for Retail Activities shall take the following form:<sup>8</sup>
- (1) for Retail Activities relating to Contestable Customers the Price Control shall consist of a [Retail Charges Limit][Retail Revenues Limit];<sup>9</sup>
  - (2) for Retail Activities relating to Non-Contestable Customers the Price Control shall take the form of a [Retail Charges Limit][Retail Revenues Limit].
- 4.6 In determining either or both of the Price Controls for Retail Activities, the Water Services Regulation Authority shall ensure that any increase in the [Retail Charges Limit or Retail Revenue Limit] shall be indexed by the movement in the Retail Prices Index [or using such other indexation mechanism as the Water Services Regulation Authority, after prior consultation with the Appointee, may determine having regard to its duties under section 2 of the Water Industry Act 1991].
- 4.7 The Appointee shall ensure that its [charges for Retail Activities][maximum allowable revenues for Retail Activities] in any Charging Year do not exceed any applicable [Retail Charges Limit or Retail Revenue Limit] determined by the Water Services Regulation Authority, or as the case may be, the Competition Commission, for that Charging Year.
- 4.8 If the [charges for Retail Activities] or the [maximum allowable revenues] for Retail Activities in any Charging Year are less than the applicable Retail Charges Limit or Retail Revenues Limit] then the [Retail Charges Limit or, as the case may be, Retail Revenues Limit] for the following Charging Year shall be increased by the amount of such deficiency. The Retail Charges Limit or, as the case may be, Retail Revenues Limit for the Charging Year starting on 1st April 2015 and each subsequent Charging Year shall only be increased by virtue of this sub-paragraph 4.8 to the extent that such deficiency is not attributable to any Charging Year ended three years or more previously.
- 4.9 The Water Services Regulation Authority may from time to time, after prior consultation with the Appointee, designate activities that are incidental to billing, payment handling, non-network calls, debt management and meter reading, to the extent that such activities relate to Contestable Customers and Non-Contestable Customers, as Retail Activities by giving notice to the Appointee but for the avoidance of doubt, no such designation shall include any of the following activities: abstraction, treatment, distribution and supply of water, collection, treatment and disposal of waste water, meter ownership, maintenance or installation. Any such designation shall take effect from the start of the next following Charging Year and

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<sup>8</sup> Subject to outcome of consultation on price control methodology.

<sup>9</sup> It is envisaged that there will either be a Retail Charges Limit or a Retail Revenues Limit, depending on the outcome of the consultation on price control methodology. The definitions will also need to await the outcome of that consultation.

notice thereof shall be given by the Water Services Regulation Authority to the Appointee no later than 1st September in the Prior Year.

5. *Matters affecting the Wholesale Charges Limit, the calculation of the Weighted Average Charges Increase, Retail Charges Limit and Retail Revenue Limit*

5.1 Where, in relation to its charges for Wholesale Activities, the Appointee determines:

- (1) to make a material change (other than one which relates solely to the amount of a charge) to the basis on which it makes or calculates any Standard Charge, or Standard Charges taken as a whole, (other than Excluded Charges) for the supply of water or the provision of sewerage services or the reception, treatment and disposal of trade effluent;
- (2) to make a material change to the scope of any such scheme, agreement or consent as is referred to in the definition of "Standard Charges" (insofar as such change relates to charges, other than Excluded Charges, for the supply of water or the provision of sewerage services or the reception, treatment and disposal of trade effluent); or
- (3) to change the basis on which the Appointee treats supplies of water or provisions of sewerage services as separate supplies or provisions for the purpose of making Standard Charges (other than Excluded Charges) which affects the calculation of Average Charge Per Chargeable Supply it shall:
  - (a) notify the Water Services Regulation Authority; and
  - (b) furnish to the Water Services Regulation Authority such explanations and Information relating to such change as the Water Services Regulation Authority considers requisite or expedient having regard to the purposes of this Condition

5.2 Where there is a material change to the basis of compiling the Retail Prices Index, this Condition, insofar as it relates to that part of the calculation of any Wholesale Charges Limit, [Retail Charges Limit or Retail Revenues Limit] to which the Retail Prices Index is relevant, shall be modified in such manner as the Water Services Regulation Authority, after prior consultation with the Appointee, may determine to be appropriate to take account of such change.

Part III. Periodic Reviews

6. *Periodic Reviews of the Appointed Business Initiated by the Water Services Regulation Authority at five yearly intervals*

6.1 Pursuant to sub-paragraph 6.3 below, the Appointee shall comply with a determination by the Water Services Regulation Authority and demonstrate to the Water Services Regulation Authority such compliance.

6.2 The Appointee shall furnish to the Water Services Regulation Authority such Information as the Water Services Regulation Authority may reasonably require to enable it to carry out a Periodic Review pursuant to sub-paragraph 6.3 below.

6.3 The Water Services Regulation Authority shall determine (having regard to all the circumstances which are relevant in the light of the principles which apply by virtue of Part I of the Water Industry Act 1991 in relation to the Water Services Regulation Authority's

determination including, without limitation, any change in circumstance which has occurred since the last Periodic Review or which is to occur):

- (1) what is the appropriate Adjustment Factor relating to Standard Charges for Wholesale Activities;
- (2) what is the appropriate level of Price Control or Price Controls in respect of Retail Activities; and
- (3) how the Appointee shall demonstrate compliance with the Price Controls determined in respect of Wholesale Activities and Retail Activities.

6.4 The Periodic Reviews referred to in sub-paragraph 6.3 above shall be conducted at five yearly intervals and shall cover periods of five consecutive Charging Years, the first such review covering the period of five Charging Years starting on 1st April 2015.

7. *Periodic Reviews of the Appointed Business where a Termination Notice has been given*

7.1 Where a Termination Notice has been given by the Secretary of State to the Appointee, the Appointee may refer to the Water Services Regulation Authority for determination by it the questions whether, on the assumption that such a Termination Notice had not been given, (but subject thereto, having regard to all the circumstances which are relevant in the light of the principles which apply by virtue of Part I of the Act in relation to the Water Services Regulation Authority's determination, including, without limitation, any change in circumstance which has occurred since the last Periodic Review or which is to occur) the Adjustment Factor relating to Standard Charges for Wholesale Activities and the Price Controls for Retail Activities should be changed (and if so what change should be made to the Adjustment Factor and the Price Controls for Retail Activities) for the five consecutive Charging Years starting with the Charging Year starting 1st April last before the Termination Notice is to expire.

7.2 A reference to the Water Services Regulation Authority under this paragraph 7 shall be made by notice given to the Water Services Regulation Authority not earlier than 1st July and not later than 14th July in the Charging Year next but one before that commencing on the said 1st April.

8. *Effect of Termination of the Appointments (or either of them) on Periodic Reviews*

Subject to paragraph 7, if the Secretary of State shall have served a Termination Notice on the Appointee then this Condition shall have effect as though, in the case of the Appointment in respect of which the Termination Notice has been given, references to a Periodic Review being carried out in respect of a period of five consecutive Charging Years were references to a Periodic Review being carried out in respect of the relevant Appointment in respect of a period of that number of consecutive Charging Years which is the lesser of:

- (1) five and
- (2) the number of consecutive Charging Years (including that in which the day on which the Termination Notice is to take effect falls) in the period starting on the first day of the first of the Charging Years in respect of which that Periodic Review is to be carried out and ending on the day on which the Termination Notice is to expire.

Part IV. Interim Determinations

9. *Matters of Interpretation and Construction which apply for the purposes of this Part IV*

9.1 In this Part of this Condition:

**"the Appropriate Discount Rate"** means such rate of return [upon borrowing] as, at the time at which the Appropriate Discount Rate falls to be applied from time to time under this Condition, investors and creditors would reasonably expect of a properly managed company holding the Appointments whose sole business consists of being a water undertaker and a sewerage undertaker and, without excluding other considerations which may also be relevant, having its equity share capital listed on The London Stock Exchange, and the same Appropriate Discount Rate shall be applied for all purposes in determining questions the subject of the same reference (including questions determined by the Water Services Regulation Authority under paragraph 11 when it determines questions referred to it by the Appointee under paragraph 10);

**"equity share capital"** has the same meaning as in the Companies Act 2006;

**"Interim Determination"** means the determination by the Water Services Regulation Authority of the relevant questions the subject of a reference by the Appointee under paragraph 10 or pursuant to paragraph 11 or, as the case may be, the determination by the Competition Commission of the relevant questions or of the disputed determinations the subject of a reference to it pursuant to sub-paragraph 12.1(2) or 12.1(3), which relates to a reference by the Appointee under paragraph 10 or a determination pursuant to paragraph 11;

**"making a Relevant Determination"** means making a determination pursuant to sub-paragraph 6.3 in a Periodic Review, or making any Interim Determination as to whether the Adjustment Factor relating to Standard Charges for Wholesale Activities or the level of a Price Control or Price Controls for Retail Activities should be changed (and if so, what change should be made to the Adjustment Factor, Price Control or Price Controls), and **"Relevant Determination"** shall be construed accordingly;

**"Net Present Value"** means the net present value calculated as at 30th September in the year in which the relevant Reference Notice is given or, where in any year no Reference Notice is given under paragraph 10 but the Water Services Regulation Authority gives a notice to the Appointee under paragraph 11, as at 30th September in the year in which the Water Services Regulation Authority gives the notice, by discounting subsequent cash flows and inflating earlier cash flows at the Appropriate Discount Rate, assuming all cash flows in any Charging Year occur on 30th September in that Charging Year;

a **"Notified Item"** is any item notified by the Water Services Regulation Authority to the Appointee as not having been allowed for (either in full or at all) in making a Relevant Determination; and for the purpose of this definition:

- (a) where any such item was not allowed for in full then it shall only be a Notified Item to the extent that it was not allowed for; and
- (b) where, in determining whether the Adjustment Factor relating to Standard Charges for Wholesale Activities or the level of a Price Control or Price Controls for Retail Activities should be changed (and if so what change should be made to the Adjustment Factor, Price Control or Price Controls), the Water Services Regulation Authority, or, as the case may be, the Competition Commission, allows for any such item as was previously so notified by the Water Services Regulation Authority then

references in this Condition to Notified Items and Relevant Items shall be taken, for the purposes of any subsequent Interim Determination, to exclude such item to the extent that the Water Services Regulation Authority, or, as the case may be, the Competition Commission, allowed for it as aforesaid;

a "**Relevant Change of Circumstance**" is any of the following:

- (1) (a) the application to the Appointee of any legal requirement; and
- (b) any change to any legal requirement which applies to the Appointee (including any legal requirement ceasing to apply, being withdrawn or not being renewed);
- (2) either of the following circumstances for any Charging Year in respect of which the Secretary of State, or, as the case may be, the Water Services Regulation Authority, notified the Appointee that variations in value received or expected to be received from Relevant Disposals of Land shall constitute a Relevant Change of Circumstance:
  - (a) where for any Charging Year the value received or expected to be received from a Relevant Disposal of any Identified Land is, or is expected to be, different from the value which the Secretary of State, or, as the case may be, the Water Services Regulation Authority, notified the Appointee was the value attributable to a Relevant Disposal of that Identified Land for that Charging Year which had been allowed for in making a Relevant Determination; or
  - (b) where for any Charging Year, and to the extent not taken into account under (a) above, the aggregate value received or expected to be received from Relevant Disposals of Non-identified Land is, or is expected to be, different from the value which the Secretary of State, or, as the case may be, the Water Services Regulation Authority notified the Appointee was the value attributable to Relevant Disposals of Non-identified Land for that Charging Year which had been allowed for in making a Relevant Determination

and so that any notification by the Water Services Regulation Authority for purposes of this sub-paragraph (2) shall be relevant for the purposes of this sub-paragraph (2) to the exclusion of any earlier notification by the Secretary of State or the Water Services Regulation Authority for the purposes of this sub-paragraph (2) to the extent that the first-mentioned notification is made in respect of matters in respect of which that earlier notification was made.

For the purposes of this sub-paragraph (2):

- (i) "**Identified Land**" means any piece or parcel of protected land identified in any such notification referred to in (a) above as is relevant for the time being for the purposes of this sub-paragraph (2) as being included in that notification, not being, or being part of, a piece or parcel of land which has previously been the subject of a transfer under paragraph 7 of Condition K;
- (ii) "**land**" includes any interest or right in or over land;
- (iii) "**Non-identified Land**" means any piece or parcel of protected land, not being, or being part of:

- (A) a piece or parcel of protected land identified in any such notification referred to in (a) above as is relevant for the time being for the purposes of this sub-paragraph (2); or
  - (B) a piece or parcel of protected land which has previously been the subject of a transfer under paragraph 7 of Condition K;
- (iv) **"protected land"** and **"disposal"** have the meanings respectively given to them in section 219 of the Water Industry Act 1991;
  - (v) a **"Relevant Disposal"** means and includes any disposal by the Appointee and any transfer under paragraph 7 of condition K;
  - (vi) a **"Relevant Disposal of Land"** means and includes a Relevant Disposal of Identified Land and a Relevant Disposal of Non-identified Land;
  - (vii) **"value"** includes value of any kind including, without limitation, cash, the value of real or personal property or any interest in such property, the value of any right or benefit (actual or prospective) and the value of any release, in whole or in part, of any obligation or claim, provided that to the extent that any property, right or benefit shall consist of a right to receive cash or any other asset then no value shall be attributed to that property, right or benefit but the cash or other asset the subject thereof shall be included and treated as value received or expected to be received in the Charging Year in which it is received or expected to be received;
  - (viii) references to **"value received or expected to be received"** shall be construed so as to include receipts by, and grants to, the Appointee, any Associated Company or any other business in which either the Appointee or any Associated Company has a material direct or indirect interest;
  - (ix) for the purpose of computing **"value received or expected to be received"** in respect of a Relevant Disposal of Land which consists of a transfer made under paragraph 7 of Condition K the "value received or expected to be received" shall be the value for which that transfer is made under that paragraph 7, but so that where that value includes a right to receive cash or any other asset then, for the purpose of this sub-paragraph, no value shall be attributed to that right but the cash or other asset the subject thereof shall be included and treated as value received or expected to be received in the Charging Year in which it is received or expected to be received;
  - (x) in the case of a right or benefit, but subject to the proviso to (vii) above, value shall be deemed to have been received at the time the right is granted or the benefit arises;
- (3) where:
- (i) in making a Relevant Determination, an amount has been allowed for on account of steps taken or to be taken for the purpose of securing or facilitating compliance with a legal requirement (not being one to comply with which the Appointee has determined to make a change to the basis on which it charges customers for water supply or sewerage services) or achieving a service standard adopted or to be adopted by the Appointee; and
  - (ii) in any such case:

- (A) the Appointee has not taken (by the date by which it was assumed for the purposes of assessing the amount allowed for as aforesaid it would take those steps) any or all of those steps which, for the purpose of assessing the amount allowed for as aforesaid, it was assumed it would take; and
  - (B) as a result, the amount allowed for as aforesaid is substantially greater than the sum of (a) the costs (if any) actually incurred by the Appointee for the relevant purpose specified in (i) above and (b) so much (if any) of that amount as has been otherwise offset by prudent management of the capital programme; and
  - (C) that purpose has not been otherwise achieved;
- (4) where:
- (a) in making a Relevant Determination an amount has been allowed for on account of capital expenditure to be incurred by the Appointee; and
  - (b) for any Charging Year ended before the making of the relevant reference under paragraph 10, or, as the case may be, the giving of the relevant notice under paragraph 11, the Notified Index is at a different level from that which the Water Services Regulation Authority last notified the Appointee in connection with a Relevant Determination was the level which it had been assumed would pertain in that same Charging Year in which it was assumed for the purpose of assessing the amount allowed for as aforesaid that capital expenditure would be incurred by the Appointee);

For the purposes of this sub-paragraph (4) and sub-paragraph 10.2:

- (A) "**the Notified Index**" means the index of national construction costs notified by the Water Services Regulation Authority to the Appointee for the purposes of this condition, or such other index as the Water Services Regulation Authority, after prior consultation with the Appointee, determines to be appropriate and reasonable for those purposes as being the index which is to apply for the purposes of the relevant Charging Year.
- (B) where:
  - (x) the Notified Index is not available by 1st September in any year;
  - (y) there is a material change to the basis of compiling the Notified Index; or
  - (z) the level of the Notified Index is revised after the determination of the questions in respect of a Relevant Change of Circumstance falling within this sub-paragraph (4)

then the question as to how changes in construction costs in the relevant Charging Year should be allowed for as a Relevant Change of Circumstance shall be determined by the Water Services Regulation Authority in such a manner as the Water Services Regulation Authority, after prior consultation with the Appointee,

determines to be appropriate and this Condition shall be modified accordingly; and

- (C) "the Indexed Capital Costs Amount" is the amount found by multiplying A by B, where

A is the aggregate amount of capital expenditure which, for the purpose of assessing the amount allowed for as described in (a) above, it was assumed would be incurred by the Appointee in the relevant Charging Year

B is the percentage difference between the level of the Notified Index for the relevant Charging year and the level notified for that same Charging Year by the Water Services Regulation Authority, as described in (b) above;

a "**Relevant Item**" is any of the following:

- (1) a Relevant Change of Circumstance (other than a Relevant Change of Circumstance falling within sub-paragraph (2) of the definition);
- (2) a Notified Item; and
- (3) a Relevant Disposal of Land

and references to a Relevant Item are to a Relevant Change of Circumstance (other than a Relevant Change of Circumstance falling within sub-paragraph (2) of the definition), a Notified Item or a Relevant Disposal of Land as the context may require.

9.2 In the definition of a "Relevant Change of Circumstance" and for the purpose of that definition:

- (1) a "**legal requirement**" is any of the following:
  - (a) any enactment or subordinate legislation to the extent that it applies to the Appointee in its capacity as a water undertaker or sewerage undertaker (and for this purpose, but without prejudice to the generality of the foregoing, "subordinate legislation" includes any order made under section 18 of the Water Industry Act 1991, and any authorisation granted, approval given, or prohibition imposed, by the Secretary of State under The Water Supply (Water Quality) Regulations 2000);
  - (b) any regulation made by the Council or the Commission of the European Union to the extent that it applies to the Appointee in its capacity as a water undertaker or sewerage undertaker, or decision taken by the said Commission which is binding on the Appointee in its capacity as a water undertaker or sewerage undertaker and to the extent that it is so binding;
  - (c) any licence, consent or authorisation given or to be given by the Secretary of State, the Water Services Regulation Authority or other body of competent jurisdiction to the Appointee for the purpose of carrying on any of the functions of a water undertaker or sewerage undertaker;

- (d) any undertaking given by the Appointee to, and accepted by, the Secretary of State or, as the case may be, the Water Services Regulation Authority for the purposes of section 19(1)(b) of the Water Industry Act 1991;
- (e) other than any such undertaking as is referred to in (d), any undertaking given by the Appointee to any enforcement authority, and accepted by that enforcement authority, to take all such steps:
  - (i) as are specified by that enforcement authority to be necessary or appropriate for the Appointee to take for the purpose of securing or facilitating compliance with any legal requirement in relation to which that enforcement authority is the enforcement authority; or
  - (ii) the taking of which is specified by that enforcement authority to be a condition or requirement of granting or renewing any such licence, consent or authorisation as is referred to in (c) or agreeing not to withdraw the same;
- (f) the Conditions of these Appointments; and
- (g) any interpretation of law, or finding, contained in any judgment given by a court or tribunal of competent jurisdiction in respect of which the period for making an appeal has expired which requires any legal requirement falling within (a) to (f) above to have effect in a way:
  - (i) different to that in which it previously had effect; or
  - (ii) different to that in which it was taken to have effect:
    - (A) for the purpose of making a Relevant Determination; or, as the case may be,
    - (B) in determining whether a Relevant Determination should be changed

but so that nothing in sub-paragraphs (a) to (g) above shall apply so as to include:

- (i) any such legal requirement as is referred to in section 41 of the Environment Act 1995; or
- (ii) that section

to the extent in either case that they require the Appointee to pay fees or charges to the relevant enforcement authority; and

- (2) "**enforcement authority**" means any person or body having jurisdiction to enforce or to take action under or in respect of the relevant legal requirement.

9.3 In paragraph 10 and in the definition of a "Relevant Change of Circumstance":

- (1) references to costs include references to expenditure and loss of revenue and references to costs being incurred include references to expenditure being made and loss of revenue being suffered;

- (2) references to receipts include references to receipts, cash or other assets of any sort, whether of a capital or revenue nature and including receipts of grants, contributions, gifts and loans and
  - (3) without prejudice to sub-paragraph (1) above, "Operating Expenditure" in sub-paragraph 10.2(6) includes those items currently so identified in Regulatory Accounting Guidelines 3 and 4. For the avoidance of doubt, depreciation, the write-down/off of assets, the profits/loss on disposal of assets and infrastructure renewals expenditure or charges are excluded.
- 9.4 (1) For the purposes of sub-paragraph 10.2(1) costs, receipts and savings shall be ascertained at the general price level prevailing, or expected to prevail, on 30 September in the year in which the Appointee gives notice under sub-paragraph 10.1, or the Water Services Regulation Authority gives notice under paragraph 11.1(1).
- (2) In sub-paragraphs 10.2(8) and 10.2(9) and sub-paragraph (3) below "**at Outturn Prices**", in relation to the amount of any Base Cash Flow or depreciation, means that amount as adjusted to take account of the actual or expected cumulative percentage change in the Retail Prices Index from that prevailing, or expected to prevail, on 30 September in the year in which the Appointee gives notice under sub-paragraph 10.1 or the Water Services Regulation Authority gives notice under sub-paragraph 11.1, up to and including that prevailing, or expected to prevail, on 30th September in the year in which the Base Cash Flow or depreciation occurred, or is expected to occur.
- (3) In sub-paragraph 10.2(8) "**Current Value**", in relation to any Base Cash Flow or depreciation at Outturn Prices, means that amount, as adjusted to take account of the actual or expected cumulative percentage change in the Retail Prices Index from 30 September in the year in which that Base Cash Flow or depreciation occurred or is expected to occur, up to and including 30 September in the relevant year.
- 9.5 For the purpose of section 13(5)(b) of the Water Industry Act 1991, the provisions of this Condition, to the extent that they relate to a Relevant Change of Circumstance falling within sub-paragraph (2) of that definition, are provisions of the Appointments which cannot be modified. This sub-paragraph shall cease to have effect if, but only if, this Condition ceases to contain any provision relating to changes to the Relevant Determination to allow for Notified Items and Relevant Changes of Circumstance.
10. *References to the Water Services Regulation Authority relating to Notified Items and Relevant Changes of Circumstance and circumstances having a substantial effect on the Appointed Business*
- 10.1 The Appointee may from time to time refer to the Water Services Regulation Authority for determination by it (having considered the proposals of the Appointee) the questions set out in sub-paragraph 10.2 or, as the case may be, sub-paragraph 10.3. Such reference shall be made by notice given to the Water Services Regulation Authority, which, in the case of the questions set out in sub-paragraph 10.2, shall be given in accordance with sub-paragraph 10.2(4). For the purposes of sub-paragraph 10.2 a single reference may be made in respect of any number of Notified Items and Relevant Changes of Circumstance and sub-paragraph 10.2 shall be construed accordingly.
- 10.2 In the case of a Notified Item or where there has been or is to be a Relevant Change of Circumstance all of the following:

- (1) what are, or are likely to be, the costs, receipts and savings reasonably attributable to the Relevant Item and also, in the case of a Relevant Change of Circumstance falling within sub-paragraph (2) of the definition, the costs, receipts and savings reasonably connected with the Relevant Disposal of Land. For this purpose the costs reasonably attributable to a Relevant Change of Circumstance falling within sub-paragraph (4) of the definition shall be taken to be equal to the Indexed Capital Costs Amount;
- (2) except in the case of a Relevant Change of Circumstance falling within sub-paragraph (2) of the definition, to what extent:
  - (a) are the costs determined under (1) reasonably recoverable through charges for services provided, functions carried out by, and other activities of, the Appointee in its capacity as a water undertaker or sewerage undertaker which are not Standard Charges for Basket Items (not being Excluded Charges);
  - (b) in the case of receipts and savings, is the Relevant Item relevant to services provided, functions carried out by, and other activities of, the Appointee as a water undertaker or sewerage undertaker which are not Basket Items in respect of which the Appointee makes Standard Charges (not being Excluded Charges)

and where it is determined that such costs are reasonably recoverable as aforesaid or, as the case may be, that the Relevant Item is relevant as aforesaid, either in full or to an extent, then references hereafter to costs, receipts and savings reasonably attributable to a Relevant Item are to those costs, receipts and savings except to that extent;

- (3) both of the following:
  - (a) what costs reasonably attributable to, or connected with, the Relevant Item as determined under (1) and what timing of incurring of such costs are appropriate and reasonable for the Appointee in all the circumstances to incur and programme, or, as the case may be to have incurred and programmed, by reason of the Relevant Item; and
  - (b) what receipts and savings reasonably attributable to, or connected with, the Relevant Item as determined under (1) and what timing of such receipts and savings is appropriate and reasonable for the Appointee in all the circumstances to achieve and programme or, as the case may be, to have achieved and programmed, by reason of the Relevant Item

and for the purpose of determining the separate amounts under (a) and (b), but without prejudice to the generality of the foregoing:

- (i) no account shall be taken of:
  - (A) any trivial amounts;
  - (B) any costs, to the extent that they would have been, or would be, avoided by prudent management action taken since the transfer date (and for this purpose what constitutes "prudent management action" shall be assessed by reference to the circumstances which were known or which ought reasonably to have been known to the Appointee at the relevant time);

- (C) any savings achieved by management action taken since the transfer date over and above those which would have been achieved by prudent management action (and for this purpose what constitutes "prudent management action" shall be assessed by reference to the circumstances at the relevant time); or
  - (D) any amounts attributable to matters allowed for in making a Relevant Determination, except to such an extent that such amounts otherwise fall to be taken into account as amounts reasonably attributable to, or connected with, the Relevant Item under this sub-paragraph (3) and sub-paragraph (1) by virtue of the definition of a Notified Item and a Relevant Change of Circumstance; and
- (ii) in the case of a Relevant Change of Circumstance falling within sub-paragraph (1) of the definition, regard shall be had to whether either:
- (a) the Secretary of State has notified the Water Services Regulation Authority of any change of policy, concerning any environmental or water-quality standard, which has been made since the last Relevant Determination or
  - (b) the Appointee has itself given notice to the Water Services Regulation Authority of the application to it of, or any change to, any legal requirement, before referring that legal requirement to the Water Services Regulation Authority under sub-paragraph 10.1;
- (4) having determined under (3) the separate amounts of costs and of receipts and savings in respect of each Relevant Item, what are the annual cash flows thereof (costs being netted off against the amount of receipts and savings for this purpose) over each Charging year included in the timing determined under (3) (those annual cash flows being hereinafter referred to as "**the Base Cash Flows**");
- (5) what is the annual aggregate of:
- (a) one half of the Base Cash Flows in respect of Relevant Changes of Circumstance falling within sub-paragraph (2) of that definition; and
  - (b) the Base Cash Flows in respect of all other Relevant Changes of Circumstance and Notified Items
- in both cases the subject of the notice or notices under sub-paragraph 10.4 or paragraph 11;
- (6) (a) where any part of an annual aggregate derived under sub-paragraph (5) consists of items to which (b) below does not apply, what is the Net Present Value of that part of the annual aggregate, calculated up to the start of the first of the Charging Years for which the next Periodic Review falls to be carried out;
- (b) where any part of the annual aggregate derived under sub-paragraph (5) consists of revenue and/or Operating Expenditure, what is the Net Present Value of that part of the annual aggregate, calculated over 15 years; and

- (c) what is the aggregate of the Net Present Values calculated under (a) and (b) ("**the Materiality Amount**");
- (7) is the Materiality Amount equal to or does it exceed ten per cent of the turnover attributable to the Appointed Business in the latest financial year for which accounting statements have been prepared and delivered to the Water Services Regulation Authority under Condition F, as shown by those accounting statements, and for this purpose where the Materiality Amount is a negative figure it shall be treated as though it were a positive figure;
- (8) if so, for each year ("**the relevant year**") until the first of the Charging Years for which the next Periodic Review falls to be carried out (having regard to any Review Notice or Reference Notice which has been given at the time when the reference is made),
- (a) what are the following amounts:
- (i) all Base Cash Flows at Outturn Prices attributable to the creation or acquisition of depreciable assets ("**Allowable Capital Expenditure**");
  - (ii) all the Base Cash Flows at Outturn Prices (save in respect of Relevant Changes of Circumstance falling within sub-paragraph (2) of that definition, where one half of the Base Cash Flow at Outturn Prices shall be used) attributable to the creation, acquisition or disposal of non-depreciable assets ("**Allowable Infrastructure Asset Expenditure**");
  - (iii) all other Base Cash Flows at Outturn Prices ("**Other Allowable Expenditure**");
  - (iv) the sum of the Current Value of all Allowable Capital Expenditure occurring up to and including the relevant year, divided by the weighted average expected life of the assets attributable to that Allowable Capital Expenditure at the time those assets were or are expected to be created or acquired ("**Allowable Depreciation**");
  - (v) the sum of the Current Value of all Allowable Capital Expenditure occurring up to and including the relevant year less the sum of the Current Value of all Allowable Depreciation occurring up to and including the relevant year ("**Allowable Net Asset Value**");
  - (vi) the sum of the Current Value of all Allowable Infrastructure Asset Expenditure occurring up to and including the relevant year ("**Allowable Infrastructure Asset Value**");
  - (vii) the Appropriate Discount Rate, adjusted so as to exclude any allowance for changes in the Retail Price Index, multiplied by the sum of:
    - A. the Allowable Net Asset Value for the relevant year; and
    - B. the Allowable Infrastructure Asset Value for the relevant year;

(the "**Allowable Return**"); and

- (b) what is the sum of:
  - (i) Other Allowable Expenditure;
  - (ii) Allowable Depreciation; and
  - (iii) the Allowable Return;

(the "**Annual Allowable Amount**");

- (9) what change to the Adjustment Factor relating to Standard Charges for Wholesale Activities or the level of a Price Control or Price Controls for Retail Activities over the period beginning from the first of the Charging Years referred to in sub-paragraph 10.4(1) (in any case where a Reference Notice has been given in respect of sub-paragraph 10.2 or sub-paragraph 11.1(1) (in any other case) until the first of the Charging Years for which the next Periodic Review falls to be carried out (having regard to any Review Notice or Reference Notice which has been given at the time when the reference is made) (the "**Relevant Period**") is most likely to allow, or, as the case may be, require, the Appointee to make such charges over the Relevant Period ("**Adjusted Charges**"), in such a manner as to secure that the increase, or, as the case may be, decrease, in revenue attributable to the making of Adjusted Charges would, in each year of the Relevant Period, be equal to

- (i) the Annual Allowable Amount for that year,

plus

- (ii) where Base Cash Flows at Outturn Prices have occurred prior to the first year of the Relevant Period, the amount, which, calculated as a constant annual amount over the Relevant Period, would result in the sum of the Net Present Values of these amounts equalling the sum of the Net Present Values of the Annual Allowable Amounts for each of the years prior to the Relevant Period.

[Provided that -

- (a) where costs have been allowed for in determining the Annual Allowable Amount, it shall be assumed that those costs will be financed other than by the proceeds of an issue of equity share capital; and
- (b) the revenue attributable to the making of adjusted Charges over the relevant period shall not result in cash flow interest cover which, measured both by its level in any one year and by trends in that level over time, is less than that appropriate to the financial position and performance which creditors would reasonably expect to be sufficient for a properly managed company holding the Appointments, whose sole business consists of being a water and sewerage undertaker, to secure an investment grade credit rating for the company.

In this condition:

**"cash flow interest cover"** means the ratio of earnings (revenue less operating expenditure as defined in sub-paragraph 9.3(3) of Condition B) to net interest payable (gross interest payable less interest receivable).]

10.3 All of the following:

- (1) whether any circumstance (other than a relevant Change of Circumstance) has occurred which has or will have:
  - (a) a substantial adverse effect on the Appointed Business or on its assets, liabilities, financial position, or profits or losses, not being one which would have been avoided by prudent management action taken since the transfer date; or
  - (b) a substantial favourable effect on the Appointed Business, or on its assets, liabilities, financial position, or profits or losses, being one which is fortuitous and (ii) not attributable to prudent management action; and
- (2) if so, what change should be made to the Adjustment Factor relating to Standard Charges for Wholesale Activities or the level of a Price Control or Price Controls for Retail Activities.

For this purpose:

- (i) what constitutes "prudent management action" shall be assessed by reference to the circumstances which were known or which ought reasonably to have been known to the Appointee at the relevant time;
- (ii) an effect shall not be regarded as a substantial adverse effect or a substantial favourable effect in any case unless, if the questions set out in sub-paragraph 10.2 were to be asked in relation to the circumstance giving rise to it, the answer to that in 10.2(7) (taking the reference in it to ten per cent as a reference to twenty per cent) would be in the affirmative.

10.4 A Reference Notice given to the Water Services Regulation Authority in respect of sub-paragraph 10.2 shall contain or be accompanied by reasonable details of the Relevant Item in respect of which the Reference Notice is given and, unless the Water Services Regulation Authority otherwise consents, shall be given not later than:

- (1) the fifteenth day of September immediately preceding the first of the Charging Years in respect of which the Appointee wishes the change to the Adjustment Factor relating to Standard Charges for Wholesale Activities or the level of a Price Control or Price Controls for Retail Activities to take effect; or
- (2) if later, where the Water Services Regulation Authority has given a notice to the Appointee under paragraph 11.1 in respect of the same Charging Year, within fourteen days from the receipt by the Appointee of that notice.

11. *Changes to the Adjustment Factor relating to Standard Charges for Wholesale Activities or a Price Control or Price Controls for Retail Activities initiated by the Water Services Regulation Authority relating to Notified Items and Relevant Changes of Circumstance and circumstances within 10.3(1)(b)*

11.1 In the case of a Notified Item or where any Relevant Change of Circumstance has occurred or is to occur, the Water Services Regulation Authority may, having given notice to the Appointee specifying the Notified Item or, as the case may be, the Relevant Change of Circumstance, of its intention so to do not later than:

- (1) the fifteenth day of September immediately preceding the first of the Charging Years in respect of which it proposes the change to the Adjustment Factor relating to Standard Charges for Wholesale Activities or the level of a Price Control or Price Controls for Retail Activities to take effect; or
- (2) if later, where the Appointee has given a Reference Notice to the Water Services Regulation Authority in respect of sub-paragraph 10.2 and falling within sub-paragraph 10.4(1) in respect of the same Charging Year, within fourteen days from the receipt by the Water Services Regulation Authority of that Reference Notice

determine the questions set out in sub-paragraph 10.2 in respect of that Notified Item or, as the case may be, that Relevant Change of Circumstance. A single notice may be given under this sub-paragraph 11.1 in respect of any number of Notified Items and Relevant Changes of Circumstance and sub-paragraph 10.2 shall be construed accordingly.

11.2 Where sub-paragraph 10.4(2) or 11.1(2) applies, the questions set out in (5) to (9) inclusive of sub-paragraph 10.2 shall be determined in respect of all Notified Items and Relevant Changes of Circumstance in respect of which the Appointee and the Water Services Regulation Authority have given notice, taken as a whole.

11.3 In the case of sub-paragraph 10.3, the Water Services Regulation Authority shall give notice to the Appointee of his intention to determine the questions set out in sub-paragraph 10.3(1)(b) and (2).

## Part V. References to the Competition Commission

### 12. *References to the Competition Commission*

12.1 Where:

- (1) pursuant to paragraph 6 or following a reference under paragraph ~~Error! Reference source not found.~~ or 7, the Water Services Regulation Authority has not given notice to the Appointee of its determination within one year from the Review Notice Date or, in the case of a reference under paragraph 7, within one year from the date of the relevant Reference Notice;
- (2) following a reference under paragraph 10, the Water Services Regulation Authority has not given notice to the Appointee of its determinations (including any determinations under paragraph 11 which fall to be taken into account in determining the questions the subject of the reference under paragraph 10) within 3 months from the date of the relevant Reference Notice; or
- (3) the Appointee disputes any determination made by the Water Services Regulation Authority under Part III or Part IV of this Condition.

the Appointee may, by notice given to the Water Services Regulation Authority within:

- (a) 13 months from the Review Notice Date or, in the case of a reference under paragraph 7, from the date of the relevant Reference Notice (in the cases referred to in sub-paragraph (1));
- (b) 4 months from the date of the relevant Reference Notice (in the case referred to in sub-paragraph (2)); or
- (c) 2 months from the date on which the Water Services Regulation Authority gives notice of its determination to the Appointee (in the case referred to in sub-paragraph (3))

require the Water Services Regulation Authority to refer to the Competition Commission for determination by it:

- (i) in any case referred to in sub-paragraph (1) or (2), the relevant question or questions (including, where relevant, the questions in respect of any Notified Item or Relevant Change of Circumstance the subject of a notice under paragraph 11); or
- (ii) in any case referred to in sub-paragraph (3), the disputed determination.

12.2 Where the Appointee requires the Water Services Regulation Authority to make a reference to the Competition Commission under sub-paragraph 12.1 above in the case referred to in section 12.1(3) of that sub-paragraph, the Appointee shall comply with the Water Services Regulation Authority's determination as if a reference had not been made until the Competition Commission makes its determination following such reference. The determination made by the Competition Commission shall then take effect as if it had been made by the Water Services Regulation Authority.

Part VI. *Provision of Information to the Water Services Regulation Authority*

13. The Appointee shall furnish to the Water Services Regulation Authority:

- (1) not later than 30th September immediately following the date of the Reference Notice (in the case of a reference under paragraph 7);
- (2) at the time when it gives the relevant Reference Notice to the Water Services Regulation Authority (in the case of a reference under paragraph 10 falling within sub-paragraph 10.4(1));
- (3) as soon as reasonably practicable and in any event not later than the expiry of one month from the date of the Water Services Regulation Authority's notice to the Appointee under paragraph 11 (in the case of such a notice, including the case of a reference under paragraph 10 falling within sub-paragraph 10.4(2))

such Information as the Appointee reasonably believes is necessary or, as the case may be, as the Water Services Regulation Authority may reasonably require in its said notice, to enable the Water Services Regulation Authority to make its determination. The Appointee shall also furnish to the Water Services Regulation Authority as soon as reasonably practicable such further Information as the Water Services Regulation Authority may from time to time by notice to the Appointee reasonably require to make its determinations.

13.2 The Appointee shall also furnish to the Water Services Regulation Authority from time to time when so requested by the Water Services Regulation Authority such Information as the

Water Services Regulation Authority may reasonably require to decide whether or not to make determinations under paragraph 11.

13.3 Any Information furnished to the Director under this paragraph 13 or under paragraph 6 shall, if the Water Services Regulation Authority so requires to make its determination, be reported on by a person appointed by the Appointee and approved by the Water Services Regulation Authority (such approval not to be unreasonably withheld) ("**the Reporter**").

13.4 The Appointee shall enter into a written contract of engagement with the Reporter which shall:

- (1) where such a report is required by the Water Services Regulation Authority under sub-paragraph 13.3, require the Reporter to prepare and furnish to the Water Services Regulation Authority, and separately to the Appointee, a written report addressed jointly to the Water Services Regulation Authority and the Appointee in form and substance such as may be specified by, or consistent with any guidelines specified by, the Water Services Regulation Authority at the time when the Water Services Regulation Authority requires the report to be furnished, the matters so specified being reasonably appropriate to enable the Water Services Regulation Authority to make its determination (to the extent that the Information in respect of which that report is required to be prepared and furnished is relevant to that determination); and
- (2) include a term that the Reporter will provide such further explanation or clarification of his report as the Water Services Regulation Authority may reasonably require and such further Information in respect of, or verification of, the matters which are the subject of his report as the Water Services Regulation Authority may reasonably require.

The contract of engagement may also include provisions requiring the Reporter, his employees and agents to keep confidential and not to disclose, except to the Water Services Regulation Authority or as required by law, any Information which the Reporter obtains in the course of preparing his report.

13.5 The Appointee shall co-operate fully with the Reporter to enable him to prepare his report, including without limitation, so far as is necessary for that purpose:

- (1) subject to reasonable prior notice to the Appointee, giving to the Reporter access at reasonable hours to any Relevant Plant and to any premises occupied by the Appointee in relation to the Appointed Business; and
- (2) subject to reasonable prior notice to the Appointee, allowing the Reporter at reasonable hours:
  - (a) to inspect and make photocopies of, and take extracts from, any books and records of the Appointee maintained in relation to the Appointed Business;
  - (b) to carry out inspections, measurements and tests on or in relation to any such premises or Relevant Plant; and
  - (c) to take on to such premises or on to or in to any Relevant Plant such other persons and such equipment as may be necessary for the purposes of preparing and completing his report.

13.6 Nothing in sub-paragraph 13.5 shall require the Appointee:

- (1) to do anything which is outside its reasonable control; or
- (2) to do, or to allow the Reporter to do, anything which would materially disrupt the Appointee's business (unless it is essential that that thing be done to enable the Reporter to prepare his report).

13.7 In sub-paragraphs 13.4 and 13.5:

- (1) references to the Reporter include references to his employees and agents; and
- (2) "**Relevant Plant**" means any plant used by the Appointee for the purpose of carrying out the Regulated Activities including, without limitation, water mains, sewers and other pipes and their accessories.