

# **Mid Kent Water plc**

A report on the references under sections 12 and 14  
of the Water Industry Act 1991



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12 and 14 of the Water Industry Act 1991

**Presented to the Director General of Water Services  
August 2000**

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<sup>1</sup>These members formed the Group which was responsible for this report under the Chairmanship of Mr P G Corbett.

## **Note by the Office of Water Services**

In accordance with section 15(6) of the Water Industry Act 1991, the Secretary of State for the Environment, Transport and the Regions has directed the Director General of Water Services to exclude from the published report certain matters, publication of which appears to the Secretary of State to be against the public interest or the commercial interests of any person. Accordingly certain figures and text have been omitted.

**The omissions are indicated by a note in the text or, where space does not permit, by the symbol ✂.**

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Part I

# **Summary and Conclusions**

# 1 Summary

## **Introduction**

1.1. On 7 February 2000 the Director General of Water Services (the Director) made two references to us, one under section 12 and the other under section 14 of the Water Industry Act 1991.

1.2. The section 12 reference requires us to determine for Mid Kent Water plc (MKW) the adjustment factor, K, and the standard amount for the water infrastructure charge, for the five charging years from 1 April 2000 up to and including the year ending 31 March 2005. The section 14 reference requires us to report on whether continuation of the company's licence without modification in relation to Notified Items operates or may be expected to operate against the public interest.

## **The determinations**

1.3. In making our determinations, we must secure that MKW is able to finance the proper carrying out of its functions as a water company, in particular by securing reasonable returns on its capital. Subject to that, we must also fulfil our other statutory duties, which are to protect the interests of customers, to promote economy and efficiency on the part of companies and to facilitate effective competition. We are satisfied that we have complied with these obligations.

## ***Determination of K***

1.4. The licences of water companies provide that in any charging year the increase in weighted average charges (ie the weighted average of the increase in charges in unmeasured water supply and in measured water supply), when expressed as a percentage, should not exceed  $RPI + K$  (the charges limit). K may be positive, negative or zero, and may be set at different values for each charging year. The effect of a negative K in excess of the RPI is to require a reduction in nominal prices.

1.5. The licences also provide for K to be reviewed by the Director in a process known as the Periodic Review. Such reviews normally take place every five years, and the resulting determination of K by the Director is subject to redetermination by the Competition Commission (CC) if the company does not accept the Director's determination. In November 1999 the Director determined K for MKW for the five years beginning 1 April 2000. MKW disputed the Director's determination and required the Director to make a reference to the CC and he duly did so.

1.6. Table 1.1 compares the K profile we have determined with that made by the Director. We have taken the Director's K for the charging year 2000/01 as our starting point as in practice bills have already been issued and we do not think it would be practicable to attempt to adjust them at this stage. As a consequence, we have adjusted K for the two subsequent years in order to achieve the necessary profile for the five years beginning 1 April 2000. The notional

P0 assumes that all the price reductions occur in the first year of the quinquennium. It is calculated to enable a direct comparison to be made between our determination and that of the Director.

TABLE 1.1 **Comparison of K determinations**

*per cent relative to the RPI*

	2000/01	2001/02	2002/03	2003/04	2004/05	Notional P <sub>0</sub>
CC	-19.7	+4.5	+3.2	0	0	-15.3
The Director	-19.7	0	0	0	+1.6	-19.5

Source: CC.

1.7. In determining K we have formed a different view from both the Director and MKW on a number of issues, including the company's ability to achieve efficiency improvements in its operating expenditure and capital expenditure programmes, the likely number of customers who will take up the option of a water meter introduced by the Water Industry Act 1999, the location of such meters, and increases in levels of bad debt. We have taken a different view on the company's pension contributions, the service performance adjustment, and recovery of costs from developers. We have also assumed a different cost of capital, we have calculated depreciation charges on non-infrastructure assets using current cost depreciation rather than the broad equivalence approach used by the Director, and we have allowed for all the costs of the inquiry for which the company is liable. We were advised that we are by law required to do this. The cumulative impact of these and other differences explains why our determination of K differs from that of the Director.

1.8. MKW told us that the Director, in determining K, had disregarded the special factors which the company had to manage. It also criticized the Director's modelling of efficiency. We have had regard both to the company's circumstances and to its performance compared with other companies in the water industry. We regard the use of comparative data as a legitimate tool in the Director's Periodic Review process and it forms an integral part of our determination of K. We consider that we must give due weight to evidence on comparative efficiency and performance, which can be assessed through statistical evidence as well as other approaches.

### ***Determination of the water infrastructure charge***

1.9. The water infrastructure charge is levied by a water company to recover the costs of providing a connection to a water supply of premises which have never been connected to a supply provided for domestic purposes. The Director determined that the standard amount for the water infrastructure charge for the year commencing 1 April 2000 should be £229.23 per property; for subsequent years that amount would be adjusted by the RPI.

1.10. We think it reasonable that the current infrastructure charge should be inflated by the RPI and that the limit in subsequent years should be inflated in the same manner. We have, accordingly, determined that the standard amount in relation to infrastructure charges for the charging year commencing 1 April 2000 shall be £229.23; for subsequent years that amount is to be adjusted by the RPI.

### ***The licence modification reference***

1.11. Provision is made in the company's licence for K to be adjusted between Periodic Reviews to take account of a change in costs associated with a Notified Item or with a Relevant

Change of Circumstance, terms which are defined in the Glossary. This procedure, which is called an interim determination, cannot take place unless the net present value of the resulting gain or loss to the company exceeds a materiality threshold of 10 per cent of the company's turnover.

1.12. The Director proposed a modification to the company's licence which would alter the calculation of the materiality threshold, thereby enabling the company to request an interim determination if changes to its operating expenditure or loss of revenue were to exceed approximately 1 per cent of its total revenue or would have an equivalent weighting when taken with changes in capital costs.

1.13. We have found that the continuation of the company's licence without modification may be expected to operate against the public interest on the grounds that the existing materiality threshold is too high. The adverse effects that may be expected are that the company would have to conduct its affairs against the risk of incurring substantial loss in relation to a Notified Item, or customers would pay excess charges as a consequence of the company not suffering any loss in relation to a Notified Item, or both. We consider the modifications proposed by the Director, with certain variations that we have proposed, would remedy or prevent the adverse effects we have identified.