

# **Sutton and East Surrey Water – 2008 Substantial effect application**

## **Introduction to reference to the Competition Commission**

Dated: 5 March 2008



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## Summary

1. The Water Services Regulation Authority (Ofwat) is the economic regulator of the water and sewerage sectors in England and Wales. Its main duties are laid down in section 2 of the Water Industry Act 1991 as amended (WIA91)<sup>1</sup>. In fulfilling our duties Ofwat's strategic aim is to protect consumers, promote value and safeguard the future.
2. Sutton and East Surrey Water Plc (SES) holds an appointment as a water undertaker for the purposes of Part II of the WIA91. The appointment (commonly known as a licence) is subject to conditions that provide for the reference to, and determination by, Ofwat of certain questions. Some such determinations by Ofwat may be referred to the Competition Commission.
3. SES has asked us to refer to the Competition Commission our decision in respect of its "substantial effect" application to increase price limits for 2009-10 from RPI -1.1% to RPI +10.2%. The circumstances on which SES's application was based were unexpected shortfalls in revenue received and the increase in energy charges it experienced.
4. Our decision was that SES's price limit for 2009-10 did not need to change. After considering what costs or, where appropriate, reductions in revenue SES could have avoided by prudent management action, based on the outcome of our modelling we concluded that SES's revenues, profits and cash flows were sufficient to allow it to finance the proper carrying out of its functions until at least the start of the next five year period on 1 April 2010 when the new price limits come into effect.
5. Our decision was also based on the wider evidence available to us on the company's financial and spending requirements. If necessary, SES could raise on reasonable terms in the capital markets sufficient funds to meet any extra requirements, at least for the very short period up to the expiry of the current set of price limits ending 31 March 2010 (i.e. now only 12 months away). But, in any case, it is understood that SES will not need to raise any additional capital over this period or curtail any planned expenditure. Therefore, in practice, SES will not need increased price limits in order to finance the proper carrying out of its functions as it has either adequate resources already to do so or can raise resources. Nor, as the correspondence makes clear, did it argue to the contrary.
6. The matter in contention between Ofwat and SES lay in the approach that Ofwat should adopt when considering SES' application for an increase in price limits. In its letter dated 3 September 2008<sup>2</sup> SES argued that Ofwat should allow companies to recover an amount equivalent to the difference between the costs and income forecasts on which the price limits for 2005-10 were set and the actual outturn to date. Furthermore, SES has

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<sup>1</sup> Section 2 of the WIA91 is set out in full in Annex 1 to this document.

<sup>2</sup> A copy of this letter is included in the supporting information.

argued that this should be applied to each of the five relevant years from the beginning of the periodic review period (1 April 2005) to the end (31 March 2010). In our submissions we will refer to this as a request to "make them whole." This is clear from the second paragraph of page 3 of its letter of 3 September 2008 in which it states that if the company "*has not received the annual returns on its capital established by OFWAT at the last periodic price review due to [substantial adverse effect] circumstances which have satisfied the 20% of turnover and prudent management action requirements, then OFWAT is **obliged** [emphasis added] under its section 2/WIA'91 duty, to restore those returns for each of the years concerned and for OFWAT not to do so for any of such years would amount to a breach of that duty for such years*". In arguing this, SES has mistakenly confused the issue of its ability to finance the proper carrying out of its functions with a guarantee of its profitability.

7. Our duties under section 2 WIA91 are to carry out our determination in the manner which we consider is best calculated to "further the consumer objective" (as defined in section 2(2B) WIA91) and to secure that companies "are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of [their] functions". In particular the latter means satisfying ourselves that the company has sufficient resources until the relevant price limits are next set, even though in this case this may result in a rate of return on capital lower than that originally provided for in the 2004 final determination. In addition, allowing SES greater resources than those which are needed in order to finance the proper carrying out of its functions would not be consistent with our duty to further the consumer objective.
8. The regulatory framework is based on medium term incentive based regulation: it incentivises companies to outperform regulatory forecasts but leaves the risk of underperformance largely with companies' shareholders. There are mechanisms in the regime to deal with uncertainty between reviews of price limits. Central to the regime therefore is the allocation of risk between consumers and shareholders. Aspects of SES's application would, if accepted, significantly distort the allocation of risk and would disadvantage consumers.

## **Part 1: Introduction**

### **The regulatory framework and risk**

9. Ofwat's main duties are laid down in section 2 of WIA91. Condition B of SES's licence contains the clauses relating to the five-yearly periodic reviews of price limits (price limits are referred to as the Adjustment Factor in the licence and are also known as K factors). The last periodic review took place in 2004 (PR04), and set price limits for the period from 1 April 2005 to 31 March 2010. The next periodic review is taking place in 2009 (PR09) and will cover price limits for 1 April 2010 to 31 March 2015. We will publish our draft determination of these price limits on 23 July 2009 and our final determination on 26 November 2009.

10. At each periodic review we determine K factors for each year of the five year period. K factors are different for different water companies and represent the amount by which a company is allowed to increase customers' bills in real terms. The (retail) price limits we set for companies are accompanied by a set of outputs that we expect the company to deliver within those price limits.
11. When we undertake a periodic review of price limits we make an assessment of what companies need to spend to meet their capital expenditure programmes and to finance their operations. We also make an assessment on future operating and capital efficiency savings.
12. Between the periodic reviews, in practice each company's actual performance will inevitably differ at least to some extent from that assumed when we had set price limits. The acceptance of this divergence by both us (on behalf of consumers) and the companies is a key component of price reviews and of our incentive based regulatory regime. Where a company benefits because its actual costs turn out to be lower than our assessment it can keep the savings for five years, at which point they are passed onto its consumers. And where actual costs turn out to be higher than our assessment, the company bears those costs until we next set price limits.
13. The cost of capital we set at a review reflects this balance of risk. It contains scope for companies to absorb some unanticipated downside risks to ensure that they can still finance the proper carrying out of their functions if costs are higher than our assessment at the last periodic review. Companies accept the inherent balance of risk in our determinations when they accept their price limits for the five year period.
14. However, there are two mechanisms for interim adjustments to price limits between periodic reviews to account for certain divergences between forecasts at a periodic review and actual events. Each mechanism deals with different situations. The presence of these mechanisms (which help mitigate risk) is also reflected in the cost of capital for a periodic review.
15. First, as described in more detail in paragraphs 16 to 19 below, costs and revenues associated with specific items can, if they are large enough individually or together, entitle either us (on behalf of consumers) or the company to ask for an interim adjustment to price limits. We are then required to calculate the appropriate change to price limits in the precise manner set down in companies' licences. Such Interim Determinations of K (IDoKs) are referred to as "standard IDoKs" in this document. Standard IDoKs can deal with forecasts or inputs which are so uncertain at the time of a periodic review as to make it impossible to take them into account with sufficient confidence at the time of the periodic review determination itself and new legal obligations specific to water companies.

16. Second, as described in more detail in paragraphs 20 to 27 below, where any circumstance has, or will have, a substantial adverse or favourable effect (as defined in Condition B), there can be a substantial effect IDoK. The costs and revenues need to be at least twice as large as a standard IDoK. This is a special and exceptional procedure and there is no set calculation methodology for adjusting price limits as there is for standard IDoKs. In such circumstances, we have discretion, subject to our relevant duties including those in section 2 WIA91, when deciding what, if any, changes to price limits should be made. The key purpose of the substantial effect clause is to constitute the ultimate reassurance to the company, its shareholders and hence the capital markets, that in the extreme situation of a prudently managed company having insufficient resources properly to carry out its functions, an appropriate adjustment can be applied.
17. In this document we refer, for ease of reference, to the substantial effect clause or substantial effect applications (rather than a substantial effect IDoK) to avoid confusion with a standard IDoK. As this reference to the Competition Commission does not directly relate to a substantial favourable effect, unless otherwise stated all references to the substantial effect applications relate to substantial adverse effect clauses/applications.

### **The standard IDoK mechanism**

18. Looking at the mechanisms in more detail each company's licence allows it to require Ofwat to determine whether price limits need to change if specific changes or circumstances (known as Relevant Items) occur between periodic reviews<sup>3</sup>. Relevant Items are defined as either Notified Items (items which are notified to a company as not allowed for, in full or at all, in price limits) or Relevant Changes of Circumstance (defined in the licence and including changes to legal obligations placed on the company as an undertaker and the failure by a company to deliver an output included in price limits).
19. The company can ask Ofwat to determine new K factors for the rest of the five year period if the net present value (NPV) of the total impact on a company's base cash flows, of costs and savings reasonably attributable to the Relevant Items, is at least 10% of the turnover of the regulated or "Appointed" business (the materiality threshold). In assessing the materiality of an application in accordance with the requirements of Condition B we:
- calculate the NPV of Relevant Items (across the five year period for capital costs and a fifteen year period for operating costs or revenue losses);

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<sup>3</sup> Sub-Paragraphs 13.1 and 13.2 of Condition B of SES's licence set out the mechanism by which the company can ask Ofwat for a standard IDoK, and sets out in detail how we should assess any application.

- disregard costs or savings which are trivial (we consider that they will be trivial if they have a NPV of less than 1% of service turnover); and
  - aggregate the value of each Relevant Item.
20. If the materiality threshold is met or exceeded, Ofwat must calculate the appropriate change to a company's price limits following the precise calculation methodology set down in the licence<sup>4</sup>.
21. The standard IDoK mechanism can also be initiated by Ofwat in certain circumstances if a company incurs materially lower costs for Relevant Items than those assumed at a periodic review.

### **The substantial effect clause mechanism**

22. The substantial effect clause (set out in Annex 2) is the relevant clause for the purposes of this reference. It has been colloquially referred to as the 'shipwreck' clause. It is a mechanism that allows a company to apply to Ofwat for an interim adjustment to its price limits if a circumstance has occurred which has, or will have, a substantial adverse effect on the company or on its assets, liabilities, financial position, or profits or losses, not being one which would have been avoided by prudent management action<sup>5</sup>. What constitutes "prudent management action" must be assessed by reference to the circumstances which were known or which ought reasonably to have been known to the company at the relevant time. (There is also a similar mechanism which can also be used by Ofwat if a company has benefited from a substantial favourable effect).
23. In determining whether the materiality threshold has been reached, we must calculate the NPV of the net extra costs or revenue losses in the same precise way as for the standard IDoK process (see paragraph 17). The only difference is that for the substantial effect clause the materiality threshold is set at 20% rather than the 10% for a standard IDoK. As with the standard IDoK mechanism the NPV of capital costs are calculated across the five year period and operating costs or revenue losses across a fifteen year period.
24. If the materiality threshold has been reached, Ofwat has to consider what change should be made to the price limits. There is no set calculation methodology for adjusting price limits as there is for standard IDoKs. Exceeding the materiality threshold merely gives us jurisdiction to investigate whether any change would be appropriate in the light of the terms of Condition B and our key duties under section 2 WIA91 and, if so, the amount of any change. At privatisation, the position was summarised by the Department of the Environment:

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<sup>4</sup> Sub-paragraph 13.2 of Condition B of SES's licence sets out how we should calculate the appropriate change to a company's price limits.

<sup>5</sup> Sub-paragraphs 13.1 and 13.3 of Condition B of SES's licence sets out the provisions of the substantial effect clause (see Annex 2).

*"17. In this case the basis of the adjustment is at the discretion of [Ofwat]. The Appointee can apply at any time, and there is no bar on changes to K in 1990-91, but it is entirely for [Ofwat] to, decide what if any K adjustment should be made."*<sup>6</sup>.

25. We outlined, in general terms, that we would consider each substantial effect application on its own merits when we made our first substantial effect determinations in 2003-04<sup>7</sup>. We also explained that even if a company's substantial effect application exceeded the materiality threshold we might not increase price limits if we were satisfied that the company could still finance the proper carrying out of its functions until the next periodic review.

26. There is no deadline during a year by which a company must submit any substantial effect application. When a company applies, we have three months in which to make a determination. We follow the same consultation process as we do with standard IDoKs, publishing a draft determination for stakeholders to comment on, notwithstanding that this is not a formal requirement.

27. In considering what, if any, change should be made to the price limits, our duty is to consider whether an adjustment to price limits is needed pursuant to our duties under section 2(2A) WIA91. Under these duties Ofwat must exercise and perform its relevant powers and duties in the *"manner which [...] it considers is best calculated-*

*(a) to further the consumer objective;*

*(b) to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out as respects every area of England and Wales;*

*(c) to secure that companies holding appointments under Chapter 1 of Part 2 of this Act as relevant undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and*

*(d) [...]"*

In practice, in this case our section 2(2A)(c) duty meant no more than assessing the situation at the time of the substantial effect application and assessing whether there were sufficient resources available to the company to finance the proper carrying out of its functions. In addition allowing SES greater resources than those which were needed in order to

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<sup>6</sup> See paragraphs 16 and 17 of the confidential explanatory notes the Department of the Environment attached to its letter dated 25 October 1989 (a copy is provided in the supporting documentation).

<sup>7</sup> Prior to SES's application, only Northumbrian Water Ltd and Bournemouth and West Hampshire Water Plc had applied for a substantial effect determination in the 20 years since privatisation. Both companies applied in 2003.

finance the proper carrying out of its functions was not consistent with our duty to further the consumer objective.

28. In making this assessment, following SES's application, Ofwat submitted that it must have regard to the situation facing SES at the time of the application. Ofwat must undertake a forward-looking enquiry as to the ability of SES to finance the proper carrying out of its functions, not a retrospective inquiry to make SES "*whole*". What is a "*reasonable*" return will depend upon all the circumstances of the case and must include the resources available to SES, its financial standing, its capital expenditure commitments, likely operating costs and other factors. Ofwat also submits that the imminence of the next periodic review (PR09) is a relevant factor.
29. Section 2(2A)(a) WIA91 requires us to further the "*consumer objective*." In its assessment, Ofwat also notes that the clear consumer detriment of a materially higher, and possibly temporary, upward spike in retail prices, against the background of no evidence of SES being unable properly to discharge its functions. Indeed, SES did not argue that it was unable to discharge its functions – rather its case was essentially simply that its profitability would fall and shareholders would suffer.

## **Part 2: Analysis of Sutton and East Surrey Water's substantial effect application**

### **Process**

30. On 17 September 2008 SES submitted an application to Ofwat under the substantial effect clause<sup>8</sup>. In its application the company stated that two circumstances were having a substantial adverse effect on it:
- increases in power costs, in particular electricity costs; and
  - the loss of revenue caused by customers using less water than assumed when we last set price limits.
31. The company calculated that the NPV of the impact of increases in power costs and revenue loss, over a 15 year period, was equal to 65% and 41% of annual Appointed Business turnover in 2007-08 respectively. It considered that, as a result, its price limit for 2009-10 should be increased (in real terms) from -1.1% to +10.2%.
32. In assessing the company's application, we considered the supporting information it provided and made use of sector wide performance data we collect to monitor company performance. We sought to clarify areas of uncertainty within SES's application.

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<sup>8</sup> Copies of SES's application and representation and of our draft and final determinations are provided in the supporting documentation.

33. We published a draft determination for consultation on 5 November 2008. Our draft conclusion was that SES's price limit for 2009-10 did not need to change. After considering what costs or, where appropriate, reductions in revenue SES could have avoided by prudent management action, we decided that it could finance the proper carrying out of its functions until the start of the next five year period on 1 April 2010. In order to seek stakeholder views on our draft determination we issued a press notice, informed local MPs in writing of our draft determination and published it on our website.
34. In response, SES provided written representations on 26 November 2008 and made oral representations on 2 December 2008. The written representations included further information to support its original application. We received representations from the Consumer Council for Water and from local MPs that were supportive of the draft determination. Having considered all stakeholders' representations we published our final determination on 17 December 2008. This confirmed that our position remained that, while the relevant materiality threshold was exceeded and hence we did need to consider the application, SES's price limits for 2009-10 did not need to change because SES could finance the proper carrying out of its functions until the start of the next 5 year period on 1 April 2010 (only roughly 12 months away now).
35. On 9 February 2009 SES wrote to ask us to refer our determination to the Competition Commission for determination by it under section 12 WIA91.

### **Summary of Ofwat's approach**

36. Our general approach to substantial effect applications is set out in paragraphs 22 to 29. Our specific approach to SES's application was to:
- adjust data in SES's application to ensure that any net additional costs and revenue shortfall were calculated against the correct 2004 final determination forecasts;
  - determine whether there were any offsetting savings associated with the circumstances and whether the revenue loss or power costs incurred by the company could have been avoided;
  - calculate whether the circumstances outlined in the company's application had an adverse effect that was, in NPV terms, at least equal to the materiality threshold;
  - determine SES's financial position for the period until the next set of price limits (1 April 2010 onwards); and
  - assess the company's ability to finance the proper carrying out of its functions until the start of the next five year period (1 April 2010).

### **Identifying costs that could have been avoided**

37. In accordance with the substantial effect clause we considered whether any of the costs or losses relating to the circumstances specified by SES

could have been avoided by prudent management action given the circumstances which were known or ought reasonably to have been known to the company at the relevant time.

### Power

38. We used a number of approaches to assess the company's increase in power costs.

- We commissioned an independent assessment of SES's approach to energy management and procurement (based on the evidence SES provided in its application). In its response to our draft determination SES commissioned additional work to support its application<sup>9</sup>. We took this work into account in making our final determination.
- We considered what alternative procurement strategies could have been adopted by the company (for example, the implications of opting for a 24 month energy contract for 2008-10 instead of two one year contracts).
- We used our econometric power model (which we use as part of our suite of models to determine company efficiency) to compare SES's power costs against those of the benchmark company in each year of the current period (2005-10).
- We compared SES's power costs against a specific company within the industry whom we identified as having broadly similar operational characteristics to SES.

39. We considered that the risks associated with SES's procurement strategy (opting for two one year contracts rather than a 24 month contract) were business risks for it and its shareholders to bear. Had we accepted the company's claim in full, it would have borne none of the risk of its decision.

40. We concluded that, collectively, our analysis showed that SES could have avoided some of the power costs it included in its application by prudent management action. We therefore reduced the costs in its claim.

### Revenue

41. For revenue we considered what had driven the variance from the forecasts that our final determination at PR04 were based upon, whether management actions might have contributed to the shortfall identified by the company and the appropriateness of the company's forecasts.

- [§].
- We used revenue forecasts based on the company's draft business plan data, not the data the company specifically provided as part of its application because the company had provided little information to support how it had calculated the new forecasts. The company's draft business plan data was provided to us on 11 August 2008 as part of our

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<sup>9</sup> The report we commissioned from Atkins and SES's report by Black & Veatch are provided in the supporting documentation.

process for setting price limits for 2010-15 and was derived from SES's statutory 25 year water resource plan.

- We adjusted SES's forecast of the number of customers who would move to a measured (metered) supply from an unmeasured (unmetered) supply in the remainder of the five year period because we had identified that the rates included in the application were likely to overstate the revenue shortfall.

For the reasons set out above, we concluded that the revenue shortfall would be less than in SES's application.

### Offsetting savings

42. We judged that the complex interaction between power costs and revenue meant that we could not calculate the extent of offsetting savings for the two circumstances with a great degree of certainty. However, our view was that, on balance, any savings were unlikely to be material.

### **Materiality calculation**

43. Once we had made these adjustments, set out in more detail in our determination and the supporting information we provided to SES (and also enclosed with this submission), we used the relevant methodology to calculate the NPV of the two circumstances. We found that the NPV of the additional power costs the company faced was equal to 20% of the Appointed Business turnover. The NPV of the revenue shortfall the company faced was equal to 24% of the Appointed Business turnover. Both of the circumstances in SES's application met or exceeded the materiality threshold and, as a result, we proceeded to consider whether we needed to change SES's price limit for 2009-10.

### **Determination of any change in price limits**

44. In summary, our approach, set out in more detail in our determination and the supporting information we provided to SES (enclosed in the supporting documentation), was to:

- model the cost changes (after excluding avoidable costs) arising from the circumstances in 2008-09 and 2009-10 using our financial model;
- model SES's financial position against a financial structure that was broadly representative of the industry (rather than the company's actual position) – which is consistent with our general approach to price setting;
- review the resulting financial indicators and financial position; and
- decide if a change to SES's price limits was necessary for 2009-10 to ensure it could finance the proper carrying out of its functions until the start of the next review period (i.e. 1 April 2010).

45. Our approach is forward looking because the substantial effect clause is designed to ensure a company can continue to finance the proper carrying

out of its functions until the next periodic review. It is not designed to restore or guarantee a specific return on capital.

46. Having reviewed the outcome of our financial modelling (discussed below), and considered the wider context within which SES was operating, we concluded that the company would be able to finance the proper carrying out of its functions until 1 April 2010.
47. Consequently we determined that the 2009-10 price limit did not need to change and should remain at RPI -1.1%.

### **Part 3: Previous areas of disagreement**

48. While we do not know the arguments SES will put before the Competition Commission, by way of background our final determination letter to SES summarised the main issues the company had raised in its representations and explained how we had taken its arguments into account. SES's written representations dated 26 November 2008 and a copy of the slides SES used for the oral hearing on 2 December 2008 are enclosed.

#### **Interpretation of the substantial effect clause**

49. SES's representation argued that:

- we did not consider the cost of capital in determining its financial position and we were therefore breaching our duty to exercise our functions in the manner we considered was best calculated to, among other things, secure that companies holding appointments as undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of their functions<sup>10</sup>; and
- we did not have wide discretion and that under the substantial effect clause we should restore its return equal to the cost of capital set in 2004 for the entire period 2005-10.

50. However, our final determination explained that we were not disregarding the cost of capital when we assessed SES's ability to finance the proper carrying out of its functions and so we did not consider that our approach was inconsistent with our duties. We explained to SES that, in reaching our decision that it would be able to raise additional funding if required, we had considered the company's return and financial indicators as an overall package (see paragraphs 54 to 60), even though it had informed us that it did not need to raise further finance, or refinance any debt, in 2009-10.

51. We explained that we did not accept SES's arguments on our discretion, and did not accept that we should restore SES's cost of capital to our PR04 assumptions for each year of the five year period from 2005. This

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<sup>10</sup> See section 2(2A)(c) of the WIA91.

would amount to using the special and exceptional procedure in the substantial effect clause to restore SES to the position in which it would have been in *not* if the substantial adverse effect had *not* occurred but to the position it *would have been in* if all the assumptions made at the time of the PR04 determination of price limits had been realised. This is clear from the second paragraph of page 3 of its letter of 3 September 2008 in which it stated that if the company "*has not received the annual returns on its capital established by OFWAT at the last periodic price review due to [substantial adverse effect] circumstances which have satisfied the 20% of turnover and prudent management action requirements, then OFWAT is **obliged** [emphasis added] under its section 2/WIA'91 duty, to restore those returns for each of the years concerned and for OFWAT not to do so for any of such years would amount to a breach of that duty for such years*".<sup>11</sup> Apart from the purely theoretical scenario where the initial determination would be precisely matched by the outturn save only for the effects of the substantial adverse effect, this is not correct.

52. We consider that the substantial effect clause is an exceptional jurisdiction and that if it is invoked, it is invoked on the basis of a defined substantial effect in relation to turnover. There is nothing in the regulatory regime that sustains SES's argument that the assumptions and cost of capital underpinning the determination of price limits at the beginning of each five year period are underwritten for the duration of the period provided that the 20% materiality threshold is met.

53. Such an obligation would significantly alter the balance of risk we assume at a price review towards consumers and away from companies and effectively represent a shift to a rate of return regulation. A move in this direction would weaken the principles of incentive based, medium term regulation and necessitate a re-evaluation of companies' required cost of capital.

### **Assessment of Sutton and East Surrey Water's financial position**

54. SES's representations stated that it believed that we had ignored the cost of capital and relied solely on financial indicators in assessing its position. SES argued that this meant our assessment was inconsistent with our approach at a price review and with our approach to previous substantial effect determinations. It also argued that our modelled financial indicators failed to meet our own preferred levels of cover for key financial indicators, as set out for PR04.

55. In the final determination we explained that while we had given less weight to the return on capital in assessing SES's financial position than we might at a price review, this did not equate to ignoring the return on capital. It

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<sup>11</sup> In its subsequent submission to Ofwat dated 26 November 2008 (a copy of which is provided in the supporting information) SES conceded in paragraph 1.2 of its annex that "*It is accepted that the clause confers a discretion on Ofwat in relation to what adjustment should be made, but we believe that it does not amount to the level of discretion you claim, for the following reasons [ ]*".

merely reflected the exceptional nature of the substantial effect provision and the short time period to the next price review. We consider that investors do not take a short term view, and are not influenced by changes in the return in individual years, particularly when a company's financial profile is adequate. Our methodology papers for both the 2004 and 2009 price reviews clearly set out that we judge a company's ability to finance the proper carrying out of its functions on both its ability to earn the cost of capital and to access financial markets.

56. Companies need to raise finance in the capital markets to undertake their investment programmes. At price reviews we set out a package of financial indicators against which we assess financial projections. We do not focus on the level of any particular indicator in any particular year. We focus on cash flow indicators both short run and long run (such as cash interest cover ratios, adjusted cash interest covers post maintenance costs, the ratio of debt to the Regulatory Capital Value (gearing) and retained cash flow to debt<sup>12</sup>). These have an important role in helping us to assess whether companies will be able to raise capital. We also look at dividend cover as an indicator relevant to equity investors but this indicator is less relevant in this case because of the very short period under scrutiny.

57. As set out in paragraph 56, we assess financial indicators as a package and do not focus on a specific indicator. While our modelling suggested that some of the modelled indicators might be lower, or not match, the financial indicator forecast for SES at PR04 they remain within a range that would allow the company to access the capital markets. Moreover:

- Our PR04 ratios did not represent a floor below which we considered companies as unfinanceable; we accepted that returns and indicators would vary over the period (as part of the balance of risk inherent in our PR04 final determination, which was also effectively accepted by SES when it accepted that determination).
- Our policy position over a number of price reviews has been to consider the overall package of indicators rather than target a specific indicator.
- We did not underwrite the indicators over the period.

58. Our assessment of the ratios SES needed to maintain to finance the proper carrying out of its functions for the one year until we next set prices was naturally different to those we consider necessary to cope with the ups and downs of a full five year period.

59. SES also considered that our assessment of its financial position was flawed because it was based on a notional financial structure (namely a reasonable assumption of the debt to equity ratio). Modelling on the basis of a notional financial structure was entirely consistent with our approach

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<sup>12</sup> Details on the levels of indicators are set out in our final determination letter, provided in the supporting information.

to previous substantial effect applications and our approach at both PR04 and previous price reviews. We adopted this approach because we believe the choice of capital structure and corresponding risk sits with companies.

60. In any case, if we had modelled SES's financial position on the basis of its actual structure it would have been in a **stronger** position than under our notional assessment (the rating agencies, who assess companies against their actual structures, believed SES's financial position to be consistent with comfortable investment grade status).

### **Identifying costs that could have been avoided – power**

61. SES disagreed with our assessment of its power costs and believed we should have included the full costs as set out in its application when considering whether to change its price limit.
62. It particularly disagreed with our consideration of what alternative procurement strategies were open to it. It believed that it acted prudently in following its consultant's advice and procuring one year contracts in 2008-09 and 2009-10 rather than a 24 month contract for 2008-10.
63. We explained that we did not accept SES's argument on its procurement strategy. We consider that, while consultants may have an important role in energy procurement, companies must make their own decisions after considering the wider context in which they operate. SES had the opportunity to fix its costs and eliminate its exposure to further price increases until the next review. It chose not to do so. Instead, the company followed its consultant's advice and chose a less cautious approach, opting for a one-year deal instead of a two-year deal – believing there was a greater chance of securing cheaper rates than those tendered in 2009-10. As a result, SES's power costs in 2009-10 are now likely to be around [x] higher than they would have been had it opted for a 24 month contract.
64. We explained that SES took a management decision to opt for a one year contract and it is a business risk that the outturn costs of its procurement strategy for 2008-10 will not be as forecast. The company should not be able to pass all of the risk onto its customers, which is what its application seeks to achieve. A company in a competitive market making a similar decision would have still faced risks (through the threat of reduced market share) if it chose to pass all its extra costs to customers through higher prices. We consider that a company concerned that further rises in power prices might place it under unacceptable financial pressure would have taken a prudent approach and reduced the risk to the business and its customers.
65. We therefore consider that it was appropriate to consider the impact an alternate procurement strategy would have had on SES's costs as one aspect of our challenge to its power cost circumstance.

66. In addition, we explained that the volatility of energy prices is an issue that all companies have had to face in this review period. This has not prevented other companies managing their procurement contracts in such a way as to avoid similar overall power cost increases over the period.

67. The other aspects of our challenge to SES's power costs circumstance are summarised in paragraphs 38 to 40 above and are set out in more detail in section 1.1 of the confidential annex to our determination letter.

### **Identifying costs that could have been avoided – revenue**

68. SES rejected our assessment of its revenue loss and believed we should have used the losses it submitted in its application in full when considering whether to adjust its price limit.

69. In particular though, SES considered our assumption that it should have recovered revenue in line with PR04 expectations is unreasonable as it does not reflect the company's actual position and the decisions it has had to take to retain the large customer in question.

70. We explained that the assumptions we made when we set price limits for 2005-10 formed part of the package that SES chose to accept at that time. The substantial effect claim on revenue related to the shortfall against those assumptions. Where the company has chosen to deviate from these assumptions we consider it is appropriate to continue to measure the revenue recovered against the assumptions accepted as part of the price limit determination.

## **Part 4: Final remarks**

71. This document is intended as an introduction to the reference and the significant issues. It is not intended to be exhaustive, but rather to provide the panel and staff with an early overview of the broad issues which are likely to be in contention. Additional documentation is also provided alongside this document. We will of course be happy to provide any further information that you require, particularly in relation to the application of the financial model used in the determination.
72. In paragraph 9 we explained that we will publish our draft determination for price limits for 1 April 2010 to 31 March 2015 on 23 July 2009. Consequently, that process and this reference may well overlap in time, though it is hoped that the Competition Commission will reach its conclusions as early as possible.

## Annex 1 Ofwat duties

Ofwat's general duties are set out in Part I of WIA91. In particular, section 2 of the WIA91, as amended by section 39 of the Water Act 2003, provides that:

### "2 General duties with respect to water industry

(1) This section shall have effect for imposing duties on the Secretary of State and on [the Authority] as to when and how they should exercise and perform the following powers and duties, that is to say--

- (a) in the case of the Secretary of State, the powers and duties conferred or imposed on him by virtue of the provisions of this Act relating to the regulation of relevant undertakers [and of licensed water suppliers]; and
- (b) in the case of [the Authority], the powers and duties conferred or imposed on [it] by virtue of any of those provisions, by the provisions relating to the financial conditions of requisitions or by the provisions relating to the movement of certain pipes.

[(2A) The Secretary of State or, as the case may be, the Authority shall exercise and perform the powers and duties mentioned in subsection (1) above in the manner which he or it considers is best calculated--

- (a) to further the consumer objective;
- (b) to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out as respects every area of England and Wales;
- (c) to secure that companies holding appointments under Chapter 1 of Part 2 of this Act as relevant undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and
- (d) to secure that the activities authorised by the licence of a licensed water supplier and any statutory functions imposed on it in consequence of the licence are properly carried out.

(2B) The consumer objective mentioned in subsection (2A)(a) above is to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services.

(2C) For the purposes of subsection (2A)(a) above the Secretary of State or, as the case may be, the Authority shall have regard to the interests of--

- (a) individuals who are disabled or chronically sick;
- (b) individuals of pensionable age;
- (c) individuals with low incomes;

- (d) individuals residing in rural areas; and
- (e) customers, of companies holding an appointment under Chapter 1 of Part 2 of this Act, whose premises are not eligible to be supplied by a licensed water supplier,

but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.

(2D) For the purposes of subsection (2C) above, premises are not eligible to be supplied by a licensed water supplier if--

- (a) they are household premises (as defined in section 17C below); or
- (b) the total quantity of water estimated to be supplied to the premises annually for the purposes of subsection (2) of section 17D below is less than the quantity specified in that subsection.

(2E) The Secretary of State and the Authority may, in exercising any of the powers and performing any of the duties mentioned in subsection (1) above, have regard to--

- (a) any interests of consumers in relation to electricity conveyed by distribution systems (within the meaning of the Electricity Act 1989);
- (b) any interests of consumers in relation to gas conveyed through pipes (within the meaning of the Gas Act 1986);
- (c) any interests of consumers in relation to communications services and electronic communications apparatus (within the meaning of the Communications Act 2003),

which are affected by the exercise of that power or the performance of that duty.]

[(3) Subject to subsection (2A) above, the Secretary of State or, as the case may be, the Authority shall exercise and perform the powers and duties mentioned in subsection (1) above in the manner which he or it considers is best calculated--

- (a) to promote economy and efficiency on the part of companies holding an appointment under Chapter 1 of Part 2 of this Act in the carrying out of the functions of a relevant undertaker;
- (b) to secure that no undue preference is shown, and that there is no undue discrimination in the fixing by such companies of water and drainage charges;
- (c) to secure that consumers are protected as respects benefits that could be secured for them by the application in a particular manner of any of the proceeds of any disposal (whenever made) of any of such a company's protected land or of an interest or right in or over any of that land;
- (d) to ensure that consumers are also protected as respects any activities of such a company which are not attributable to the exercise of

functions of a relevant undertaker, or as respects any activities of any person appearing to the Secretary of State or (as the case may be) the Authority to be connected with the company, and in particular by ensuring--

- (i) that any transactions are carried out at arm's length;
- (ii) that the company, in relation to the exercise of its functions as a relevant undertaker, maintains and presents accounts in a suitable form and manner;
- (iii) that, if the person is a licensed water supplier, its licence does not authorise it to carry on any activities in the area of the company;

(e) to contribute to the achievement of sustainable development.

(4) In exercising any of the powers or performing any of the duties mentioned in subsection (1) above in accordance with the preceding provisions of this section, the Secretary of State and the Authority shall have regard to the principles of best regulatory practice (including the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed).]

(5) In this section the references to water and drainage charges are references to--

- (a) any charges in respect of any services provided in the course of the carrying out of the functions of a relevant undertaker; and
- (b) amounts of any other description which such an undertaker is authorised by or under any enactment to require any of its customers or potential customers to pay.

[(5A) In this section--

"consumers" includes both existing and future consumers; and

"the interests of consumers" means the interests of consumers in relation to--

- (a) the supply of water by means of a water undertaker's supply system to premises either by water undertakers or by licensed water suppliers acting in their capacity as such; and
- (b) the provision of sewerage services by sewerage undertakers.]

(6) For the purposes of this section--

[(a) subject to subsection (6A) below, the reference in subsection (1) above to the provisions of this Act relating to the regulation of relevant undertakers and of licensed water suppliers is a reference to the provisions contained in Part 2 of this Act (except section 27A, and Schedule 3A), or in any of sections 37A to 38, 39, 39B, 39C, 66B, 66D,

66F to 66H, 66K, 66L, 95, 96, 153, 181, 182, 192A, 192B, 195, 195A and 201 to 203 below;

(b) the reference in that subsection to the provisions relating to the financial conditions of requisitions is a reference to the provisions contained in sections 42, 43, 43A, 48, 51C, 99, 100 and 100A below; and]

(c) the reference in that subsection to the provisions relating to the movement of certain pipes is a reference to the provisions of section 185 below.

[(6A) [Subsections (2A) to (4) above and section 2A below] do not apply in relation to anything done by [the Authority] in the exercise of functions assigned to [it] by section 31(3) below ("Competition Act functions").

(6B) [The Authority] may nevertheless, when exercising any Competition Act function, have regard to any matter in respect of which a duty is imposed by any of [subsections (2A) to (4) above and section 2A below], if it is a matter to which [the Office of Fair Trading (in this Act referred to as "the OFT")] could have regard when exercising that function.]

[(7) The duties imposed by subsections (2A) to (4) above and section 2A below do not affect the obligation of the Authority or, as the case may be, the Secretary of State to perform or comply with any other duty or requirement (whether arising under this Act or another enactment, by virtue of any Community obligation or otherwise).]"

Under section 12(3)(b) of the WIA91, the Commission is also required to determine price limits "*in accordance with—*

(ii) *the principles which apply, virtue of Part I of this Act, in relation to determinations under this Chapter by [Ofwat]."*

## Annex 2 The substantial effect clause

Relevant extracts from paragraph 13 of SES's Condition B:

*"13.1 The Appointee may from time to time refer to [Ofwat] for determination by [it] (having considered the proposals of the Appointee) the questions set out in [...] sub-paragraph 13.3. Such reference shall be made by notice given to [Ofwat] [...].*

*[...]*

*13.3 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 (i) fortuitous and (ii) not attributable to prudent management action; and*

*(2) If so, what change should be made to the Adjustment Factor.*

*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 13.2 were to be asked in relation to the circumstance giving rise to it, the answer to that in 13.2(7) (taking the reference in it to ten per cent as a reference to twenty per cent) would be in the affirmative."*