

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

**Response to Sutton and East Surrey Water’s  
submission to the Competition Commission**

Dated: 9 April 2009



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## Overview and summary

1. Ofwat's main duties as the economic regulator of the water and sewerage sectors in England and Wales are laid down in section 2 of the Water Industry Act 1991, as amended (WIA). 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) has asked us to refer to the Competition Commission our decision of 16 December 2008 not to adjust its price limits from -1.1% to 10.2% in real terms following its substantial adverse effect claim in respect of changes to its power costs and water income.
3. Our decision was that SES's price limit for 2009-10 did not need to change. In reaching this decision we considered all the information we had relevant to the case. We followed a process that was consistent with SES's licence and our duties under WIA. Our approach is described in this and earlier documents<sup>1</sup>.
4. 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 (a risk compensated within the cost of equity in the allowed return on capital). There are mechanisms in the regime to mitigate risks that can arise between reviews of price limits, under certain specific circumstances.
5. SES's arguments in its submission to the Competition Commission on 23 March 2009 display a fundamental lack of understanding of the regulatory framework and its treatment of risk. Aspects of SES's application would, if accepted, significantly distort the allocation of risk and would disadvantage consumers. It seeks to materially increase its price limits to generate extra revenue which it does not need in practice.
6. SES's arguments and assertions are fundamentally flawed in a wide range of areas:
  - the nature of Ofwat's duties under section 2 WIA
  - the difference between and use of the standard interim determination mechanism and the substantial effect clause mechanism
  - the distinction between the two stages of the test set out in the substantial effect clause (the first being purely jurisdictional and the second being a test of what adjustment we should make to price limits)
  - our challenges in relation to prudent management action
  - the nature and allocation of economic risk

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<sup>1</sup>Sutton and East Surrey Water – 2008 Substantial effect application Introduction to reference to the Competition Commission (5 March 2009). Draft determination letter to SES 4 November 2008 (Ofwat ref: 04a) and Final determination letter 16 December 2008 (Ofwat ref:06a)

Each of these are summarised below and set out in greater detail in the remainder of this document.

7. SES's principal argument is that once the 20% threshold in the substantial effect clause is met, "the risk is no longer allocated to companies"<sup>2</sup>. It argues that once the threshold is passed, it should be given an interim adjustment to its prices to put it in the position as if the causes of these differences had not arisen. SES also asserts "Ofwat is obliged 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 its duty for such years"<sup>3</sup>. This is a request to "make them whole" and, in effect, rewrite history. This interpretation is not supported by the language of its licence or the WIA. What the language of the licence and the WIA mean is that once materiality is satisfied, we have discretion, in the light of the section 2 WIA duties, to consider what, if any, adjustment should be made to price limits. We need to satisfy ourselves that the company has sufficient resources to finance its functions until price limits are next formally reset, i.e. the forward looking period up until 1 April 2010. This we have done.
8. Such an approach is consistent with approaches taken within other regulated sectors. If as SES asserts, prices should be automatically adjusted once the threshold is satisfied, then it would wholly undermine medium term incentive regulation by transferring risk beyond a very limited amount (we estimate this to be around 2% of turnover in one year for an opex or revenue item) to consumers. This would protect equity shareholders in a way that is not consistent with the equity risk premium. It would almost eliminate equity risk.
9. SES asserts that we have ignored the effects of its substantive adverse effect in earlier years. This is not the case. The impact of prior year costs and revenues are reflected in the balance sheet of the company at any particular point in time. Consequently, the ability of a company to finance its functions for future periods would clearly be affected by changes in past costs and revenues and hence reflected in our assessment. In any event, if SES had had a substantial effect claim that had passed the jurisdictional threshold in a previous year, it could have made an application at that stage – there is no time limit on when a substantial effect application can be made.
10. In its submission SES asserts that standard interim determinations (standard IDoKs) and substantial effect claims differ only in terms of the materiality threshold (10% of relevant turnover for the former and 20% for the latter). This is a fundamental misunderstanding of the regulatory framework. Standard IDoKs allow companies (and to a lesser extent Ofwat) to seek revised price limits if specified changes occur in the period since price limits were last set. This implies that changes to cash flows are incremental and arise from only specific items. It is not a 'mini periodic review' of price limits to take account of changes in all costs and forecasts, only those related to the

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<sup>2</sup> Paragraph 68 of SES's submission to the Competition Commission

<sup>3</sup> SES letter to Ofwat on 030908 (Ofwat ref: 02e)

specified changes. For standard IDoKs there is a specific mechanism to adjust price limits for the specified changes set out in the licence that mimics the way prices are set at a periodic review in respect of these incremental cash flows. Standard IDoKs are not uncommon and are relatively mechanistic. If substantial effect claims were similar but simply operated at a higher threshold, then the mechanistic approach to adjusting price limits may also have been considered appropriate when the substantial effect clause was drafted. However, the licence does not do this and the clause does not operate in this fashion. If the materiality threshold is satisfied, the licence requires us simply to consider what change should be made to price limits in accordance with our duties. It is a special and exceptional procedure that does not specify a mechanism to determine any potential change in price limits.

11. It appears that SES wishes to conjoin these two types of regulatory mechanisms because the standard IDoK looks at incremental cash flows in specified items for the whole of the period. It wishes such an approach to be applied for substantial effect claims but has no legal basis to do so. SES also ignores other regulatory risk sharing mechanisms for dealing with in-period costs that do not follow such an approach. For example, the logging up and down mechanism Ofwat operates at periodic reviews takes account of changes in outputs but only allows the company to recover the financing costs from the start of the next set of price limits onwards<sup>4</sup>. It does not allow the companies to recover the financing costs (or related operating costs) incurred before that point.
12. SES also asserts that the substantial effect clause is completely symmetric. It is not. Ofwat can operate the clause where there has been a substantial favourable effect on the business. The substantial favourable effect must be fortuitous and not attributable to prudent management action. In practice we believe that it is more difficult for Ofwat to operate the clause for a number of reasons. For example, there is an asymmetry of information in favour of the company. Also, it would require Ofwat to demonstrate that a substantial favourable effect was not attributable to management action, when the achievement of more favourable financial outcomes is accepted as one of the central aims of management. There have been no substantial favourable effect claims initiated by Ofwat.
13. SES argues that Ofwat must somehow 'prove' that its conduct falls outside the range of prudent management action and that our judgement relies on the benefit of hindsight. We considered what options were open to SES at the time and in light of approaches taken by other water companies over the five years of price limits. It is common business practice that when faced with volatility in an item that is not a key trading factor in the business, management can remove this volatility ex ante by using hedging instruments. Energy costs would fall into this category. SES implies that any other

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<sup>4</sup> The logging up and down mechanism is explained in more detail in paragraph 31

company that did not follow precisely the actions that it took could be considered not to be prudent. There are examples in the water industry of companies that hedged their power costs for five years because they recognised that energy trading is not one of their functions. Other companies used two or three year hedges. Separately, and somewhat contradictorily, SES also states that it lobbied for power costs to be a Notified Item<sup>5</sup> (NI) at the periodic review in 2004 (PR04) because of the volatility of power costs. As this paragraph shows, other companies took action to eliminate this volatility but SES did not.

14. There are a number of ways we can deal with uncertainty between periodic reviews. For power costs we decided that a NI was not appropriate. Instead we allowed a 40% uplift to power costs for 2005-10 and accepted that any further risk was rightly borne by companies. The regulatory regime is not designed to eliminate all risk from businesses. In these circumstances incentive based regulation would cease to be operative.
15. SES also argues that an analysis of the duty to finance functions means that it must earn at least its cost of capital in every year. Section 2(2A)(c) WIA states that Ofwat must exercise and perform the powers and duties in the manner it considers best calculated to secure that companies such as SES “are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of [their] functions”. We do this in light of the particular circumstances of each decision which we make. SES incorrectly reads across our general approach (as set out in our methodology for setting price limits) for a five year future period to its substantial adverse effect claim. We have satisfied ourselves that SES can finance its functions for the period until price limits are reset from 1 April 2010. This is a period of one year rather than the five years covered by the price review. We considered that [X] and the related package of financial indicators were adequate for it to finance its functions.
16. SES rightly points out that our policy at price reviews is designed to allow companies to access capital markets in order to finance capital programmes. Our position was that, if necessary, SES could raise on reasonable terms in the capital markets sufficient funds to meet any extra requirements and that, in any case, SES did not need to raise any additional capital over this period or curtail any planned expenditure. We note that the credit rating agency Moody's Investors Service<sup>6</sup> does not consider that our final determination has impacted the credit quality of SES which remains at investment grade and hence its ability to access capital markets.

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<sup>5</sup> Notified Items are explained in more detail Annex 3

<sup>6</sup> See Moody's Investors Service Global Credit Research Credit Opinion March 2009 (Ofwat Ref: 14a)

## Introduction

17. This document provides further explanation of our determination of SES's substantial effect application in response to issues raised by SES in its submission to the Competition Commission of 23 March 2009, and where necessary corrects factual errors in SES's submission. It should be read together with previous documents, principally the draft and final determinations and our initial submission to the Competition Commission on 5 March 2009.

## Incentives and risk within the regulatory regime

18. Our approach to price setting has developed and evolved since privatisation and draws on our duties as set out in section 2 WIA. Neither the WIA nor companies' licences set out a detailed methodology for setting price limits at five yearly periodic reviews. Our approach is set out in advance of a periodic review<sup>7</sup> so that all stakeholders can gain a clear understanding of how we will set both price limits and outputs and how we intend to deal with variations in costs.
19. Central to this is the forward looking approach we take when we set price limits. When we set price limits we ensure that companies can recover the costs they are likely to incur in future years, but they cannot recover financing costs (and operating costs) incurred in the past. This provides incentives on companies to manage cost increases.
20. The price limits are assessed on the basis of a package of assumptions. When we set price limits each company is provided with a detailed breakdown of this package including the forecast costs, revenue, financial assumptions and outputs that underpin the price limits. This is set out in a company's supplementary report<sup>8</sup> which allows it to understand:
  - What its price limits will be;
  - What outputs it must deliver within those price limits;
  - When it can ask for the package to be changed; and
  - How outperformance and underperformance will be treated.

Once a company accepts price limits it is up to it to decide how to allocate resources to deliver these outputs.

21. Over successive periodic reviews Ofwat has refined its approach and introduced new mechanisms to strengthen the incentives on companies. Examples of this include:

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<sup>7</sup> For PR04 this was Setting water and sewerage price limits for 2005-10: Framework and approach (Ofwat ref: 07a)

<sup>8</sup> A copy of SES's supplementary report is enclosed with this submission (Ofwat ref: 19ba)

- Establishing a rolling incentives mechanism that ensures companies retain the benefit of capital and operating cost efficiency improvements for five years and subsequent fine tuning to improve this incentive for leading performers.
- Making assumptions on the scope for improvement in each company's efficiency.
- Introducing an overall assessment of customer service which rewards good performance through an uplift in revenue and penalises poor performance through a reduction in allowed revenue.
- Using a notional financial structure and single cost of capital assumption in price setting.

22. As well as providing the right incentives for companies to improve we must also ensure that we do not weaken incentives or provide perverse incentives:

- We have considered whether the length of the price review remains appropriate and how we can encourage long term planning.
- We would not wish to encourage companies to follow detrimental practices. For example for the 2009 periodic review (PR09) we are introducing a revenue correction mechanism to ensure that companies do not have an incentive to encourage consumers to use more water than is necessary.
- We have considered whether the mechanisms we put in place to protect companies from uncertainties weaken incentives on companies to minimise costs.
- We considered whether the regulatory regime and the way we set price limits was incentivising companies to implement a sub-optimal solution to achieve an output.

23. The incentive regime has worked well. We have seen significant improvement in drinking water quality and environmental performance, as well as improvement in the level of service that consumers receive from increasingly efficient companies able to deliver improvements at lower cost.

24. The key element of an incentive based regime is to ensure incentives remain with companies to continue to improve and manage costs. In many respects the aim of the regime is to mimic the pressures that would face management within a competitive environment, by promoting rivalry through the use of comparative techniques in setting price limits (particularly in projecting costs) and, more broadly, by leaving management responsible for managing business risks that arise in the market. The reward for companies that manage cost pressures and other risks that arise, and at the same time achieve outperformance against the financial assumptions underlying price limits, is that they achieve higher financial returns over a period of time. Consumers benefit at future price reviews as we take account of the efficiencies achieved. This is similar to the 'super-normal' returns a company may achieve through achieving a position of competitive advantage in a competitive market (until such time as its rivals' actions erode this).

25. When we set price limits we must make forecasts across a five year period but, inevitably, actual performance varies from forecast. The greater the uncertainty, the greater the risk of variation from our forecasts. If, as a consequence, price limits are too high it allows companies to easily 'outperform' our targets weakening the incentives on companies to reduce costs. In the long term consumers would pay more than they needed to. Equally if price limits are set at a level which is too low, in the long term, consumers pay more as incentives on companies to outperform are weakened. In setting incentives, we must also consider how the risk of variation from our forecasts is shared between shareholders and consumers.
26. When we set price limits we need to consider whether changes in costs and outputs that the companies face between periodic reviews will affect businesses in the wider economy equally or specifically affect the water sector only. A fundamental tenet of incentive-based regulation is that companies, not consumers, should bear business risks. However this is mitigated to a certain degree by the protections within the regime designed to deal with uncertainties, including the substantial effect mechanism.
27. At a five year review we will take a judgement on the cost of capital taking into account the balance of risks between the companies and consumers across the whole price limit package. The substantial effect clause therefore does not operate in isolation: it is just one mechanism amongst many in the regulatory framework for dealing with uncertainty. It is important to explain the operation of the various mechanisms as this illustrates when risk is borne by companies and when by consumers. The main mechanisms are:
- The five yearly review period.
  - Indexation.
  - Standard IDoKs.
  - Logging up and logging down.
  - Shortfalls.
  - The change protocol.
  - The substantial effect clause.
28. The five yearly review period takes into account the efficient costs companies incur. As a result new price limits reflect any efficient variation from cost and revenue forecasts at the previous review. This provides a strong protection for companies in the medium to long term. It resets a company's position going forward, it does not reimburse companies or consumers for variations in costs in the previous period, since to do so would substantially dilute management incentives. However, it does ensure any variation is only borne for between one and five years (depending upon when they are incurred), not in perpetuity.
29. Indexation protects companies in the short term against a range of cost variations because price limits are adjusted for RPI. This means that water companies are automatically protected against costs increases that all businesses face (to the extent that they are reflected in RPI). Consequently

we would not make any specific allowances for these costs in price limits because managing them is a normal business risk. Some companies also have protection against construction costs outstripping the general rate of inflation (although SES agreed to the deletion of this protection in its licence in 1994).

30. Standard IDoKs deal with specific uncertainties and risk for specific changes in outputs. They allow companies to recover the efficient costs incurred within the period relating to the specific changes if, in aggregate, they meet a 10% of turnover materiality threshold (more detail is provided in paragraphs 40 to 43).
31. Logging up and logging down is an important mechanism for ensuring that future price limits reflect variations in costs due to changes in outputs. In some cases companies will incur legitimate costs for outputs not previously included in price limits. However, individually they may be cumulatively less than 10% of turnover and therefore not qualify for a standard IDoK. The mechanism covers items that would qualify for a standard IDoK but has also covered some outputs not covered in standard IDoKs. When prices are next set companies will have the efficient costs of non-trivial outputs 'logged up' – generally through an adjustment to the regulatory capital value. However, this mechanism does not allow the companies to recover the within period financing costs or related operating costs of any new outputs, but it does ensure that the ongoing financing costs (and any related operating costs) are included in future price limits.
32. Shortfalls protect consumers where a company is funded to deliver a specific output but fails to deliver it. Once we have confirmed that the output was still required we will then make a financial adjustment which both removes costs from future price limits and recovers the financing costs allowed for the output over the previous five year period.
33. The change protocol<sup>9</sup> provides a step by step process for agreeing the financial adjustments to reflect new costs and outputs that arise within a five year period once price limits have been set. The financial adjustments are implemented either through a standard IDoK or a logging up or down adjustment at a following price review. While it does not reduce the risk companies face it reduces the uncertainty companies face since it provides a process to confirm that they will be able to recover costs at the next periodic review or at an interim determination.
34. The substantial effect clause ensures companies can continue to finance the proper carrying out of their functions if the company has faced a circumstance which has or will have a substantial adverse effect which would not have been avoided by prudent management action.

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<sup>9</sup> The AMP4 change protocol (which covers the period 2005-10) is enclosed with this submission (Ofwat ref: 19bb)

35. What is clear within this wider framework is that companies:
- Are protected in the medium and long term from efficient cost variations and only bear the risk of cost variations for a short period until the next review.
  - Even then companies are protected from some variation for costs they incur in the short term through the operation of RPI and standard IDoKs.
36. Equally consumers:
- Bear the risk that, in the short term, companies benefit from variations in costs.
  - Bear longer term risks that arise and are reflected in future price limits.
  - But benefit from the operation of the incentive regime in the medium and long term as prices are reset and efficiencies captured.
37. In summary companies have incentives to minimise costs and manage cost increases as they retain the benefit of outperformance for a period of time (ie: until the next periodic review). Consumers benefit from this in the future from price limits that reflect lower costs achieved by the companies.
38. Central to any incentive based regime is the fact that both parties must accept that there is a risk that the return a company will achieve in each year may be higher or lower than forecast when price limits were set. Importantly, the cost of capital we set reflects the risk a company faces in the package it accepts in the final determination. To propose as SES does that the returns should be guaranteed clearly shifts the risk from companies and onto consumers and would represent a shift from incentive based regulation to rate of return regulation.

## **Role of the substantial adverse effects clause<sup>10</sup>**

### **Difference between the standard IDoK and the substantial effect clause**

39. It is SES's view that the standard IDoK process and the substantial effect clause are very similar. This is simply incorrect. The standard IDoK and substantial effect clause mechanisms are not the same and do not operate in the same way in relation to adjusting price limits. This is clear from the wording of the respective provisions.

### **Standard IDoKs**

40. Standard IDoKs allow companies (and to a lesser extent Ofwat) to seek revised price limits if specified changes (known as Relevant Items) occur in

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<sup>10</sup> A detailed history of the substantial effect clause is available in annex 3 to this document

the period between periodic reviews<sup>11</sup>. Cash flows are incremental to the determination at a periodic review and arise from only specific items. It is not a 'mini periodic review' of price limits.

41. While IDoKs are designed to reduce uncertainty the allocation of risk can vary. Notified Items (NIs) can be designated as either 'one way' or 'two way'. The key difference is that 'one way' NIs only allow companies to recover costs where they prove to be greater than those allowed when price limits were set. Ofwat cannot recover the difference if costs prove to be lower than allowed for in price limits. At the last periodic review all but one of the NIs was designated as 'one way' meaning the risk lay with consumers if costs in these areas proved to be lower than forecast. SES incorrectly assert that all NIs were 'two way'.
42. The licence sets out how Ofwat must calculate the Materiality Amount – 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. Ofwat must then consider whether the Materiality Amount is equal to or exceeds 10% of the turnover of SES' regulated business (i.e. the materiality threshold).
43. If the Materiality Amount exceeds 10% there is a specific mechanism to adjust price limits set out in the licence that mimics the way prices are set at a periodic review in respect of these incremental cash flows<sup>12</sup>. Such standard IDoKs are not uncommon and are relatively mechanistic.

### **The substantial effect clause**

44. In contrast, the substantial effect clause is a more general mechanism that allows a company to apply to Ofwat for an interim adjustment to its price limits if any circumstance (other than a Relevant Change of Circumstance (RCC)) 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.
45. There are only two questions in what is a two stage process:
  - a materiality question as to whether there has been, or will be, a substantial effect, not being one which would have been avoided by prudent management action; and
  - if so, what change should be made to price limits.

There is therefore no set calculation methodology in the licence for adjusting price limits as there is for standard IDoKs.

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<sup>11</sup> Further details are set out in annex 3.

<sup>12</sup> Further details are provided at annex 4.

46. In relation to the second question, we consider what, if any, change should be made to price limits in light of our duties under section 2 of WIA. For clarity we reproduce this in full below because SES's submission is selective in its reference to our duties.

*"(2A) [Ofwat] shall exercise and perform the powers and duties mentioned [...] 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) [...]*

*[...]*

*(3) Subject to subsection (2A) above, [Ofwat] shall exercise the powers and duties mentioned [...] in the manner which [...] 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;*

*[...]"*

47. The only relevance of the standard IDoK calculation methodology for substantial effect applications is that since 1994, for the purpose of establishing whether or not an application is material (i.e. the first stage in the two stage process), the licence requires that we calculate the NPV of the net extra costs or revenue losses in the same precise way as for the standard IDoK process. 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.
48. If the materiality threshold has been reached, Ofwat then has to consider what change should be made to the price limits. In this instance, unlike the standard IDoK there is no prescriptive mechanism for how Ofwat should determine what, if any, adjustment should be made to price limits. We note here that SES concedes that the substantial effect clause is "less prescriptive" than the standard IDoK mechanism as to the outcome of an application

(paragraph 76 of SES' Submission to the Competition Commission dated 23 March 2009).

49. Consequently, exceeding the materiality threshold merely gives us jurisdiction to investigate whether any change should be made and, if so, the amount of any change in light of our duties under section 2 WIA.
50. This is the approach that we followed when we received the first applications under the substantial effect clause from Northumbrian Water Limited and Bournemouth and West Hampshire Water plc in 2003. At that time, for clarity, we provided a broad outline of our likely approach to future applications<sup>13</sup>, but noted that we would consider each substantial effect application on its own merits:

*" On receipt of an application under [the substantial effect clause] we will therefore consider two questions:*

- *Does the company have a material case that we must consider?*
- *If the company has a material case what change do we consider should be made to the Adjustment Factor?*

*[...]*

*Once materiality is established we have discretion in determining what change should be made to the Adjustment Factor. [The substantial effect clause] is not mechanistic in calculating the change to the Adjustment Factor in the way [...] for standard interim determinations because [the substantial effect clause] must be capable of dealing with a range of unforeseen events. It allows greater flexibility when considering what change should be made in the specific circumstances that a company believes are causing a substantial adverse effect.*

*We will first consider the impact of a substantial effect on a company's ability to finance the proper carrying out of its functions, with reference to the [Ofwat's] duties under Section 2 of the Water Industry Act 1991.*

*For example, in determining what change should be made to the Adjustment Factor we will look to ensure that it strikes the appropriate balance between:*

- *ensuring the financing of proper carrying out of functions;*
- *protecting customers' interests; and*
- *promoting economy and efficiency.*

***It may be that following detailed analysis and proper consideration of all of [Ofwat's] Section 2 duties we might decide that a material application should not result in any change to the Adjustment Factor.***

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<sup>13</sup> Northumbrian Water and Bournemouth and West Hampshire determination letters (Ofwat refs: 07d and 07f)

*Alternatively we might apply a smaller adjustment than that claimed by a company, if we were satisfied that, on the facts, a company would still be able to finance its functions with the smaller than proposed change to the Adjustment Factor." (emphasis added)*

51. It is clear that exceeding the materiality amount does not automatically entitle a company to any change in price limits – it merely gives Ofwat jurisdiction to investigate what, if any, change should be made in the light of our duties under section 2 WIA. SES disputes our approach.
52. SES believes there is a clear logic that the starting point for an adjustment of price limits for a substantial effect claim is the same as a standard IDoK.
53. It appears that SES wishes to conjoin these two types of regulatory mechanisms because standard IDoKs look at incremental cash flows for specified items for the whole of the period. It wishes such an approach to be applied for substantial effect claims.
54. However, there is no basis to support SES's view. If the substantial effect clause was in fact the same as a standard IDoK but simply operated at a higher threshold then the mechanistic approach to adjusting price limits from section B13.2 of its licence would be referred to as well as the materiality calculation. The licence does not do this and does not operate in this fashion.
55. When we consulted on reinserting the substantial effect clause in 2001 for the 12 companies that did not have it we explained that:

*"[...] the perception of risk by investors in those companies that have retained this clause does not seem to be lower than that for companies which have not."*

*"Whether or not the clause was included in a licence [Ofwat] would, in pursuit of [its] duty to ensure that a company could finance its functions, have to consider the case for revised price limits on its merits<sup>14</sup>.."*

The implication is that investors at that time saw the substantial effect clause mechanism as closely aligned to the duties, in particular the duty to finance functions, contained within section 2 WIA rather than as a mechanistic process in the manner of a standard IDoK.

56. The approach we take is consistent with the original intention of the clause. At privatisation, the position was summarised by the Department of the Environment:

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<sup>14</sup> MD 167 Modification of conditions of appointment: Proposal about condition B, part IV (interim determinations) and other possibilities- included with this submission (Ofwat ref: 19bg)

"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>15</sup>

At that time, as now, the clause contained the same two stage process of answering the questions of (i) whether there was a substantial effect which would have been avoided by prudent management action and (ii) if so, Ofwat having discretion to consider what, if any, change should be made to price limits.

57. It is also in line with the approach taken in other regulatory regimes where such mechanisms exist. For example, the Office of Rail Regulation (ORR) uses the trigger of a breach of a key financial ratio over a three year forward-looking period, as the point at which there is the **option** to undertake an interim review of Network Rail's outputs and access charges. In this case there is no automatic right to an interim adjustment<sup>16</sup>. It should be noted that the licences of energy companies, including the distribution network and transmission companies, regulated by Ofgem currently have much more limited similar mechanisms.
58. Interestingly while SES argues, on the one hand, that the substantial effect clause is essentially the same as a standard IDoK on the other hand its own proposal includes a degree of discretion.
59. We made our determination in the light of our section 2 WIA duties. In particular, we did this in the way that we considered was best calculated to ensure that SES was able (in particular, by securing reasonable returns on its capital) to finance the proper carrying out of its functions. 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 finance the proper carrying out of its functions would not be consistent with our duty to further the consumer objective. Section 2(2A)(a) WIA also requires us to further the "*consumer objective*". In our assessment, we also note the clear consumer detriment of a higher, and possibly temporary upward spike in prices, against no hard evidence of SES being unable properly to discharge its functions. In fact, SES did not argue that it was unable to discharge its functions
60. Our approach does not, as SES claims, favour a company that comes in earlier or later in the period. This argument presumes that the clause works to allow companies to recover all lost costs, a point we dispute. We are clear that a substantial effect clause is about ensuring a company can finance the

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<sup>15</sup> See paragraphs 16 and 17 of the confidential explanatory notes the Department of the Environment attached to its letter dated 25 October 1989 (Ofwat ref: 01d)

<sup>16</sup> ORR publication: Procedural approach to conducting an interim review in CP4 December 2008

proper carrying out of its functions. If a company believes that it is unable to do so at any point within the period then it can apply.

61. Also, as we explain in paragraph 193, our approach to modelling ensures that the impact of cost variations in the earlier years of the period on a company's financial position are taken into account in our assessment of whether an interim adjustment is required.

### **SES's position on risk borne by companies**

62. In its submission SES asserts that its licence allocates risk between companies and customers and that our determination should not consider risk. It argues that the company carries the risk below 20% and once the 20% materiality threshold is reached all risk is borne by consumers. SES argues that Condition B is 'a code to deal with uncertainty' and that we should not consider risk as part of our determination.
63. We disagree. Risk is not just allocated in the licence. Risk is central to all our decisions and regulation must consider the appetite for risk. Doing so is an important element of our duty to further the consumer objective under section 2(2A)(a) WIA and our duty, subject to section 2 (2A) WIA, to promote economy and efficiency by companies in carrying out their functions.
64. SES's view of risk is entirely dependent upon its view that the standard IDoK and substantial effect clause are essentially the same mechanism with the exception of the higher materiality threshold. The 20% materiality threshold is purely a jurisdictional test; if it is met Ofwat has the jurisdiction to consider what change to price limits it should make. It does not automatically transfer risk from companies to consumers once it is crossed. As set out above, this is not how the text in the licence is drafted. In addition, it is not clear to us how a position where a company was essentially absolved of all risk above a particular threshold (in this instance 20%) could possibly be consistent with providing incentives on that company to manage costs and seek to improve efficiency. It would also unnecessarily protect equity shareholders in a way that is not consistent with the equity risk premium included in the allowed costs of capital.
65. Framing 'risk' in terms of the materiality threshold also overstates the actual risk the company faces. The company bears risk on actual costs not the costs that are calculated to determine materiality. The materiality threshold calculation for a substantial effect claim follows the same process for a standard IDoK except the threshold is twice as high. This explicitly uses a fifteen year future period for operating costs and revenue (but only a five year period for capital costs, which SES's submission does not make clear). By definition a significant proportion of the change in operating costs or revenue cannot have been incurred and represents an extrapolation for the purposes of assessing materiality for such items. The actually incurred costs are likely to be a fraction of materiality and it is the incurred costs or revenue changes

that we must consider in the light of our duties under section 2 WIA and, consequently, whether to make an adjustment to price limits.

66. As an illustration, at the extreme, a single variation in an opex/revenue item in year 5 of a price limit period equivalent to 2.0% of turnover in one year could meet the 20% materiality threshold. This is very different to suggesting that the company carries risks on costs 'up to 20% of turnover'. This implies that a variation of as little as 2.0% in one year would, in SES's view, warrant a substantial effect claim and a change in price limits that restores a company's return for each year of the period. This would significantly distort the allocation of risk to the disadvantage of consumers.
67. SES's approach also ignores the other regulatory mechanisms in place (explained in more detail in paragraphs 27 to 36) that reduce the risk the company faces. These need to be taken into account:
- The RPI element of price limits protects companies against the risk of changes in costs and outputs that affect industry in general.
  - The company only has to bear these actual costs until the next review, in a worst case scenario, 5 years. In the case of SES's application the biggest proportion of in-period costs are yet to be incurred and there is less than 12 months until new price limits come into effect, for which SES's costs will have been considered afresh.
68. SES argues Ofwat did not make a NI at the last periodic review for either power costs or income. As regards income this is not strictly the case as income loss due to consumers who switch to a measured supply (an element of SES's claim) is covered by one of the current NIs. As regards power costs, while Ofwat did not make a NI for such costs, they are covered to the extent that power costs are reflected in RPI, and also to the extent that any increased usage associated with additional outputs that qualify as a NI or RCC (and hence for a standard IDoK) can be recovered. For example the operating costs associated with a new obligation to improve water quality which requires a more energy intensive treatment process could be recovered in a standard IDoK.
69. Nevertheless, at PR04, Ofwat did consider it appropriate to make a special assumption of a 40% increase in power costs, over and above those already reflected in each company's base costs (see paragraphs 76 and 77 below).

### **SES's view on risk and the implication of our decision on power costs at PR04**

70. SES has argued that the way that the licence allocates risk means that

*"in effect Ofwat is permitted a margin of error in not having made the relevant matters an NI. Once 20% materiality is breached however, the risk is no longer allocated to companies<sup>17</sup>."*

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<sup>17</sup> Paragraph 68 of SES's submission to the Competition Commission.

71. The substantial effect clause is not designed as a ‘margin for error’ on cost forecasts as the company contends. We explained at PR04 (partially quoted by SES at paragraph 70 of its submission to the Competition Commission) that:

*“It is natural that companies should seek protection from as many changes as possible. **However we have concluded that some of the changes they propose are adequately dealt with in the price setting mechanism, for example power costs and pensions. Others will be reflected in changes in the RPI. Others are simply business risks that need to be accepted by water and sewerage companies as for any other company, for example loss of customers through competition. We have reviewed all of the issues raised by the companies carefully and we judge that the risks are small and even if they appeared, companies should use their management skills to minimise the effects. The cost of capital takes account of this and other forms of business risk.**”<sup>18</sup> (Emphasis added).*

72. This is particularly relevant for power costs. At periodic reviews companies propose a variety of issues which they feel should be covered by NIs. In deciding whether NIs are appropriate in each case Ofwat has to decide what costs are likely to be uncertain, which can be allowed for in price limits and which are risks that all companies within the economy face. Each option carries a different risk for consumers and for companies.

73. At PR04 SES argued that costs in 11 areas should be classified as NIs<sup>19</sup>:

- Electricity costs;
- abstraction charges;
- accounting standards;
- bad debt;
- Traffic Management Act;
- insurance costs;
- business rates;
- meter optants;
- deferred tax payments
- pensions; and
- tax treatment of certain expenditure.

SES was one of only five companies that argued for a NI for electricity costs. Although we allowed costs in five areas to be NIs we did not make power costs a NI.

74. In the case of power we made an explicit allowance for additional costs in our final determination. [✂] In 2004 work commissioned for Water UK<sup>20</sup> (covering

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<sup>18</sup> Page 242 Future water and sewerage charges 2005-10 (Ofwat ref: 07b)

<sup>19</sup> Section B 1.4 of SES’s PR04 final business plan

the period 2005-10) suggested a step change in costs with a narrow range around a central forecast.

75. We considered that the price of electricity was a risk that all businesses in the wider economy faced not just the water sector. Ordinarily we would expect the RPI element of companies' price limits to provide a significant degree of protection from the risks (including power) all businesses are exposed to and the remainder would be business risk. However, at that time evidence suggested that companies, who are relatively large energy users, were facing a step change in power costs at the start of the period.
76. As a result, we assumed that energy prices would increase by 40% over 2005-10. This figure was a central estimate informed by evidence provided by companies and market evidence at that time. It was also in line with the findings of consultancy work commissioned by Water UK.
77. Overall, for SES we made an additional allowance for power costs that was of the same magnitude as the forecast in SES's business plan<sup>21</sup>.
78. In our supplementary report to SES we explained that for energy costs:
- "we judge the risk of these items to be small and to be either covered by the general inflation part of the price limits or to be a part of normal business risk. Companies should use their management skills to minimise these risks. The cost of capital takes account of this and other forms of business risk.*
- [ ]
- "allowance has been made for changes in base opex in the determination<sup>22</sup>"*
79. We had made a decision, based on the evidence at that time, about the likely level of future power costs. Our allowance for additional power costs reflected this and this in turn was reflected in price limits. The remaining risk was considered to be with the company, which in turn was reflected as part of the overall cost of capital allowed for the company. Consumers carried the risk that if energy prices had been lower than our assumptions we would not be able to recover this benefit from companies.
80. It is not clear why SES believes this approach to be contradictory or why making a special allowance for power costs is a strong indicator that power costs should have been an NI. In such a case we would not look to put in place a NI if we felt that we had dealt with the issue adequately in price limits. To do so would be to insulate a company from all risk. This would not reflect

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<sup>20</sup> Water UK is the trade body that represents all UK water and wastewater service suppliers at national and European level.

<sup>21</sup> Our forecast was £0.701m per annum (including our assumption on the impact of energy prices on RPI) above the power costs the company was already incurring. SES's final business plan assumed costs would increase by an average of £0.73m per annum

<sup>22</sup> SES PR04 supplementary report – page 28 included with this submission (Ofwat ref: 19ba)

the position for businesses in the wider economy and would weaken the incentives on companies to manage costs.

81. The company argues that there is no effective recourse against the failure to make power costs a NI. This is not the case as the company is able to appeal our determination to the Competition Commission. The fact that it chose not to meant that it accepted the level of risk inherent in the overall package of the determination.
82. Our final determination was clear that increases in power costs above the special allowance allowed for 2005-10 was a business risk. We explained that this risk was reflected in the cost of capital we set for companies. SES's position appears to be that if power costs increase above the special allowance for 2005-10 this is a consumer risk not a business risk. But, on the other hand, it says that in determining the adjustment to price limits we should restore the return on capital to the cost of capital allowed at PR04. Such an argument is contradictory because our PR04 cost of capital was made on the basis that any additional variation in power costs was a business risk.

#### **The extent to which a 'change' in operation of the substantial effect clause was accounted for in 2004**

83. SES, in its submission, seeks to imply that our conclusions on the consultation on licence amendments prior to PR04 demonstrate that we were fully aware of how the clause worked (that is we knew it worked in the way that SES argue in their submission) and that our decision on the cost of capital must therefore have reflected a regime where substantial effect clauses were not a 'shipwreck'. This is not the case.
84. In 2004, in light of the applications in 2003 by Northumbrian Water and Bournemouth and West Hampshire Water, we explained that we intended to consult on possible amendments to the substantial effect clause along with other possible amendments to Condition B in advance of the PR04 final determination. When the standard IDoK materiality calculation was modified to its current form in 2000 (to extend, for the purposes of calculating materiality, the period for assessing operating costs and revenue losses from five to fifteen years), this also affected the materiality calculation for substantial effect applications. This was not our intention and we did not consult on it at the time. As a result, our view was that it was now easier to meet the materiality threshold for a substantial effect application. We therefore proposed to modify the substantial effect clause to restore the materiality calculation to its pre-2000 form in a wider consultation published in March 2004.<sup>23</sup>

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<sup>23</sup> MD 189 Proposed licence modifications consultation – included with this submission (Ofwat ref: 19bc)

85. In the event opposition from companies meant that Ofwat subsequently decided<sup>24</sup> not to pursue this proposal at that stage with the Competition Commission. We have not made any subsequent modifications to the wording of the substantial effect clause.
86. Our consultation was only in relation to the calculation of the materiality threshold for a substantial effect (i.e. the first question in the two stage process under the substantial effect clause); we did not seek views on the approach we took to determine whether an interim adjustment was required (the second stage of the process).
87. Consequently when we set new price limits at PR04 we did so in the knowledge that materiality could be reached more easily. But our approach to determining whether an interim adjustment to price limits was needed remained as described in 2003, that is we would ask two broad questions: Is the materiality threshold reached? And if so does the company need an increase? Our view also continued to be that:

*“It may be that following detailed analysis and proper consideration of all of the Director’s Section 2 duties we might decide that a material application should not result in any change to the Adjustment Factor.*

*Alternatively we might apply a smaller adjustment than that claimed by a company, if we were satisfied that, on the facts, a company would still be able to finance its functions with the smaller than proposed change to the Adjustment Factor.”*

### **Impact on incentives of SES’s proposal**

88. We believe that aspects of SES's application would, if accepted, significantly distort the allocation of risk and would disadvantage consumers because it would:
- reduce incentives on companies to manage costs between reviews; and
  - pass the risk for management decisions to consumers.
89. Restoration of returns in the manner argued by SES removes incentives and leads to an exercise in cost pass through. The safety net SES envisages can only but serve as a disincentive for proper management as a company is completely insulated from variations against a final determination package as long as it faces material changes in costs or revenues.
90. By allowing companies to recover all underperformance retrospectively companies would have less incentive to reduce costs as they would know that a relatively small, short lived, variation in one year would allow them to recover all underperformance within the year across the business.

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<sup>24</sup> MD 194 Proposed Licence modifications conclusions – included with this submission (Ofwat ref: 19bd)

91. An incentive based regime recognises that company performance can vary. In some cases a company will outperform or benefit from favourable movements in input prices. In this instance it should retain the benefit of this. Conversely where it underperforms or price inputs increase it must accept that it bears the risk.
92. SES argues that where returns are lower than anticipated they should be restored. This is rate of return regulation and it would clearly weaken the incentives on companies to mitigate costs and improve efficiency.
93. Following the company's argument, we should also use the substantial favourable effect mechanism to recover any outperformance of the return allowed at the previous periodic review in all years even if they did not relate to the circumstance. It seems hard to believe that companies would not argue that such an approach would remove the incentive on companies to outperform.
94. SES argue<sup>25</sup> that our position that full recovery of costs would undermine incentive based regulation 'is a curious statement given that full recovery is the prescribed remedy for all NI/RCC claims under the licence'. This misses the point in that such a mechanism is in place for the standard IDoK but not for the substantial effect clause. As explained in paragraphs 40 to 43, the standard IDoK applies only to incremental cash flows relating to specific changes in outputs. It is not part of the substantial effect clause.
95. SES suggests that 'it is common for regulatory mechanisms to allow full recovery'. This may be the case if a rate of return regulatory framework is used but should not be the case for medium term incentive frameworks such as that used in the water sector.
96. However, it is also important to correct some inaccuracies in SES's submission in this area. Firstly, the revenue correction mechanism (which will be in operation for the period 2010-15 not the current period) was not introduced primarily, as SES implies, to allow full recovery of lost income. In RD 14/07<sup>26</sup> we explain that the revenue correction mechanism is being introduced because:

*"We carried out work to address two problems:*

*1. Under a price cap, with increasing levels of household metering, companies benefit significantly from increased volume, undermining any incentive to promote water efficiency.*

*2. Companies' revenue can vary significantly from forecast, with a disproportionate impact on profits. [...] Knowing this, companies have an*

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<sup>25</sup> Paragraph 276 of SES's submission to the Competition Commission

<sup>26</sup> RD 14/07 review of form of price control mechanism enclosed with this submission (Ofwat ref: 19be) – RD letters are those we send to the regulatory directors of the companies

*incentive to understate expected revenues. There is no incentive for companies to share revenue outperformance with consumers."*

97. Secondly, the change protocol does not automatically provide for full recovery for certain RCCs. The change protocol is a mechanism primarily used for environmental and water quality outputs. It allows other stakeholders (e.g. the quality regulators, DEFRA,) to examine changes in companies' outputs. The change protocol provides a step by step process for agreement on how we will determine what efficiently incurred new costs and outputs will be allowed when price limits are next set (which might be at a periodic review or if sufficient in a standard IDoK). It is not a risk allocation tool but it is a tool which helps to reduce uncertainty.

98. Companies will only recover the full, efficiently incurred costs agreed through the change protocol if these items are included in a standard IDoK application. If they are dealt with at a price review they only get the costs going forward from the start of the next price review through the logging up/ logging down process. The change protocol<sup>27</sup> for PR04 clearly states that:

*"These procedures only finance from the start of the next pricing period the reasonable net additional costs arising from recognised changes and make no allowance for a company's financing costs up to this date."*

[ ]

*"Each company's price limits assumes a cost of capital that reflects business risk. One of these risks is the potential need to finance progress on required changes for the balance of the pricing period unless the scale of the changes enables it to seek an interim determination"*

99. Of the three examples the company cites to support its position (RCC/ NI provision, the change protocol and revenue correction mechanism) only one relates to cost recovery in the manner SES suggests, and this relates specifically to the standard IDoK mechanism.

100. We see no reason to believe that our approach would jeopardise the long term delivery of service improvements<sup>28</sup>. Price limits are set every five years and they reflect the ongoing costs that each company faces. In the long term price limits will reflect the cost of delivering the service to consumers.

101. SES argue that our approach at "previous SAEs does not contradict the principles of incentive regulation." We note that previous substantial effect applications did not restore returns in previous years, they were forward looking.

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<sup>27</sup> The AMP4 change protocol – page 17 enclosed with this submission (Ofwat ref: 19bb)

<sup>28</sup> Paragraph 36 of SES's submission to the competition commission.

## **Symmetry of the substantial effect clause**

102. SES asserts that the substantial effect clause is completely symmetric or might in fact favour consumers. This is not the case and the clause, in practice, is more likely to favour companies. The substantial favourable effect must be fortuitous and not attributable to prudent management action. It is very difficult to conceive of circumstances which would meet this test and we believe that it is more difficult for Ofwat to operate the clause. There are a number of reasons for this. For example, the asymmetry of information in favour of the company. Also, it would require Ofwat to demonstrate that a substantial favourable effect was not attributable to management action, when the achievement of more favourable financial outcomes is accepted as one of the central aims of management. There have been no substantial favourable effect claims initiated by Ofwat.
103. SES points to companies' decisions to voluntarily abate price limits in support of its view of asymmetry. While we are not clear which abatements SES is referring to, abatements have in the past been made in recognition of the fact that Ofwat could have triggered a standard IDoK. Other examples in the late 1990s included instances where early efficiency savings achieved by companies were shared between shareholders (through enhanced returns) and consumers (who received the benefit ahead of a periodic review). These examples do not support the idea of an asymmetric substantial effect clause.

## **Ofwat's analysis**

### **Our general approach to the determination process**

104. Our final determination and draft determination decision letters set out the approach we followed in making our determination. We provided a summary of our approach in our previous submission to the Competition Commission.
105. Once we receive a substantial effect application, companies' licences give us three months, from the day of receipt, to make a determination. To provide greater transparency we produce a draft determination and hold a short consultation period so that all stakeholders are able to comment on our initial decision.
106. The timescale for this is tight and we explain to all companies that the onus is on them to ensure the accuracy and completeness of their application and the data therein<sup>29</sup>. This is particularly important because of the information asymmetry that exists between the company and us. We are only able to make our decisions based on the information that is presented to us or which we already hold.

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<sup>29</sup> Letter to SES dated 1 July 2008 (Ofwat Ref: 17b )

107. The consultation period between the draft determination and final determination provides companies (and other parties) with the opportunity to comment on our decisions and provide any further information that it feels will support its case. Most importantly it provides the company with an opportunity to ensure we have all the information relevant to the case and are fully aware of its arguments.
108. SES cites situations it believes demonstrate a failure to engage with the evidence. This appears to be driven by:
- [✂]
  - What the company saw as Ofwat ignoring evidence (including that of the reporter) related to energy use and procurement.
109. We disagree with the company's view. SES appears to equate a difference of opinion with a failure to engage. We understood the information the company had presented and the arguments it put forward but disagreed with its position.
110. We appointed Atkins to do a desk-top study as we wanted its view on the information provided to us by SES. As explained above the onus is on companies to provide us with the necessary evidence to fully demonstrate its case. This was a conscious decision on our part because of the information asymmetry and the tight timescale. [✂] The company had an opportunity to comment on the findings of the review in its representation. The company also took the opportunity to commission its own review and provide additional supporting information which we considered for our final determination.
111. The terms of reference for the Atkins review did include an option for a second stage visit to the company. In the event, having considered the findings of the Atkins' review, we did not identify points that we needed the consultant to follow up through a site visit.
112. Reporters are appointed by each company, subject to Ofwat's approval. The reporter's role is to assist Ofwat to fulfil its statutory duties. The reporter's primary duty of care is to Ofwat. The reporter also has a duty of care to the company.
113. The reporters comment on and certify the non-financial elements of the information that companies submit to us. Their role is to help ensure that companies' regulatory information is complete, reliable and accurate.
114. As well as scrutinising the companies' data, reporters help us to ensure that information from different companies is comparable. We give them guidance on the information that has the most impact on our regulatory decision making. As a result, we are able to compare company information to regulate the industry and to establish robust assumptions about relative efficiencies and service to consumers.

115. Reporters have two major roles: scrutinising the historical data presented in companies' June returns, and the forecast data presented in their submissions for periodic reviews of price limits<sup>30</sup>.
116. Reporters also carry out special investigations for us including standard IDoKs and substantial effect applications.
117. SES argues that we ignored the evidence it presented to us (including evidence of the reporter). This is not the case. Our decision did take the information provided by the reporter and others into account but we must consider all the information available to us and based on this make what we believe to be the appropriate decision.
118. SES also raises an issue in relation to the term "circumstance" for the materiality calculation. We agree with SES that this does not have a practical impact for this case because both circumstances individually pass materiality.

### **Consistency**

119. SES believes that our approach to determining whether an interim adjustment was needed was inconsistent with our approach to determining Bournemouth and West Hampshire Water's and Northumbrian Water's substantial effect applications.
120. Each of our decisions is made in light of the circumstances at the time. The requirements and objectives of the regulatory regime change and evolve over time (for example the Water Act 2003 amended our section 2 WIA duties). When we made our decisions for Bournemouth and West Hampshire Water and Northumbrian Water (the first decisions we have had to make under the substantial effect clause) we were clear that we would consider each future application on its own merits. We also explained that we might decide that a material application should not result in any change to the Adjustment Factor and that we might not always adjust price limits for material applications (see paragraph 50).
121. In the past we have explained that we must retain discretion over the ways in which price limits are set and keep under review the regulatory framework in the light of all relevant developments.<sup>31</sup> The substantial effect clause was expressly designed to afford us with discretion in how we approach each application.
122. Our approach to SES's application considered the facts relevant to its particular case and reflected our wider section 2 WIA duties, our approach to setting price limits at a periodic review and previous substantial effect determinations.

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<sup>30</sup> The June returns are annual returns companies submit as part of the regulatory process – they enable us to carry out our annual monitoring of their performance.

<sup>31</sup> MD166 The regulatory framework 310101 – included with this submission (Ofwat ref: 19bf)

## SES's revised data

123. SES's submission to the Competition Commission contained updated data compared to the application that we based our determination on. We have not had an opportunity to review this new information in any detail and as far as we are aware it has not been reviewed and certified by the company's Reporter.
124. Although we have not assessed the updated power costs in SES's submission we do note that its corrected power figures are around 2% – 3% higher than it estimated in its original substantial effect application on 17 September 2008. We do not know the reason for this but consider that it will have a very limited impact on SES' performance in the power model.
125. SES's submission includes revised data for forecast income [X]. We are unable to comment on these revisions although we note that they will rely heavily on the accuracy of accruals for unbilled revenue.

## Prudent management

126. The following sections provide a brief outline of our approach to SES's application and responds to issues SES raises in its submission to the Competition Commission.
123. SES overcomplicates the "prudent management" test in its submissions<sup>32</sup>. It incorporates, among other things, a concept of "imprudence" that is not included in the licence. It also states that "because the aim of the clause is clearly to distinguish prudent management action from that which is not prudent, it requires that conduct leading to disallowance be imprudent." What sub-paragraph 13.3 of SES's Condition B actually says is that, for the purpose of establishing whether a substantial adverse effect claim is material, Ofwat has to consider:

*"(1) Whether any circumstance (other than a Relevant Change of Circumstance) has occurred which has or will have:*

*(a) a substantial adverse effect [...], not being one which would have been avoided by prudent management action taken since the transfer date;*

*[...]*

*For this purpose:*

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<sup>32</sup> See paragraphs 61 to 65 of SES's submission to the Competition Commission.

(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 [water company] at the relevant time; [...]"*

124. This has to be applied in the light of the circumstances of a particular case in the round. SES's submission instead tries to limit the application of the prudent management test, including attempting to incorporate a concept of 'imprudence'. For example, it says that:

*"Ofwat can only legitimately challenge SESW's actions if it is able to establish, with clear evidence, that the method of procuring the electricity lies outside the range of prudent management action, that the method was prudent but it was applied imprudently (given what SESW knew or ought to have known at the time of procurement), and, in either case, that any established imprudence caused the substantial effect on SESW.*

*In so far as advice from external consultants is taken by a water undertaking in such a case, Ofwat would need to show a defect or shortcoming in either the approach taken by the consultant or in the expertise of the consultant and that there was something in the course of conduct proposed by the consultant which, having regard to the circumstances which were known or ought reasonably to have been known to the water undertaking at the time, it was outside the range of prudent behaviour of the undertaking to have accepted."<sup>33</sup>*

125. Acting prudently clearly involves adopting a careful and cautious approach. Ofwat therefore considered, for example through comparison with what other water companies had done, whether prudent management action would have avoided costs or, where appropriate, reduced revenue. We also note that while advice from consultants has an important role to play, the company itself is responsible for making its decision in the wider context in which it operates.

126. SES seeks to argue that Ofwat has committed a "manifest error" because we referred (in our introduction to the reference to the Competition Commission) to what costs or, where appropriate, reductions in revenue SES "could have avoided by prudent management action". However, in the interest of clarity, we only considered whether costs or reductions in revenue would have been avoided through prudent management action.

127. Although the final determination did not use the phrase "prudent management", Ofwat's position was clear in the draft determination and it was merely a change of style rather than argument. The final determination letter made clear that:

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<sup>33</sup> Paragraphs 64 and 65 of SES's submission to the Competition Commission.

*"Having considered the representations, we have retained the approach we used in the draft determination for the reasons set out later in this letter and in the attached annex."*

128. Following SES's representations on the draft determination, we decided in our final determination to instead explain in greater detail the thinking behind our decision. We wished to avoid any misperception that our comments were directed at the company as a whole, rather than in relation to management action on specific issues in this case.
129. We also note that, subject to the duties set out in section 2(2A) WIA, we also have a duty to exercise and perform our relevant powers and duties (including making determinations under Condition B) in the manner that we consider is best calculated to promote economy and efficiency by water companies in carrying out their functions.
130. The following sections provide a brief outline of our approach to SES's application and responds to issues SES raises in its submission to the Competition Commission.

#### **Power costs**

131. SES's application was the first substantial effect application that included a claim related to changes in operating costs. Bournemouth and West Hampshire Water and Northumbrian Water's applications both related to revenue shortfall only. We thought carefully about how we should consider the issue of prudent management.
132. Our approach is set out in our initial submission and our final determination letter, but in short we took both a qualitative and quantitative view of SES's application. This took account of relevant available objective evidence available to us at the time on what would have been achieved by prudent management action, informed by real evidence of other companies' performance in managing similar issues.
133. Our qualitative review employed Atkins to independently review the data and information SES had provided on its energy procurement and management strategies to help us better understand SES's approach.
134. We also considered what alternative procurement strategies were available to the company as we were aware that other companies had taken a different approach to SES.
135. Our quantitative assessment of SES's application was informed by our econometric power model and comparison to a company with similar circumstances.

#### Qualitative review - Energy management

136. We took Atkins' review of energy management into consideration when we made our draft determination. We provided a copy of the report with our draft determination letter. In response SES disputed Atkins' conclusion and also submitted a copy of a report it had commissioned from Black & Veatch on the efficiency of its energy management<sup>34</sup>.
137. Having assessed these two reports for our final determination we considered that whilst some aspects of the Black & Veatch report did support SES's case in this area, we still judged that:
- there was no indication that SES was a leading company in its management of energy use; and
  - it was not clear that SES had made, or attempted to make, the step change in its culture or strategy that we might expect to see from a company that was under significant pressure from rising power costs.
138. In its submission SES rejects our assessment of its energy management practices and states that we were therefore wrong to challenge the power costs in its application on this basis.
139. However, we explained to the company that our decision was not based solely on the Atkins and Black & Veatch consultant reports. This was just one strand of evidence that we used to inform our assessment of the company's power costs.
140. In paragraph 239 of its submission, SES also highlights that it believes Atkins' report was not critical of the company in relation to pumps and the pumping of water, areas which account for 94% of its energy use. [✂].

#### Qualitative review - Energy procurement

141. SES's application and submission set out the company's approach to energy contracts for the years 2008-09 and 2009-10. In its report, Atkins identified that SES had the opportunity to sign 24 month contracts for the period 2008-10 when it opted to sign its one year contract for 2008-09. Atkins also identified that:
- [✂]
142. We therefore considered it appropriate to examine what SES's power costs would have been if it had fixed its energy prices for 2008-10. Our analysis capped power costs for 2009-10 at the same level as 2008-09 (this was in fact a slightly conservative approach in that it gave slightly higher costs in 2009-10 than if we had applied the unit price quoted in the 24 month contract).
143. This approach suggested costs in 2009-10 would have been [✂] lower than the costs forecast in SES's substantial effect application.

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<sup>34</sup> See paragraph 243 of SES's submission to the Competition Commission.

144. SES disagrees with this assessment in its submission as it considers that it acted prudently in opting for one year contracts for 2008-09 and 2009-10.
145. In our final determination we stated that:
- “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.”
  - “By choosing the less cautious approach the company is seeking to pass on a business risk of further increases to consumers.”
  - “This is a management decision and it is a business risk that outturn costs will not be as forecast.”
  - “Our approach to regulation has always been that we would not expect to protect companies from normal business risk.”
146. We consider that it is common business practice that when companies are faced with volatility in an item that is not a key trading factor in their business (such as energy prices), management can remove this volatility ex ante by using hedging instruments.
147. During PR04 SES lobbied for a NI on power costs, effectively asking that consumers protect it from the risk. It believed energy prices would be volatile but did not look to remove its exposure to volatility. As we have set out in paragraphs 70 to 82, we consider that the consequences of such business risk should lie with the company, not its consumers.
148. SES’s submission implies that any other company that did not follow precisely the actions that it took could be considered to not be prudent.
149. There are several examples in the water sector of companies that hedged power costs because they recognised that one of their functions was not that of an energy trader. One company fixed its prices for the whole five year period to remove any risk of price volatility, whilst other companies used two or three year hedges. [✂] We note that for PR09 companies are again considering hedging costs for the period.
150. Once we had made our PR04 final determination each company knew the allowance in price limits for power costs, all had to consider how to manage these costs over the five year period. These companies faced the same energy price challenges as SES over the five year period yet they managed their procurement strategies in such a way as to avoid similar increases in power costs over the period.
151. The adoption of such strategies does not rely on hindsight and clearly demonstrates that the price component of power costs is not completely out of management control, as SES’s submission seems to imply. Comparative analysis is central to the regulatory regime and it is right that we consider the approach that other companies have taken.

152. SES argues that it "...was in receipt of professional advice from a leading firm that stated clearly that the lowest expected cost strategy was to contract for one year only."
153. We do not dispute that SES's procurement strategy was based on the advice of its consultant and that it had a process in place to procure energy. However, we consider that companies must make their own decisions after considering the wider context in which they operate.
154. No decision can be made in isolation, it is correct that we should assess whether it considered all relevant factors. SES argues that the market as a whole failed to anticipate the movement in energy prices. However, it was SES's choice to expose itself whilst other companies made management decisions to remove the risk. We therefore consider that it is correct that we should consider the impact of SES's decision as the risk should rest with the company, not consumers.
155. In its submission to the Competition Commission SES argues that its decision to take a one year contract reduced the risk to consumers. This argument appears to be at least partly based on its interpretation of how the licence works (that is that above 20% materiality threshold all the risk lies with consumers and costs are automatically returned to the company).
156. We would question whether the company's decision did reduce the risk consumers faced. Fixing prices would have protected the company against further price increases. By not fixing its costs, the company and therefore consumers, were still exposed to further price increases.
157. In its representation to us SES argued on page 10 that, in a competitive market, it would have been able to pass the additional costs of energy price rises to consumers<sup>35</sup>. Such an argument implies that all the risk for management decisions rests with consumers. We do not believe that this is correct as businesses in the wider economy when facing similar increases in input prices would face a choice to absorb costs, in full or in part, in order to retain consumers or risk losing market share (for example to competitors who have adopted more effective cost control strategies). They still retain the risk associated with movement in input prices. Any decision on energy contracts would be made in the context of other pressures on the business. Its decision would not be made in isolation and we consider it appropriate to consider management actions in the same context.

#### Quantitative review - econometric power model

158. As we set out in paragraph 131, part of our quantitative review of SES's power costs was informed by use of our econometric power model. Ofwat is not obliged to set prices that finance the functions of an inefficient company

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<sup>35</sup> SES's representation on our draft determination (Ofwat ref: 05b)

(see for example section 2(3)(a) of WIA). So when we set price limits we include challenging efficiency improvement factors in price limits to drive companies to improve their efficiency over time. As part of our analysis of the costs included in an interim determination we analyse companies' costs to understand whether they are those that an efficient company would incur. We have challenged SES's power costs using comparative techniques which allow us to compare their relative efficiency to other companies in the sector.

159. We used our power econometric model to assess SES's power costs as we considered that it allowed us to make an objective, quantitative assessment of both SES's energy efficiency and procurement performance relative to that of the other companies, who had all faced similar electricity price challenges. The power model is well established and is validated by our econometric adviser, Professor Mark Stewart.
160. In modelling SES's performance up to 2007-08 we used power costs reported as part of the June return (we use the information collected annually in June returns to inform our annual monitoring). For 2008-09 and 2009-10 we used the power costs forecasts that companies provided in their draft business plans as part of the PR09 process.
161. For each year of the five year period we looked at how far SES's power costs were from those of the benchmark company, and what reduction in costs would be required for SES to achieve that benchmark performance.
162. When assessing SES's power performance in our econometric modelling we made a 10% adjustment to all companies' residuals to take account of uncertainties in data. This is consistent with the adjustment we apply to our combined, overall efficiency model, which was based on information provided by Professor Mark Stewart.
163. In its submission SES considers that the results of our econometric modelling are irrelevant, as "There is no reason to believe that SESW would have varied relative to the efficiency frontier from 2008/09 to 2009/10 for any reason other than the impact of its power procurement contract."
164. We acknowledge that SES's decision on its procurement strategy will have affected its performance in the power model, particularly in 2009-10. However, the power model is designed to capture companies' total energy cost performance, including procurement and energy usage management performance. We consider that both the price paid for inputs and how efficiently those inputs are used are legitimate areas to review when assessing companies' performance. We consider that companies have control over both these aspects of costs in the same way that they do for all areas of the business (eg, chemicals, materials). It is correct that our assessment is designed to maintain incentives on companies to manage both aspects. If input prices were simply seen as a cost passed to consumers then there would be little incentive for companies to manage procurement efficiently.

## Quantitative review - comparison to a similar company

165. The second strand of our quantitative analysis was to compare SES's performance to that [X] which is a significant driver of companies' power costs and one of the explanatory variables in our power model<sup>36</sup>.
166. In making the comparison we compared SES's performance against [X]
- [X]
  - comparing the relationship between power cost and the unit costs of water delivered in 2009-10 for the two companies.
167. We made the comparisons in the final year of the period to provide a check against our econometric model, which for 2009-10 was based only on forecast data.
168. The econometric and unit cost comparisons generated reductions in power costs in SES's substantial effect application of 40% and 50% respectively.

## Overall assessment

169. Having considered all the strands of our analysis, we applied the following challenge to SES's claim.
- For the first four years (2005-09) we excluded costs from SES's claim that represented the distance between its costs and the benchmark company as determined by the power model for each year.
  - For 2009-10 we applied a single cost reduction of [X] based on the evidence of our range of analysis.
170. We considered that it was appropriate to reduce SES's costs by the amount the power model suggested for 2005-06 to 2008-09 as it provided a robust overall assessment of both SES's procurement and management performance. The cost reductions suggested by the model were supported by the other strands of our analysis.
171. In 2009-10 we decided to make a more conservative reduction to the company's costs than our analysis suggested as we used forecast data (2008-09 data from companies' business plans was based in part on actual costs). We therefore applied a [X] downward adjustment to its 2009-10 costs.

## **Revenue**

172. As with power, our approach is set out in our initial submission and our final determination letter. In short, we considered the factors that had driven the variance between outturn and forecast, whether prudent management action

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<sup>36</sup> Pumping head is a measure of how much the water in the system is pumped (companies in hilly areas will require more power to move water around for example)

would have avoided the shortfall identified by the company and the appropriateness of the company's forecasts for revenue for the remainder of the period.

173. Our challenge to SES' revenue data built on the approach we used in Northumbrian Water and Bournemouth and West Hampshire Water's substantial effect applications in 2003. We considered the challenges applied in those cases and considered each company's specific circumstances.
174. As a result of our analysis we reduced the size of the revenue shortfall SES included in its application.

#### Special agreement income for Gatwick Airport

175. In analysing SES's revenue claim, we identified that the company had not charged tariffs to Gatwick Airport in line with our PR04 forecasts. We therefore assumed that SES had recovered revenue in line with the assumptions we used when we set its price limits for 2005-10.
176. SES has raised concerns about our approach to income from Gatwick in both its representation on our draft determination and its submission to the Competition Commission.
177. However, ahead of PR04 we explained that, unless companies could demonstrate, using average accounting costs, that the prices paid by large consumers were cost reflective we would make a standard assumption on the extent to which prices to large consumers would increase relative to K factors for consumers within the tariff basket. [✂]
178. [✂]
179. [✂]
180. We therefore maintained the existing tariff differential. That is prices for these consumers would increase by 75% of the K for tariff basket consumers plus RPI for each year.
181. In addition, SES has a published standard tariff for large users, the charges for which are 25% lower than for household consumers. [✂]
182. Our position is that a company should not price below average accounting costs. If it does, shareholders, rather than consumers, in general should bear the shortfall in cost recovery.
183. SES has also argued, in its written representation, that following Ofwat's pricing structure could have resulted in losing the contract, leaving other consumers facing higher prices to cover the shortfall. It argued that the agreement was the result of competitive negotiations. We would note that:

- In our PR04 methodology paper we stated that "we expect companies to manage any changes in their revenues from competition within the existing price limits<sup>37</sup>".
- Water resources in the South East of England are stretched. [✂]
- [✂]

184. Our approach is consistent with a similar issue in Bournemouth and West Hampshire Water's substantial effect claim

### Total revenue

185. In its submission SES argues that its revenue circumstance is based only on shortfalls around retail water income and that we were wrong to include items like rechargeable works and assess its shortfall against all appointed business revenue.

186. Our draft and final determinations of its application were based on its revenue shortfall against all appointed revenue. SES made no comment on our approach in either its written or oral representations on our draft determination. In addition, SES's original application to us framed its revenue circumstance in terms of 'loss of income' not 'loss of retail water income'.

187. We consider that it is appropriate to include all the revenue the appointed business receives in our assessment of its revenue shortfall. If we did not adopt this approach then it is possible that:

- consumers could be paying for costs that the company incurred but not benefiting from the income it received; and
- our financial modelling would include costs but not the associated income, and so the company's financial position would appear worse than was actually the case.

188. Our approach is consistent with the approach we adopted for both Northumbrian Water and Bournemouth and West Hampshire Water's substantial effect applications. In both cases we considered all income of the appointed business and excluded income from the non-appointed business. (We note that the data we used in determining SES's application was extracted from SES's draft business plan, in which we instruct companies to only include income related to the appointed business.)

## **Assessing whether price limits needed to change**

### **How we assess a company's ability to finance its functions at a periodic review**

189. In determining whether price limits needed to change we:

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<sup>37</sup> Section 7.29 *Setting water and sewerage price limits for 2005-10* (Ofwat ref: 07a)

- modelled the cost changes (after excluding avoidable costs) arising from the circumstances in 2008-09 and 2009-10 using our financial model;
  - modelled SES's financial position using an approach consistent with our general approach to price setting;
  - assessed SES's financial position for the period until we next set price limits; and
  - based our decision on the ability of the company to finance its functions for that period.
190. Our approach is set out in more detail in our initial submission and our final determination letter.
191. Our approach to financing functions at a five year review has been clearly set out in our methodology statements and accurately referred to by SES. It is carried out in light of our section 2 WIA duties. We have a duty to act in a way which we consider is best calculated to secure that companies are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of their functions as appointed undertakers. When we apply this duty we do so in the light of the particular circumstances of the case. At a periodic review we interpret this duty as having two strands. One is to secure that, if a company is efficiently managed and financed, it is able to earn a return at least equal to the cost of capital. The second is that its revenues, profits and cash flows must allow it to raise finance on reasonable terms in the capital markets. We refer to this second strand as financeability. This is not a 'statutory test' as SES suggest<sup>38</sup>.
192. Determining a forward looking cost of capital for a five year period is not a mechanistic process. There are several models and sources of evidence to draw on, which help to inform our decision but there is an element of judgement because some data requires interpretation.<sup>39</sup>

### **How we assessed SES's ability to finance its functions for a substantial effect determination**

193. The substantial effect clause confers discretion on Ofwat to consider what, if any, change should be made to price limits if the materiality threshold is met. It is not prescriptive (compared with the standard IDoK)
194. The cost of capital that we set at a price review needs to be sustainable over the five year period and investors must have adequate comfort in the transparency of the regulatory regime to invest in the sector over the long term. For example, bond investors have invested in very long maturity debt and equity investors in the sector generally have a relatively long term investment horizon. However we do not consider that investors (both debt and

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<sup>38</sup> Paragraph 137 of SES's submission to the Competition Commission.

<sup>39</sup> Our approach to, and decisions on, the cost of capital at PR04 are set out in full in our PR methodology and final determination documents (document references 07a and 07b respectively)

equity) take a short term view, and are not unduly influenced by changes in the return in individual years, particularly when a company's financial profile is adequate.

195. Having assessed the relevant costs SES faced (see sections on power and revenue), we then considered the rate of return and package of financial indicators that this would imply for SES for 2009-10. [✂] We consider this to be acceptable, particularly given the adequate financial position shown by the package of financial indicators. We also took account of the exceptional nature of the substantial effect clause and the short time period to the next price review. We believe investors would take a longer term view of the position of a company and would not expect to see returns in each year exactly matching the cost of capital allowed at a price review.
196. We concluded that SES is financeable. We considered the financing requirements for the remainder of the current period and the fact that price limits (and consequently all assumptions and costs) will be reset in 2010. We consider that in this short period SES would be in a position to raise additional funding if required.

#### **How we took into account the impact of earlier years**

197. SES argues that historic costs should be taken into account. In fact our approach to financial modelling in the determination did take into account the impact of the additional costs and revenue shortfall in earlier years. This is because we took a starting position for modelling which is based on the company's actual costs and revenue performance. Consequently the cash flow impact of out or under performance is built into the financial position when we project forward using our forecasts to reach a decision on requirements for the remainder of the period.
198. In contrast the company's approach simply recovers all underperformance for all years. As we have set out, we believe our approach reflects the appropriate balance of incentives. It accounts for the impact of actual performance on cash flows but, does not guarantee a return, it retains the incentives on companies to manage costs in all circumstances.

#### **Restoring the return on capital**

199. SES argues that an analysis of the duty to finance functions means that in considering what change should be made to price limits it must earn at least its cost of capital in every year.
200. Section 2(2A)(c) WIA requires us only to exercise and perform our powers and duties in the manner we consider is best calculated to secure that companies are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of their functions as undertakers. The licence does not prescribe or define 'reasonable'. What is 'reasonable' will depend on all 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. Because, as we explain at paragraph 28, price limits reflect actual costs the imminence of PR09 is also a relevant factor. At a periodic review we consider that a reasonable return is a return equal to a cost of capital but we accept that returns may vary up and down in between. SES incorrectly reads across our general approach (as set out in our methodology for setting price limits) for a five year future period to its substantial adverse effect claim.

201. A substantial effect claim is not a periodic review and we have satisfied ourselves that SES can finance its functions for the period until price limits are reset. Ofwat must act in accordance with its duties under section 2 WIA in the light of the particular circumstances of each case.
202. Allowing SES greater resources than those which are needed in order to finance its functions is not consistent with our duty to further the consumer objective. This would be the consequence of SES's claim.
203. As set out in paragraphs 52 to 54, SES seeks to conjoin the operation of standard IDoKs and substantial effect clauses. It is worth noting that in relation to standard IDoKs, companies' licences are not all the same. For the majority of companies including SES's, standard IDoKs contain no reference at all to 'reasonable returns on capital'. The licence states:

*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 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 investors and creditors would reasonably expect of a properly managed company holding the Appointment, whose sole business consists of being a water undertaker and having its equity share capital listed on the London Stock Exchange."*

204. The key financial indicator for these companies (including SES) is a simple interest cover in a standard IDoK. For all other companies the key financial indicator is the rate of return. It is clear therefore that even for a standard IDoK when determining changes in price limits the rate of return is not, as SES might suggest, absolute.

205. Our section 2(2A)(c) duty does not mean, as SES asserts, that ‘Ofwat is obliged to restore returns for each of the years concerned and for Ofwat not to do so would amount to a breach of its duty for such years’ (emphasis added). They do mean that we need to satisfy ourselves that the company has sufficient resources until price limits are next formally reset i.e. the forward looking period up until 1 April 2010. This is what we did.
206. In reaching this conclusion we have looked at the company's returns and financial ratios as a package and have come to a view as to whether the company is able to fulfil its obligations. We do not consider that this requires us as part of a substantial effect determination to restore SES's returns to the levels assumed at PR04. We are satisfied that on the basis of the financial position set out in the final determination the company can finance its functions at least until we reset price limits at PR09. We will of course come to a view on the appropriate cost of capital for SES as part of the PR09 process.
207. The company asserts that, in reaching our decision, we did not take account of the return on capital and our determination letters either ignored or only mentioned the return on capital.
208. The return on capital was part of the package of indicators on which we made our judgement. It was included in the table of indicators described to the company in the draft determination. We clarified this point in the final determination stating that:
- “In assessing your application we have given less weight to the return on capital than we might at a review, but this does not equate to ignoring the return on capital.”*
209. SES argues that, in our determination, we have interpreted a reasonable rate of return as one that just allows the company to avoid financial default. This is not the case.
210. While the reported return in the final determination [✂], lower than forecast at PR04 we are satisfied that it, and the related package of financial indicators, are adequate. We explained to SES that in making that decision we considered:
- The short period until prices are next set (one year rather than the five years covered by the price review). At this point the company's costs and revenues are reset to reflect its actual performance and the company bears no further risk.
  - That the company did not need to raise any capital but even if it did it would be able, on the basis of the package of indicators in the final determination, to do so.
211. We note that the credit rating agency Moody's Investors Service does not consider that our final determination has impacted the credit quality of SES and hence its ability to access capital markets:

*“Moody's notes, that Ofwat's decision to reject the company's application for an interim price determination does not affect SES's underlying bond rating of Baa1, which reflects the combination of SES's business and financial risk profile, the latter also being subject to financial covenants, which limit the company's ability to increase leverage.*

*Moody's expects the company to maintain a financial profile in line with its financial covenants until the end of the current period, despite certain cost pressures. However, we also assume that these cost pressures will be assessed by the regulator at the 2009 price review.*

212. SES argues that investors require clear signals about the rate of return they can reasonably expect to earn over the medium term. We agree and this is what we consider when we set price limits at a periodic review. However, in between periodic reviews returns could vary. The return in each year of the review could be lower or higher than forecast - this is the risk companies and consumers face within the regime. However, we consider that investors do not take a short term view, and are not unduly influenced by changes in the return in individual years, particularly when a company's financial profile is adequate and that companies' actual costs are reflected in the price limits we set at a future periodic review.
213. An important point to clarify is that in arriving at the financial ratios for the final determination we have modelled cash interest payments to debt investors and dividend payments to shareholders using the assumptions we made at PR04. We have not assumed any reduction in cash payments to debt providers or equity providers in our assumptions. We have been able to conclude that the company remains able to finance its functions because it has an adequate financial profile whilst maintaining its payments to capital providers at the levels assumed at PR04. [✂]

## **Financial indicators**

214. When we assess company's financial performance against financial indicators we do so as part of a package. Of particular concern in the medium term is that gearing (on a notional basis) measured as the ratio of debt to regulatory capital value should remain within the PR04 gearing range (below 65%).
215. Beyond that there is no priority ranking system as such because there is no consensus in the use or definition of financial ratios between the rating agencies and within capital markets generally. And in addition, the credit rating agencies are clear that ratings are based on a broad assessment of the company, not simply a quantitative assessment of the ratios.
216. The adjusted cash interest cover II ratio (capital expenditure ratio) is perhaps less important for the substantial effect application because the ratio suffers

from the effect of lumpy capex spend. For the substantial effect application we used SES's capex projections for 2008-09 and 2009-10, which included higher capex than set at final determination at PR04 because the company had reprofiled its capex programme. We did not therefore give this ratio much weight in our decisions on the substantial effect claim.

217. Financial ratios explicitly used by equity investors (eg long run dividend cover, dividend yield) are also used at price reviews - again their medium term nature means they are less helpful in short run analysis as in this case.
218. On the basis of the same financial ratio package that was used for PR04, we concluded that, as a package, the financial ratios for SES are consistent with investment grade status. We considered the level of the ratios in the package was adequate.
219. SES argues that we have 'lowered' the financial ratios used at PR04. 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 the range we used at PR04 and would allow the company to access the capital markets. At PR04 in making our determination for SES we stated that:

[✂]

220. Moreover it is important to note that our PR04 ratios did not represent a floor below which we considered companies as unfinanceable. We accepted that returns and indicators could 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). We did not underwrite the indicators over the period.

### **The use of a notional financial structure**

221. We modelled SES's financial position using a notional financial structure that was in our view, consistent with the risk profile of the industry (rather than the company's actual position). This is also the approach we take at periodic reviews. We adopted this approach because we believe that management and investors choice of capital structure and corresponding specific financial risk sits with companies. Such an approach is entirely consistent with our approach to previous substantial effect applications and our approach at previous periodic reviews.
222. Such an approach ensures that the sort of 'moral hazard' SES refers to (paragraphs 301- 303 for example) would not be an issue as our decision on whether to adjust price limits is not influenced by an individual company's particular capital structure.

*"Each company's management is free to choose its own capital structure. We must be satisfied that customers are protected from any undue additional risk*

*arising from a particular structure and that companies remain able to access the capital markets readily and at reasonable cost to finance present and prospective capital programmes. We have said that if these highly geared structures increase the level of, for example, refinancing risk then this is a matter for the shareholders of, and lenders to, the companies that adopt these structures, not their customers.”<sup>40</sup>*

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<sup>40</sup> Setting water and sewerage price limits for 2005-10: framework and approach (Ofwat ref: 07a)

## Annex 1 The substantial effect clause

*"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."*

## Annex 2 Detailed history of the substantial effect clause

### Background and history

223. The substantial effect clause is set out in sub-paragraph 13.3 of Condition B of SES's Appointment. It is an exceptional jurisdiction and can only be invoked on the basis of a substantial effect on turnover. The substantial effect clause sets out a two stage process. Firstly, there is a jurisdictional question as to whether the materiality threshold has been reached (i.e. whether any circumstance has occurred which has or will have a substantial adverse or favourable effect as defined in Condition B). If the materiality threshold has been reached, then Ofwat proceeds to consider the second question about what change should be made to price limits (the Adjustment Factor).
224. The changes in the substantial effect clause across the water industry are summarised in the timeline below:

<b>August 1989</b>	Original appointments of water only and water and sewerage undertakers granted on privatisation by the Secretary of State for the Environment or the Secretary of State for Wales include a one-way substantial adverse effect clause (that is Ofwat cannot use to recover a substantial favourable effect).
<b>1993/1994</b>	Each company is offered the option of accepting a "two-way" substantial effect clause (covering both substantial adverse and favourable effects) or having the clause removed completely. Some companies (including what is now SES) chose the former, others the latter.
<b>2000</b>	The standard IDoK materiality calculation was modified to its current form in 2000 (to extend the period for assessing operating costs and revenue losses from five to fifteen years). This change affected the materiality calculation for substantial effect applications, which had been the same (with different thresholds) since 1994. This was not the intention and was not consulted on at the time.
<b>January 2001</b>	Ofwat consults on the possibility of incorporating the substantial effect clause into the licences of the 12 water companies <sup>41</sup> which did not then have it <sup>42</sup> (following a request in relation to Dwr Cymru Cyf (Welsh Water) to have the clause included in tis licence). (MD 167 Ofwat ref: 19bg)
<b>2002</b>	As a result of the January 2001 consultation and responses, the substantial effect clause was inserted into the licences of those water companies (except for Thames Water Utilities Limited and

<sup>41</sup> Excluding Albion Water Limited, which was appointed in 1999 to supply water to one large non-domestic customer in north Wales and for which price limits have therefore not yet been necessary.

<sup>42</sup> The 12 water companies which did not then have the substantial effect clause in their licence were Dŵr Cymru Cyfyngedig (Welsh Water), Northumbrian Water Ltd, Severn Trent Water Ltd, Southern Water Services Ltd, Thames Water Utilities Ltd, United Utilities Water plc, Wessex Water Services Ltd, Bristol Water plc, Cambridge Water Company Plc, Dee Valley Water Plc, Portsmouth Water Ltd and South Staffordshire Water Plc.

	United Utilities Water plc ) who did not then have it.
<b>2004</b>	Ofwat consulted (MD 189 Ofwat ref: 19bc) on a number of licence modifications, including a proposal to return the substantial effect materiality calculation to its original form (following the first substantial effect applications in 2003). Some companies opposed the proposal and Ofwat subsequently decided (MD 194 Ofwat ref: 19bd) not to pursue this proposal at that stage.
<b>2005</b>	The substantial effect clause was inserted into the licences of Thames Water Utilities Limited and United Utilities Water plc.

At privatisation in 1989 all water companies had a version of the substantial effect clause in Condition B of their Appointments that only applied to adverse effects. The wording in relation to adverse effects was essentially the same (although the current version of the substantial effect clause now includes a specific materiality test by reference to some of the questions used to calculate a standard IDoK (sub-paragraph 13.2(7) of SES' Condition B)). For example, paragraph 13.3 of Condition B of SES' Appointment at privatisation provided that the relevant questions were:

*"Both of the following:*

*(2) whether any circumstance which has a substantial adverse effect on the Appointed Business or on its assets, liabilities, financial position, or profits or losses, has occurred, not being one which would have been avoided by prudent management action taken since the transfer date; and*

*(3) if so, what change should be made to the Adjustment Factor.*

*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."*

There was therefore the same two stage process of answering the questions of (i) whether the effect was material and (ii) if so, Ofwat having discretion to consider what, if any, change should be made to price limits. The position was summarised at the time by the Department of the Environment:

*"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>43</sup>*

<sup>43</sup> See paragraphs 16 and 17 of the confidential explanatory notes the Department of the Environment attached to its letter dated 25 October 1989 (Ofwat ref: 01d)

In 1994 the licences of water companies<sup>44</sup> were amended to reduce the number of grounds for adjusting charges between five-yearly price reviews. In announcing the proposed amendments (Ofwat news release 1/94 – included with this submission Ofwat ref: 19bh), Ian Byatt, the then Director General of Water Services, said:

*"I welcome these moves and believe that the interests of each company and its customers would be best served if most changes in price limits were made at a Periodic Review. This should provide a stable basis on which each company may draw up its expenditure plans. It would enable revenue to grow more steadily, investment to be reasonably stable and assets to be renewed in a steady and sustainable way.*

*"Customers will also benefit through more predictable price changes".*

The number of Relevant Changes of Circumstance for standard IDoKs was reduced from 8 to 3 or 4 (depending on the company). In addition, the substantial effect clause (referred to at the time as the "Long-Stop Provision") was either deleted or amended to make it a two-way process, so that either the company or Ofwat could seek to revise price limits in unforeseen circumstances. Ten companies (including what is now SES) agreed to the two-way clause in 1994.

Ofwat consulted on the possibility of incorporating the substantial effect clause into the licences of all water companies in January 2001 (MD 167 Ofwat ref: 19bg). Glas Cymru Cyf, a company limited by guarantee that would be wholly debt-financed, announced in November 2000 that it had agreed terms for the acquisition of Dwr Cymru Cyf (Welsh Water). As part of its proposal, Glas Cymru sought some modifications to Welsh Water's licence, including the insertion of the two-way substantial effect clause. After consideration of this request, Ofwat concluded that there was no significant difference in regulatory impact between those companies that had the clause and those that did not. In either case, Ofwat would have to consider on its merits a case for revised price limits following a very material operational or financial shock which was not attributable to any fault of management:

*"In reviewing the request from Glas Cymru, I have looked for differences in regulatory impact between those companies which have the clause at present and those that do not. I have not found any significant difference. For example, the perception of risk by investors in those companies that have retained this clause does not seem to be lower than that for companies which have not.*

*"I have further considered what practical difference the presence or absence of the shipwreck clause would make should a company find itself obliged to make a case to me for revised price limits following upon some very material operational or financial shock which was not attributable to any fault of management. Whether or not the clause was included in a licence I would, in pursuit of my duty to ensure that a company could finance its functions,*

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<sup>44</sup> With the sole exception of Cholderton and District Water Company Limited, which is an exceptionally small water undertaker supplying water to approximately 800 properties in several parishes on the Hampshire/Wiltshire border.

*have to consider the case for revised price limits on its merits. If I was persuaded that a change was necessary – and I should in either case need strong evidence that the need for the remedy had not arisen from the company's mismanagement – then I would still be able to revise an Appointee's price limits even in the absence of the shipwreck clause. I would do so through a licence modification to change the K factors for that Appointee."*

Northumbrian Water Limited made the first ever application under the substantial effect clause for revised price limits in September 2003 (at the same time as a standard IDoK application). Bournemouth and West Hampshire Water then made the second application in November 2003. We publicly set out our approach to substantial effect applications in Annex A to each final determination on these applications (published in December 2003 and February 2004 respectively). These final determinations therefore made clear to the industry and other stakeholders that each application would be considered on its merits and that a material application might not result in any change to price limits:

*"The **substantial effect** clause allows a company to ask us to consider what change should be made to the Adjustment Factor where a circumstance has occurred which has, or will have, a substantial adverse effect on the Appointed Business or on its assets, liabilities, financial positions or profits or loans which would not have been avoided by prudent management action. On receipt of an application under [the substantial effect clause] we will therefore consider two questions:*

- ***Does the company have a material case that we must consider?***
- ***If the company has a material case what change do we consider should be made to the Adjustment Factor?***

*[...]*

*Once materiality is established we have discretion in determining what change should be made to the Adjustment Factor. [The substantial effect clause] is not mechanistic in calculating the change to the Adjustment Factor in the way [...] for standard interim determinations because [the substantial effect clause] must be capable of dealing with a range of unforeseen events. It allows greater flexibility when considering what change should be made in the specific circumstances that a company believes are causing a substantial adverse effect.*

*We will first consider the impact of a substantial effect on a company's ability to finance the proper carrying out of its functions, with reference to the Director's duties under Section 2 of the Water Industry Act 1991.*

*For example, in determining what change should be made to the Adjustment Factor we will look to ensure that it strikes the appropriate balance between:*

- *ensuring the financing of proper carrying out of functions;*

- *protecting customers' interests; and*
- *promoting economy and efficiency.*

*It may be that following detailed analysis and proper consideration of all of the Director's Section 2 duties we might decide that a material application should not result in any change to the Adjustment Factor.*

*Alternatively we might apply a smaller adjustment than that claimed by a company, if we were satisfied that, on the facts, a company would still be able to finance its functions with the smaller than proposed change to the Adjustment Factor."*

In the Northumbrian Water Limited and Bournemouth and West Hampshire Water plc final determinations, we also explained that we intended to consult on possible amendments to the substantial effect clause along with other possible amendments to Condition B in advance of the 2004 Periodic Review final determination of price limits for the 2005-2010 period.

A consultation on, among other things, a proposal to change the **materiality** calculation (i.e. the first question in the two stage process under the substantial effect clause) was published in March 2004 (MD 189 Ofwat ref: 19bc). The calculation for materiality for substantial effect applications was introduced in the 1994 amendments (for those water companies that agreed to the two-way clause) and used the same process as for a standard IDoK, except that the materiality threshold for the former (20% of turnover) is higher than for a standard IDoK (10%). When the standard IDoK materiality calculation was modified to its current form in 2000 (to extend the period for assessing operating costs and revenue losses from five to fifteen years), this therefore also affected the materiality calculation for substantial effect applications. This was not the intention and was not consulted on at the time. As a result, it is now easier to meet the materiality threshold for a substantial effect application. We therefore proposed to modify the substantial effect clause to restore the materiality calculation to its pre-2000 form. Some water companies opposed the proposal and Ofwat subsequently decided (MD 194 Ofwat ref: 19bd) not to pursue this proposal at that stage. No subsequent modifications have yet been made to the wording of the substantial effect clause.

## **Annex 3 – Standard IDoKs – Relevant Changes of Circumstance and Notified Items**

The relevant provisions of Condition B of SES's licence are set out in Annex 4, but the Relevant Items and the standard IDoKs since 2004 are set out below. Standard IDoKs are available to water companies provided that each of the matters at issue is a Relevant Item – that is, either a Relevant Change of Circumstance or a Notified Item.

### Relevant Changes of Circumstance

The Relevant Changes of Circumstance are defined in Condition B. The standard ones are:

- RCC(1): a new or changed legal requirement (each of these is also defined);
- RCC(2): differences in the proceeds of land disposals from that assumed when price limits were last set; and
- RCC(3): failure to achieve some output, funding for which was provided at the last price setting.

A few companies (not including SES, which agreed to its deletion in 1994) have a fourth – RCC(4) – changes in the construction price index (COPI) from what was assumed at the last price setting.

### Notified Items

Notified Items are anything that, at a price setting, we have recorded specifically as having not been allowed for (either in part or at all). There are currently five. They cover:

- changes up or down in the number of meter optants;
- increases in household bad debt and the costs of managing household debt;
- increases in charges for abstractions and discharges to controlled waters;
- charges for lane rental/traffic management; and
- increases in the taxation of infrastructure expenditure arising from the introduction of International Financial Reporting Standards (IFRS).

### Standard IDoKs since 2004

Since 2004, when the last five-yearly price review took place, there have been two standard IDoKs, both of which took place in 2007.

Bristol Water plc's application covered the additional costs and/or loss of revenue resulting from the following four items:

- a greater number of customers taking up the free meter option than was allowed for in the 2004 final determination (Notified Item);
- increases in bad debt and the costs of managing bad debt (Notified Item); and
- increases in charges for abstractions from and discharges to controlled water (Notified Item).

Dee Valley Water Plc's application covered the additional costs and/or loss of revenue resulting from the following four items:

- a greater number of customers taking up the free meter option than was allowed for in the 2004 final determination (Notified Item);
- increases in bad debt and the costs of managing bad debt (Notified Item);
- increases in charges for abstractions from and discharges to controlled waters (Notified Item); and
- additional expenditure for the protection of assets (Relevant Change of Circumstance).

## Annex 4 – Standard IDoKs

### **"Part IV. Interim Determinations**

#### **12. Matters of interpretation and construction which apply for the purposes of this Part IV**

##### **12.1 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 Appointment whose sole business consists of being a water undertaker and, without excluding other considerations which may also be relevant, having its equity share capital listed on The International Stock Exchange of the United Kingdom and the Republic of Ireland Limited, 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 14 when it determines questions referred to it by the Appointee under paragraph 13);

**"equity share capital"** has the same meaning as in the 1985 Act;

**"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 13 or pursuant to paragraph 14 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 subparagraph 15(2) or 15(3), which relates to a reference by the Appointee under paragraph 13 or a determination pursuant to paragraph 14;

**"making a Relevant Determination"** means determining the Adjustment Factor initially or determining, in carrying out the most recent Periodic Review or making any subsequent Interim Determination (or, where there has been no Periodic Review, in making any Interim Determination) whether the Adjustment Factor should be changed (and, if so, what change should be made to the Adjustment Factor), and **"Relevant Determination"** shall be construed accordingly;

**"Net Present Value"** means the net present value calculated as at 30 September in the year in which the relevant Reference Notice is given or, where in any year no Reference Notice is given under paragraph 13 but the Water Services Regulation Authority gives a notice to the Appointee under paragraph 14, as at 30 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 30 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 should be changed (and if so what change should be made to the Adjustment Factor), 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 determining the Adjustment Factor initially or whether the Adjustment Factor should be changed (and if so what change should be made to the Adjustment Factor); 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 determining the Adjustment Factor initially or whether the Adjustment Factor should be changed (and if so what change should be made to the Adjustment Factor)*

*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 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 the Appointee has determined to make a change to the basis on which it charges customers for water supply 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 from 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;*

*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.*

12.2 *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 (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 Communities to the extent that it applies to the Appointee in its capacity as a water undertaker, or decision taken by the said Commission which is binding on the Appointee in its capacity as a water 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 Environment Agency or other body of competent jurisdiction to the Appointee for the purpose of carrying on any of the functions of a water 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 determining the Adjustment Factor or, as the case may be,*
- (B) *in determining whether the Adjustment Factor should be changed (and if so what change should be made to the Adjustment Factor)*

*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.*

12.3 *In paragraph 13 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 subparagraph (1) above, "Operating Expenditure" in subparagraph 13.2(6) includes those items currently so identified in Regulatory Accounting Guidelines 3 and 4 and in the July Return 1999 Reporting Requirement, line 22 in table 21. 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.*

12.4 (1) *For the purposes of sub-paragraphs 13.2(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*

13.1, or the Water Services Regulation Authority gives notice under sub-paragraph 14.1(1).

(2) In sub-paragraphs 13.2(8) and 13.2(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 13.1, or the Water Services Regulation Authority gives notice under sub-paragraph 14.1(1), up to and including that prevailing, or expected to prevail, on 30 September in the year in which the Base Cash Flow or depreciation occurred, or is expected to occur.

(3) In sub-paragraph 13.2(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.

12.5 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 Adjustment Factor to allow for Notified Items and Relevant Changes of Circumstance.

### **13. References to the Water Services Regulation Authority relating to Notified Items and Relevant Changes of Circumstance [...]**

13.1 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 13.2 [...]. 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 13.2, shall be given in accordance with sub-paragraph 13.4. For the purposes of sub-paragraph 13.2 a single reference may be made in respect of any number of Notified Items and Relevant Changes of Circumstance and sub-paragraph 13.2 shall be construed accordingly.

13.2 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;*
- (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 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 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 the 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 Adjustment Factor was last determined; 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 13.1;*

- (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 13.4 or paragraph 14;*
- (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 over the period from the beginning of the first of the Charging Years referred to in sub-paragraph 13.4(1) (in any case where a Reference Notice has been given in respect of sub paragraph 13.2) or sub-paragraph 14(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, the 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 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 investors and creditors would reasonably expect of

*a properly managed company holding the Appointment, whose sole business consists of being a water undertaker and having its equity share capital listed on the London Stock Exchange."*