

**WATER SERVICES REGULATION AUTHORITY
WATER INDUSTRY ACT 1991, SECTION 12**

SUTTON AND EAST SURREY WATER PLC

Notice of Reference: Substantial Effect Interim Price Determination

5 March 2009

1. (a) Sutton and East Surrey Water plc (“the Company”) holds an Appointment as a water undertaker for the purposes of Part II of the Water Industry Act 1991 (“the Appointment”);
(b) on 16 December 2008, the Water Services Regulation Authority (“Ofwat”) made a determination (“the Disputed Determination”) of the questions set out in sub-paragraph 13.3 of Condition B of the Appointment. The terms of the Disputed Determination are set out in Schedule 1 hereto;
(c) the Company has required Ofwat to refer the Disputed Determination to the Competition Commission (“Commission”). The terms of the Company’s notice are set out in Schedule 2 hereto.
2. Ofwat, as required by section 12(3)(a) of the Water Industry Act 1991 and the Appointment, refers the Disputed Determination to the Commission.
3. The Commission shall report on and determine the Disputed Determination within a period of six months from the date of this reference.

**Signed for and on behalf of the
Water Service Regulation Authority**

**Regina Finn
Chief Executive**

Schedule 1

Mr N Fisher
Managing Director
Sutton and East Surrey Water plc
London Road
Redhill
Surrey
RH1 1LJ

16 December 2008

Dear Nick

13.3 Substantial effect application – final determination

Background

On 5 November 2008 we published our draft determination of Sutton and East Surrey Water's application under paragraph 13.3 of Condition B ("the substantial effect clause") of its Appointment ("licence").

Sutton and East Surrey Water submitted its application on 17 September 2008 asking that price limits be increased to 10.2%, before inflation, in 2009–10 to recover costs related to two circumstances which you argued were beyond the company's control:

- increases in power costs, in particular electricity costs; and
- the loss of income from customers using less water than assumed when we last set price limits.

The company had calculated the materiality of these two circumstances to be 65% and 41% of turnover respectively according to the method set out in the licence.

Our draft determination explained that while we found that both circumstances were individually above the 20% materiality threshold, we considered that price limits did not need to change.

Representations received

We received a number of responses to our draft determination. CCWater supported our draft determination decision, arguing that customers should not be required to pay any more for the 2005–10 period than previously agreed. We also received correspondence from Members of Parliament supporting our draft determination.

We received both written and oral representations from Sutton and East Surrey Water. In those representations you explained your position which was that the company's original request to increase price limits in 2009–10 from –1.1%, before inflation, to +10.2%, before inflation, remained valid. You argued that:

- we should restore the return on capital equal to the cost of capital set in 2004 for the entire period 2005–10,
- we had not proven that the company's actions were not prudent,

- our analysis of whether the company could finance its functions was inappropriate,
- we should restore the operating costs (including those unrelated to the substantial effect) and revenue streams for 2008–09 and 2009–10 to the level that the company had forecast, and
- we should correct our determination for inconsistencies identified during the consultation period.

Your Chairman also wrote to Philip Fletcher raising concerns that, while we had listened to the company's representation we had not explained the basis of our decisions. This letter and annex sets out more detail on our reasoning which we hope will be helpful in enabling you to understand our decisions.

Final determination

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. However, we have made some adjustments to our analysis based on your representations and these are explained later in more detail.

We maintain the view that the increase in power costs and the revenue shortfall were issues that were within management control, that more could have been done to manage them and that risks taken by management are appropriate business risks for the business to bear as it would have retained any benefit that may have accrued from the decision. We have adjusted your application to reflect our view.

After these adjustments we found the power and revenue circumstances were both individually above the 20% materiality threshold for the substantial effect clause. We calculated the net present value of the power circumstance to be equivalent to 21% of the relevant turnover and the net present value of the revenue shortfall circumstance to be equivalent to 25% of the relevant turnover.

In determining whether price limits need to change we have:

- assessed your financial position for the period until we next set price limits; and
- based our decision on the ability of your company to finance its functions for that period.

Taking this approach and having reviewed the outcome of our financial modelling, our final determination is that your price limit for 2009–10 does not need to change as we believe that Sutton and East Surrey Water will still be able to finance its functions until we reset price limits for the period 2010 to 2015.

Consistent with previous substantial effect applications, we treated your case as one to be based on its own particular set of circumstances and we used the discretion granted by the licence to determine what an appropriate change to your price limits might be.

The remainder of this letter explains our position on the major issues that you raised in your representation. The confidential Annex sets out in detail:

- how we have challenged your application;
- a description of how we have determined whether price limits need to increase;
- explanations of how we have taken your representation into account; and

- explanations of why we have retained our current approach.

We also enclose a disc that contains the financial model and interim determination model used by us.

Analysis of the costs and revenues arising from the circumstances of your application

Power

For the draft determination we explained that we believed that the company could have done more to manage its power costs, in other words, this is an issue that we consider was within management control and it was a choice by management as to the strategy adopted and the risks taken. We said that we had commissioned Atkins and had used our econometric models to support our review of your application. Drawing on this analysis we excluded a proportion of your costs. In your representation you disagreed with this.

- You responded to conclusions in the report written by Atkins and asked Black and Veatch to review your operations. They stated that energy usage was efficiently managed and not being managed ‘imprudently’.
- You argued that there was no supporting evidence to our view that the company should have agreed to a two year contract. You further stated that the company took its decision on the basis of advice from recognised experts.
- You believed our use of the power models were flawed, that we had not taken account of the company’s special factors and that our use of the benchmark was inconsistent with our approach to setting efficiency targets.

In light of your representation we have made some changes to our analysis of your power claim which have led to higher levels of opex. But our adjustment to 2009–10 costs remains the same as at the draft determination. Our judgement does not rely on any single piece of evidence but draws collectively on our analysis. We have considered your representations but have not been persuaded that we should modify our approach. In particular we would note that:

- The company representation provided additional information to support your argument that the company used power efficiently. However, it is not clear that the company moved towards best practice or made a step change in its approach to energy management in response to the circumstance (i.e. increasing power costs) as we might expect to see where significant cost pressures were exerted.
- 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. If the company was concerned that a further rise in power costs might place the company under, what it believed to be, unacceptable financial pressure it could have taken a more cautious approach and taken a two year fixed contract. Such an approach would have reduced the risk to both the business and customers. Consistent with our approach to regulation more generally we do not believe that the risk in such circumstances should lie with customers – it is a business risk and should be borne by shareholders.
- Although we have employed the econometric models in a slightly different way compared to price reviews we believe this is reasonable. We are not seeking to set efficiency targets, nor are we seeking to provide incentives to outperform our assumptions, as we do in price reviews.

Revenue

In our draft determination we explained that we made adjustments to revenue data to ensure Sutton and East Surrey Water recovered costs from all customers in a manner that is consistent with the assumptions we used for setting price limits for 2005–10.

In your representation you explained that our draft determination did not reflect the company's actual position and the decisions it had to make. You stated at the time we set price limits that you did not agree with our assumptions.

The assumptions we made when we set price limits for 2005–10 formed part of the package that Sutton and East Surrey Water chose to accept at that time.

The substantial effect claim on revenue relates to the shortfall against the assumptions we made at that time. While the company has chosen to deviate from these assumptions it is appropriate to continue to measure the revenue recovered against the assumption accepted as part of the price limit determination.

We have not changed our revenue assumptions from the draft determination except to correct for inconsistencies identified during the consultation process.

Other issues

In our draft determination we explained that we would consider whether we should deduct from the claim any offsetting savings associated with the circumstances. Our view remains that the complex interaction between power costs and revenue means that, for the final determination, we cannot calculate the net impact with a great degree of certainty. Our view also remains that any impact is not likely to be material.

In line with our approach to the draft determination we have adjusted your data to ensure that any net additional costs and revenue shortfall is calculated against the correct 2004 final determination assumptions.

Determination of changes to your price limits

In our draft determination we explained that:

- The substantial effect clause confers flexibility and discretion on Ofwat to consider what, if any, change in a company's price limits we need to make in cases such as this.
- In making our decision we must consider our duties under section 2 of the Water Industry Act 1991.

After we published our draft determination, Keith Mason wrote to you on 14 November 2008 to provide additional detail on our position. We have now considered the further points contained in your representation in response to our draft determination and Keith Mason's letter.

In your representation you argued that our approach to determining whether a change in your price limits was needed was incorrect. You:

- disagreed with our interpretation of our duties and the way we had assessed whether the company could finance its functions;

- argued that the substantial effect clause did not provide us with the discretion we claimed; and
- argued that we should restore the return on capital to the levels allowed when price limits were last set.

We believe the approach we took at the draft determination continues to be appropriate for the reasons set out below. Consequently, we have taken the same approach as for the draft determination that is to:

- model the cost changes (after challenge) arising from the circumstances for 2008–09 and 2009–10 using our financial model;
- review the resulting financial indicators and financial position; and
- decide if a change to your price limits was necessary for 2009–10 to ensure Sutton and East Surrey Water could finance its functions.

We do not believe that automatically restoring the return on capital to the 2004 final determination allowed cost of capital would be appropriate, especially if the company's financial position showed that it could finance its functions so no restoration was necessary.

We do not consider that the assumptions underpinning the determination of price limits at the beginning of a regulatory period are underwritten by the regulator for the duration of the regulatory period provided that the 20% materiality threshold is met. To do so would undermine the principles of incentive based medium term regulation. It could also, by definition, allow a company more than it needed to finance its functions in the period until the next review. There is no obligation on Ofwat in the licence or section 2 of the Water Industry Act 1991 to restore Sutton and East Surrey Water to the position it would have been in if all the assumptions made at the time of the 2004 final determination had been realised. Consequently, in the exercise of our discretion, we have only considered your position in 2009–10.

Ofwat's duty is to consider whether an adjustment to price limits is needed in order to discharge its obligations under section 2 of the Water Industry Act 1991. In particular this means satisfying ourselves that the company has sufficient resources until prices are next set, even though this may result in a rate of return on capital lower than originally provided for in the 2004 final determination. Allowing Sutton and East Surrey Water greater resources than those which are needed in order to finance its functions is not consistent with furthering the consumer objective.

The representation raised some concern that our use of financial indicators to determine a company's ability to finance its functions was inappropriate. This misunderstands our approach. In reaching our view on Sutton and East Surrey's ability to finance its functions we have considered the wider context, including the forecast return on capital itself, and not just the company's financial indicators.

We have considered your 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 interim period you would be in a position to raise additional funding if required. The published financial information strongly suggests that you do not currently need to access capital given your high level of cash balances and committed liquidity facilities.

Our methodology papers for both the 2004 price review and 2009 price review clearly set out the way in which we assess a company's ability to access financial markets (through consideration of financial indicators). This is a key strand in our judgements as to whether a

company is able to finance its functions. In this specific case, given the exceptional nature of the substantial effect process, the favourable financial indicators and the short time until prices are reset, we believe the return on capital is reasonable and that it does not need to be equivalent to any previously determined cost of capital. 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.

Conclusion

The draft determination we published in November was based on the information available to us at that time and the subsequent consultation period was an important opportunity for us to consider all stakeholders' views on this case.

We are pleased that this provided the company with the opportunity to submit further information to support its case and allowed us to clarify aspects of the application and understand any concerns the company may have had with our approach. For the final determination we have considered all of the representations we received and reviewed the additional data you provided alongside the information in the original application and subsequent query responses.

This letter, the accompanying confidential annex and enclosed disc set out in detail the approach we have taken to your application, how we have considered your representations and the reasons for our decision.

This letter has been copied to Martin Hurst (DEFRA), Jeni Colbourne (DWI), David King (Environment Agency HQ), David Bland OBE (Chairman of CCWater London and South East) and your local Members of Parliament.

REGINA FINN

Encs

Confidential annex to accompany final determination letter



Schedule 2

Sutton and East Surrey Water plc

Water Industry Act: Section 12

Notice to the Water Services Regulation Authority (“OFWAT”) of requirement for reference to the Competition Commission: Price Determination

Pursuant to Condition B, Part V, paragraph 15(3), (c) and (ii) of the Company’s Appointment as a water undertaker (“Licence”), we hereby give you notice that:

- (a) we dispute your Final Determination dated 16 December 2008 of our application dated 17 September 2008 for an adjustment to our price limits under paragraph 13.3 of Condition B (the substantial effect clause) of our Licence; and
- (b) we require you to refer the disputed determination to the Competition Commission for determination by it.

DATED this 9th day of February 2009

(signed) **Nick Fisher**
Managing Director
Sutton and East Surrey Water plc

Condition B of SES's licence—subparagraphs 13.1, 13.2 and 13.3

13. *References to the Water Services Regulation Authority relating to Notified Items and Relevant Changes of Circumstance and circumstances having a substantial effect on the Appointed Business*

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 or, as the case may be, sub-paragraph 13.3. Such reference shall be made by notice given to the Water Services Regulation Authority, which, in the case of the questions set out in sub-paragraph 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.

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.

SES's SAE claim

Our Ref: NJF/LAT/Ofwat

Your Ref:

17th September 2008

Ms R Finn
 The Water Services Regulatory Authority
 Centre City Tower
 7 Hill Street
 Birmingham
 B5 4UA

Dear Ms Finn

**Special Adverse Effect Application under clause 13.3 of the SESW Licence—
Power and Income**

We refer the following matter to the Authority for determination by it.

During the current five-year regulatory period SESW has suffered increases in power costs, in particular increases in electricity costs, and losses of income which have and will have a substantial adverse effect on the Appointed Business and could not have been avoided by prudent management action. In order to correct for this substantial adverse effect, SESW's k factor for the year 2009/10 needs adjusting by 11.3 from -1.1 to 10.2.

Materiality

The increased power costs and loss of income pass the materiality test specified in paragraph 13.3(ii) of SESW's licence.

As requested we have submitted to Ofwat a soft copy of the materiality calculation using its IDOK model. For completeness we have also included our calculation as Appendix 1 to this letter.

Increased power costs

The increase in power costs is due to the increases in the unit cost of electricity. The impact of these increases on SESW for the five years of the current regulatory period is given in the table below. By 2009/10 SESW's power costs, even on lower than anticipated volumes, will be almost two and a half times the amount allowed for in the 2005/10 price determination.

Power costs (2002/03 prices, £000)	2005/06	2006/07	2007/08	2008/09	2009/10
Final Determination	[X]	[X]	[X]	[X]	[X]
Actual	2,455	3,223	2,902	3,088	[X]
Difference	[X]	[X]	[X]	[X]	[X]
Actual as % of Final Determination	[X]%	[X]%	[X]%	[X]%	[X]%

Attached as Appendix 2 is a description of SESW's approach to minimising the use and cost of electricity and information relating to the increase in the cost of electricity. For convenience, the format of the appendix generally follows the matters relating to power costs raised in Ofwat's letter of 1 July 2008.

Loss of income

Over the current five-year period SESW's water income is expected to be almost 3% less than assumed by Ofwat in its Final Determination. In essence, this loss of income has arisen because SESW's customers have used and are using less water than was assumed by Ofwat in its Final Determination. This is particularly clear from the lower than assumed average amount of water used by metered domestic customers. In addition, the rate at which customers have opted to switch to meters occurred sooner than was assumed in the Final Determination.

The following tables provide a good picture of the financial impacts of the reduction in water used and where the reduction has occurred.

Water income (2002/03 prices, £m)	2005/06	2006/07	2007/08	2008/09	2009/10
Final Determination	[X]	[X]	[X]	[X]	[X]
Actual/Forecast	40.713	40.889	41.508	41.080	[X]
Difference	[X]	[X]	[X]	[X]	[X]
Actual as % of Final Determination	[X]%	[X]%	[X]%	[X]%	[X]%
Unmeasured income (2002/03 prices, £m)	2005/06	2006/07	2007/08	2008/09	2009/10
Final Determination	[X]	[X]	[X]	[X]	[X]
Actual/forecast	27.821	27.364	26.463	25.452	[X]
Difference	[X]	[X]	[X]	[X]	[X]
Actual as % of Final Determination	[X]%	[X]%	[X]%	[X]%	[X]%
Measured income (2002/03 prices, £m)	2005/06	2006/07	2007/08	2008/09	2009/10
Final Determination	[X]	[X]	[X]	[X]	[X]
Actual	12.892	13.525	15.044	15.628	[X]
Difference	[X]	[X]	[X]	[X]	[X]
Actual as % of Final Determination	[X]%	[X]%	[X]%	[X]%	[X]%
Number of Domestic Meters (000)	2005/06	2006/07	2007/08	2008/09	2009/10
Final Determination	[X]	[X]	[X]	[X]	[X]
Actual	49.695	57.714	67.243	74.995	[X]
Difference	[X]	[X]	[X]	[X]	[X]
Actual as % of Final Determination	[X]%	[X]%	[X]%	[X]%	[X]%
Consumption per domestic meter (m³)	2005/06	2006/07	2007/08	2008/09	2009/10
Final Determination	[X]	[X]	[X]	[X]	[X]
Actual	124.2	113.8	120.6	115.6	[X]
Difference	[X]	[X]	[X]	[X]	[X]
Actual as % of Final Determination	[X]%	[X]%	[X]%	[X]%	[X]%
Total metered consumption (000m³)	2005/06	2006/07	2007/08	2008/09	2009/10
Final Determination	[X]	[X]	[X]	[X]	[X]
Actual	15,377	15,480	17,287	17,951	[X]
Difference	[X]	[X]	[X]	[X]	[X]
Actual as % of Final Determination	[X]%	[X]%	[X]%	[X]%	[X]%
Total water consumption (000m³)	2005/06	2006/07	2007/08	2008/09	2009/10
Final Determination	[X]	[X]	[X]	[X]	[X]
Actual	52,063	48,835	49,030	49,887	[X]
Difference	[X]	[X]	[X]	[X]	[X]
Actual as % of Final Determination	[X]%	[X]%	[X]%	[X]%	[X]%

Appendix 3 provides more information about the loss of income. Again for convenience, the format of Appendix 3.1 generally follows the matters relating to water income raised in Ofwat's letter of 22 August 2008. Appendix 3.2 includes a full comparison between the assumptions in Ofwat's Final Determination and Actuals of all the elements of the tariff basket and other water income. The tables above have been extracted from Appendix 3.2.

Adjustment/k factor

A k factor adjustment of 11.3, adjusting SESW's k factor for 2009/10 from -1.1 to 10.2, is required to reinstate the returns over the current five-year regulatory period that were determined by Ofwat in its Final Determination. In arriving at this figure we have adjusted for outperformance and underspend outside the areas of power and water income. We have also included an adjustment relating to the increases during the period 2005/10 to SESW's RCV resulting from Ofwat's application of the COPI index to capex (R Lee's letter to N Fisher dated 2 May 2008).

The following table shows the relative magnitude by year of the impacts of increased power costs and reduced income and the various offsets we have made against them.

<i>Figures are discounted at the cost of debt and in 2002/03 prices (£000)</i>	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Income—water	[X]	[X]	[X]	[X]	[X]	[X]
Income—other	[X]	[X]	[X]	[X]	[X]	[X]
Opex—power	[X]	[X]	[X]	[X]	[X]	[X]
Opex—other	[X]	[X]	[X]	[X]	[X]	[X]
Tax paid	[X]	[X]	[X]	[X]	[X]	[X]
Capex—excess return	[X]	[X]	[X]	[X]	[X]	[X]
Capex—excess CCD	[X]	[X]	[X]	[X]	[X]	[X]
COPI increase to RCV—return	[X]	[X]	[X]	[X]	[X]	[X]
Total	[X]	[X]	[X]	[X]	[X]	[X]

In order to correct for the net discounted loss of £[X]m, arising as outlined in the above table during the five-year period 2005/06 to 2009/10, additional income of £[X]m (in 2009/10 prices), or a k factor 10.2 as opposed to the existing k factor for 2009/10 of -1.1, is required in 2009/10.

The supporting information to this table is included as Appendix 4.1.

The required k factor has been calculated using the tariff basket in the Target model that SESW is using for the forthcoming price review. A copy of the output is attached as Appendix 4.2.

CCD and RCV

As can be seen from the previous table, the calculation of the k factor gives credit for the return on the underspend of capex, and the associated reduction in CCD, during the five-year period 2005/06 to 2009/10. However, if these credits are included in the k factor adjustment a corresponding increase of £[X]m (in 2002/03 prices) is required to SESW's RCV at the end of 2009/2010. The calculation of the increase in RCV is included in Appendix 4.1 (Table S4).

The alternative to not adjusting SESW's RCV is to leave the RCV unchanged and to allow the adjustments associated with the delayed capex to flow through in the normal way after five years. However, if this approach is adopted it does require the two capex lines to be deleted from the above table. This would significantly increase the income requirement in 2009/10 and therefore the required k factor for 2009/10. This is not our preferred approach.

For your information a calculation of the income shortfall based on omitting capex and CCD is included as Appendix 4.1 Table S2(a).

CCD has been calculated using the average asset life of [X] years used by Ofwat in its Final Determination for SESW. A copy of our calculation of this average asset life is also included in Appendix 4.1 after the tables.

Figures and assumptions

Most of the figures in this application and which are summarised in the above shortfall table will already be known to Ofwat.

Actual figures for 2005/06, 2006/07 and 2007/08 agree with Regulatory Accounts, June Returns, etc. The only adjustment we have made is in the Opex—other figures in the above table where we have removed the FRS 17 adjustments in 2005/06, 2006/07 and 2007/08 (none have been anticipated in the forecasts for 2008/09 and 2009/10). The FRS 17 adjustment to accounts is a non-cash adjustment and is not part of Ofwat's determination which deals with pensions on a contributions paid basis. Appendix 5 is copies of the regulatory documents referred to in this application.

The forecasts for 2008/09 and 2009/10 agree with the Draft Business Plan ("DBP") with the exception that, because of the wet summer, we are now forecasting significantly lower (6.8% lower) water consumption in 2008/09 than was assumed in the DBP. This has resulted in lower income and power costs than those included in the DBP. The water income figures come from the Target model SESW is using to prepare for the forthcoming determination. As explained in our DBP, the water income figures produced by Ofwat's Reservoir model are incorrect.

You will be aware that this application has already been substantially reviewed on your behalf by SESW's Reporter and that this review will be completed in the near future. We believe the application includes everything needed for the Authority to arrive at its determination. However, please contact us if you require any further information.

Yours sincerely

Nick Fisher
Managing Director

Ofwat's power model

Summary of the model

1. Ofwat's power model is one of a number of models it uses at price reviews in setting efficiency targets. These models allow Ofwat to compare the costs of the water and sewerage companies by estimating the extent to which differences in their costs are due to the differences in their characteristics.

2. Ofwat considers that a water company's power costs are largely driven by its need to pump water. In the power model this is measured by distribution input and average pumping head. Distribution input is the total amount of water being put into the system and the average pumping head is how much, on average, this water has to be pumped.

3. The regression used in the model is (Ofwat notation):

$$\ln(pc) = \alpha + \beta \ln(H \times V)$$

where pc is spend on functional power, H is distribution input and V is average pumping head. As this is a log-linear model, β gives the percentage change in pc that would arise from a 1 per cent change in $H \times V$. Ofwat uses a log-linear specification to allow for economies of scale.

4. Ofwat uses the estimated equation to calculate predicted power costs for each company. The difference between the predicted and actual power costs, the residuals from the regression, are then calculated as a percentage of the predicted costs. The residuals are reduced by 10 per cent to account for statistical errors.

5. Finally, for each company, Ofwat calculates the difference between its residual (expressed as a percentage of predicted costs) and that of the benchmark company.

The benchmark firm is the most efficient firm relative to its pumping requirements that satisfies the following criteria: ¹ Ofwat has no concerns about the company's data meeting their reporting criteria; the company has no special characteristics that are outside the control of management and which significantly reduce costs relative to the sector norm; and the firm represents a reasonable proportion of the sector. Ofwat considers that this gives a measure for each company of the extent to which its actual costs exceed those that it would achieve were it to perform as efficiently as the benchmark firm.

6. Table 1 shows the inputs to the model and the results for the year 2007/08.

TABLE 1 **Results from the Power Model using 2007/08 data**

[X]

Source: Power model 2008—SES FD 171208.

Ofwat's use of the model in the assessment of SES's SAE claim

7. In assessing SES's claim, Ofwat compared SES's performance on power costs in each year of the price control period with that of the benchmark company. The results are given in Table 2. For the years 2008/09 and 2009/10, Ofwat used information from the draft business plans for 2009 and 2010 power costs. For 2009/10, the percentage reduction was also informed by comparison with a similar company.

¹Relative efficiency assessments 2007/08—supporting information.

TABLE 2 **SES efficiency relative to the benchmark firm, 2003/04 to 2009/10**

Year	Benchmark firm	SES efficiency relative to the benchmark firm %
2003/04	[3]	-4.15
2004/05	[3]	-1.96
2005/06	[3]	11.14
2006/07	[3]	4.19
2007/08	[3]	10.44
2008/09	[3]	9.58
2009/10	[3]	[3]

Source: Extracts from results provided by Ofwat for power model run using power costs reported in June Returns 2004 to 2008 and Draft Business Plans for 2008 and 2009.

Note: The residual for 2003/04 and 2004/05 has not been adjusted by 10 per cent.

Comments

8. The CC has concerns with how Ofwat has used the power model in the assessment of SES's SAE claim.

9. Our main concern is that SES's performance is compared with that of different benchmark companies in different years and that the effect of this is to compare SES against a level of performance over the price control period that no single company achieved.

10. Table 3 shows the results of the power model for SES and the benchmark companies for the years 2003/04 to 2009/10. The figures in brackets are the position of the companies when ranked by their relative performance in the year. We can see from this that the benchmark company changes in each year and that the relative performance of each benchmark company has varied over the period—each has slipped to two-thirds of the way down the rankings in at least one year.

TABLE 3 Efficiency of SES and the three benchmark firms for years 2003/04 to 2009/10

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
SES	-4.15 (5)	-1.96 (3)	11.14 (6)	4.19 (12)	10.44 (7)	9.58 (5)	[X] [X]
[X]	0 (6)	17.43 (9)	19.6 (13)	0 (6)	18.03 (15)	8.51 (4)	0 (2)
[X]	13.05 (15)	24.58 (13)	0 (2)	9.5 (14)	0 (3)	3.04 (3)	3.17 (5)
[X]	1.75 (8)	0 (4)	11.6 (7)	2.8 (8)	9.99 (6)	0 (2)	28.72 (14)

Source: Extracts from results provided by Ofwat for power model run using power costs reported in June Returns 2004 to 2008 and Draft Business Plans for 2008 and 2009.

11. Over short periods such changes in relative performance will be driven by the differences in the prices paid-for electricity—technical efficiency will not change significantly year-on-year. Some of the differences in the prices paid may be simply due to the timing of contracts. The effect of this is to judge SES against a benchmark that no company actually achieved over the period of the price control and which may not have been achievable.

Other comments

12. To run the model for 2008/09 and 2009/10, Ofwat used power costs taken from draft business plans.² Ofwat made a 10 per cent adjustment to the power model residuals to account for possible errors in the data and in its statistical processes. The assessment of SES's efficiency is therefore vulnerable to other firms' estimations of their future power costs.
13. The price review settlement for each company will be based on targets for improving efficiency. For most firms these targets will require it only to narrow the efficiency gap compared with the benchmark companies. To then compare SES, as Ofwat has done, with the benchmark company and 'disallow' any difference in residuals could

²Ofwat SES final determination 16 December 2008.

be to compare SES against a target that it was not expected to achieve when the price controls were set. In this particular case this may not be a problem as the results above suggest that SES was in 2003/04 performing well compared with the benchmark firm.

14. Ofwat attributes all the difference between the adjusted residuals to inefficiency. It is possible that the gap might be due to other factors that affect the amount of electricity used that are not included in the model. This possibility is recognized by Ofwat in its criteria for the selection of the benchmark company. In this particular case Ofwat has recognized that SES has special characteristics and in 2009/10 compared its performance against that of 'a similar company'.

Materiality threshold sensitivity analysis

Results on the sensitivity of the materiality test to alternative assumptions for the impact of the circumstances in the years 2010/11 to 2019/20.

1. In Section 3 we explained that the materiality test requires us to calculate the NPV of the impact of the relevant circumstances over fifteen years. Both SES and Ofwat calculated the NPV by using actual results and current estimates¹ for the five years of the current pricing period and then projecting forward the figures estimated for the year 2009/10 for the remaining ten years. This approach is not required by the licence and so we considered the sensitivity of the materiality finding to alternative assumptions.
2. In relation to power, SES's forecast excess costs, if adjusted for 2010/11 to 2019/20, would need to be reduced to leave an excess of £[~~30~~] million (2008/09 prices) (all other inputs being held the same) in order to give a materiality amount of 20 per cent (equal to the materiality threshold). This compares with an excess of £[~~30~~] million used by SES.
3. In relation to income, SES's forecast shortfall, if adjusted for years 2010/11 to 2019/20, would need to be reduced to a shortfall² of £[~~30~~] million (2008/09 prices) in order to give a materiality amount of 20 per cent. This compares with a shortfall of £[~~30~~] million used by SES.

¹Both Ofwat and SES use actual results for 2005/06, 2006/07 and 2007/08. Ofwat uses best estimates for 2008/09 and 2009/10 for both power and income; SES uses best estimates for 2008/09 and 2009/10 power costs but rolls forward the 2007/08 actual income data for 2008/09 and 2009/10.

²Using actual data (2004/05–2007/08) and latest forecasts for 2008/09 and 2009/10.

Financial analysis

1. This appendix sets out further detail of our financial analysis of SES's claim; it expands on paragraphs 4.62 to 4.72 of the provisional determination. It includes details of our analysis of current weighted average cost of capital (WACC), the definitions of the PR04 other financial indicators used by Ofwat, current investment grade guidelines from a credit rating agency and analysis of the adjusted cash interest II ratio.

Current estimates of WACC

2. In assessing the section 2(2A)(c) duty, we considered SES's forecast returns on RCV for 2008/09 and 2009/10 in relation to current estimates of WACC. In paragraph 4.67 we have focused on post-tax WACC as this is what equity investors will be concerned with. However, in paragraph 4.65 we looked at pre-tax returns on RCV to assess historic figures, and therefore for consistency we have included pre-tax estimates of current WACC below.
3. Table 1 below sets out the estimated ranges for pre- and post-tax WACC from the NERA Cost of Capital report for PR09 prepared for Water UK in January 2009 (the NERA report).¹ As this report was not prepared specifically for this assessment, we note that caution should be placed in making exact comparisons to SES's position. We note that NERA's work has been performed on behalf of Water UK and has been used by Water UK as part of its PR09 submissions. We have not seen Ofwat's cost of capital analysis for PR09 and as such have not been able to consider NERA's report within the wider views submitted as part of the PR09 process.

¹January 2009, Cost of Capital for PR09, A Final Report for Water UK.

4. Table 1 shows that SES's 2008/09 pre-tax return is just below the mid-point of the range and its post-tax return is above the mid-point of the range of estimates reviewed. SES's forecast return for 2009/10 is [X] below the mid-point of the range of estimates for both pre- and post-tax.

TABLE 1 NERA's estimates of WACC (real)

WACC estimates	Pre-tax		Post-tax	
	Estimates	Midpoint	Estimates	Midpoint
NERA*	6.4–7.1	6.8	4.6–5.1	4.9
SES return on RCV†				
2008/09		6.3		5.0
2009/10		[X]		[X]

Source: NERA report, CC calculations, SES.

*NERA estimated WACC based on a combination of the results from its Capital Asset Pricing Model (CAPM) and Dividend Growth Model (DGM) analysis. NERA assumed a gearing of 60 per cent and a tax rate of 28 per cent.

†We have used SES's pre-tax return using the RCV calculated using the actual (rather than forecast (as in Table 6 of the provisional determination)) Current Cost Depreciation and Infrastructure Renewal Charges.

5. We considered the effect on the NERA estimates of SES's forecast gearing level in 2008/09 and 2009/10 of [X] per cent. In our calculation we adjusted the report's CAPM estimates to reflect SES's higher forecast gearing level.² The results showed that both pre- and post-tax WACC were around [X] per cent lower at [X] per cent gearing compared with the reports original gearing levels.
6. We did not make any adjustment in our calculations for any increase in the cost of debt which may arise at higher gearing levels. We would, though, expect—given the difference in gearing levels between the report and SES—that SES's cost of debt would be higher. However, we consider that any increase in cost will have a limited effect on the overall WACC calculation. This view is based on NERA's report which estimates that an increase in gearing from 60 to 68 per cent, which equated to a change from an A– to a BBB+ rating, would lead to the cost of new debt increasing

²The NERA report used a range of 0.88 and 1.13 for the equity beta at 60 per cent gearing. We calculated that this equated to between [X] and [X] at SES's [X] per cent gearing. We used the NERA WACC estimates based on its CAPM calculation for the cost of equity. This range is different from its overall estimates of WACC included in Table 1 above which incorporated the results of its DGM analysis.

by only 0.2 per cent. Any increase in the cost of new debt would in addition be partly offset by the level of embedded debt included in the WACC calculation.

7. We also considered whether the estimate we looked at for WACC should be increased through the inclusion of a small company premium. A small company premium has sometimes been included by regulators and was included by Ofwat at PR04. SES's cost of capital as a result included a post-tax premium of 0.7 per cent. Ofwat considered that this was required because for small companies the costs of raising finance had a proportionally higher effect on them and their investors and they should be compensated accordingly. Ofwat told us that it was considering whether there remained a need for a small company premium as part of PR09.
8. We consider that Ofwat's argument for the inclusion of a premium may be applicable in assessing the current level of WACC and, as such, a small company premium may be required. However, we have not undertaken research to determine at what level, if any, a small company premium should be set and whether as a result it would require an adjustment to the estimates of WACC. We note that NERA does not address the question of whether a small company premium is required for PR09 in its report. We note, however, that if we include a post-tax premium of 0.7 per cent, as at PR04, the midpoint of the NERA WACC estimates would increase to 5.6 per cent. Under this assumption, SES's return on RCV for both 2008/09 and 2009/10 would be below this estimated midpoint.
9. As an additional comparator we also compared SES's return on RCV with NERA's estimates of the risk-free rate of 2.5 per cent to assess whether SES is forecast to

provide a return to investors above this rate.³ We note that SES's return in both 2008/09 and 2009/10 is above this estimate.

Other financial performance indicators

10. The following financial indicators were considered by Ofwat at PR04 along with return on RCV. We have used this package of indicators along with return on RCV in our analysis of both the section 2(2A)(a) and 2(2A)(c) duties.

TABLE 2 **PR04 financial ratios**

<i>Ratio</i>	<i>Description</i>
Cash interest cover	(FFO)/gross interest
Adjusted cash interest cover I (Capital maintenance charges basis)	(FFO less current cost depreciation and infrastructure renewals charges)/gross interest
Adjusted cash interest cover II (Capital maintenance expenditure basis)	(FFO less capital maintenance expenditure)/ gross interest
Debt/regulatory capital value (also termed 'Gearing')	A company's net debt expressed as a percentage of its total capital. This is calculated as: net debt/ RCV
Debt payback	(FFO less dividends paid)/net debt

Source: Ofwat.

Note: **FFO** represents Funds from Operations: a financial measure defined as the cash flow from a business's operations plus interest received less tax paid.

Current investment grade guidelines

11. In the NERA report, Moody's current position on investment grade guidelines is set out—see Table 3 below. SES is currently rated Baa1 (equivalent to Standard & Poor's BBB+). Reviewing SES's forecast total business performance against these requirements, the debt payback levels are better than the Baa1 ranges and the adjusted cash interest cover I ratio is within the range in all years but [X], where it is below. Gearing exceeds the 75 per cent limit in 2008/09 and 2009/10 but is within Moody's Baa2 range, which is still classed as investment grade.

TABLE 3 **Moody's ratio guidelines Baa1**

	<i>Baa1</i>	<i>Baa2</i>
Adjusted cash interest cover I	>1.4 & < 1.6	>1.2 & < 1.4
Gearing (%)	>68 & <75	>75 & <85
Debt payback (%)	>6 & < 8	>4 & < 6

Source: NERA cost of capital for PR09, *A Final report for Water UK*, January 2009.

³It is implicit within the equity risk premium that realized returns can from time to time go below the risk-free rate.

Adjusted cash interest cover II

12. Adjusted cash interest cover II represents funds from operations less capital expenditure as a proportion of gross interest. As water companies are part of a capital-intensive industry and have ongoing capital expenditure programmes, the ratio is considered appropriate when assessing a company's financial position as capital expenditure is a key cash outflow.
13. We accept Ofwat's position set out in paragraph 4.33 that this ratio will be affected in any given year by the timing of capital expenditure and that changes from the capital expenditure profile assumed at PR04 will distort the ratio. To assess whether there are any underlying problems with the ratio excluding the effect of the timing of capital expenditure, we adjusted the actual funds from operations by projected (PR04 assumed) capital expenditure rather than by actual capital expenditure. It should be noted that capital expenditure across the five-year period is forecast to be within [redacted] per cent of that anticipated at PR04.⁴
14. Table 4 shows the adjusted cash interest cover II ratio on both an actual capital expenditure basis and adjusted to reflect PR04 forecast capital expenditure. It shows, assuming that capital expenditure had occurred at the same time as was assumed at PR04, that the ratio would have been around 2x throughout the period and would have averaged 2.0 across the period. The ratio is below 2x only in 2009/10.

TABLE 4 Adjusted cash interest II ratio using both PR04 assumed capital expenditure (capex) and actual capex

	2005/06	2006/07	2007/08	2008/09	2009/10	Total/ average
Ratio for PR04 assumed capex spend	2.01	2.17	2.20	2.10	1.64	2.02
Ratio using actual capex spend	3.67	1.45	1.27	1.93	[redacted]	[redacted]

Source: SES response to CC queries raised 14 May 09—CC calculations from base data provided.

⁴£[redacted] (actual) compared with £[redacted] (PR04) (Source: SES).

Glossary

Adjusted cash interest cover I	Capital maintenance charges basis. This is calculated as: (FFO less current cost depreciation and infrastructure renewals charges)/gross interest.
Adjusted cash interest cover II	Capital maintenance expenditure basis. This is calculated as: (FFO less capital maintenance expenditure)/gross interest.
Adjustment Factor	See ' K factor '.
Appointed Business	The business consisting of the carrying out of the functions of a water or water and sewerage company appointed by Ofwat for the purposes of Part II of the WIA91 .
Appointee	A water or water and sewerage company appointed by Ofwat for the purposes of Part II of the WIA91 .
Atkins	Atkins Limited. An engineering consultancy.
Atkins report	Energy cost review report, prepared by Atkins for Ofwat (dated November 2008).
Average Pumping head	The average height that water needs to be pumped to transport it from source to customer.
Black & Veatch	Black & Veatch Corporation. An engineering, consulting and construction company.
Black & Veatch report	Energy efficiency report, prepared by Black and Veatch for SES (dated November 2008).
BWH	Bournemouth & West Hampshire Water plc.
Cash Interest Cover	This is calculated as: (FFO)/gross interest. See also Adjusted cash interest cover I and Adjusted cash interest cover II .
CC	Competition Commission.
CCWater	The Consumer Council for Water. A statutory, consumer body representing water and sewerage consumers in England and Wales.
Charges Limit	The maximum amount a water company may charge under the terms of its licence . Condition B 3.2 of SES's licence defines the Charges Limit as RPI + K where RPI is the percentage change in the Retail Prices Index between November in the prior year and the immediately preceding November, and K is the Adjustment Factor).
Cost of capital	The opportunity cost of funds provided to a business.
Debt payback (RCF:debt(%))	This is calculated as: (FFO less dividends paid)/net debt.

FD	Final Determination. A final determination by Ofwat on what adjustment should be made to the Adjustment Factor .
FFO	Funds from Operations. A financial measure defined as the cash flow from a business's operations plus interest received less tax paid.
FFO: debt (%)	This is calculated as: (FFO)/net debt .
Gearing (%)	A company's net debt expressed as a percentage of its total capital. This is calculated as: net debt/ RCV .
IDoK	An interim determination of K as outlined (ie outside of a normal periodic review) under licence Condition B.
Jacobs	Jacobs Consultancy UK Limited. A management consultancy. Jacobs is the Reporter appointed by SES to review documents submitted to Ofwat, eg June Returns and Business Plans.
'K' or 'K factor'	At each periodic review Ofwat determines K factors for each year of the five-year price control period. K factors are different for each water company and represent the amount by which a company is allowed to increase customers' bills in real terms. The price limits Ofwat sets for companies are accompanied by a set of outputs that Ofwat expects the company to deliver within those price limits. The K factor may be changed through an IDoK between price reviews. Also known as an Adjustment Factor .
Licence	An instrument appointing a water undertaker (or water and sewerage undertaker) under Part II of the WIA91 .
Materiality amount	The NPV of the total impact on a company's base cash flows, of costs and savings reasonably attributable to the Relevant Items or circumstance. For income/operating expenditure, the NPV is calculated over a 15-year period. For capital expenditure, the NPV is calculated over a five-year period.
Materiality threshold	The qualifying criteria for interim determinations. For a Standard IDoK the Materiality Amount must be equal to at least 10 per cent of the turnover attributable to the Appointed Business . For a substantial effect IDoK the threshold is 20 per cent of turnover.
Moody's	Moody's Investors Service. A provider of credit ratings, research and risk analysis.
NERA	National Economic Research Associates, Inc. An economic consultancy.
NES	Northumbrian Water Limited.
Notified Item	Any item notified by Ofwat to the Appointee as not having been allowed for (either in full or not at all) in the determinations at the most recent price review. Also known as an ' NI '. Notified Items for the 2004 Price Review were:

- a difference (up or down) in the expected uptake of optional meters;
- increased levels of bad debt or debt management costs arising from the companies' disadvantaged position, including their inability to disconnect household customers for non-payment of bills;
- increases in charges for abstraction and discharges to controlled waters;
- increases in costs arising from lane rental or the Traffic Management Act; and
- the impact of International Financial Reporting Standards on the taxation of infrastructure expenditure.

Notional gearing	An assumption made as to the level of ' gearing ' (debt/ RCV) of a business. At the 2004 Price Review , Ofwat assumed a level of notional gearing of 55 per cent for water companies.
NPV	Net present value.
Ofwat	The Water Services Regulation Authority. The economic regulator of water and sewerage companies in England and Wales.
Oxera	Oxford Economic Research Associates Ltd. An economic consultancy.
PR04	In this report, either: <ul style="list-style-type: none"> • the period covered by the 2005–2010 price control period (ie 1 April 2005 to 31 March 2010); or • the process of setting water companies' price limits, which concluded in 2004, and the final determinations made by Ofwat in respect of the 2005–2010 price control period, as the context requires.
PR09	The process of setting water companies' price limits which will set price limits for the period 1 April 2010 to 31 March 2015.
RCF	Retained cash flow. The cash retained in a company each year from funds generated. Calculated as operating cash flow, less any tax and financing payments (dividends and net interest)
RCV	Regulatory capital value. The capital base used in setting price limits. The RCV was the market value initially assigned to each company prior to the 1994 Price Review and now includes the net movement from this opening position of any additional net capital expenditure, less current post-depreciation and infrastructure renewal charges.
Rechargeable works	Works performed by one water company on behalf of a third party (eg a developer or fire brigade); and so 'recharged' to the third party.
Relevant Change of Circumstance	Variations in circumstances, as laid down in licence Condition B. Also known as a ' RCC '. RCCs fall into four categories: <ul style="list-style-type: none"> • RCC(1): The application or change to specified legal requirements.

- RCC(2): A change in the values received or expected from sales of land.
- RCC(3): A change where a company has not delivered an output assumed when price limits were set.
- RCC(4): [Not relevant].

Relevant Item	Either a Notified Item or a Relevant Change of Circumstance .
Reporter	In the context of the regulated water sector in England and Wales: Reporters are independent professionals who are appointed by each water company but have a duty of care to Ofwat . Ofwat approves the Reporter appointments and the Reporters act as professional commentators and certifiers on the regulated activities of the water companies.
Return on RCV	This is calculated as: operating profit/ RCV .
RPI	A general purpose domestic measure of inflation in the UK. Also known as the Retail Prices Index .
SAE	See substantial adverse effect .
SES	Sutton and East Surrey Water plc.
Small company premium	A premium on the basic cost of capital for WOCs . At the 2004 Price Review , Ofwat gave a small company premium of 0.7 per cent (post-tax) to SES .
Standard IDoK	An IDoK concerning a Relevant Change of Circumstance or Notified Item (see Condition B 13.2 of SES's licence)—in contrast to a substantial effect IDoK .
Substantial adverse effect	See Condition B 13.3 of SES's licence —‘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’.
Substantial effect	Either a substantial adverse effect or a substantial favourable effect .
Substantial favourable effect	See Condition B 13.3 of SES's licence —‘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’.
Substantial effect clause	The clause in an Appointee's licence concerning substantial effects . See Condition B 13.3 of SES's licence .
Substantial effect IDoK	An IDoK concerning a substantial effect .
Utilyx	Utilyx Limited. An energy advisory firm.
WASC	Water and sewerage company. WASCs provide water and sewerage services.

Water UK	A water industry association, representing UK statutory water supply and wastewater companies.
WIA91	Water Industry Act 1991 (as amended).
WOC	A water-only company. WOCs provide water but not sewerage services.