

SUTTON AND EAST SURREY WATER PLC

INTERIM PRICE DETERMINATION

Provisional determination

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Summary

1. On 5 March 2009, The Water Services Regulation Authority (Ofwat) referred the disputed determination of a substantial adverse effect (SAE) claim by Sutton and East Surrey Water plc (SES) to the Competition Commission (CC) for determination. The reference was made under section 12(3) of the Water Industry Act 1991 (WIA) following a notice from SES requiring Ofwat to refer the disputed determination to the CC. We are required to report to Ofwat by 4 September 2009.
2. On 17 September 2008, SES referred a claim to Ofwat for determination in relation to two claimed circumstances, each of which, it stated, had a substantial adverse effect on its business. The first claimed circumstance was an increase in power costs and the second a loss of income. On 16 December 2008, Ofwat issued its final determination of SES's claim. Ofwat determined that no adjustment to the price limits was required.
3. We have provisionally determined that:
 - the increased power costs effect would not have been avoided by prudent management action;
 - the loss of income effect would not have been avoided by prudent management action; and
 - SES's claim satisfies the materiality test (as defined in Condition B of SES's licence).
4. Having established that SES's claim is eligible for consideration as a substantial effect, we were required to consider what change should be made to the 'Adjustment Factor' (Condition B 13.3 of SES's licence).

5. First, we considered the principles relevant to determining the adjustment. We consider that we have a wide discretion, but that this discretion must be exercised consistently with relevant statutory duties, as set out in section 2 of the WIA.
6. In relation to the section 2(2A)(a) duty (the 'consumer objective'), we considered that it might be in consumers' interests to allow a positive adjustment to SES's price limits if this were required to avoid an increase in SES's cost of capital. We looked at the impact of only the substantial adverse effects on SES's business against the various measure of financial performance used by Ofwat when the price controls were set. We concluded that the impact over the price control period is of a scale that is consistent with the level of risk reflected in the PR04 regulatory settlement.
7. We then considered how allowing an adjustment to the price limits in the specific circumstances covered by this claim might impact on the behaviour of other water companies if similar circumstances were to arise again. We then considered whether allowing an adjustment to the price limits in the specific circumstances covered by this claim was consistent with the regulatory aims of the WIA. We concluded that to allow an adjustment in relation to SES's increase in power costs was not consistent with the aims of the WIA to the extent that this could undermine the incentives water companies have to manage their energy costs in the long-term interests of consumers.
8. In relation to the section 2(2A)(b) duty (the 'securing functions duty'), we noted that no suggestion has been made, and no evidence suggests, that SES is failing properly to carry out its functions, or is likely to fail to carry out its functions, in the PR04 price control period. Accordingly we considered that the section 2(2A)(b) duty is satisfied.

9. In relation to the section 2(2A)(c) duty (the ‘financing functions duty’), we considered that it is appropriate to look at SES’s current and future financial position. We looked at SES’s return on capital in terms of the performance of the company, compared with the return on capital projected at the time of the PR04 regulatory settlement and industry averages. We also looked at SES’s forecast return on capital compared with current estimates of the cost of capital. We then considered SES’s other financial performance indicators as defined by Ofwat at PR04.
10. We note that:
- SES’s forecast return on capital for 2008/09 and 2009/10 is lower than the return on capital projected at PR04.
 - SES’s forecast post-tax return on capital for 2008/09 is above an estimate of the midpoint of the current cost of capital and its forecast return for 2009/10 is below this estimate.
 - SES’s other financial performance indicators were within guidelines for investment grade status in the early part of the PR04, but are forecast to weaken in 2008/09 and 2009/10.
11. Whilst we considered the 2009/10 return on capital and certain interest cover ratios to be low, we did not consider 2009/10 indicators to be indicative of long-run performance for SES due to the nature of the circumstances. We saw no evidence to suggest that SES’s business will not perform in line with the rest of the industry in the future, and we noted that the next pricing review (PR09) is a short time away. Considering return on capital alongside the other financial performance indicators, the nature of the circumstances, and evidence from a leading credit rating agency; we considered the return on capital to be reasonable and concluded that the company is able to finance its functions both now and going forward.

12. We have had regard to the regulator's other duties as identified in the WIA, and in particular to the duties to promote economy and efficiency by the water companies, and to have regard to the principles of best regulatory practice. Our assessment of the potential implications an adjustment to SES's price limits would have on incentives going forward is relevant to the first of these duties. We do not consider that a positive adjustment to SES's price limits is necessary or appropriate to comply with these.

13. We have provisionally determined that no adjustment to SES's price limits be made.

Provisional determination

1. The reference

- 1.1 On 5 March 2009, Ofwat referred the disputed determination of an SAE claim by SES to the CC for determination. The reference was made under section 12(3) of the Water Industry Act 1991 (WIA91). We are required to report to Ofwat by 4 September 2009. Our report must provide 'definite conclusions on the questions or other matters comprised in the reference, together with such an account of their reasons for those conclusions as, in the opinion of the CC, is expedient for facilitating a proper understanding of those questions or other matters and of their conclusions'. Our terms of reference are set out in Appendix A.
- 1.2 SES has required that Ofwat refer the matter to us in accordance with paragraph 15 of Condition B of its Instrument of Appointment (commonly known as a licence, the terminology adopted elsewhere in this report) because SES disputed Ofwat's determination of the questions raised in SES's substantial effect applications dated 17 September 2008.
- 1.3 In conducting the determination, we have taken evidence both in writing and orally from SES and Ofwat. SES was asked to provide a main submission to which Ofwat was asked to respond. SES was invited to reply to Ofwat's response. We held hearings with both SES and Ofwat. We have also taken account of additional correspondence from both of these parties.
- 1.4 Whilst we have examined correspondence related to the disputed determination, including Ofwat's final determination, our role is not to assess the merits of that determination but to determine the questions afresh. We have also received and

taken account of submissions from two third parties—Water UK¹ and CCWater.²

Written submissions from the parties have been placed on our website.³

- 1.5 The CC is not obliged to publish provisional findings in this reference. However, we are issuing this provisional report in order that SES, Ofwat and any other interested persons can provide to us any views on our analysis, reasoning and provisional determination of the questions.

2. Background

SES's claim under the substantial effect clause⁴

- 2.1 On 17 September 2008, SES referred a claim to Ofwat for determination in relation to two claimed circumstances, each of which, it stated, had a substantial adverse effect on its business. The first claimed circumstance was an increase in power costs and the second a loss of income. SES requested that its price limits be increased by 10.2 per cent in 2009/10, rather than reduced by 1.1 per cent, as provided by Ofwat at the 2004 periodic review (PR04).⁵

- 2.2 The increase in power costs circumstance arose from an increase in actual and forecast electricity costs experienced by SES during the five years covered by PR04, over and above that anticipated and allowed for when price limits were set at PR04. SES's latest forecast indicated that, in 2008/09 prices, its power costs had increased in 2008/09 to £3.8 million and would increase to £[£] million in 2009/10 (from £2.6 million allowed for in each year at PR04, as assumed by the claim).

¹A water industry association, representing UK statutory water supply and wastewater companies.

²The Consumer Council for Water. A statutory, consumer body representing water and sewerage consumers in England and Wales.

³www.competition-commission.org.uk.

⁴The substantial effect clause is described in paragraphs 2.30 to 2.35.

⁵'Future water and sewerage charges 2005–10—Final Determinations.' In this report, we use 'PR04' to refer to either the period covered by the 2005–2010 price control period (ie 1 April 2005 to 31 March 2010) or to 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.

2.3 SES estimated the income shortfall in 2008/09 to be £2.4 million and £[~~2.4~~] million in 2009/10 (both in 2008/09 prices). The loss of income circumstance was attributed by SES to two events:

(a) Metered customers had used less water than anticipated. SES said that this was mainly because of weather conditions. Lower rainfall in the winters of 2005/06 and 2006/07 caused drought conditions which resulted in SES imposing a Non-Essential Use ban. The summers of 2007 and 2008 were exceptionally wet which reduced demand for water, in particular for gardening use.

(b) Unmetered customers had opted to switch to a metered service at a faster rate than had been assumed at the previous price review (ie PR04).⁶

2.4 In considering SES's claim, Ofwat was required to determine two questions. The first question was whether any circumstance had occurred which had or would have a substantial adverse effect on SES's business, or on its assets, liabilities, financial position, or profits or losses. In addressing this first question, Ofwat was required to exclude effect(s)⁷ which would have been avoided by prudent management action and to determine whether a calculation relating to the claimed effects gave a sum which was equal to or exceeded the 'Materiality Amount', as defined in the licence. If such a circumstance had occurred, Ofwat had to determine the second question of what change it considered should be made to the 'Adjustment Factor' (K).⁸

2.5 Ofwat determined that each of the circumstances constituted an SAE. However, it considered that the increase in power costs and the income shortfall were to some extent issues that were within management control and adjusted SES's claim to reflect this view. Ofwat determined that no adjustment to SES's price limits was

⁶SES's SAE application—submission to the CC, Section 2.3.1.

⁷SES and Ofwat disagreed as to whether the two circumstances could be aggregated. See paragraph 3.6.

⁸Clause 13.3 of Condition B of SES's licence.

required because in its view SES would still be able to finance its functions until price limits were reset for the period 2010 to 2015.

- 2.6 On 9 February 2009, SES gave notice to Ofwat that it disputed the determination and required Ofwat to refer the disputed determination to the CC for determination.

Background to water regulation

- 2.7 There are currently 21 regional monopoly water companies in England and Wales. Ten provide both water and sewerage services (WASCs) and 11 provide only water services (WOCs). We refer to the WASCs and WOCs together as 'the water companies'. Ofwat is their economic regulator. The 1989 Water Act enabled the privatization of the WASCs and conferred on the Secretary of State the power to appoint companies to be the water or sewerage undertaker for any area of England and Wales. The WASCs were appointed as water and sewerage undertakers. The former privately-owned statutory water companies (WOCs) were also appointed as water undertakers for their geographic areas and became subject to the same regulatory system. They were given the freedom to convert to plc or limited company status.
- 2.8 Regulated WASCs and WOCs own their assets, such as reservoirs, treatment works, distribution pipes and sewers. WOCs are generally smaller businesses with historically lower capital expenditure requirements. In general, the water companies operate as monopolies within the geographical area in which they operate. Unlike in other privatized utility sectors in the UK, competition is not as well developed in the water sector. Competition in the water industry is available through two routes: 'inset' appointments, where an existing undertaker or new entrant replaces another undertaker for a specific area; and water supply licensing, which allows new companies to compete to supply water to large customers using at least 50 megalitres a year

(Ml/yr). The inset process has led to the creation of five new undertakers that together supply both industrial customers and mixed-use developments. Six companies currently hold water supply licences. No customer has yet switched supplier under this regime, but Ofwat is working with the Government to reform this market. Proposed changes include reducing the 50 Ml/year threshold.

- 2.9 In the UK, the industry regulators for water, gas, electricity and airports all currently use variants of RPI-X regulation which allow regulated companies to increase prices in line with inflation less a factor which reflects an assessment of the scope for efficiency savings. Ofwat uses a formula of $RPI+/-K$ where K represents the changes in revenue needed to allow an efficient company to finance the delivery of services and other outputs each year. Different K factors are set for each company which, among other things, reflect Ofwat's assessments of the relative efficiency of the water companies and therefore the ability of each to achieve efficiency savings.
- 2.10 A system of comparative competition underpins this regulatory system. Ofwat aims to take account of objective differences in the operating environments of the companies before making comparisons between them. These comparisons enable Ofwat to come to an informed assessment of how each company's performance compares with that of the most efficient companies. On this basis Ofwat sets a scoring system for levels of customer service and efficiency assumptions that are incorporated into price controls specific to each company which require the company to become more efficient. Companies have the incentive, once these price limits have been set, to achieve additional cost savings by operating even more efficiently as they can keep the gains from doing so for five years. These savings are then passed on to customers at subsequent periodic reviews. The benefits achieved are thus both local and national, since a well-performing company will help to set future targets for the others.

2.11 Charge controls for SES are implemented through its licence,⁹ and SES's licence also contains clauses relating to the five-yearly periodic reviews of price limits. Permissible changes (in real terms) to price limits are referred to as the Adjustment Factor in the licence and, as above, are also known as K factors. The last periodic review took place in 2004 (PR04), and set price limits for the period from 1 April 2005 to 31 March 2010. The next periodic review is taking place in 2009 (PR09) and will set the price limits to apply from 1 April 2010 to 31 March 2015.

2.12 There are a number of mechanisms in the water regulation regime which are intended to protect companies and customers from material changes in costs and revenues. At PR04 these were set out as follows:

(a) *Interim determinations*. These allow the companies, or Ofwat, to seek revised price limits if specified changes occur in the period since price limits were last set which have a total impact on the company amounting to at least 10 per cent of a company's turnover (the materiality threshold).

(b) *Logging up and down*. This process is the means by which, at a periodic review, Ofwat deals with the changes in outputs required of companies since the last periodic review. This process deals primarily with smaller changes and provides a mechanism for Ofwat to 'log up' any 'reasonable net additional' costs at the next periodic review. Similarly reductions in outputs (ie changes to quality enhancement programmes) required are 'logged down'. The logging up and down mechanism is not specifically included in companies' licences.

(c) *Substantial effect determinations*. These allow companies, or Ofwat, to seek revised price limits if a circumstance beyond a prudent company's control changes, providing that the total adverse or favourable impact on the company satisfies a prudence condition (which differs depending on whether the circum-

⁹Clause 3.2 of Condition B defines the 'Charges Limit' as the percentage calculated as RPI + K (where RPI is the percentage change in the Retail Prices Index and K is the Adjustment Factor).

stance is favourable or adverse) and also passes a materiality threshold. If so, then Ofwat has to consider what change should be made to the price limits.

(d) *Five-yearly periodic review process.* This process resets price limits every five years to reflect any efficient variation from costs and revenue as forecast at the previous review.

The legal and regulatory framework

2.13 The regulation of water supply in England and Wales is controlled by the WIA91 which consolidated, with amendments, earlier legislation. The WIA91 has been amended, in particular by the Water Industry Act 1999 (which provided new entitlements for water customers) and by the Water Act 2003 (whose aims included the sustainable use of water resources and strengthening the voice of consumers).

2.14 Following constitutional changes in the UK, the functions of the Secretary of State have largely been transferred (originally to the National Assembly for Wales, and now, by the Government of Wales Act 2006, to the Welsh Ministers) in relation to any water undertaker or sewerage undertaker whose area is wholly or mainly in Wales.

2.15 As from 1 April 2006, the Director General of Water Services has been replaced as regulator by a body corporate, known as the Water Services Regulation Authority.¹⁰ However, the Authority has continued to be known as Ofwat. In addition, the Water Act 2003 set up a new independent CCWater, and amended the general duties on Ofwat as regulator.

Issues related to the reference

2.16 Section 12(3) of the WIA91 requires the CC to determine this reference in accordance with the same principles, set out in Part 1 of the WIA91 which Ofwat was

¹⁰Section 1A WIA91.

required to apply. These principles are considered further in paragraphs 2.18 to 2.22 below.

- 2.17 As from 1 October 2004, by virtue of section 12(3A) WIA91, where the reference to the CC concerns the review of a price control, and the CC is to decide to what extent it is reasonable to take into account in its determination costs incurred or borne by the company in connection with the reference, the CC must also have regard to the extent to which, in its view, its determination is likely to support the company's (rather than Ofwat's) claims in relation to the questions referred to it.

Duties of the regulator

- 2.18 Section 2 of the WIA91 sets out general duties with respect to the water industry which are imposed on the Secretary of State and Ofwat (and, for the purposes of this determination, on the CC) as to when and how they should exercise their powers and duties relating to the regulation of the water industry. In particular, subsection (2A) provides that Ofwat (and thus the CC) must exercise and perform its relevant powers and duties in the manner which it considers is best calculated:¹¹

- (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 in respect of every area of England and Wales;
- (c) to secure that companies holding appointments are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and
- (d) to secure that the activities authorized by the licence of a licensed water supplier and any statutory functions imposed on it in consequence of the licence are properly carried out.

¹¹Section 2(2A) WIA91 as amended by the Water Act 2003.

- 2.19 The 'consumer objective' is defined¹² as being 'to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services.'
- 2.20 For these purposes, Ofwat (and so the CC) is required to have regard to the interests of:
- (a) individuals who are disabled or chronically sick;
 - (b) individuals of pensionable age;
 - (c) individuals with low incomes;
 - (d) individuals residing in rural areas; and
 - (e) customers of companies holding an appointment under Chapter I of Part 2 of the WIA91, whose premises are not eligible to be supplied by a licensed water supplier,
- but this is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.
- 2.21 Section 2(3) requires Ofwat to exercise and perform its powers and duties in the manner in which it considers is best calculated to promote economy and efficiency by the water companies, and section 2(4) requires Ofwat to exercise its powers having regard to the principles of best regulatory practice.¹³ However, the subsection (3) duty is expressly made subject to the primary duties in subsection (2A), as described in paragraph 2.18 above.
- 2.22 As from 1 April 2005, the new duties imposed on Ofwat include the duty to exercise its powers in the manner which it considers is best calculated to further the consumer objective.

¹²Section 2(2B) WIA91.

¹³Section 2(3) and (4) WIA91 as amended by the Water Act 2003.

Licence conditions

2.23 SES holds an appointment as a water undertaker for the purposes of Part II of the WIA91.

2.24 There are two mechanisms for interim adjustments to price limits between periodic reviews: standard interim determinations of K (standard IDoKs) and the substantial effect clause (through a substantial effect IDoK). These are incorporated in SES's licence.

Standard IDoKs

2.25 Ofwat told us that standard IDoKs could deal with:

- (a) forecasts or inputs which are so uncertain at the time of a periodic review that it is impossible to take them into account with sufficient confidence at the time of a periodic review; and
- (b) any new legal obligations specific to water companies.¹⁴

2.26 Under a standard IDoK, changes in costs and revenues associated with specific items or circumstances (known as 'Relevant Items') that occur between periodic reviews can, if they satisfy a materiality threshold (described below), entitle the company to request an interim adjustment to price limits.¹⁵ There are two types of Relevant Item:

- (a) Notified Items (NIs) are items which are notified by Ofwat to a company as not allowed for (either in full or not at all) in price limits;¹⁶ and
- (b) Relevant Changes of Circumstance (RCCs) which are defined in the licences; these include changes to legal obligations placed on the company and the failure by a company to deliver an output included in price limits.

¹⁴Ofwat's 'Introduction to reference to the Competition Commission', 5 March 2008, paragraph 15.

¹⁵Clauses 13.1 and 13.2 of Condition B of SES's licence set out the mechanism by which the company can ask Ofwat for a standard IDoK, and sets out in detail how it should assess any claim.

¹⁶See glossary for definition of NIs.

2.27 The materiality threshold is achieved if the net present value (NPV) of the total impact on a company's base cash flows, of costs and savings reasonably attributable to the Relevant Items identified, is at least 10 per cent of the turnover of the regulated or 'Appointed' business. The methodology for assessing the materiality of a claim, in accordance with the requirements of licence Condition B, is set out in Appendix B. In summary, the Condition B approach is to:

- calculate the NPV of the base cash flows (costs, receipts and savings) of each of the Relevant Items for 'the relevant year';
- multiply the NPV calculated across the remainder of the current five-year periodic review period for capital costs and a 15-year period for operating costs or revenue losses, both starting from 'the relevant year';¹⁷
- disregard costs or savings which are trivial or which would have been avoided by prudent management action; and
- aggregate the value of each Relevant Item to determine a 'materiality amount' which is then compared with the materiality threshold of 10 per cent to determine whether the materiality threshold has been passed.

2.28 In practice, in following the approach set out above, Ofwat has normally interpreted:

- costs or savings to be trivial if they have a NPV of less than 1 per cent of service turnover; and
- the 15-year NPV period to comprise the five years of the current pricing period with the cost/savings for the fifth year projected forward for ten years.

2.29 If the materiality threshold is met or exceeded, Ofwat calculates the appropriate change to a company's price limits following the precise calculation methodology set down in the licence.¹⁸

¹⁷The approach to the discount rate differs between companies, ie is not standard across all licences.

¹⁸Clause 13.2 of Condition B of SES's licence sets out how the appropriate change to a company's price limits should be calculated. The wording of the licence is set out in Appendix B.

The substantial effect clause

2.30 The substantial effect clause provides for both substantial adverse effects and for substantial favourable effects.

- *Substantial adverse effects*

2.31 A company may apply to Ofwat, under a substantial effect IDoK, for an interim adjustment to its price limits, if a circumstance has occurred which has, or will have, a substantial adverse effect on the company or on its assets, liabilities, financial position, or profits or losses, not being one which would have been avoided by prudent management action. 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'.¹⁹

2.32 Clause 13.3 of Condition B of SES's licence provides that in determining whether the materiality threshold has been reached, the NPV of the net extra costs or revenue shortfall is to be calculated in the same way as for the standard IDoK process, except that the materiality threshold is set at 20 per cent rather than 10 per cent.

2.33 If the materiality threshold has been reached, Ofwat has to consider what change should be made to the price limits. There is no mechanism prescribed as to how to work out the adjustment factor, unlike with the standard IDoK process.

2.34 There is no deadline during a year by which a company must submit any SAE claim. When a company applies, Ofwat has three months within which to make a determination.

¹⁹Clauses 13.1 and 13.3 of Condition B of SES's licence sets out the provisions of the substantial effect clause. The wording of the licence is set out in Appendix B.

- *Substantial favourable effects*

2.35 A substantial favourable effect claim could be brought by Ofwat if there was a material circumstance that was fortuitous and not attributable to prudent management action. At the present time Ofwat has brought no such cases.

Previous SAE claims

2.36 Two previous interim price determinations have been made by Ofwat in response to SAE claims: Northumbrian Water (NES) and Bournemouth & West Hampshire Water (BWH) (the 2003 claims). Both claims were made in 2003 for adjustments for 2004/05, the last year of the 2000–2005 price control period.

2.37 Whilst these claims may have some relevance, and have been cited by SES, we note that these determinations involved the exercise of Ofwat's discretion, having regard to the particular facts of each claim; and that the determinations were made before the changes introduced by the Water Act 2003 came into effect.

2.38 Both claims were made in respect of lower-than-expected revenues. In NES's case, the revenue reduction was driven primarily by a declining level of demand from large users. In BWH's case, revenues were lower than expected for both metered domestic customers and for non-households (mainly caused by local business failures).

2.39 The corresponding K factors were adjusted following both claims, although Ofwat made various adjustments to the parties' claims. Ofwat stated in both cases that the amount needed for the company to finance the proper carrying out of its functions was that which 'will enable the company to raise sufficient revenue such that the

company achieves an appropriate return on capital and that the financial indicators used at the 1999 review are satisfied'.²⁰

3. Assessment of SES's claim

3.1 We have first to determine the question whether any circumstance has occurred which has or will have a substantial adverse effect on SES's business or on its assets, liabilities, financial position, or profits or losses. The effect(s) must not be ones that would have been avoided by prudent management action and must be equal to, or exceed, the materiality amount as calculated in accordance with clause 13.2.

Circumstance

3.2 SES made its claim, and Ofwat its determination, on the basis of two claimed circumstances: (1) increases in power costs; and (2) loss of income. In its determination letter, Ofwat appears to accept this formulation, without discussion of what constitutes a 'circumstance' or whether 'increases in power costs' and 'loss of income' were, in themselves, a 'circumstance'.

3.3 The word 'circumstance' is not defined in SES's licence. Clause 13.3(1) of Condition B concerns 'any circumstance other than a Relevant Change of Circumstance'; and towards the end of clause 13.3, the word is used in what appears to be a different sense and with a different meaning: "prudent management action" shall be assessed by reference to the circumstances which were known or which ought reasonably to have been known to [SES] at the relevant time'.

3.4 As the question in clause 13.3(1) requires us to consider whether any circumstance has occurred which has, or will have, a certain effect, it appears that there must be a

²⁰Bournemouth & West Hampshire ('Calculation of change to the adjustment factor') and Northumbrian Water ('Outcome of your claim') interim determinations, pp11–12, 16–19.

causal link between the claimed circumstance and the claimed effect. We consider that 'circumstance' for the purposes of the substantial effect clause is likely to have a wide meaning, which would include external factors which are outside the company's control. In other words, we consider that drought is a 'circumstance' for these purposes, but a decision to install new pumps, even if not foreseen in the relevant settlement, would not be a 'circumstance'. The action taken by management to avoid the effects of a 'circumstance' is relevant for deciding whether a circumstance has had a 'substantial adverse effect'.²¹

- 3.5 SES claimed that the 'loss of income' circumstance arose because its customers had used and had continued to use less water than was assumed by Ofwat in its PR04 determination, and because the rate at which customers had opted to switch to meters had been faster than was assumed by Ofwat in its PR04 determination. SES also claimed that this was because of the weather—a drought in 2006/07 which led to SES making a Non-Essential Use ban, followed by poor summer weather. This strongly suggests that 'loss of income' is not, in strictness, itself a 'circumstance' but the outcome or effect of one or more circumstances.

Aggregation

- 3.6 SES said that the effects of its two claimed circumstances could be aggregated for the purposes of determining this question. Ofwat considered that this issue had no practical impact on the claim because Ofwat assessed that both of the claimed circumstances individually passed the materiality test.
- 3.7 We noted that the wording of paragraph 13.3(1) of SES's licence is in the singular: whether any circumstance has occurred which has or will have a substantial adverse

²¹Clause 13.3 (1)(a) says: 'which has ... a substantial adverse effect ... not being one which would have been avoided by prudent management action.'

effect. However, Condition A 1 (Interpretation and Construction) of SES's licence includes a provision that: 'Unless the contrary intention appears: words and expressions used in these Conditions shall be construed as if they were in an Act of Parliament and the Interpretation Act 1978 applied to them.' Section 6(c) of that Act states that: 'In any Act, unless the contrary intention appears words in the singular include the plural and words in the plural include the singular.'

- 3.8 In considering the different views of SES and Ofwat, we noted that, in practice, Ofwat appears to have accepted aggregation of different circumstances which have similar effects (eg 'loss of income'). It may be difficult for a company to identify satisfactorily the particular effects of each circumstance, in contrast to the cumulative effect of connected circumstances (eg different weather occurrences). Also, we noted that, if no aggregation was permitted, it would prevent the regulator from having jurisdiction to consider a claim from a company which had suffered loss arising from, say, three different circumstances, each of which had a Materiality Amount of 19 per cent. Such an outcome might be contrary to the aims of the provision.
- 3.9 On the other hand, if such aggregation is permitted, it would mean that a regulator would have jurisdiction to consider a reference from a company that had suffered loss from, say, three different circumstances, even though each had a Materiality Amount of only 10 per cent, and would make it easier for a company to make a claim which satisfied the Materiality Amount test.
- 3.10 The purpose of these provisions is stated by clause 1.3(3) of Condition B to be to enable the Appointee to refer the questions in clause 13.3 to Ofwat. We consider that it is consistent with the aims of the Act that the 'materiality amount' provision is simply to establish jurisdiction, and that the merits of such a claim are determined by Ofwat, exercising its discretion, and having regard to all the evidence before it.

3.11 We consider that the words of paragraph 13.3(1), if given a literal interpretation, would suggest that no aggregation of different circumstances is intended. However, applying a more purposive approach to the construction of these provisions, and with reference to the statutory aims, we consider therefore that a relatively liberal interpretation of these provisions may be appropriate to achieve these policy aims.

The prudent management action test

3.12 Clause 13.3(1)(a) states that a substantive adverse effect for these purposes is not one which would have been avoided by prudent management action, and clause 13.3(i) states that 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 SES at the relevant time.

Energy costs

3.13 Ofwat took the view that, to some extent, SES's claim relating to energy costs could have been avoided by prudent management action in the areas of:

- (a) power procurement; and
- (b) energy efficiency.

3.14 SES did not agree. We consider below Ofwat's challenges in each of these areas and SES's views. We then set out our own assessment of each of these points. We then consider whether the energy costs effect would have been avoided by prudent management action.

Power procurement

- *Ofwat's determination*

3.15 Ofwat in its final determination of SES's claim stated that it considered 'whether all of the company's power costs were prudently incurred'.²² In relation to power procurement, this assessment focused on SES's purchase of electricity contracts, for 2008/09 and 2009/10, in which it fixed its electricity costs for 12 months.

3.16 Ofwat argued that by opting for a 12-month contract for 2008/09 instead of hedging for a longer period, the company sought to pass on the risk of further price increases to customers.²³ Ofwat stated that:

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.²⁴

3.17 SES disagreed with Ofwat's assessment that its actions had not been prudent. We received submissions from both Ofwat and SES on this issue.

- *Ofwat's submissions to us*

3.18 Ofwat argued to us²⁵ that its regulatory approach has always been that it would not expect to protect companies from normal business risk and that increasing power prices are normal business risks. In PR04, in response to SES's request that power costs be classified as an NI, Ofwat allowed for a 40 per cent increase in power costs in price limits. Ofwat said:

²²Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application – final determination', Confidential Annex, p1, paragraph 1.1.

²³Ibid, Annex, p3, 4th bullet; Ofwat's introduction to reference to the Competition Commission, 5 March 2009, paragraphs 38–39.

²⁴Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application – final determination', p4.

²⁵Ofwat's response to SES's submission to the CC, 9 April 2009, paragraph 29.

We judge the risk of these items [ie the risks associated with power costs and other NIs proposed by water companies but not allowed by Ofwat] 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.²⁶

3.19 Ofwat told us in its response that ‘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’.²⁷ Ofwat also told us that there had been several examples in the water sector of companies that had hedged power costs during PR04 and gave the example of [X], which has similar operational characteristics to SES and employed two-year hedges during the period. It also noted that for the next price control period (PR09) companies were again considering hedging costs for the period.²⁸

3.20 Ofwat also noted that:

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.²⁹

²⁶SES PR04 supplementary report, p28.

²⁷Ofwat’s response to SES’s submission to the CC, 9 April 2009, paragraph 146.

²⁸Ibid, paragraph 149.

²⁹Ibid, paragraph 150.

3.21 To SES's argument, which had been put in the course of the disputed determination, that it had followed professional advice from a leading firm, Ofwat stated that it did:

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 ... companies must make their own decisions after considering the wider context in which they operate ... it was SES's choice to expose itself whilst other companies made management decisions to remove the risk.³⁰

3.22 Ofwat noted³¹ that during PR04 SES argued that power costs should be made an NI.³² Ofwat argued that this showed that whilst SES had argued that energy prices would be volatile, it did not remove its exposure to this volatility. Although power costs were not made an NI at PR04, Ofwat noted that it had allowed for a 40 per cent increase in power costs. In PR04, Ofwat stated that in coming to the 40 per cent figure, in addition to evidence from the water companies, it had considered the conclusions of Oxera (which had been commissioned by Water UK) and current market evidence.³³ Ofwat told us that the Oxera report suggested an increase in the range of 22 to 47 per cent. We note that Oxera did not look at forward markets beyond one year's duration in its report and also said that actual cost changes might vary significantly between individual companies due to differences in characteristics.³⁴

3.23 Ofwat estimated that given SES's decision to sign a 12-month contract, its power costs in 2009/10 were likely to be around [X] to [X] per cent higher than they would have been had the company taken out a 24-month contract. As a result, it therefore

³⁰Ibid, paragraph 154.

³¹Response to SES's submission 9 April 2009, paragraph 147.

³²See glossary.

³³Price Review 2004—Final Determinations, p160.

³⁴Oxera study of energy prices 2004, p6.

considered what SES's 2009/10 costs would have been if it capped them at the level at which they would have resulted, had it taken out a 24-month contract in November 2007. Ofwat estimated that this suggested that SES's 2009/10 costs would have been [redacted] per cent lower than its claimed costs.³⁵

3.24 Ofwat also argued that the decision should have been taken in the wider context of SES's business. Ofwat told us that:

[SES] are a regulated monopoly. They are not a competitive company [or] commodity trader. That is the broader environment within which they operate ... We are saying, in this context, the level of risk that the company, the management, decided to bear did not seem to have been scrutinised in the context of whether that level of risk was appropriate for this business.

3.25 In addition, Ofwat argued that the risk profile of power costs should have led SES to do more actively to manage this cost over the five-year period of PR04. Ofwat argued that SES should have 'done more' with the knowledge of the risks which it was aware of at the time. Ofwat highlighted that power costs represented a significant proportion of SES's operating expenses (due to its high average pumping head) and that SES was aware of the risk of large price fluctuations as shown by its lobbying of Ofwat to have electricity costs classified as an NI.

3.26 Ofwat further stated that:

We take the view that the absence of any evidence that they addressed risk and had processes in place to understand risk, took advice on risk, even put the question of risk to their consultants—there is no evidence

³⁵SES estimated the 2009/10 power costs based on the prices set out in the 24-month bids in November 2007. This estimates a cost in 2009/10 of £[redacted] million, compared with an adjusted claim figure (2 April 2009) of £[redacted] million: a difference of 33 per cent to the claim figure. Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application – final determination', Confidential Annex, p2, paragraph 1.1.2.

of that either—points, it seems to us, very, very strongly indeed that this was a company that acted imprudently.

- *SES's view*

3.27 With regard to its overall approach to risk, SES told us that the water industry provided an essential service and therefore a low-risk approach was adopted for its operational activities. At the same time it sought to minimize the cost of delivering its service which was consistent with the efficiency objectives of an incentive-based regime.

3.28 SES argued that Ofwat needed to prove that SES acted 'imprudently' or that its external consultant's advice was defective or expertise was lacking and that SES was on notice of the defect or lack of expertise and had acted imprudently in accepting the consultant's advice. SES argued that to establish that SES acted 'imprudently', Ofwat must prove that SES's conduct fell outside the range of what may be described as 'prudent management action'. SES argued that it was the processes adopted by SES that had to be considered, not the outcome from the application of those processes; and that its licence prohibited reference to hindsight and out-turn in the assessment of prudent management action.³⁶

3.29 SES argued that its decision in 2007 was taken using all the information available at that time and the advice of an expert (Utilyx). SES argued that Utilyx's advice indicated that signing a one-year power purchase agreement was the most prudent course of action at that point, given expectations over future power prices, and it followed this advice. SES told us: 'We are a small company and therefore we employ the experts ... to give us advice, we assess the advice, we review the advice, we then make our decisions and we then take the action we have decided to do' and

³⁶SES SAE application—submission to the CC, 23 March 2009, paragraphs 61 and 62.

“There was potentially a greater chance of securing cheaper rates [in 12 months time]”. That seemed ... very firm advice to us, and these are the experts’.

3.30 In response to a question as to whether it had told Utilyx to adopt a low-risk strategy when it had established the terms of its engagement as energy advisers, SES stated that ‘they know we are a water company, they deal with water companies, they know we are low risk ... I am sure it came out that we were low risk, yes, I am sure that was discussed’. SES also told us that:

Utilyx has worked for a lot of water companies, they understand the industry, we had had discussions with them, Mike [SES’s Operations Director] had had discussions with them about the contract, discussions whether to go to tender, they understood our attitude to risk. They understood that we were a low-risk business and we wanted certainties, as far as we could get them. They understood that.

3.31 SES contended that Ofwat’s judgement relied on the benefit of hindsight and that ‘Ofwat confuses the unintended outcome of a sound management process with imprudence’.³⁷ It argued that the fact that the outcome of its decision led to higher costs in 2009/10 compared with what could have been achieved in 2008/09 was not relevant as its actions must be assessed in accordance with the circumstances which were known or which ought reasonably to have been known to SES at the relevant time in accordance with the terms of its licence.³⁸

3.32 SES argued that ‘the fact that prices for 2009/10 are, in practice, higher than was reflected in forward contracts that could be signed in 2008 is a demonstration that the

³⁷SES SAE application—submission to the CC, 23 March 2009 paragraph 49.

³⁸SES licence Condition B, clause 13.3.(2)(i).

market as a whole, not just SES, failed to anticipate the movement in energy prices that subsequently occurred'.³⁹

3.33 As noted above, in the approach to PR04, SES requested that electricity costs be made an NI. Electricity was not made an NI at PR04 but a 40 per cent increase in electricity prices from 2004/05 to 2005/06 was included. SES stated that the fact that this increase was included underlined how much costs had actually risen in practice and argued that 'The very fact of the special allowance for power costs is a strong indicator that power costs should have been an NI'.⁴⁰

3.34 In SES's response to Ofwat's hearing, it made the following points in reference to Ofwat's 40 per cent PR04 adjustment:

(a) First, it noted that the 40 per cent allowance was applied to actual power costs in 2003/04 and that, given Ofwat's comments at PR04, that energy costs would rise by this amount 'over the next two years', this meant that Ofwat was forecasting power costs for 2005/06 only. SES noted that its 2005/06 actual power costs 'were around 44 per cent higher than in 2003/04'. SES provided data which it claimed indicated that it was paying 'below the market price'⁴¹ in 2003/04 by comparing an average of its actual price paid to the spot price and to the one-month-forward price (the average one-month hedge price) which indicated that it paid below both the average-day-ahead (spot price) and average-month-ahead prices (the average one-month hedge price).⁴² SES commented that these two average prices were very close to one another.

(b) Secondly, SES also stated that in practice, although Ofwat's headline allowance was 40 per cent, it actually received 'only 29 per cent' and that 'Ofwat assumed that the other 11 per cent would come through as additional income via a higher

³⁹SES SAE application—submission to the CC, 23 March 2009, paragraph 219.

⁴⁰SES SAE application—submission to the CC, 23 March 2009, paragraph 75.

⁴¹£17.25 per MWh compared with £20.94 per MWh on the average month ahead price for the year.

⁴²Data provided to SES by Utiylix—see SES email to the CC dated 4 June 2009.

than otherwise RPI.’ SES argued that any additional income was theoretical as ‘the net benefit of a higher RPI would be reduced by its impact on other costs and that any remaining benefit would be received with a significant lag.’

3.35 Finally, in respect of the PR04 40 per cent allowance, SES stated that:

the 40% was neither an adequate allowance for increases in energy costs in 2005/06 nor for the volatility in energy costs thereafter. There is no indication that the 40% was intended to include a premium to cover the costs of hedging for five years and, in any event, the market data strongly suggests that it would not have been possible to secure hedging at that time for that period.

The latter comment was made following discussion by SES with [redacted] and, SES argued, was supported by the fact that no other water company fixed its energy prices for five years in 2003/04.

3.36 SES noted that Atkins, which was commissioned by Ofwat to perform an independent assessment of SES’s approach to energy management and procurement, stated that: ‘The purchase of a single year agreement in 2007 for the period 2008/9 seems very reasonable’⁴³ and that Jacobs, SES’s reporter, concluded that ‘Without hindsight it is difficult to conclude that the Company should have adopted a different approach’.⁴⁴ SES therefore concluded that ‘What the evidence shows is that a decision to hedge for one year clearly falls within the range of prudent responses to volatile electricity prices’.⁴⁵

⁴³Atkins ‘Energy Cost Review of Sutton & East Surrey Water—A report for Ofwat’, p14.

⁴⁴Reporter Report, September 2008, p6: 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 companies.

⁴⁵Reply to Ofwat’s response dated 9 April 2009, paragraph 32.

3.37 SES told us that (although it did not consider it relevant to any assessment of its power purchasing processes in relation to whether it had acted prudently) for the four years to March 2009 its approach had resulted in electricity being purchased at an average of [X] per cent less than both the average spot and one-month hedge prices. Similar procedures for the preceding five years (the five years to March 2005) had resulted in electricity being purchased at an average of [X] per cent less than the average spot price and [X] per cent less than the average one-month hedge price.

3.38 SES noted that, even if it had signed a two-year contract, it would still have exceeded the threshold for a substantial effect IDoK.⁴⁶ In its main submission to us, it noted that:

Based on the evidence available at the time the cost forecast for the two year contract would already have placed SES very close to the threshold for an SAE IDoK. By contrast, given the cost forecasts available at that time, signing the one year contract left the company with an expectation of being further from the IDoK threshold, not nearer.⁴⁷

In subsequent correspondence, SES provided calculations to show that electricity prices based on the then two-year contract would have resulted in a materiality measure of 32 per cent without Ofwat's RPI adjustment,⁴⁸ or 26 per cent after making that adjustment.

⁴⁶SES calculated that if it had contracted for 24 months at the rates tendered in 2007 the increase in total power costs would have still been greater than the 20 per cent materiality threshold and would have therefore triggered an SAE claim.

⁴⁷SES main submission, paragraph 226.

⁴⁸Ofwat at PR04 included an adjustment of 40 per cent in its Final Determination for power costs. This adjustment comprised a 40 per cent increase in the allowance for power costs within operating costs and a 0.5 per cent adjustment to RPI. Ofwat in its assessment of SES's power cost claim adjusted SES's base PR04 cost by £0.193 million a year to take account of the PR04 RPI adjustment and ensure a like-for-like comparison. SES has contested the validity of making this adjustment, on the basis that it was not possible to separate out the power element of the RPI adjustment from changes in other operating costs, and has therefore added it back in its calculations of the adjustment required to power costs.

- *Our assessment*

- 3.39 We consider that this test involves deciding two questions: (1) has there been a failure of prudent management action? and (2) would avoidance of that failure have avoided the relevant adverse effect? It appears that these questions are largely ones of fact—was there a failure and is there a material causal connection between the failure and the adverse effect.
- 3.40 On this basis we considered whether SES fell below the standard of a reasonably competent board of management in some respect. This question must be answered without the benefit of hindsight—by reference to the circumstances known to SES at the relevant time—so it appears that the issue is whether the management action was prudent, not whether it succeeded in avoiding the adverse effect. In other words, there may be a range of prudent actions, not all of which would be successful in avoiding the adverse effect, but so long as SES has taken action which comes within the range, it will have satisfied this test.
- 3.41 We examined various documents relating to SES’s power procurement decision and its decision to appoint Utiyix, including proposal documents, board minutes, the Utiyix Master Agreement together with its related Customer Service Agreement covering the services provided, and contemporaneous email discussions regarding pricing and timing of tendering. We noted that the emphasis of much of the documentation related to the electricity price and that relatively little emphasis had been placed on risk.
- 3.42 SES appointed Utiyix⁴⁹ in October 2007 to assist management in the purchasing of electricity. For the years 2008/9 and 2009/10, Utiyix advised SES on its procurement strategy and ran on SES’s behalf a web-based auction to supply SES with electricity.

⁴⁹Prior to this, Atkins were SES’s advisers.

In November 2007 SES signed two contracts (Half-hourly with [REDACTED] and Non half-hourly with [REDACTED]) to supply it with electricity for the 12-month period starting April 2008, and in August 2008 SES signed a further two contracts for the 12-month period starting April 2009.

- 3.43 For the 2008/09 contract agreement, Utilyx advised SES in November 2007 in relation to the 24-month contract offers that ‘there was potentially a greater chance for securing a cheaper rate for the 2nd 12 month period in 2008/early 2009’.
- 3.44 With regard to SES’s actions, the evidence indicates that SES followed the procedures agreed by its board for the tendering and agreement of contracts, and SES followed Utilyx’s advice that to contract for one year only might result in the lowest expected cost.
- 3.45 We approached Utilyx directly to attempt to establish its terms of reference and whether it had been told to take the risk profile of SES into consideration. The only specific references to risk in the advice provided by Utilyx to SES were included in correspondence that relates to the period after the 2008/09 contract agreement upon which Ofwat’s adjustment for prudence was based. Despite its timing, we consider that this correspondence sheds some light, albeit limited, on the understanding between SES and Utilyx. In relation to the potential move to a flexible contract basis, an email from Utilyx to SES stated:
- We do recommend ... [SES] to put in place a minimum 36 month or even 60 month contract to ensure that when budgets are set by OFWAT for the next determination period you are in a position to continually monitor your price exposure and put in place the appropriate risk management strategy to support the individual objectives and requirements of your business.

- 3.46 In addition, we note that Utilyx's April 2008 note on SES's annual contracting strategy contains the following: 'If as a business you cannot deal with any further increase in cost then this is the equivalent of hitting a stop-loss and you should lock out now protecting your business against further increase in energy prices regardless of market outlook ...'.
- 3.47 SES placed much emphasis on the fact that it was following expert advice. We considered this to be a relevant and important factor, provided that the advice took account of the circumstances of the company (particularly with regard to risk) and that management did not act on advice uncritically.
- 3.48 We note that the Atkins report concluded that a one-year deal was an appropriate and reasonable strategy and that the purchase of single-year contracts was consistent with the wider supply market behaviour.
- 3.49 SES argued that the market as a whole failed to anticipate the upwards movement in energy prices in 2008 onwards, drawing attention to the fact that two-year fixed contracts were priced at a slight discount to one-year fixed contracts (1 to 2 per cent) at the time of its November 2008 auction. In our view, it is clear that energy prices are far from completely predictable and that the possibility of relatively largely price movements is always present, even if such events are infrequent.
- 3.50 SES also argued that on balance, over the years, the forward contracts recommended by the consultants had been very close to the average day-ahead and month-ahead prices for the first four years of PR04. SES therefore suggested that this comparison indicated that SES had paid less than the average market price for electricity overall in the first four years of PR04 and therefore it was important not to

take electricity costs for one year in isolation when considering the issue of prudent management.

- 3.51 We consider that the risk that SES took, by choosing to fix prices from April 2008 for one year, rather than for a longer period, was one where the upside potential was likely to benefit SES and its shareholders, but the downside risk might be borne by SES's customers.⁵⁰ We also note the lack of evidence that supports SES's claim that in taking this decision management considered the risks appropriately.
- 3.52 Whether SES, or another water company in the same position, should in 2008 have fixed its electricity prices for 12 or 24 months was a commercial decision. In making this decision there was a balance to be struck between ensuring certainty with regard to its power costs and minimizing the price that it would expect, on average, to pay. We do not consider that water companies should be expected to reduce risk to the minimum, regardless of cost, but we do consider that prudence requires an emphasis on caution rather than speculation. That SES decided in 2008 to sign a 12-month contract does not seem to us to be imprudent in the light of the advice from an expert, based on market rates at the time, that electricity prices were expected to fall. In the event this did not happen, but whether an action was reasonable at the time cannot be judged in the light of information received after the time the decision was taken.
- 3.53 Taking all the evidence presented into account, we conclude, with respect to the materiality threshold, that SES's procurement decision was a calculated commercial decision which, while not imprudent, was towards the riskier end of the spectrum of a range of available actions for a regulated utility.

⁵⁰The extent to which this risk would be borne by customers depends upon the application of the SAE provision. Under SES's reading of the appropriate application of the SAE provision, this risk could be borne by customers to a considerable extent.

Energy efficiency

- *Ofwat's view*

3.54 Ofwat also challenged SES's claim on the basis that Atkins suggested that SES could have done more to manage its power usage. Ofwat stated 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.⁵¹ At its hearing, Ofwat explained that 'we would have expected them to have a look at it [power usage] given that they were dealing with a rise in energy prices'.

3.55 Ofwat's conclusion on SES's power cost circumstance was informed by a number of analyses, including an independent assessment of SES's approach to energy management and procurement (the Atkins report); use of its own econometric power model to compare SES's power costs against those of the benchmark company in each year of the current period 2005–10; and comparing SES's performance against a specific company within the industry which it identified as having 'broadly similar characteristics' to SES. Ofwat was also provided with a report commissioned by SES (the Black & Veatch report).

3.56 Ofwat noted that although SES had argued that the Atkins report was not critical of the company in relation to pumps and the pumping of water, Atkins had commented on SES's overall strategy, and suggested some shortfalls in SES's approach to pumps and pumping operation.⁵²

⁵¹Ofwat response to SES submission, 9 April 2009, paragraph 137.

⁵²Ofwat response to SES submission, 9 April 2009, paragraph 140.

- *SES's view*

3.57 SES rejected Ofwat's suggestion that it was inefficient. It argued that:

- (a) The Atkins report commissioned by Ofwat was not critical of the company in relation to pumps and the pumping of water, which account for 94 per cent of SES's electricity usage.
- (b) The relatively minor negative impressions reported by Atkins were not well founded. SES argued that any negative impressions were the result of Atkins only doing a 'desk' exercise, and would have been avoided if Atkins had spoken to SES.
- (c) The Black & Veatch report concluded that 'energy usage by SES is efficiently managed and we have not identified any opportunities for significant improvement or that electricity usage is being managed "imprudently"'.
- (d) SES's practices were efficient.
- (e) SES had taken particular steps to minimize leakage—a strategy that was most appropriate to reducing its energy costs as the amount of electricity used was directly proportional to the amount of water supplied. SES told us that it estimated that its leakage reduction had reduced energy consumption by about 25 per cent. The Atkins report noted that SES's leakage performance was in the upper quartile of industry performance.
- (f) Ofwat's econometric modelling did not add any weight to Ofwat's argument; instead it merely restated the effects of SES's procurement decision since the econometric model examined monetary expenditure on power and conflated procurement and efficiency issues.

- *Our assessment*

3.58 We are required by clause 13.2(3), when we make the materiality amount calculation, to take no account of costs that would have been avoided by prudent management action.

- 3.59 We have therefore considered evidence relevant to the question of whether SES, or another company in a similar position, should, in response to the increase in the price it was going to have to pay for its electricity, have taken steps which SES did not take to improve its efficiency in the use of electricity made.
- 3.60 Generally we would not necessarily expect water companies to be able to respond in the short term to increasing energy prices by improving their efficiency in the use of energy as this will be largely driven by capital expenditure in reducing leakage and the maintenance and replacement of pumps which will be agreed with Ofwat and be reflected in the regulatory settlement.
- 3.61 We also note, in particular, that:
- (a) the broad thrust of Atkins' analysis (in its report to Ofwat) supports SES's position; we take the view that the existence of some opportunities for improvement is not of itself sufficient to demonstrate a lack of prudence; and
 - (b) the requirement to demonstrate a step change in its culture or strategy does not in this case seem justified given the circumstance of short-term energy price movements or in the context of a company that already has a high exposure to energy prices and might be expected to already give substantial management attention to energy efficiency.
- 3.62 We are also of the view that in the particular circumstances of this claim, very limited weight should be given to the output from Ofwat's power model; in a volatile market the effect of procurement decisions is likely to be amplified by Ofwat's power model. We acknowledge that Ofwat's assessment of SES's energy costs compared with the frontier company and the similar company was intended to capture differences in costs due to both procurement decisions and energy efficiency. However, the frequent changes in the identity of the frontier company that Ofwat uses as a

benchmark may indicate that SES performance was being compared against a benchmark that no individual company did or could have achieved. The concerns that we have with Ofwat's use of the results of its power model in the assessment of this claim are discussed in more detail in Appendix D.

- 3.63 We conclude that there is no evidence that SES was imprudent in failing to take steps to improve its energy efficiency in response to the increases in electricity price.

Assessment of the energy cost circumstance

- 3.64 As discussed in paragraphs 3.53 and 3.63, we consider that SES's approach to energy procurement and energy efficiency was within the range of prudent actions. We conclude that the increased power costs effect would not have been avoided by prudent management action.

The materiality test

- 3.65 In this section we review the parties' assessments of the materiality test and conclude as to the eligibility of SES's claim.

Ofwat's adjustments

- 3.66 In considering SES's submission, Ofwat considered that a number of adjustments were appropriate. This section discusses the more significant adjustments. Ofwat also identified some relatively minor adjustments, which are referred to in paragraph 4.60.

Definition of 'relevant income'

- 3.67 In assessing SES's income shortfall, Ofwat considered an income figure that included non-water incomes and rechargeable works. SES disputed this definition of

income, arguing that the relevant revenue measure was the shortfall to ‘water income’ by which it meant tariff basket, large user and special agreement income.

3.68 SES argued that the higher rechargeable works entailed additional costs, and that in any case these revenues were not part of the circumstance it claimed.⁵³

3.69 Ofwat argued that it was necessary to consider all income together as it was not possible to separate out the associated costs for various income streams and this could lead to unsatisfactory outcomes. Ofwat also argued that SES’s original claim framed its income circumstance in terms of ‘loss of income’ and not ‘loss of retail water income’.⁵⁴ Ofwat argued that its approach was consistent with the approach it had adopted in assessing the 2003 claims.

3.70 As discussed in paragraphs 3.2 to 3.5, the reasonable definition of a circumstance may raise certain difficulties. We consider that in this example Ofwat’s concern about cost identification is of limited relevance and that it is reasonable for us to consider the circumstance as relating to ‘water income’ at least for the assessment of materiality. Our reading of SES’s substantial effect claim does not suggest that ‘loss of income’ was intended to suggest that the circumstance should be assessed over all income, including rechargeable works.

Special agreement income for [✂]

3.71 The adjustments Ofwat made to SES’s revenue shortfall included: adjusting for differences in the parties’ views as to how to adjust for inflation and as to the income forecasts going forwards; as well as a specific adjustment made by Ofwat regarding the shortfall in income incurred in relation to special agreement customers. Ofwat excluded the shortfall that had arisen due to SES charging [✂] the contracted price

⁵³SES SAE application—submission to the CC, 23 March 2009, paragraph 189.

⁵⁴Ofwat response to SES submission, 9 April 2009, paragraph 186.

rather than the price assumed in the PR04 settlement (which assumed a price increase). Ofwat noted that 'The substantial effect claim on revenue relates to the shortfall against the assumptions we made at that time PR04. 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'.⁵⁵

3.72 We consider that the claim made by SES did not include a claim that the [X] contract was a circumstance or that 'loss' from the [X] contract formed part of the claimed 'loss of income' circumstance, as this was specified to arise from customers using less water, and switching to meters more rapidly, than was assumed by Ofwat in its PR04 determination.⁵⁶

3.73 For this reason, we do not consider that it is relevant to consider whether the adverse effect of this contract was one that would have been avoided by prudent management action. Furthermore, we consider that no claimed losses arising from the [X] contract can properly form part of SES's claim or be included in the calculation of the materiality amount.

Assessment of SES's claim: materiality

3.74 SES's calculations indicated that the NPV of the impact of increases in power costs and income shortfall, over a 15-year period, were equal to 65 per cent and 41 per cent of annual Appointed turnover in 2007/08 respectively.

⁵⁵Ofwat letter to SES dated 16 December 2008 '13.3 Substantial Effect Application—Final Determination', p5.

⁵⁶SES letter to Ofwat of 17 September 2008, p2 (see Appendix C): '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.'

3.75 After certain adjustments, Ofwat determined that the NPV of the additional power costs the company faced was 25 per cent of the Appointed Business turnover and that the NPV of the income shortfall was equal to 30 per cent of the Appointed Business turnover. Thus, although Ofwat did not agree with SES as regards the figures calculated, it did agree with SES that both of the circumstances in SES's claim met or exceeded the materiality threshold of 20 per cent.

Power

3.76 Table 1 sets out SES's claim in relation to power.

TABLE 1 **SES's SAE claim: power**

	<i>£ million (2002/03 prices)</i>				
	2005/06	2006/07	2007/08	2008/09	2009/10
Actual	2.455	3.223	2.902	3.088	[£]
PR04*	2.221	2.180	2.140	2.100	[£]
Excess costs	0.234	1.043	0.762	0.988	[£]
Materiality amount					64.8%

Source: Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application – final determination'.

*Includes efficiency assumption adjustments made by Ofwat which SES accepted.

Note: The materiality amount has been calculated based on SES's IdoK model using the 5th year forecast extended for 10 years as is consistent with SES's methodology.

3.77 SES subsequently accepted Ofwat's challenge regarding inclusion of Head Office costs within the PR04 comparative figures and made updates regarding the estimated excess power costs in the forecast years (2008/09 and 2009/10). The effect of these adjustments is to increase the materiality amount to 66.2 per cent.

3.78 Table 2 sets out Ofwat's assessment of SES's SAE claim in relation to power.

TABLE 2 Ofwat's assessment of the SAE claim in relation to power

	£ million (2002/03 prices)				
	2005/06	2006/07	2007/08	2008/09	2009/10
Actual	2.182	3.088	2.600	2.792	[£]
PR04	2.460	2.418	2.377	2.337	[£]
Excess costs	(0.278)	0.670	0.223	0.455	[£]
Materiality amount					25.3%*

Source: Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination'.

*The materiality amount (power) by Ofwat was noted in the Substantial Effect—Final Determination to be 20.7 per cent. This incorporated an error and has subsequently been corrected to 25.32 per cent.

Note: Ofwat calculated the materiality amount using its IdoK model, actual/forecasts for the current pricing period and extending the 2009/10 forecast out for ten years.

3.79 Both Ofwat and SES's assessments of the claim in relation to power meet the 20 per cent threshold.

Income

3.80 Table 3 sets out SES's SAE claim in relation to income.

TABLE 3 SES's SAE claim in relation to income

	£ million (2002/03 prices)				
	2005/06	2006/07	2007/08	2008/09	2009/10
Actual	40.713	40.889	41.508	41.080	[£]
PR04	41.163	42.209	42.981	42.752	[£]
Revenue shortfall	0.450	1.320	1.473	1.672	[£]
Materiality amount					41.0%

Source: Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination' and for materiality SES income application 170908.

Note: SES's materiality amount was calculated using the IdoK model, using actual results for the current prices period (to 2007/08) and extending the last year of actual results forward for 12 years. This is a different approach to that taken by Ofwat and SES for the power circumstances and different to Ofwat's treatment of income circumstances; where in all cases the last year of forecast results (ie those for 2009/10) are projected forward for a further ten years.

3.81 SES submitted forecasts⁵⁷ that had been updated compared with those submitted to Ofwat for its income for 2008/09 and 2009/10. These updates do not have an impact on SES's calculation of income as they were not used in SES's assessment of the

⁵⁷ Provided in 'SES Submission to the CC 23 March 09'. The shortfall entered into the materiality amount for revenue has been altered slightly by SES in its submission to the CC (from its original submission to Ofwat). The shortfalls in 2006/07 and 2007/08 have increased by £0.02 million and £0.03 million respectively (in out-turn prices). These alterations impact marginally the materiality amount for revenue as calculated by SES. The materiality amount is now calculated as 41.6 per cent of 2007/08 turnover (an increase from 41.0 per cent).

materiality amount. (That assessment projected forward the last year of actual results [2007/08].)

3.82 Table 4 sets out Ofwat's SAE claim in relation to income.

TABLE 4 Ofwat's assessment of SAE claim in relation to income

	<i>£ million (2002/03 prices)</i>				
	2005/06	2006/07	2007/08	2008/09	2009/10
Actual	42.261	42.164	42.422	42.068	[X]
PR04	42.478	42.989	43.537	43.736	[X]
Revenue shortfall	0.217	0.825	1.115	1.667	[X]
Materiality amount					30.0%*

Source: Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination'

* The materiality amount as calculated by Ofwat was noted in the Substantial Effect—Final Determination to be 24.7 per cent. This has subsequently been corrected to 30.0 per cent as the original calculation had incorrectly inflated the figures within the IdoK model.

Note: Ofwat has calculated the materiality amount using its IdoK model, actual/forecasts for the current pricing period and extending the 2009/10 forecast out for ten years.

3.83 Both SES and Ofwat's assessments of the claim in relation to revenue meet the 20 per cent threshold.

Our assessment of the materiality requirement

3.84 Given that both parties believe the materiality threshold to have been met, we considered whether a further detailed assessment of materiality amounts by the CC was necessary. The most significant difference between the two parties' claims was Ofwat's dismissal of a large part of the excess power costs incurred by SES on the grounds 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'.⁵⁸ Since we

⁵⁸p3 Ofwat letter to SES dated 16 December 2008 '13.3 Substantial Effect Application—Final Determination'.

do not agree with Ofwat's adjustments for prudent management action, our assessment of the size of the effect would be expected to be greater than Ofwat's.⁵⁹

- 3.85 Because of the 15-year nature of the materiality amount calculation, the effect of the forecast adverse performance in the years beyond the current pricing period and hence beyond the current detailed forecast is a key driver of the overall materiality amount.
- 3.86 Although both SES and Ofwat calculated the NPV by using the fifth year figure⁶⁰ as the basis for subsequent years, the licence condition does not specify that this is how the calculation should be carried out. In our view, this approach to calculating the NPV may be considered unreliable if the factors affecting the fifth year are unlikely to be sustained. Accordingly we reviewed the sensitivity of the 2010/11 to 2019/20 cash flows to assess whether alternative plausible forecasts for the fifth year might affect our conclusion with regard to the materiality amount. The results of these sensitivities are set out in Appendix E. Given the size of any reduction (to the shortfall in income or excess in costs) that would need to be made to SES's figures in order for either claim to not meet the SAE materiality threshold, we do not believe that a recalculation of the materiality amounts is necessary. We accept the view of the parties that the threshold has been met with regard to both circumstances.
- 3.87 Clause 13.2 of Condition B requires claimants to offset any reduced costs associated with lower income. In this case, we agree with Ofwat's view⁶¹ that any adjustment would not be significant enough to alter the outcome of the materiality threshold test.

⁵⁹The other differences between the parties were in relation to revenue from [§], the treatment of RPI and various assumptions made in estimating income from households. We agree with Ofwat that it is appropriate to exclude from the materiality test that impact of lower revenue from [§]. We note that other adjustments appear overall to be reduce the size of the claim.

⁶⁰Except for SES's treatment of revenue shortfall where it projected the last known actuals (2007/08) forward to the end of the 15-year period, ie for 12 years.

⁶¹Ofwat letter to SES, 16 December 2008, p5: '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.'

SES stated that any such adjustment ‘would be academic ... because savings resulting from reduced volumes [were] treated as an offsetting factor in [SES’s] materiality calculation for power costs ...’.⁶²

Conclusion as to the eligibility of SES’s claim

3.88 We consider that the effects would not have been avoided by prudent management action and that SES’s claim satisfies the materiality test. We therefore conclude that SES’s claim is eligible for consideration as a substantial effect.

4. The appropriate adjustment to K

4.1 The second stage of our determination is to decide what change should be made to the Adjustment Factor (K). We first consider evidence presented to us on the purpose of the substantial effect clause. We then go on to discuss the relevant principles to this case. This is followed by a section in which we apply the principles to the determination of K; we then set out our conclusion.

The purpose of the substantial effect clause

4.2 Both SES and Ofwat provided submissions as to the purpose of the substantial effect clause.

4.3 The substantial effect clause is currently present in the licences of all the water companies. This has not always been the case and both SES and Ofwat drew attention to various aspects of how the clause had developed. In the early years of the clause it was at various times referred to as a ‘long-stop provision’ and a ‘shipwreck clause’. Both Ofwat and SES suggested that we should be wary of attaching particular significance to these descriptions.

⁶²SES SAE application—submission to the CC, 23 March 2009, paragraph 179.

4.4 Ofwat told us that, at first, the substantial effect clause was ‘one way’—that is to say, it allowed companies to make a claim for a substantial adverse effect, but it did not allow Ofwat to make an adjustment if a circumstance had had a substantial favourable effect on a company.⁶³ From 1994, companies were offered a choice between having a ‘two-way’ clause, that covered both substantial adverse effects and substantial favourable effects, or having no substantial effect clause at all, so some companies had a licence which included such a clause, and some did not. In 2002, most of the companies that did not have a substantial effect clause agreed to include such a clause in their licence, and the remaining companies modified their licences to include such a clause in 2005. A chronological outline of the history of the clause is given in Table 5.

TABLE 5 Chronological outline of the history of the substantial effect clause

August 1989	Original appointments of WOCs and WASCs granted 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).
1993/1994	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.
2000	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 5 to 15 years). This change affected the materiality calculation for substantial effect claims, which had been the same (with different thresholds) since 1994. According to Ofwat, this was not the intention and was not consulted on at the time.
January 2001	Ofwat consults on the possibility of incorporating the substantial effect clause into the licences of the 12 water companies which did not then have it (following a request in relation to Dwr Cymru Cyf (Welsh Water) to have the clause included in its licence).
2002	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 United Utilities Water plc) who did not then have it.
2004	Ofwat consulted 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 claims in 2003). Some companies opposed the proposal and Ofwat subsequently decided not to pursue this proposal at that stage.
2005	The substantial effect clause was inserted into the licences of Thames Water Utilities Limited and United Utilities Water plc.

Source: CC based on Annex 2 to Ofwat's response.

⁶³Ofwat Response 9 April 2009, Annex 2, Detailed history of the SAE clause.

Previous substantial effect claims

- 4.5 We were told by Ofwat that, prior to the disputed determination of SES's claim, it had made two determinations of SAE claims, but it had not made a substantial favourable effect determination.
- 4.6 The 2003 claims (see paragraphs 2.36 to 2.39) have been cited by SES in support of its case. However, we note that the final determinations involved the exercise of Ofwat's discretion, having regard to the particular facts of each claim; and that the determinations were made before the changes introduced by the Water Act 2003 came into effect. For these reasons, we consider that, beyond illustrating the approach of the then regulator to such claims (for example, that the power is discretionary—unlike determinations of Standard IDoK claims—and that the discretion includes a power both to change, and to make no change, to K), these decisions are of only limited assistance to us in determining the questions raised by SES and the disputed determination. We consider that we are not bound in any way by the views of Ofwat expressed in these determinations.

Previous statements about the purpose of the clause

- 4.7 In its PR04 determination, Ofwat stated that the SAE provision provided water companies with some protection from external events that had a substantial adverse effect on companies' costs or revenue:

[I]f there are significant changes to specified outputs or if very significant events occur that are outside the control of an efficient company we have mechanisms to allow for changes to price limits (up and down). These mechanisms are known as interim determination and substantial effect determinations respectively.⁶⁴

⁶⁴PR04, p25, section 1.7.

As a further protection companies' licences allow for substantial effect determinations. These allow companies, or Ofwat, to seek revised price limits if a circumstance beyond a prudent company's control changes so that the adverse or beneficial impact on the company amounts to at least 20% of a company's turnover.^{65,66}

Submissions made to us

4.8 SES told us that the substantial effect clause allocated risk between companies and customers. It said that although the clause had previously been characterized as a provision that would only apply in extreme circumstances, following the change to the materiality amount calculation clause in 2000, this was not an appropriate characterization. In SES's view, the clause was intended to allocate to customers risk associated with any effect that satisfied the materiality and prudent management action tests.

4.9 SES argued that the purpose of the clause was corrective, to restore companies to the position whereby they received a sufficient return to ensure they could finance their functions, and not to provide protection in the case of extreme, 'shipwreck', events as the clause also provided for substantial favourable events for which there was no 'shipwreck' analogy.⁶⁷

4.10 Ofwat told us that:

The key purpose of the substantial effect clause is to constitute the ultimate reassurance to the company, its shareholders and hence the capital markets, that in the extreme situation of a prudently managed

⁶⁵PR04, pp240–241.

⁶⁶PR04 on p231 states: '[T]he package of financial indicators we have used to assess the price limits does not represent a "floor". There remains scope for companies to absorb unanticipated downside risk and still remain within the investment grade credit rating range. We have assumed a cost of capital in price limits that is towards the high end of the possible range and well above one based solely on current market levels. This in itself allows for the possibility of unexpected cost shocks.'

⁶⁷SES's SAE application—submission to the CC, 23 March 2009, paragraph 95.

company having insufficient resources properly to carry out its functions, an appropriate adjustment can be applied.

In Ofwat's view, passing the materiality test meant only that it had to consider whether an adjustment to K was necessary. There was no presumption that an adjustment should be made.

- 4.11 Both parties made submissions to us in relation to a consultation Ofwat undertook in 2004 concerning the substantial effect clause (see Table 5 above). Ofwat told us that its view held during the 2004 consultation was that the materiality threshold was too easy to trigger and that 'the substantial effect clause in its current form has the effect of altering the balance of risk for unavoidable material events between customers and shareholders in a way that was not envisaged'. SES drew attention to the same statements as evidence of how Ofwat accepted that risk was allocated by companies' licences.

Our view

- 4.12 We have not found it necessary to form a view as to the purpose of the substantial effect clause. However, we do make the following observations:
- (a) We have not seen evidence to suggest that the clause is intended to operate solely as a 'shipwreck' clause in the sense that it would assist companies that had experienced a disaster. We share the views of the parties that this language is potentially misleading.
 - (b) We have not seen evidence to suggest that the SAE provision is intended to operate as a mechanical risk allocation mechanism in the way that SES suggests. In our view, if this had been the intention then the wording of the licence would have given an indication of this, although we accept that some discretion would have been inevitable in practice, given that an SAE may be triggered by many different types of events.

Principles relevant to determining the adjustment

4.13 The parties' positions as to how they believe an adjustment to K should be considered are set out below. This is followed by our views on the relevant principles.

SES's position

4.14 SES acknowledged that there was no automatic mechanism that applied in relation to SAE claims and that Ofwat therefore had discretion in considering SAE claims. However, SES argued that this discretion was limited by part (c) of section 2A of the WIA, which, SES argued, was Ofwat's principal duty relating to the financing of the water undertakings, and required Ofwat to set K factors that ensured the return on capital in order to finance functions.⁶⁸

4.15 SES contrasted the language of part (a) of section 2(2A) of the WIA, which required Ofwat 'to further the consumer objective' with that of part (c), which required Ofwat to 'to secure that companies ... are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions'. It argued that the term 'to further' was less prescriptive than 'to secure' and that accordingly part (c) was the principal duty under the WIA.⁶⁹ It argued that the grammatical and ordinary meaning of the term 'to further' was less prescriptive than 'to secure', that this was consistent with the purpose of the statute, with the legislative history of the consumer objective and with legal certainty and that accordingly part (c) was the principal duty under the WIA. SES also argued that there was in any event no conflict between the consumer objective and financing functions as the long-term interest of consumers was met by allowing companies to recover their costs, including returns on investment and by encouraging and rewarding efficiency.

⁶⁸SES SAE application—submission to the CC, 23 March 2009, paragraph 112.

⁶⁹SES SAE application—submission to the CC, 23 March 2009, paragraph 78.

- 4.16 SES stressed its view that the section 2 duty was a continuing duty and accordingly did not only apply up until the end of the current price control, but also beyond it. Although the adjustment to K would only apply within the current price control, SES argued that the adjustment would affect investors' expectations of returns beyond this point, thereby affecting the availability of capital and companies' ability to make the necessary investments for benefits to accrue to consumers over decades with a view to providing good and reliable services for current and future generations. SES argued that, were the decision to depart from the methodology adopted by Ofwat with regard to the 2003 claims, regulatory inconsistency would be negatively affected also. SES argued that Ofwat, in the disputed SES determination, had only concerned itself with the remainder of the PR04 price control.
- 4.17 SES told us that it had sufficient financial resources and facilities in place in the period to operate until the next price determination. It told us that these resources were dependent on it meeting its required ratios which it expected to do; however, it stated that 'those ratios will be very tight' and that in respect of its bond covenants 'we can only draw down the banking facilities providing we are meeting our bond covenants ... we should just about be able to meet the bond covenants but it will be fairly tight'.
- 4.18 SES argued that whether or not it had sufficient resources in place to finance its operations until the next review was not the relevant consideration. It argued that it 'cannot finance its functions within the true meaning of section 2 of the [WIA 1991] which requires a return to be secured in order to secure that it is able to finance its functions'.
- 4.19 SES argued that the substantial effect clause allocated risk between the company and its customers. It argued that this risk allocation (subject to the prudent

management action proviso) was specified by the materiality threshold, such that the risk of a variation within the range determined by the materiality threshold was borne by the company, and the risk of a variation outside the range determined by the materiality threshold was borne by customers.

- 4.20 SES argued that the substantial effect clause had a corrective function to correct for material changes either not foreseen at the periodic review or of a scale not foreseen. SES argued that Ofwat's approach to standard IDoKs (characterized by SES as fixing return equal to the cost of capital and verifying financial indicators to see whether it is necessary to increase the return) applied to substantial effect claims. SES argued that, in a case where there was no underperformance, the correct interpretation of the substantial effect clause would adjust for the circumstance in such a way as to ensure a reasonable return on capital and that both historic and future actual returns on RCV should be assessed; and that any adjustment to K should compensate for the effect across the full PR04 period. It argued that Ofwat's approach would not do this as Ofwat ignored the effects of the SAE in earlier years.⁷⁰
- 4.21 SES argued that its approach was in line with section 2 of the WIA, was consistent with Ofwat's approach to the 2003 claims (noting, in particular, that SES (in its view) was in a worse financial position than at least one of the 2003 claimants, which had been partially successful in its SAE claim for an adjustment) and was consistent with the framework for other types of IDoK (NIs and RCCs). SES, however, also argued that in the previous substantial effect decisions Ofwat had erred in not taking account of returns over the whole price control period in its calculation of K.
- 4.22 SES considered that in making this calculation it would be appropriate for Ofwat to take account of performance in the rest of the business, where SES had out-

⁷⁰SES's submission to the CC, paragraphs 269 & 275.

performed its price determination, and offset this against the substantial effects and therefore reduce the K adjustment accordingly.⁷¹

4.23 SES argued that the rate of return projected at PR04 was the relevant benchmark rate with which to assess its actual return on RCV, since:

(a) Such an approach would be consistent with Ofwat's assessment of the 2003 claims.

(b) This rate provided clear signals to investors as to what return could be expected to be earned over the medium term. If the regulator allowed actual returns to deviate substantially from this the perceived level of risk of the industry would increase.

(c) The rate had been the subject of extensive consultation and scrutiny.

(d) The SAE process was not intended to be burdensome, which a re-evaluation of a benchmark rate of return would be.⁷²

4.24 SES also said that if:

the Commission wishes to consider the reasonable rate of return to be a cost of capital other than that determined at the 2004 Final Determination, Ofwat's current analysis of the cost of capital for the water sector is the most relevant. This should include all the submissions on the cost of capital and the small company premium made by, or on behalf of, water companies.

Ofwat's position

4.25 Ofwat told us that the regulatory framework with regard to the water industry was based on medium-term incentive-based regulation, and that it incentivized com-

⁷¹SES SAE application—submission to the CC, 23 March 2009, paragraph 7.

⁷²SES SAE application—submission to the CC, 23 March 2009, paragraphs 283–290.

panies to outperform regulatory forecasts because shareholders retained any out-performance for an appropriate period. The risk of underperformance was left largely with companies' shareholders. It told us that there were mechanisms in the regime to deal with uncertainty between reviews of price limits and that therefore the allocation of risk between consumers and shareholders was central to the regime. It argued that aspects of SES's claim would, if accepted, distort significantly the allocation of risk and would disadvantage consumers.⁷³

4.26 Ofwat argued that the cost of capital set at a five-year price review needed to be 'sustainable over the period and investors must have adequate comfort in the transparency of the regulatory regime to invest in the sector over the long term'.⁷⁴ Ofwat argued that investors took a longer-term approach when assessing investment performance and as such they accepted that the actual return on capital may fluctuate from that forecast in any given year. Ofwat also noted that the cost of capital it used at PR04 reflected its views on the general business risks companies faced and its views on items such as power costs and revenue losses as a result of competition.

4.27 With regard to SES's argument that its proposed approach was consistent with that applying to other types of IDoK, Ofwat argued that there was no reason to expect that these different types of IDoK should be treated in the same way (except as specified by the licence) and noted the differences between the types of situation these provisions were designed to deal with. Ofwat noted that for some companies (including SES), the key financial indicator in a standard IDoK was a simple interest cover. It also noted that standard IDoKs made no reference to 'reasonable returns on

⁷³Ofwat's 'Introduction to reference to the Competition Commission', p4, paragraph 8.

⁷⁴Paragraph 194. Ofwat Response to SES's submission to the CC.

capital' and that competition and power costs were explicitly excluded as NIs at PR04 because the cost of capital took account of this and other forms of business risk.⁷⁵

4.28 In the disputed determination Ofwat, having made certain adjustments (described in paragraphs 3.66 to 3.83 above) to SES's claim, assessed the result⁷⁶ of the substantial effects on SES's rate of return and a package of financial indicators in 2008/09 and 2009/10. Ofwat concluded that SES was able to finance its functions. In forming this view, it took account of the exceptional nature of the substantial effect clause and the short time period to the next review; it also took account of the fact that price limits would be reset in 2010 and considered that in the short time period until then SES would be in a position to raise additional funding if required. Ofwat noted that the 'published financial information strongly suggests that [SES did] not currently need to access capital given [its] high level of cash balances and committed liquidity facilities'.⁷⁷

4.29 In response to SES's claims in paragraph 4.21, Ofwat argued that its approach to assessing the SAE claim accounted for the historic cost of any adverse effect, as the financial modelling was based on actual costs and therefore the cash flows of historic under- and overperformance had been incorporated into the ratio review, and hence assessment of SES's ability to finance its functions for the remainder of the price review period.⁷⁸

4.30 Ofwat argued that section 2(2A)(c) of the WIA referred to 'reasonable returns on capital' but that the licence did not prescribe or define reasonable. It argued that what was reasonable depended on all the circumstances of the case, including the

⁷⁵SES PR04 supplementary report, p28.

⁷⁶Ofwat used actual performance (on a notional capital structure) for the first three years of the quinquennium adjusted for its interpretation of the substantial effects and then using this opening position assessed the adjusted substantial effects in the final two (forecast) years holding other PR04 assumptions to be true.

⁷⁷Final determination, 16 December 2008, p7.

⁷⁸Ofwat, response to Sutton and East Surrey Water's submission to the Competition Commission, 9 April 2009, paragraph 197.

resources available to SES, its financial standing, its capital expenditure commitments, likely operating costs, the imminence of the next price review and other factors. It also argued that allowing SES greater resources than those which were needed to finance its functions would not be consistent with its duty to further the consumer objective. Ofwat did not agree with SES that section 2(2A)(a) of the WIA should be accorded less weight than section 2(2A)(c). Ofwat considered that the duties were compatible with each other, as securing that the functions of water companies were properly carried out, and securing that they could effectively do that by financing the proper carrying out of their functions, was in the long-term interests of consumers.

4.31 Ofwat stated that its methodology for assessing a company's ability to access financial markets was set out in its methodology papers for both the 2004 price review and 2009 price review and it was based on a consideration of the return on capital⁷⁹ and a set of financial indicators. In assessing SES's financial position, Ofwat argued that whilst it may have given less weight to the return on capital, its judgment was based on both the rates of return and financial indicators assessed as a package.

4.32 Ofwat assessed the claim by reviewing overall business performance (on a notional⁸⁰ capital structure basis) for the first three years of the PR04 price control period, adjusted for its assessment of the substantial effects. Then, using this opening position, Ofwat assessed the effect of the circumstances (adjusted for its assessment of these) in the final two (forecast) years assuming that all other aspects of the business develop in line with the PR04 assumptions. It told us that in its SAE determination it had excluded all costs and savings not related to the claim itself (ie those not related to the power cost and income circumstances), as it believed it to be

⁷⁹In this report, we assess 'return on capital' by assessing the rate of return on RCV. Ofwat and SES use the term 'ROCE' to refer to this measure.

⁸⁰Ofwat adjusted the business performance to reflect its PR04 assessment of 'notional capital structure', ie an assumption regarding the appropriate level of debt and equity in a water company.

more appropriate to deal with these other factors at the next periodic review where they would receive the appropriate level of scrutiny. It argued that to do otherwise would be to expand the scope of the SAE determination towards a detailed, line by line, challenge of each additional cost or saving in a manner very similar to the periodic review process. It considered that such an approach would not seem compatible with the short, three-month, time frame in which the licence stated a substantial effect claim should be completed.

4.33 In relation to the weight it placed on SES's financial ratios, Ofwat told us that it assessed financial performance against a range of indicators. It considered there to be no ranking of these indicators (with the exception of setting a notional gearing) because there was no consensus in the use or definition of financial ratios between the rating agencies and within capital markets generally.⁸¹ However, Ofwat stated that one of the indicators, Adjusted Cash Interest Cover II, was less important for this SAE claim because the ratio was disproportionately affected by the timing and size of actual as opposed to forecast capital expenditure. It told us that as a result, it did not give this ratio much weight in its decision.

4.34 Ofwat stated that it did not see the guideline PR04 ratios as 'a floor beneath which [it] considered companies as unfinanceable'.⁸² Ofwat concluded that 'On the basis of the same financial ratio package that was used for PR04 ... 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'.⁸³ Ofwat also stated that 'it does not focus on the level of any particular indicator in any particular year'.⁸⁴

⁸¹Ofwat, response to Sutton and East Surrey Water's submission to the Competition Commission, 9 April 2009, paragraph 215.

⁸²Paragraph 57, SES—2008 Substantial effect application. Introduction to the reference to the Competition Commission.

⁸³Ofwat, response to Sutton and East Surrey Water's submission to the Competition Commission, 9 April 2009, paragraph 218.

⁸⁴Paragraph 56, Ofwat's Introduction to reference to the CC dated 5 March 2008.

- 4.35 If a company's financial profile was adequate and future pricing reviews adjusted for actual costs, then Ofwat considered that these fluctuations would not unduly influence investors' assessment of performance. In light of this, Ofwat considered that SES's rate of return was reasonable and that it did not need to be equivalent to any previously determined cost of capital.⁸⁵
- 4.36 Ofwat told us that subsequent to its determination of SES's SAE claim the credit rating agency Moody's did not consider that this had adversely affected the credit quality of SES and hence its ability to access financial markets. Moody's stated 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'.⁸⁶

Our assessment of the relevant principles

- 4.37 We consider that, in answering the clause 13.3(2) question: 'what change should be made to the Adjustment Factor' we are exercising a discretionary power. In doing so, as a matter of general law, it appears that we have a wide discretion to decide what factors are relevant and what weight to give to those factors. However, section 12(3) WIA91 requires us to determine this question in accordance with the principles which apply, by virtue of Part I of the WIA91, in relation to such determinations made by Ofwat, and these are set out in section 2 WIA91.
- 4.38 Section 2 WIA91 has been substantially amended by the Water Act 2003. In its current form, it specifies primary aims in subsection (2A); secondary aims, which are expressed to be 'subject to subsection (2A)', in subsection (3); and some general principles in subsection (4). The primary aims most relevant to this determination

⁸⁵Ofwat, Final determination 16 December 2008, p7.

⁸⁶Moody's credit opinion 16/03/09.

appear to be those in section 2(2A)(a) to (2A)(c) of the WIA. Although the ‘consumer objective’ is placed first, and is elaborated by subsections (2B) and (2C) we consider that the order in which the various aims are listed creates no hierarchy and that case law shows that, faced with such a range, we can decide the means by which the legislative aims are to be achieved.⁸⁷ SES put it to us that the different wording of (2A)(a) ‘to further’ the consumer objective, and of (2A)(c) ‘to secure’ that companies were able to finance the proper carrying out of their functions indicated that (2A)(c) was the more important aim. We do not agree, and we have considered the relevant aims in the order in which they appear in subsection (2A) in the following assessment.

Section 2(2A)(a)—consumer objective

- 4.39 Section 2(2B) states that ‘the consumer objective’ is to protect the interests of consumers. We consider that, all else being equal, it is not protecting the interests of consumers to allow water companies to increase prices beyond the limits set out in the relevant periodic determination. Nevertheless, an adjustment to K when a circumstance has had a substantial adverse effect on the relevant water company may protect the interests of consumers if it were to result in a reduction to the level of risk to which water companies are exposed such that prices over the longer term were lower than they would otherwise be. As well as this potential effect, we also recognize the potential that allowing such an adjustment to K would have to undermine the incentives that water companies have to become more efficient.
- 4.40 Ofwat said in PR04 that the substantial adverse effect provision was one of a number of mechanisms that protected water companies from significant changes between reviews by allowing for the possibility for adjustments to K. Ofwat also said that it took into account that these mechanisms were in place in its assessment of risk and

⁸⁷See, for example, *R v Director General of Telecommunications, ex p. Cellcom* [1999] ECC 314 at 330.

its judgement on the cost of capital.⁸⁸ We conclude from these statements that the substantial adverse effects provision was expected to reduce the risks to which water companies were exposed and that this was reflected in the price settlement.

4.41 It is therefore our view that it is appropriate to consider the impact of the relevant substantial adverse effects on the financial performance of the company and, in particular, to assess whether the impact is consistent with the level of risk reflected in the price settlement. In making this assessment, we look at the impact of only the relevant substantial adverse effects over the PR04 period.

4.42 In making this assessment, we consider that it is necessary to look at the impact of the substantial adverse effects on the various measures of financial performance used by Ofwat when the price controls were set including the 'package' of indicators used to ensure that companies would be able to maintain good credit rating. When looking at the impact of only the substantial adverse effects, it is likely that the company's rate of return on capital will be below the cost of capital used in PR04. This is not, however, in itself sufficient to justify an adjustment to K as it is to be expected that even an efficient company may not necessarily achieve the rates of return expected when the price controls were set. However, it is our view that it is useful to see how a company has performed against the package of other financial performance indicators when considering whether the impact of the effects of the circumstance on a company's performance is within the scale that the company was expected to absorb within its price settlement. These ratios were used by Ofwat to check that the water companies which meet their efficiency targets would be able to maintain issuer or corporate credit ratings comfortably in the investment grade range.⁸⁹ The financial ratios are, however, only a guide. Ofwat said that the

⁸⁸PR04, p240.

⁸⁹PR04 p230.

indicators did not represent a 'floor' and that there remained scope for companies to absorb unanticipated downside risk and still remain within the investment grade credit rating range.

4.43 In considering whether an adjustment to K is likely to protect the interests of consumers, it is also necessary to consider the implications this may have for the behaviour of water companies in future in dealing with similar events. In the water industry, protecting consumer interests by providing companies with strong financial incentives to strive continuously to be more efficient has been central to the regulatory regime. Ofwat has put considerable emphasis on strengthening these incentives. To allow a company to charge its customers higher prices than allowed for by the original settlement has the potential to undermine these incentives. We note that Ofwat recognized this as an issue when considering whether particular risks should be listed as NIs⁹⁰. The implications for incentives are also relevant to the section 2(3) duty to promote the economy and efficiency by the water companies.

4.44 Where the consequences of substantial adverse effects are totally outside the control of the regulated firm, there can be no concern about the impact on incentives of allowing adjustments to K. However, it may be difficult for a regulator to form a view as to the extent to which the consequences of a particular circumstance were avoidable. It is our view that one of the aims of incentive-based regulatory regimes such as that in place for the water industry, where price controls are set periodically at a level which reflects the risks to which companies are exposed, is to minimize the extent to which regulators have to make these such judgements.

⁹⁰PR04, p239.

Section 2(2A)(b)—to secure that functions are properly carried out

- 4.45 Section 2(2A)(b) requires us when assessing an SAE claim to do so in the manner which we consider is best calculated to secure that the functions of the water company are properly carried out in respect of every area of England and Wales.

Section 2(2A)(c)—to secure financing functions

- 4.46 Section 2(2A)(c) requires us to assess an SAE claim in the manner we consider is best calculated to secure that the claimant company is able (in particular, by securing a reasonable rate of return) to finance the proper carrying out of its functions.
- 4.47 We do not agree with SES that the effect of subsection (2A)(c) is that, in the event of an SAE, Ofwat has a duty to change K to restore SES's rate of return to that assumed at the last price review. Ofwat said in PR04 that the settlements should allow an efficiently managed and financed business to earn a return at least equal to its cost of capital,⁹¹ but it is our view that this statement must be understood in the context that it was made, ie at the time that K, and so the price that companies would be allowed to charge for the next five years, was set. We consider that there is no legitimate basis on which this statement can be interpreted as providing a guarantee as to the actual return that each company would deliver, whether or not there was an SAE.
- 4.48 In the context of an SAE claim, section 2(2A)(c) requires us to secure that the company submitting a claim is able to continue the proper carrying out its functions. We consider that in order to do this, we need to consider not simply whether the company is unable, as a consequence of the adverse effects, to continue to carry out its functions, but whether, as a consequence of the adverse effects, its ability, going

⁹¹PR04, p217.

forward, to continue the proper carrying out of its functions appears likely to be impaired.

4.49 We therefore consider that it is appropriate to look at SES's current and future financial position. In this particular case, SES's current position is the more relevant as we can expect the question of whether, going forward, SES is able to continue the proper carrying out of its functions to be addressed by Ofwat's next periodic review (PR09).

4.50 In considering SES's current ability to finance the proper carrying out of its functions, we consider that it is appropriate to focus on its financial performance in 2008/09 and 2009/10, although its performance in the earlier years is relevant to the extent that this may affect its current ability to secure finance. We have assessed the company's current ability to secure finance by looking at the business' performance as a whole (rather than considering the substantial effects in isolation). We have reviewed performance against current estimates of the cost of capital to check whether the company could raise finance in the current market. In doing so, we have taken account of the company's actual capital structure to ensure that section 2(2A)(c) duty is satisfied with regard to the business as it is today.

4.51 We consider that the reference in section 2(2A)(c) to 'in particular by securing reasonable rates of return on their capital' forms part of the duty set out in subsection (2A)(c) to secure finance, and does not form a separate obligation to secure reasonable rates of return which is separate from this main duty. We consider that for these purposes it is appropriate to consider the rates of return having regard to the circumstances of the company over the whole of the current PR04 period.

4.52 We recognize that to form a view on the appropriate adjustment to K focusing only on SES's current position could affect the incentives created by the regulatory regime for the water companies to become more efficient. A problem could arise if, for example, a change to K was considered to be more likely for a company that has under-performed against its efficiency targets than for a company that had met these.

Application of these principles to SES's substantial effect claim

4.53 Having discussed our view on the relevant principles, we now apply them to SES's claim. We set out our assessment of the financial situation of the company, in line with the duties set out in the WIA 1991.

4.54 We first note that no suggestion has been made, and no evidence suggests, that SES is failing to properly carry out its functions or likely to in the PR04 price control period. Accordingly we consider that the section 2(2A)(b) duty is satisfied.

4.55 We proceed to consider whether the section 2(2A)(c) duty is fulfilled and then assess the section 2(2A)(a) duty as it applies to this case. We consider the duties in this sequence to assist our analysis; we do not consider there to be any hierarchy of these duties.

4.56 We consider it relevant that Ofwat is currently carrying out an assessment of the industry for its next periodic review (PR09). Investors will take the proximity of this review and their expectations of its outcome into account in their investment decisions, as well as their perception of how the substantial effect clause will work in the coming period. In addition, investors will form a view as to the riskiness of individual water companies, and the sector as a whole, taking into account a range of factors which are likely to include the past performance of individual companies and of the regulatory regime.

- 4.57 We have used a combination of current market and PR04 comparators to assess SES's financial position.
- 4.58 The nature of a 'circumstance' is such that it may have a wide range of financial effects. Some of these effects will be short term, affecting individual years, and some will have longer-term effects (eg periods of exceptionally dry or wet weather will have short-term effects but changes in customer usage and metering will have longer lasting effects).
- 4.59 We consider, given the nature of the circumstances for which the claim is made, that financial indicators need to be assessed both for individual years and over a number of years to provide a complete picture of SES's financial position and its ability to finance the proper carrying out of its functions.
- 4.60 We note that Ofwat made various adjustments to SES's substantial effect claim. Some of these were based on management prudence assessments with which we disagree (see paragraph 3.64). An adjustment was made for the shortfall from special agreement customers, which we agree does not specifically relate to the circumstances (see paragraphs 3.72 and 3.73). Other adjustments were made due to differences in the parties' approaches to adjusting for RPI and use of revised forecasts on which we have not needed to form a view as the adjustments made do not have a material impact on the claim. In general, the adjustments made reduce the size of SES's claim.
- 4.61 In this particular case, in assessing SES's substantial effect claim we have examined it without making adjustments to SES's original claim. As such, it demonstrates the largest financial effect the circumstances have had and are forecast to have on the financial position of the company.

The section 2(2A)(c) duty

- 4.62 We first consider the section 2(2A)(c) duty by assessing SES's return on RCV, both actual and forecast against its projected PR04 return and against industry averages. We then look at SES's forecast return on RCV for 2008/09 and 2009/10 against current estimates of the cost of capital. We then consider SES's financial ratios both for the recent past and using forecasts.
- 4.63 We noted SES's view (see paragraph 4.24) that Ofwat's current analysis of the cost of capital for the water sector was the most relevant. However, Ofwat's PR09 determination of the cost of capital for the PR09 period is not complete.
- 4.64 In our analysis, we have considered information from NERA Cost of Capital report for PR09 prepared for Water UK in January 2009 (the NERA report).⁹² This report provides a useful reference point for assessing the reasonableness of SES's return on RCV and is discussed further in Appendix F.

Our analysis

- 4.65 We considered SES's return on RCV. Table 6 shows SES's and the water industry's average pre-tax returns on RCV⁹³ compared with PR04 estimates. It shows that all sectors of the industry have underperformed compared with the PR04 projections and that they are also expected to underperform going forward. SES's average return on RCV of [X] per cent for the five-year period is [X] per cent of that projected at PR04. This compares to an average of [X] per cent of PR04 projections for WOCs and the industry average of [X] per cent of PR04 projections. This under-performance is principally driven by the forecast returns in 2008/09 and 2009/10 since the return on RCV for the first three years of the period at [X] per cent of PR04

⁹² January 2009, Cost of Capital for PR09, A Final Report for Water UK (the NERA Report).

⁹³ Pre-tax ROCE has been used in preference to post-tax ROCE as this removes the effect of different gearing/capital structures when actually comparing returns of different companies.

projections was close to the industry average for the first three years of the period of [redacted] per cent.

TABLE 6 Return on RCV (pre-tax, pre-interest)

	<i>per cent</i>					
	2005/06	<i>Actual</i> 2006/07	2007/08	<i>Forecast</i> 2008/09 2009/10		<i>Average</i>
SES—Actual	7.1	7.0	6.5	5.6	[redacted]	[redacted]
PR04	7.1	7.6	7.8	7.8	[redacted]	[redacted]
WASCs—Actual	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
PR04	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
WOCs—Actual	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
PR04	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Industry—Actual	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
PR04	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

Source: Ofwat.

4.66 SES told us that there was a mismatch in our comparison of actual returns to PR04 projections in Table 6.⁹⁴ SES produced revised numbers to compensate for this mismatch for its own performance, which showed a reduction in the average actual return over the period from [redacted] to [redacted] per cent. We accept that there are potential inconsistencies in the datasets used in Table 6 for all companies. However, we consider that the data provides useful information on SES’s relative performance against industry averages. We also note that the data has been prepared on the same basis as the ‘Financial Performance & Expenditure’ report which Ofwat prepares and uses to assess general levels of industry performance.

4.67 We reviewed forecast performance against current estimates of the after-tax cost of capital (see Appendix F). The midpoint of NERA’s estimates was 4.9 per cent.⁹⁵ SES’s 2008/09 forecast performance of [redacted] per cent was [redacted] above these mid-point

⁹⁴SES told us that the profit figures used for calculating the actual returns on RCV included the actual Current Cost Depreciation (CCD) and Infrastructure Renewals Charge (IRC) whilst the Regulatory Capital Value (RCV) used in the same calculation uses the CCD and IRC as projected at PR04. The RCV is not adjusted for differences between the actual CCD/IRC and those in PR04. Therefore there is a potential mismatch where actual returns are being compared with the PR04 returns. In addition, SES told us that the PR04 CCD/IRC was used to calculate the revenue requirement, which meant that from an economic point of view the value has been consumed and taken off the RCV. SES stated that its CCD and (to a lesser extent) IRC were less than the PR04 projections and as a result profits were higher than expected but the RCV had not been adjusted to reflect the lower CCD/IRC charges.

⁹⁵We considered that there were reasons to consider that these estimates might err on the high side. See Appendix F.

estimates and SES's 2009/10 forecast performance of [X] per cent was [X] these estimates. If a post-tax small company premium in line with PR04 of 0.7 per cent, as discussed in Appendix F, is included, then both years' forecasts [X] the revised midpoint estimate. Variability of returns is, however, to be expected and the estimates of cost of capital include risk premiums; SES's performance in both 2008/09 and 2009/10 is expected to be above the risk-free rate.

- 4.68 Having considered return on RCV, we then considered SES's other financial indicators. The financial ratios assessed were those set out by Ofwat for all water undertakings at PR04 (see Appendix F for details and definitions).
- 4.69 Table 7 sets out the ratios based on SES's financial structure.⁹⁶ The cash interest cover ratios [X] across the five-year period [X] Ofwat's PR04 guidelines throughout. The adjusted cash interest cover I ratio [X] across the five-year period until the 2010 forecast when there is forecast to be a [X]. Adjusted cash interest cover II varies across the period and is forecast to be [X] in 2010. We agree with Ofwat (see paragraph 4.33) that this ratio is particularly sensitive to the timing of capital expenditure and should not be given particular weight; this ratio is discussed in Appendix F. Whilst gearing has increased, we note that it is below 80 per cent, which is the 'covenant level under the structured financing that triggers a restriction in dividend payments and additional indebtedness'.⁹⁷ The debt payback ratios fall across the five-year period but are above Ofwat's PR04 guidelines throughout.

⁹⁶This takes account of SES's levels of debt and equity. For much of its analysis Ofwat used a notional capital structure in order to exclude the effects of financing decisions taken by SES.

⁹⁷Standard and Poor's: Sutton and East Surrey Water Plc, 5 November 2008.

TABLE 7 SES financial ratios based on actual and Business plan forecast

	2005/06	2006/07	2007/08	2008/09 Draft un- audited accounts*	2009/10 FBP† forecast	Average	PR04 guidelines
	Actual	Actual	Actual				
Cash interest cover	5.56	5.71	5.18	5.04	[X]	[X]	Around 3
Adjusted cash interest cover I	2.54	2.49	2.06	2.04	[X]	[X]	Around 1.6
Adjusted cash interest cover II	3.67	1.45	1.27	1.93	[X]	[X]	Around 2
Gearing (debt/RCV) (%)	59%	68%	71%	77%	[X]%	n/a	<65%
Debt payback (%)	23%	19%	17%	15%	[X]%	n/a	>7%

Source: Data provided by SES

*Adjusted for tax paid: SES has been managing its cash position carefully in 2008/09 and as a result has not paid its tax directly. Tax has been paid by an inter-group account and is held as an inter-group creditor on SES's balance sheet. The adjusted tax paid position shows the ratios that would have been recorded had SES paid its tax bill in cash.

†FBP—Final Business Plan (as submitted to Ofwat for the purposes of the ongoing PR09 process).

Note: SES noted that there were some inconsistencies with data previously submitted to Ofwat as the method for treating preference dividends had changed. The figures above include preference dividends as interest paid in all years for trend comparability.

4.70 The ratio guidelines currently provided by Moody's for regulated business credit ratings (see Appendix F) are not very different from Ofwat's PR04 guidelines. The Moody's thresholds for investment grade (Baa2 and above) are slightly less onerous than those set at PR04 which were intended to ensure the water companies were comfortably within investment grade. We note that Moody's does not list the adjusted cash interest cover II ratio as part of its key ratios reviewed in its credit reports.

4.71 Having shared the latest forecasts with the credit ratings agencies, SES has not suffered from any recent changes to its credit rating. This indicates that the credit rating agencies consider the financial position of SES to support an investment grade.

Evaluation of the section 2(2A)(c) duty

4.72 Our review of the return on RCV shows that SES's past performance has been broadly comparable to the industry as a whole, although all sectors of the water industry have underperformed the PR04 estimates. This does not suggest that historical performance will adversely affect the ability of SES to raise finance in the current market. Forecast performance for 2008/09 and 2009/10 is lower than projected PR04 return on RCV. However, compared with current estimates of the

cost of capital, with or without a small company premium, the return on RCV is considered reasonable in the overall context; it is [REDACTED] to the estimates of the cost of capital in 2008/09; and [REDACTED], it is providing a positive return above the risk-free rate.

4.73 The other financial performance indicators show a similar picture to return on RCV, with ratios in the early part of the PR04 period being within [REDACTED] in 2008/09 and 2009/10. The majority of the ratios meet Ofwat's PR04 and credit rating agency guidelines. [REDACTED].⁹⁸ We consider that in the short term, cash interest cover is the most important interest cover ratio as it highlights any immediate issues with cash flow; cash interest cover is currently comfortably within the guidelines. The adjusted cash interest cover ratios take account of the ongoing need for capital expenditure to sustain the business. [REDACTED]. We consider the average of these ratios across PR04 to be helpful indicators. The average adjusted cash interest cover I ratio of [REDACTED] across the PR04 period is above Ofwat's guideline of around [REDACTED]. Over the whole PR04 period the adjusted cash interest cover ratios are on average close to or above the guidelines set.

4.74 Whilst we consider the 2009/10 return on RCV and [REDACTED], we do not consider 2009/10 indicators to be indicative of long-run performance for SES due to the nature of the circumstances. The impact of procurement contracts in 2008/09 and 2009/10 will unwind and we have not seen evidence that suggests that the business will not perform in line with the rest of the industry in the future. The next pricing review (PR09) is a short time away. There appears to be no immediate need for additional finance to fund the operations of the business. Taken together with the other financial indicators, the nature of the circumstances, and the evidence from Moody's, we consider the return on RCV to be reasonable and conclude that the company is able to finance its functions.

⁹⁸[REDACTED]

Section 2(2A)(a) duty

4.75 Having assessed that the section 2(2A)(c) duty has been satisfied, we consider whether the substantial effect circumstances may have a long-run effect on investors' assessment of risk sharing and hence the future cost of capital. As stated in paragraph 4.39, in general an increase in prices is not in the interest of consumers. However, there are times when a price increase may be appropriate; for example, if this will maintain the terms on which capital is obtained without undermining the efficiency incentives of water companies.

4.76 As outlined in paragraphs 4.43 and 4.44, in assessing the section 2(2A)(a) duty we consider only the effects of the circumstances on the performance of the company against the financial ratios used by Ofwat in setting the price controls, ie we consider the effect that these circumstances have on the company's financial position, whilst assuming that other aspects of the business have developed in line with the PR04 assumptions (including the capital structure assumed in the PR04 determination).

4.77 These notional ratios are set out in Table 8 and are compared to the PR04 guidelines (as noted in paragraph 4.70, these are close to, but slightly more demanding than, current credit rating agency guidelines for investment grade status).

TABLE 8 SES financial ratios based on SAE isolated effects and a notional financing structure

	2005/06	2006/07	2007/08	2008/09	2009/10	Average	PR04 guidelines
Cash interest cover	4.23	3.69	3.79	3.51	[REDACTED]	[REDACTED]	Around 3
Adjusted cash interest cover I	1.73	1.27	1.40	1.26	[REDACTED]	[REDACTED]	Around 1.6
Adjusted cash interest cover II	1.40	1.14	1.72	1.56	[REDACTED]	[REDACTED]	Around 2
Gearing (debt/RCV)	57%	59%	60%	61%	[REDACTED]%	N/A	<65%
Debt payback	21%	18%	19%	17%	[REDACTED]%	N/A	>7%

Source: Ofwat.

Note: N/A = not applicable.

4.78 Table 8 shows that cash interest cover, gearing and debt payback are all above the PR04 guidelines. [REDACTED]

- 4.79 As noted in our analysis of the section 2(2A)(c) duty (see paragraph 4.73), the adjusted cash interest cover ratios are viewed as a medium-term measure of performance. We have again reviewed the averages here and find that the average adjusted cash interest cover I ratio is [REDACTED] and the average adjusted cash interest cover II ratio is [REDACTED]. We have noted previously that we, like Ofwat, view the guidelines as just that and not floors or guarantees. We consider [REDACTED] for adjusted cash interest cover I to be acceptable, it is [REDACTED] and falls within Moody's criteria for Baa1 ratings (Baa2, which is an investment grade, has a guideline of >1.2 and <1.4). Adjusted cash interest cover II (which is not covered as a key ratio by Moody's in its credit reports) is [REDACTED] across the period; we note this, but do not think that the level of this ratio on its own would cause investment grade status to be called into question.
- 4.80 On balance, assessing the impact of the substantial adverse effects on SES's business over the PR04 price control period against these ratios, we think that the impact on SES is of a scale that it would have been expected to be able to absorb within its price settlement.

Implications for incentives

- 4.81 In paragraphs 4.43 to 4.44, we observe that in exercising discretion in relation to an SAE claim it is appropriate to consider the effect allowing a claim might have on the incentives that the water companies might have in responding to future changes in circumstance. The potential implications for incentives will depend on the nature of the circumstances and, in particular, the extent to which the potential consequences for the business and its customers can be managed by the water companies. We have therefore considered how allowing an adjustment to K in the specific circumstances covered by this claim might impact on the behaviour of SES were similar circumstances to arise again.

Power costs

- 4.82 In our view, allowing an SAE claim in the event that energy prices increase by more than allowed for in the price settlement could undermine the incentives water companies would otherwise have to manage their energy costs in the long-term interests of consumers.
- 4.83 We accept that there is a limited amount that water companies can do in the short term to reduce their demand for electricity. We accept SES's argument that in the case of energy efficiency this is largely driven by capital expenditure in reducing leakage and the maintenance and replacement of pumps which will be agreed with Ofwat and be reflected in the regulatory settlement. Such decisions will be driven by expectations about energy prices over the longer term.
- 4.84 However, we consider that to the extent that the SAE provision is expected to limit the downside risks to a company and its shareholders associated with higher energy costs, it will inevitably affect commercial decisions in relation to the procurement of energy; and do so to the detriment of customers.
- 4.85 For a company effectively to manage its energy costs, it will have to incur certain costs and these costs may be higher at times of volatile energy prices. To protect customers and shareholders from fluctuations in prices, a company may, for example, take out long-term contracts but, over the longer term, a company adopting such a strategy would expect to pay a premium over expected prices. It is a matter of commercial judgement as to whether this premium is worth incurring. There are also the costs of management time and effort put into procurement. The terms on which energy companies are prepared to supply water companies are not advertised—management time, effort and judgement is required for a company to know what options it has. If the exposure of a company to higher prices is limited in some way,

this will inevitably reduce its willingness to incur such costs in managing the downside risks.

- 4.86 To the extent that there is an expectation that Ofwat might intervene to reduce K if energy prices turn out to be lower than assumed, the potential benefits to water companies of adopting a strategy that will benefit their shareholders if energy price fall will be reduced. However, to the extent that the SAE provision protects companies from downside risks, it will affect their incentives to manage the energy price volatility between price reviews.
- 4.87 In our view, preserving the incentives that water companies have to manage their power costs is particularly important because it is so difficult for Ofwat to take a view on what would have been efficiently incurred energy costs. This is illustrated by the debate in this case in relation to Ofwat's use of its power model (see Appendix D). Ofwat is at an information disadvantage compared with the management of the water companies as it does not know what options were available to them.
- 4.88 It is our view that it is precisely these issues that RPI-X style regulation is intended to address. The regulated prices having been set, it is up to the companies to manage events as they unfold during the price controls as effectively as they can. The price settlement will over the longer term reflect the risks that they face.

Income from households (tariff volume)

- 4.89 We do not think that the same arguments apply to adjusting K for the shortfall in income from households.
- 4.90 There is almost nothing that a company can do in the short term to deal with a shortage of supply in periods of dry weather. Its ability to deal with drought will

depend on investment in reservoirs and leakage (and metering). In theory, if protected to some degree from the revenue loss associated with having to impose restrictions, this might impact on its incentives to invest in the capacity required to avoid the need to do so. In practice, this seems rather unlikely since investment incentives are driven by other regulatory processes (under which companies propose investments for inclusion in their asset management plans and Ofwat agrees or disagrees to their inclusion in the RCV).

- 4.91 Where the shortfall in income is due to lower demand for water in wet weather or a higher-than-expected number of households choosing to have a meter, we do not believe that allowing a price adjustment would obviously encourage companies to behave in ways that are undesirable.

Evaluation of the section 2(2A)(a) duty

- 4.92 We have looked at the effect the particular circumstances that are the subject of SES's claim on its business and have concluded that the impact over the price control period is of a scale that is consistent with the level of risk reflected in the price settlement.
- 4.93 With regard to the impact on incentives, we conclude that to allow an adjustment in relation to the circumstance giving rise to an increase in SES's power costs was not consistent with the aims of the WIA, to the extent that this could damage the incentives that companies would have in future, were similar circumstances to arise. There appears to be less risk that allowing an adjustment to K to reflect the shortfall income from households is inconsistent with the aims of the WIA.

Conclusion

- 4.94 We consider that, in general, the consumer objective set out in WIA section 2(2A)(a) is furthered by ensuring, over time, low prices, to the extent that these are consistent with the aims of the WIA and Ofwat's other duties. It might be in consumers' interest that a positive adjustment to K be made, for example if this were required to avoid an increase to SES's cost of capital. However, our analysis suggests that the case for making an adjustment to K on these grounds is weak. Furthermore we have concerns that to make an adjustment could, going forward, be damaging to the incentives that SES has to be cost efficient. Our analysis leads us to conclude that the consumer interest would not be furthered by a positive adjustment to K
- 4.95 We have seen no evidence to suggest that SES is not properly carrying out its function as a water undertaker and we consider that the duty set out in WIA section 2(2A)(b) is met with regard to SES.
- 4.96 We consider, having taken regard of a range of factors including, in particular, its return on capital, that SES is able to finance the proper carrying out of its functions with prices at their current level and that a positive adjustment to K is not necessary in order to satisfy the duty set out in WIA section 2(2A)(c).
- 4.97 We have had regard to the regulator's other duties as identified in the WIA, and in particular to the duty to promote economy and efficiency by the water companies, and to have regard to the principles of best regulatory practice. Our conclusion in relation to the potential impact on incentives is also relevant to the section 2(3) duty to promote economy and efficiency of the water companies. We do not consider that a positive adjustment to K is necessary or appropriate to comply with these.
- 4.98 Our provisional determination is that no adjustment to K be made.