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Pamela Taylor
Chief Executive

Dear John

Sutton and East Surrey Competition Commission Appeal - Water UK evidence to the inquiry.

I am writing on behalf of members of Water UK, the organisation that represents the appointed water businesses in the UK.

This evidence focuses on key points of principle regarding the application of the 'substantial effects' clause (SEC), rather than to the specific details of the case launched by the company in question, Sutton and East Surrey Water Ltd (SES).

In particular, given the importance of the 'substantial effects' clause in the framework of risk mitigation measures that jointly define the balance of risk between shareholders, bondholders and customers, we believe that the process of this appeal should lead to greater understanding of the role of this mechanism and the principles governing its application.

At Water UK's recent City Conference, investors clearly registered the importance they place on there being greater transparency as to how the mechanism should or would be applied. Indeed Regina Finn helpfully committed Ofwat to respond to this call and the industry and investors await this clarification.

In particular, it would be helpful for the Commission to explain clearly its assessment of the role of the SEC, to establish greater transparency

regarding the process for reviewing a SEC determination and to ensure clarity as to the reasons for its and Ofwat's decisions (including how these relate to the decisions made in the previous two cases, Northumbrian and West Hampshire, and hence what 'precedent' exists). We should also like the Commission to consider carefully how the question of 'prudence' in decision making can be assessed ex post, avoiding recourse to the wisdom of retrospective hindsight.

These points relate in particular to a) the decision by Ofwat, despite the company breaching the '20% of turnover' hurdle, not to grant any adjustment in revenues/returns b) Ofwat's conclusion that the company had not acted prudently in its management of its energy purchasing contracts.

We consider each of these in turn.

a)

The substantial effects clause is an important element in the regulatory framework establishing the balance of risk between shareholders and customers. Its successful application in two previous cases has provided some comfort to investors.

We recognise that, in the case of a SEC and by comparison with the IDoK mechanism, the law apparently grants Ofwat greater discretion in whether and how it determines if an adjustment is needed. Ofwat has argued that there is no implied requirement to return the company to the previously envisaged rate of return. The company however, argues that Ofwat's discretion is in practice much more limited. These are important legal questions to be addressed by the Commission.

However, whatever the legal position, it is apparent that good regulation may not be best served by a process where discretion leads to an undue degree of unpredictability that raises investor perceptions of regulatory risk. This is important to both equity and debt investors – the SEC is important factor in credit ratings' agencies assessments of companies in the sector and has also been highlighted as a creditor protection in bond and bank prospectus documents.

It would be helpful for instance if the Commission were to identify clearly the common principles which apply to SEC applications. It is important that in future Ofwat is able to demonstrate consistency in the application of

principles in reaching its judgments. A lack of consistency may lead to a perception of a change in the balance of risk between shareholders and customers, and/or an increase in perceived regulatory risk. Either way, any such change in the perceived risk profile of the industry would clearly have implications for the cost of capital in the future.

b)

Turning now to the question of retrospection and the application of hindsight regarding the company's handling of its energy purchasing contracts, it is evident to any observer that energy markets have been highly volatile in recent years. Energy price predictions in recent years have invariably turned out to have been wrong. In these circumstances companies must aim to secure contracts based upon information available at the time. According to the licence, companies must be prudent in their management. We consider it important that the Commission explores carefully what 'prudency' requires of management – it is not, in our view, the ability accurately to predict the future, or to take a specified view on risk.

We trust these comments are helpful, and we look forward to your determinations. These are important matters that have a fundamental impact on the perception of the stability, predictability of the regulatory regime, and the risk framework into which investors are buying.

Yours sincerely

Janet Wright
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