

## **Ofwat's response to the Competition Commission's provisional determination of Sutton and East Surrey Water plc's price limits**

1. On 17 June the Competition Commission (CC) published its provisional determination report.
2. Overall, we welcome the CC's provisional determination and consider it to be the right outcome for consumers.
3. We support the CC's conclusions on the operation of the substantial effect clause that:
  - passing the materiality threshold does not automatically result in an adjustment to price limits.
  - there is discretion in determining what change, if any, should be made to price limits, given our duties in section 2 of the Water Industry Act 1991 (WIA91) in the light of the individual circumstances of each case at the time of the application.
4. We believe these to be important principles and it is clear that the substantial effect clause does not set out a prescriptive mechanism for adjusting price limits.
5. We particularly welcome the emphasis the CC places on maintaining the incentives implicit within the RPI-X regulatory regime. Companies are incentivised to manage costs because they retain the benefits of outperformance and bear the cost of underperformance. As we have argued to the CC the company's approach, if accepted, would significantly weaken the incentive regime. This is because the company could have passed downside costs that materialised from its procurement decisions to customers, but could have retained any benefit if instead electricity prices had moved as it expected. This would not just mean that Sutton and East Surrey Water's (SES) customers would face higher bills, but could also result in all customers facing higher bills in the future. The CC's conclusions ensure that the incentive remains on companies to manage costs.
6. Given our comments above, we do not think that it is necessary to respond in detail to each point, but we set out below some further comments on the provisional determination.
7. We note the CC's comments on the relatively risky nature of SES's procurement decision and its acknowledgement that companies must consider, and bear, the risks associated with their decisions. As we explained in our 9 April submission (and the CC recognises in paragraph 3.51 of its provisional determination), SES has provided no evidence that it had properly considered the risks and impact of electricity costs on its business until after prices moved against it. This is despite the fact that power costs are a large proportion of its operating costs and that SES

believed, as far back as 2004, that these costs were going to be volatile. Other companies took appropriate steps to actively manage the risks associated with power procurement.

8. The only evidence SES has put forward in relation to long term hedging of energy costs across the five-year period comes from discussions it held in 2009, almost at the end of the relevant period. This does not support a view of a company taking prudent action from 2005, when price limits came into force. We do not consider that a belated recognition of the need to operate prudently would be sufficient to satisfy the test set out in the clause.
9. We therefore respectfully continue to believe that SES's approach to energy procurement over the five year period was not prudent.
10. As part of its determination, the CC considered what constituted a 'circumstance'. As the CC states, defining the circumstance is not necessarily a simple process but one which affects not only the costs but also the offsetting savings that can be taken into account. We consider that the relevant circumstance for the purposes of the substantial effect clause will depend upon each individual case. Part of this process is to determine whether the circumstance, as stated by a company in its application, is appropriate or whether the circumstance is in fact wider or narrower than the company's definition. The starting point has to be an assessment based on the facts of the case not simply what a company considered to be relevant in its application. And whilst we note the discussion about causation, we would need to consider this issue further if it arose in the future.
11. In conclusion, we support the CC's provisional determination and consider it to be the right one for consumers. The CC has noted in the provisional determination that, since 1 October 2004, it can 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. Section 12(3A) WIA91 requires it to have regard to the extent to which its determination is likely to support the company's (rather than Ofwat's) claims in relation to the questions referred to it. We do not think that consumers should bear any of the costs involved in this determination.
12. In our hearing on 6 May 2009, the CC asked about further information we would receive that would be relevant to its determination. We explained that we would receive further information when the company submitted its 2009 June return. Each company is required by its licence to submit this audited annual return, which covers its activities in the previous financial year (ending on 31 March). SES has now submitted its return for financial year 2008-09.
13. The return and financial indicators SES reports in its 2009 June return appear to be better than those set out in tables 6 and 7 of the provisional determination document, which drew on final business plans. For example,

SES reports a post-tax return on capital for 2008-09 of 6.01%. This compares to the [X]% forecast by SES in its final business plan, which it submitted to us on 7 April 2009. We have set out updated data tables in Annex 1. We have not yet analysed or challenged companies' 2009 June returns.

**Ofwat**  
**1 July 2009**

## Annex 1 Updated CC data tables

We have updated tables 6 and 7 from the CC's provisional determination document to take account of companies' 2009 June return submissions. The updated figures are highlighted in bold.

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

	Actual				Forecast	Average
	2005/06	2006/07	2007/08	2008/09	2009/10	
SES—Actual	7.1	7.0	6.5	<b>6.1</b>	[X]	[X]
PR04	7.1	7.6	7.8	7.8	[X]	[X]
WASCs—Actual	[X]	[X]	[X]	[X]	[X]	[X]
PR04	[X]	[X]	[X]	[X]	[X]	[X]
WOCs—Actual	[X]	[X]	[X]	[X]	[X]	[X]
PR04	[X]	[X]	[X]	[X]	[X]	[X]
Industry—Actual	[X]	[X]	[X]	[X]	[X]	[X]
PR04	[X]	[X]	[X]	[X]	[X]	[X]

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

	2005/06	2006/07	2007/08	2008/09	2009/10	Av.	PR04 guidelines
	Actual	Actual	Actual	Actual	FBP forecast		
Cash interest cover	5.56	5.71	5.18	<b>5.18</b>	[X]	[X]	Around 3
Adjusted cash interest cover I	2.54	2.49	2.06	<b>2.15</b>	[X]	[X]	Around 1.6
Adjusted cash interest cover II	3.67	1.45	1.27	<b>2.07</b>	[X]	[X]	Around 2
Gearing (debt/RCV) (%)	59%	68%	71%	<b>77%</b>	[X]	n/a	<65%
Debt payback (%)	23%	19%	17%	<b>16%</b>	[X]	n/a	>7%

**Note:** Whilst we have updated the 2008-09 figures we cannot update the weighted averages as these were calculated by SES.