Response to provisional determination

1. Introduction and summary

1. This paper provides Sutton and East Surrey Water's (SESW) response to the Provisional Determination published by the Competition Commission (Commission) on 17th June 2009.

Commission's Provisional Determination is perverse

2. The Commission has accepted that

- **SESW's loss of water income and increase in energy costs would not have been avoided by prudent management action; and**
- **the materiality of the adverse effects is five times the 20% threshold that defines Substantial Adverse Effects in SESW's licence.**

3. Perversely, however, the Commission has then concluded that no adjustment to K is required. This discrepancy between materiality and the failure to adjust K is highlighted by the following table, comparing the Commission's decision to the two previous SAE determinations by Ofwat:

Company ***(date)***	**Materiality**	**K adjustment**	Comment
Northumbrian Water ***(2003)***	**25%**	**3.2%**	Based on PR99 rate of return plus additional return to improve financial ratios
Bournemouth and West Hants Water ***(2003-04)***	**40%**	**3.8%**	Financial ratios strong before K adjustment, K adjustment driven entirely by PR99 rate of return
SESW ***(2008-09)***	**110%**	**Nil**	Financial position close to NWL's, PR04 rate of return not used.

Commission's Provisional Determination is fundamentally flawed

4. As detailed in this response and as summarised below the Commission's Provisional Determination contains a number of manifest and fundamental errors, and misdirections namely:

- **The Commission's assessment of reasonable returns is wrong.**

1. Commission's return on capital figures for SESW are incorrect.

2. Commission has extracted the wrong cost of capital figure from the NERA report.

3. Failure to take proper account of the small company premium.

4. Failure to maintain regulatory consistency on the cost of capital.

5. Commission overstates returns on capital over the five year period.

6. Commission has not considered the impact of outperformance on returns

The Commission has neither used the cost of capital for the period 2005/10 determined at PR04, nor has it made a proper calculation of its own.

Correcting the Commission's assessment makes a substantial difference. Factual errors in the measurement of returns and the cost of capital mean that the gap between returns and the cost of capital is four times greater than that taken into account by the Commission (see Table 1 below). SESW's return does not come close to a reasonable return on capital.

- **Assessment of financial ratios is inappropriate**

1. Commission has misapplied the two strand test.

2. Financial ratios should be assessed on notional capital structure.

3. Commission has failed to take account of actions taken by SESW's holding company to avoid SESW breaching its financial covenants.

4. Financial ratios for small companies should be used, and each year's ratios tested against them.

The Commission has not established a coherent basis for concluding that returns below the cost of capital are reasonable. Its assessment ultimately collapses to a financial ratio test. This is not consistent with the Water Industry Act

- **Absence of K adjustment is not consistent with licence**

1. Commission ignores the scale of materiality for SESW.

2. Commission's approach resets the SAE materiality threshold at around 240%.

3. Commission's use of the risk-free rate is not correct.

4. Commission has not applied valid test of reasonable returns.

No account has been taken of the degree to which the present application passes materiality. The view that the materiality amount is "simply to establish jurisdiction" is said to be "consistent with the aims of the Act". This is not correct.

SESW's estimate of materiality is around 110%. This is over five times the threshold set out in the licence. In effect the Commission is creating an additional *de facto* threshold which is not written down and which forms no part of the licence.

The Commission's use of the risk-free rate as a benchmark is flawed. It implies that materiality would need to be 240% before a K adjustment was applied. Furthermore, the risk-free rate cannot be an appropriate benchmark for returns since any typical water company would be in breach of financial ratios before returns hit this level. Therefore, the Commission's assessment of returns reduces only to a test of financial ratios.

- **View on companies' expectations on risk is unfounded**

1. Commission makes assertions about expectations on risk that are unfounded and contrary to the evidence that is available.

2. Commission's approach is contrary to precedent.

In its Provisional Determination the Commission makes assertions regarding the level of risk that companies' accepted as part of the price control. Those assertions are unfounded and in contradiction to the evidence that is available. Expectations regarding risk were consistent with the previous SAE determinations and this level of risk was allowed for in the PR04 cost of capital.

- **Exclusion of power costs from K unfounded**

1. Exclusion of power costs from eligibility for a K adjustment derives from a basic error of economic analysis.

2. Commission has failed to perform an adequate cost-benefit analysis of its proposal.

3. Commission's approach will result in a higher cost of capital.

4. Commission's position is inconsistent with the Act and the licence and is not lawful.

Effectively the Provisional Determination purports to rewrite the clause to exclude items that are, to any degree, within management control.

The exclusion of power costs from eligibility for a K adjustment on the grounds that to allow such costs would undermine incentives is

incorrect. The Commission's argument fails to distinguish between costs that are within the control of management and those which are not; the Commission has not evaluated the costs and benefits of the options it has considered; and the Commission has not reviewed or evaluated the full range of options available to it.

The proposal results in greater risk being borne by investors and will inevitably result in a higher cost of capital in the future. The significance of this is illustrated by the market reaction to the Provisional Determination; a copy of Merrill Lynch's assessment is attached as Annex 2. The approach adopted by the Commission is clearly seen to be a change of policy and one that increases risk to investors and is clearly contrary to the Commission's conclusion in paragraph 4.94 concerning the consumers interest.

- **Approach creates perverse incentives**

  The Commission's approach creates perverse incentives on companies. In particular it would encourage companies to increase their level of gearing and therefore reduce the financial resources that they have available to deal with any adverse shocks. It will also discourage holding companies from early intervention, as to intervene would apparently damage the prospects of a successful SAE application. It would also encourage companies to apply earlier rather than attempt to mitigate the situation.

- **Numerous process failures have been made by the Commission**

  The result has been an unfair procedure for SESW.

5. **In the light of the above SESW believes that the Provisional Determination is unsound and cannot support the conclusion that no adjustment of its K is either necessary or appropriate.**

2. Assessment of reasonable rate of return is wrong

6. The Commission has assessed SESW's return on capital (i.e. return on RCV) in comparison to an estimate of the cost of capital. The Commission's figures for SESW's return on capital and its figure for the cost of capital are both wrong. Both elements of the cost of capital – the industry element and the small company premium are incorrect. Simply correcting the Commission's errors makes a material difference and clearly shows that SESW's returns are not reasonable in relation to the cost of capital.

7. The Table below highlights the scale of the Commission's errors.

	Commission's Provisional Determination		Corrected figures (NERA report)		Corrected figures (PR04)	
	2008/09	2009/10	2008/09	2009/10	2008/09	2009/10
SESW post-tax return	5.0%	3.5%	3.9%	3.6%	3.9%	3.6%
Post-tax WACC	4.9%[1]		6.4%[2]		6.6%	
Gap between return and WACC	**+0.1%**	**-1.4%**	**-2.5%**	**-2.8%**	**-2.7%**	**-3.0%**
Average gap across both years	**-0.7%**		**-2.7%**		**-2.9%**	

Table 1: Corrections to Commission analysis of returns and cost of capital

Commission's return on capital figures for SESW are incorrect

8. Table 6 of the provisional determination provides data on the pre-tax return on the RCV. SESW had told the Commission that these figures for the return on RCV were not correct, but the Commission persists in using them. The reason the figures are incorrect is that the profit figures in Table 6 are calculated using actual CCD not the CCD that was allowed at PR04. In order to calculate SESW's regulatory return the correct approach is to use the CCD allowed at PR04 as this is the figure used in the calculation of SESW's RCV[3].

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[1] The Commission does not include the small company premium and corresponds to the figures stated in Table 1 of Appendix F of the Determination. In the text the Commission also consider a scenario with a small company premium of 0.7%. Even in this scenario there is a substantial difference between the Commission's estimates and the corrected figures.

[2] The figure includes small company premium of 0.8%. If the low-high range from the NERA report is included then the range is [✂] to [✂]

[3] For example, if actual CCD is less than allowed CCD then this will increase the apparent return on RCV. However, because CCD is a non-cash item and RCV is rolled forward using allowed CCD rather than actual CCD there is no actual increase in the return on RCV..

9. SESW's correct regulatory returns have already been provided to the Commission, but are repeated in the Table below.

Year	Pre-tax return	Post-tax return
2005/06	6.7%	7.0%
2006/07	6.6%	6.8%
2007/08	5.6%	4.0%
2008/09	5.2%	3.9%
2009/10	4.1%	3.6%
Average	**5.6%**	**5.1%**
Allowed return at PR04	**7.6%**	**6.6%**

Table 2: SESW corrected pre-tax and post-tax return on capital

10. The average pre-tax return on capital for the five year period is 5.6%, compared to 6.0% on the figures used by the Commission. The post-tax return for 2008/09 and 2009/10 is 3.9% and 3.6%, and not the 5.0% and 3.5% used by the Commission. Therefore, the corrected returns are materially lower than those used by the Commission in its assessment.

11. The reference in paragraph 4.66 to similar "potential inconsistencies" (i.e. returns using actual rather than allowed CCD) in other companies does not justify the Commission's approach. The only relevant comparison is between SESW's return on capital reflecting regulatory CCD and the cost of capital because RCV is calculated after allowance for regulatory CCD. The approach the Commission has adopted compares profit calculated on one basis with an asset value calculated on another basis. **As a result the Commission's rate of return of SESW is wrong**.

Commission has extracted the wrong cost of capital figure from NERA report

12. In its analysis of the rate of return the Commission compared SESW's return on RCV to the weighted average cost of capital (WACC) of the water industry estimated by NERA[4] (paragraphs 4.64 to 4.67 and Appendix F).

13. The first point to note is that this is not a like for like comparison. The Commission compared SESW's return on capital for 2008/09 and 2009/10 to NERA's estimate of the cost of capital estimate for the period 2010/11 to

4 NERA, *Cost of capital for PR09, A final report for Water UK*, January 2009.

2015/16. In the absence of a proper calculation of the cost of capital for this period, there is a strong case for using the figure determined at PR04. This would be consistent with the two previous SAE determinations where the PR99 cost of capital was used.

14. Crucially, the Commission compared the post-tax return on RCV to the mid-point estimate of the post-tax WACC from the NERA report and concluded that the return was above the cost of capital in 2008/09. Even using the Commission's figure for SESW's return on capital (5.0%) this conclusion is wrong because the Commission has extracted the wrong number for the post-tax cost of capital from the NERA report.

15. The NERA report contains two definitions of the post-tax cost of capital:

    - the 'vanilla' post-tax WACC – this is the weighted average of the actual cost of debt and the post-tax cost of equity;

    - the post-tax WACC net of tax shield – this is the weighted average of the cost of debt after subtracting the tax benefits of debt and the post-tax cost of equity.

16. The Commission have used the second definition, the post-tax WACC net of tax shield, as the benchmark to compare the post-tax return on RCV. **This is the wrong benchmark.** The correct benchmark is the 'vanilla' post-tax WACC. The reason for this is that the benefit from the tax shield on debt reduces the company's corporate tax payments, not the post-tax return. It is double counting the impact of the tax shield to compare the post-tax return to the post-tax WACC net of the tax shield. Ofwat's financial modelling of price limits has always been based on the correct definition, the 'vanilla' post-tax WACC. The Commission has considered the different definitions of the cost of capital in previous inquiries and is well aware that the 'vanilla' post-tax WACC is the right measure[5].

17. The range of the 'vanilla' post-tax WACC in the NERA report is 5.3% to 5.8%. **The mid-point of this range is 5.6%, significantly above the incorrect 4.9% figure used by the Commission.** It was the 4.9% figure that permitted the Commission to assert that SESW's forecast return for 2008/09 was above the estimate of the cost of capital.

18. Finally, there is no support for the Commission's unreasoned and unsubstantiated view that the NERA report estimates *"might err on the high side"*[6].

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[5] In addition to Ofwat see for example, Competition Commission, *Sutton and East Surrey Water plc, A report on the references under sections 12 and 14 of the Water Industry Act 1991*, September 2000, Appendix 8.3.

[6] Footnote to para 4.67 of the provisional determination.

Failure to take proper account of the small company premium

19. The Commission's assessment of the cost of capital is further flawed because of its approach to the small company premium. The Commission's analysis considers the cost of capital under two scenarios:

    - first, with no small company premium;
    - second, with a small company premium of 0.7%.

20. This approach has two mistakes. First and most important, there is no basis to attach equal weight to the scenario where there is no small company premium. Second, the allowance of 0.7% for the small company premium is insufficient.

21. The Commission considered the basis for the small company premium in Appendix F of the determination. The appendix states:

    "We also considered whether the estimate we looked at for WACC should be increased through the inclusion of a small company premium. A small company premium has sometimes been included by regulators and was included by Ofwat at PR04." [para 7, emphasis added]

22. The use of the word *"sometimes"* is misleading. The need for a premium to the cost of capital for small water companies in England and Wales has been considered four times: by Ofwat in 1994, 1999 and 2004; and by the Competition Commission in 2000[7]. **On all four occasions a small company premium has been allowed.**

23. The Commission also notes in paragraph 8 of Appendix F that *"We note that NERA does not address the question of whether a small company premium is required for PR09 in its report."* This is also misleading. The aim of the NERA report was specifically and solely to estimate the cost of capital for the industry. A separate report was undertaken by NERA for all the water only companies (including SESW) to estimate the small company premium. This report concluded that a premium of [✂] ('vanilla' post-tax WACC) was justified for a company the size of SESW. This report was submitted to Ofwat as part of the Final Business Plan in April 2009. A copy of this report is provided as Annex 1 to this response.

24. As a result, all of the regulatory precedent supports the need for a small company premium to the cost of capital. This is also supported by the analysis undertaken by NERA.

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[7] Competition Commission, *Sutton and East Surrey Water plc, A report on the references under sections 12 and 14 of the Water Industry Act 1991*, September 2000, paras 8.35 – 8.40.

25. In terms of the appropriate scale for the small company premium the Table below summarises the available evidence. The evidence shows that the regulatory decisions on the small company premium for SESW are in the range 0.75% to 0.9%. The recent evidence collected by NERA indicates the small company premium is above this level.

	Premium to post-tax WACC
Ofwat (1994)	0.75%
Ofwat (1999)	0.9%[8]
CC (2000)	0.9%
Ofwat (2004)	0.8%
NERA analysis for PR09	[✂]

Table 3: Evidence on small company premium

26. The Commission's analysis referred to the Ofwat PR04 figure of 0.7%. This was the small company premium on the post-tax WACC net of the tax shield. **It is the wrong figure.** The Commission has repeated the error it made when extracting its cost of capital figure from the NERA report. The figure for the small company premium the Commission should have identified is the 'vanilla' post-tax WACC is 0.8%[9].

27. The evidence shows that there is no basis for the Commission to use a range of 0% to 0.7% for the small company premium, as it has implicitly done in its analysis.

28. Just correcting for the definition of the post-tax WACC and applying the small company premium from PR04 has a material impact on the estimate of the cost of capital. **The cost of capital used by the Commission is 4.9% whereas the correct figure is not less than 6.4%.**

29. Furthermore in the scenario where the Commission does include the small company premium it uses selective evidence. It combines the NERA estimate of the industry cost of capital with the Ofwat PR04 allowance for the small company premium. To be consistent it should either:

- apply the NERA estimate for both components to give a figure of [✂] (5.6% [✂]); or
- use the PR04 figure for the industry cost of capital as well as the small

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8 The published figure of 0.75% was the premium on the post-tax net of tax shield WACC. The premium of 0.9% relates to the post-tax WACC as used to set price limits in the financial model.

9 Ofwat, *Future water and sewerage charges 2005-10 Final Determinations*, December 2004, p226.

company premium to give a figure of 6.6%.

Failure to maintain regulatory consistency on the cost of capital

30. The corrected view of the return on RCV versus the cost of capital shown above is supported by other evidence on the cost of capital. SESW's position in this application has been that it is appropriate to use the cost of capital from the previous price control as the benchmark for an SAE application. This was the approach adopted by Ofwat in its determinations of both NWL's and BWH's SAE applications. The benefit of this approach is that it provides greater certainty to the company and investors. It also avoids the need to undertake a potentially complex assessment of the cost of capital. The value of SESW's approach has been demonstrated by the errors made by the Commission's assessment of the cost of capital in this case. The PR04 post-tax cost of capital for SESW was 6.6%. This is slightly above the corrected Commission figure of 6.4% shown above.

31. The Commission has previously highlighted the importance of regulatory consistency in cost of capital decisions.

    "We agree that stability in regulatory decisions is very important and therefore we have been very cautious in reducing the ERP used in the cost of capital below that used by the MMC."[10]

32. The principle of stability in regulatory decisions is achieved, in effect, by using the PR04 figure or by using the figure of slightly lower figure 6.4% as outlined above. However, it is not achieved by using a figure of 4.9% or 5.6% as the Commission has adopted in its provisional determination. It should have been clear to the Commission that these figures were not appropriate given the scale of difference from the previously determined figures.

33. The evidence from PR04 and the NERA analysis, together with the small company premium, shows that **the range 6.4% to 6.6% provides a suitable benchmark for the cost of capital**.

Correcting for the Commission's errors makes a material difference

34. The Commission's analysis of the return on RCV compared to the cost of capital contains a number of basic errors. The Table below highlights the scale of these errors.

[10] Competition Commission, *Sutton and East Surrey Water plc, A report on the references under sections 12 and 14 of the Water Industry Act 1991*, September 2000, para 8.30.

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Post-tax WACC	4.9%		6.4%		6.6%	
Gap between return and WACC	**+0.1%**	**-1.4%**	**-2.5%**	**-2.8%**	**-2.7%**	**-3.0%**
Average gap across both years	**-0.7%**		**-2.7%**		**-2.9%**	

Table 4: Corrections to Commission analysis of returns and cost of capital

35. After correcting for these errors the gap between the return on RCV and the cost of capital for 2008/09 and 2009/10 is **four times greater** than the Commission estimate without the small company premium (-2.65% compared to -0.65%)[11]. Even when the Commission includes the small company premium the true gap is still twice as large as the Commission estimated.

36. Furthermore, using the range from the NERA analysis of the industry cost of capital for PR09 plus the allowed small company premium for PR04, the range for the post-tax cost of capital is 6.1% to 6.6%. SESW's return on capital is well below this range in both years.

37. In paragraph 4.74 the Commission concluded that *"we consider the 2009/10 return on RCV …. to be low compared to the guidelines"*. This was based on a gap of 1.4% (see Table 4). The actual gap is at least 2.8%. Furthermore, contrary to the Commission's reasoning[12], in the corrected analysis there is no overlap between the SESW rate of return and the cost of capital in either year. **The necessary corrections to the Commission's figures, as outlined above, fundamentally undermine the Commission's conclusion that SESW's return on capital is reasonable.**

Commission overstates returns on capital over the five year period

38. Table 2 above shows that SESW's returns over the five year period were 5.6% pre-tax and 5.1% post-tax. In its Provisional Determination the Commission presents pre-tax figures as percentages of the PR04 allowance. Using the correct figures the ratio of actual to allowed returns for SESW is 74% pre-tax (i.e. a shortfall of 26%).

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[11] Using the [✂] of the NERA range.

[12] Paragraph 4.67.

39. In paragraph 4.65, the comparison with PR04 rates of return for SESW and the industry takes as its base point Ofwat's assessment of a reasonable return at PR04. What is wholly unreasoned is how a significant departure from the PR04 rate of return remains a reasonable return.

40. It is correct that companies may not achieve their PR04 rate of return as companies bear a number of diverse risks. However, that statement does not assist the analysis here because the departure from PR04 rates of return is due to the circumstance giving rise to the SAE. Paragraph 4.65 is therefore limited to assessing how big a variation there is between PR04 and actual figures. Firstly, this creates a new materiality threshold in place of 20% materiality, thereby rewriting the clause. Secondly, the grant of a return 26% below a reasonable return is a manifest failure to act in the way best calculated to secure a reasonable return.

41. The Commission also shows data on returns for the industry as a whole. SESW is not in a position to comment on these figures other than to note that the returns for the rest of the industry appear to be materially higher than for SESW. Otherwise the comparison is not relevant. The Commission does not explain how it interprets the comparison or how the comparison is relevant to the application of the SAE as set out in the licence and the Act.

42. There is no analysis of the underlying factors that influence other companies' returns. For the avoidance of doubt, if other companies' returns have been depressed by higher energy costs, it cannot be correct to use this fact to justify accepting as reasonable SESW's current returns below the cost of capital. Such an approach would have the effect of excluding the protection of the SAE provision from companies that have suffered disproportionately from an industry-wide circumstance.

Commission has not considered impact of outperformance on returns

43. The returns on capital that SESW has achieved also include the company's outperformance and efficiency in other areas. By only considering returns which include this outperformance the Commission fails to take account of a relevant consideration. This could penalise companies that have suffered an adverse shock but had outperformed in other areas. Such an approach would damage incentives for efficiency.

44. Taken across the five year period, stripping out the out-performance reduces the average post-tax return on capital for SESW from 5.1% to 4.1%. Expressed as a percentage of PR04 allowed returns, the average post-tax return falls from 77% to 62%. In other words the adverse effects have resulted in a 38% shortfall in returns over the five years.

3. Assessment of financial ratios is inappropriate

45. The Commission's assessment of financial ratios contains significant errors, both of approach and of application. The Commission has also failed to take account of the actions taken by SESW's holding company to avoid SESW breaching its financial covenants.

Error of approach – misapplication of two strand test

46. The Provisional Determination decides that the obligation to secure reasonable rates of return on capital is not separate from the duty to finance the proper carrying out of functions (paragraph 4.51). The two strands of the duty are considered and the conclusion is first that the rate of return is reasonable and secondly that the financial position of SESW supports an investment grade.

47. However what is missing from the analysis is the effect of the inclusion of the words *"in particular by securing reasonable returns on their capital"* on the interpretation of the duty to secure that companies are able to finance the proper carrying out of their functions. Adapting Lord Brandon's words in Bromley *LBC v GLC* [1982] 1 All ER 129 at 180, the object of Section 2(2A)(c) is to impose a defined method (i.e. securing a reasonable return on capital) of assessing whether the functions can be financed.

48. Because of "the highly capital intensive and long-term nature of the industry" (Ofwat hearing, p. 177, ll. 4-5), it specifically takes a medium term approach which is *not* asking whether the company is able to "to raise finance in the current market" (paragraph 4.72) and is *not* focused on the short term (paragraph 4.73) or on an "immediate need" for additional finance (paragraph 4.74). If proper account is taken of the full terms of the duty (financing functions in particular by securing a reasonable return), **the short-term finance approach is not adopted by the Act and cannot be used in support of the finding that the return on RCV is reasonable** (paragraph 4.74).

49. In addition, for the consumer objective the Commission has been prepared to consider the long-term effects of providing an adjustment to K (paragraph 4.39 of the Provisional Determination). Though there are other objections to the Commission's approach to the consumer objective (considered further at paragraphs 132 to 134 below), the long-term consideration in that case presents a stark contrast with the approach to financeability which is considered exclusively in the short-term. The whole point of providing for returns on capital as the defined method of financing functions is to adopt a long-term view. The Commission's reasoning on financeability simply fails to engage with this issue, preferring to adopt neat easy tests of whether SESW can access the requisite funds, whether from banks or, in this case, from holding company support (see paragraph 57 below). This ignores the legislative scheme, the terms of the licence and abandons all semblance of regulatory consistency.

50. Moreover, the Commission's approach is at odds with all previous applications of the s 2.(2A)(c) duty which have given proper effect to a return on capital in applying s. 2(2A)(c). At all previous price control and substantial effect determinations, Ofwat has applied this duty using the two strand test. As Ofwat explained[13]:

    "We continue to interpret this duty as having two strands. First, a company that is efficiently financed and run can deliver its services to consumers ***earning a return on its capital*** *base (measured by the RCV)* ***at least equal to the cost of capital****. Second, a company's revenues, profits and cash flows must allow it to raise finance on reasonable terms and thereby avoid passing undue costs to consumers. The availability, cost and other conditions of financing are directly related to a company's financial position and prospects. Such considerations are often referred to as 'financeability'. We discuss our approach to financeability in section 5.3."* [p45]

51. As we explained previously[14] Ofwat's application of this two strand test has not been affected by the change in the wording of the Act. The duty to secure that companies can finance their functions is achieved by ensuring that the return on capital is at least equal to the cost of capital.

52. Finally, it is this misconstruction of the nature of the duty which enables the Commission to find that SESW's current position is "the more relevant" as PR09 will look after SESW's future position (paragraph 4.49). Once lost, the return will not be made up. And it is no answer to say that PR09 is close or that there is no evidence that the business will not perform in line with the industry in future (paragraph 4.74). **The Commission must act in the manner it considers is best calculated to secure fulfilment of the s. 2(2A) duties, in particular its principal duty under s. 2(2A)(c). It is not permitted to avoid its duty because someone else will shortly have a similar duty to perform**.

Error of approach – financial ratios should be assessed on notional capital structure

53. The Commission has undertaken its assessment of financial ratios on the basis of actual financial structure. This is an incorrect approach and is at odds with Ofwat's approach which is to assess ratios on the basis of a notional capital structure.

54. This Commission's approach is flawed for two reasons.

55. First, the use of notional ratios is not a matter of discretion. **The Commission is obliged to have regard to consistency and s. 2(3)(b) shows that the**

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[13] Ofwat, *Setting price limits for 2010-2015: Framework and approach,* March 2008.

[14] Response to issues raised at the Hearing, p6.

principle of non-discrimination is an integral part of the regulatory regime. If an adjustment was to be available to inefficient companies or inadequately capitalised companies but not efficient or well capitalised companies when subject to the same substantial adverse effects, this neither satisfies the requirement for consistency nor that for non-discrimination. In addition the availability of an adjustment for the same circumstances would be arbitrarily determined by the company's own circumstances.

56. Second, the use of actual rather than notional financial structures could reward companies that have adopted inefficient levels of gearing or taken on inefficient debt instruments. **This would damage incentives for the companies to act in an efficient way.**

Commission has failed to take account of actions taken by holding company to avoid SESW breaching its financial covenants

57. A key error in the Commission's assessment of financial ratios is that it has not taken account of the steps that have been taken to ensure that SESW's financial ratio covenants have not been breached. SESW is not breaching its covenants only because of shareholder support. Without this support SESW would be in breach of its covenants and would not have been able to draw down the funds needed to finance its regulatory capital expenditure in 2009/10.

58. The steps that SESW has taken to maintain its financial ratios include the following:

- the ordinary dividend to shareholders in 2008/09 has been reduced by 40%;
- accumulated profits in the non-appointed business have not been distributed to shareholders in order to preserve cash[15]; and
- SESW has withheld amounts due to its holding company for tax losses it has surrendered.

59. Had these measures not been taken SESW would have breached its covenants. **By disregarding these actions the Commission has failed to take into account the costs already incurred by SESW's holding company in maintaining adequate financial ratios.**

60. The Commission's statement in paragraph 4.71 that *"SES has not suffered from any recent changes to its credit rating"* fails to understand that this is only achieved as a result of the actions that have been taken to preserve ratios.

[15] These are non-regulated activities within SESW.

61. These failings by the Commission further underscore the importance of basing the assessment of financial ratios on notional rather than actual financial structures.

Errors of application – financial ratios for small companies should be used, and each year's ratios tested against them

62. In addition, there are specific errors of application in the Commission's assessment of financial ratios.

63. Para 4.70 and Appendix F of the provisional determination refer to ratio guidelines provided by Moody's. These ratios were taken from the NERA report for Water UK. However, these ratios apply to large regulated businesses. The NERA report on the small company premium identified that rating agencies consider different ratio levels for smaller companies. Moody's had provided evidence to NERA that adjusted cash interest cover ratios would need to be higher for a water only company than a water and sewerage company to achieve the same rating.

64. In addition, the Commission has considered the average of each ratio across the 2005/06 to 2009/10 period as part of its assessment. These average values do not have any relevance in assessing the ability to finance functions. When considering SESW's financial position in 2008/09 and 2009/10 it is the ratios in those years that are relevant.

4. Absence of K adjustment is inconsistent with the licence

65. The Commission's approach to determining the adjustment to K is inconsistent with terms of the licence.

    - No account has been taken of the degree to which the present application passes materiality. The view that the materiality amount is "simply to establish jurisdiction" is said to be "consistent with the aims of the Act". This is not correct.

    - SESW's estimate of materiality is around 110%. This is over five times the 20% threshold set out in the licence. In effect the Commission is creating an additional *de facto* threshold which is not written down and which forms no part of the licence.

    - The Commission's use of the risk-free rate as a benchmark is flawed. It implies that materiality would need to be **around 240%** before a K adjustment was applied.

    - Furthermore, the risk-free rate cannot be an appropriate benchmark for returns since any typical water company would be in breach of financial ratios before returns hit this level. Therefore, the Commission's assessment of returns reduces only to a test of financial ratios. This does not satisfy the section 2 duty and means that the Commission's approach is, in reality, a shipwreck test.

66. Paragraph 13.3(2) of Condition B of the licence states that if a substantial effect has occurred the next consideration is *"what change should be made to the Adjustment Factor"*. In other words, following an adverse effect with materiality of greater than 20% the regulator is required to consider a change to the K factor.

67. Paragraph 13.3 gives at least three pointers towards the meaning and effect of the materiality threshold:

    - the figure of 20% defines what is a *substantial* effect;

    - 20% is to be contrasted with the 10% threshold for standard IDoKs (NIs) which gives rise to an automatic adjustment to K – the fact that a threshold has been chosen by the draftsman which is double that for items specifically identified by the regulator is highly important. There is no room for an approach which deems 20% to be a pretty low threshold – that ignores the intention of the legislature which is expressed by the words of the provision;

    - 20% is a threshold which applies only to those costs/loss of income which pass the test of prudent management – once this test has been satisfied it is even clearer that what is left should be eligible for a K adjustment.

68. Yet no account has been taken of the degree to which the present application passes materiality. It is treated as a mere jurisdictional threshold giving – according to the Commission – no information relevant to the K adjustment. **The judgment that the materiality amount is "simply to establish jurisdiction" is said to be "consistent with the aims of the Act" (paragraph 3.10). This is not correct.**

69. The aims of the Act are important but comprise the second stage of the assessment, not the first. The first stage is to interpret the words of paragraph 13.3 of Condition B of the licence and to identify whether a strained interpretation of those words is justified in order to fulfil the purpose of the provision (Bennion, 5th Edition, section 304). The Commission neither applies the words of the licence (defining what is substantial) nor finds it necessary to form a view of the purpose of the clause save to observe that it does not operate as a shipwreck clause and does not operate as a mechanical risk allocation (paragraph 4.12). As Lord Simon observed in his judgment in the House of Lords in *Black-Clawson International Ltd. v. Papierwerke Waldhof-Aschaffenberg AG* [1975] AC 251 at 647D, it is a rare case in which it is not necessary to identify the legislative purpose. Identification of that purpose is critical here. Notwithstanding that the Commission states that the clause should not be interpreted as a shipwreck clause (like the standard IDOK in paragraph 13.2 of Condition B), in practice that is precisely the effect of its Provisional Determination. Such inconsistencies would be avoided by recognising that the clause is designed to have a corrective function, intervening between periodic reviews in order to ensure compliance with the continuing duty under s. 2(2A)(c).

70. Turning to the second stage and the aims of the Act, whereas such aims could result in a construction which limits the adjustments to K in cases which exceed materiality by a modest margin, to exclude an adjustment in a case where materiality is satisfied more than five times **amounts to a rewriting of the clause and the introduction of a *de facto* threshold which is not written down, which forms no part of the licence and which in effect replaces the 20% materiality threshold**. Such a result is contrary to legal certainty in which "The acceptance of the rule of law as a constitutional principle requires that a citizen, before committing himself to any course of action, should be able to know in advance what are the legal consequences that will flow from it" (Lord Diplock in *Black-Clawson* at p. 638).

SESW's materiality is five times greater than the threshold

71. In the Provisional Determination the Commission does not reach a definitive conclusion on the overall materiality of power costs and income effects. However, the main difference between SESW's and Ofwat's calculation of materiality related to the prudent management challenge on power costs. Since the Commission has rejected this prudent management challenge, its view on materiality is much closer to the SESW's position than it is to Ofwat's.

72. SESW's estimate of materiality is around 110%. This is over five times the threshold set out in the licence. In the Provisional Determination the Commission makes no reference to the scale of materiality in relation to the

threshold. Nor does it explain how its decision not to adjust the K factor can be consistent with exceeding the materiality threshold by such a multiple.

Commission's approach resets the SAE materiality threshold at around 240%

73. One of the factors that the Commission refers to in its assessment of the K adjustment is the fact that SESW's return on RCV remains above the risk-free rate (assumed by the Commission to be 2.5%). The implication of the Commission's decision is that:

- if the return on RCV is above the risk-free rate, and financial ratios are considered adequate at some level, then no adjustment to K is required; and

- if the return on RCV is below the risk-free rate then the return on capital is not "reasonable" and a K adjustment is required.

74. This approach means that a return between the cost of capital and the risk-free rate falls within the risk that the company accepted as part of the price control. The logic of this approach is incorrect.

75. First of all this approach bears no relation to the terms of the licence. To illustrate this we asked Frontier Economics (Frontier) to consider the impact of a substantial adverse effect on a typical water company. The calculations were based on data from Ofwat's Report on Financial Performance[16]. Using industry data for 2006/07 and 2007/08 Frontier calculated the scale of effect that would reduce the return on capital from the level allowed by Ofwat at PR04 to the risk-free rate of 2.5%.

- This analysis is carried out for a representative water company. First, using actual industry data for the years 2006/07 and 2007/08 published by Ofwat in its *Financial Performance and Expenditure* report, the financial results for a representative water company were created. This includes turnover, operating costs, capital charges, tax and profit. The turnover is adjusted to give a post-tax return on RCV equal to the PR04 allowance. For the years in question this allowance was relatively small.

- The next step was to solve for the reduction in turnover that would yield a post-tax return on RCV of exactly 2.5%. In making this calculation, an effective tax rate of 15% was assumed[17] and notional gearing of 55% (which is the gearing level that Ofwat assumed for the industry in

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[16] Ofwat, *Financial performance and expenditure of the water companies in England and Wales 2007/08*, September 2008.

[17] To reflect a reasonable proxy of the effective tax rate currently faced by the industry.

PR04).

- Using this turnover figure, Frontier calculated the shortfall (relative to realised turnover). This shortfall is the 'circumstance' for which this representative water company can make a SAE claim. Using this calculated shortfall, and the formulae in Ofwat's IDoK model, the implied materiality level was calculated.

76. The analysis showed that for an event to reduce the return to 2.5% would **result in a materiality amount of around 240%, twelve times greater than the threshold specified in paragraph 13.3 of Condition B**. It is apparent that the Commission's approach to the K adjustment is at odds with that envisaged in the licence. The licence distinguishes between the materiality for a standard IDoK at 10% and a substantial effect IDoK at 20%. If the licence had only intended K adjustments to apply when the return on capital dropped below the risk-free rate then the licence would have specified a materiality threshold that was consistent with this.

Commission's use of the risk-free rate is incorrect

77. Furthermore, as highlighted above, there is no basis for using the risk-free rate as the floor for establishing "reasonable" returns. The provisional determination notes in Appendix F that *"it is implicit within the equity risk premium that realized returns can from time to time go below the risk-free rate"*. This statement is factually correct but is irrelevant in choosing the risk-free rate as the benchmark. It is clear that investors bear some risk of earning actual returns below the risk-free rate. However, this may relate to risks that fall outside of the substantial effect clause. For example, there is always a probability (however small) that the government will change the approach to regulation and expropriate some or all of the investors' capital. Alternatively there could be some serious management failure that results in negative returns. The existence of these risks, which can contribute significantly to the risk premium that investors require, provides no guidance on the amount of risk that investors ought to, or expected to, take for risks that are covered by the substantial effect clause.

78. Separately, the case for considering the risk-free rate as a legitimate floor for returns in an SAE application is further undermined by considering the relationship between the returns and financial ratios. For a typical water company the financial ratios would be breached significantly before the return on RCV fell to the risk-free rate.

79. This is illustrated by Figure 1 below. This shows the link between Adjusted Cash Interest Cover I and the return on RCV. The modelling on is based actual data for the industry as a whole (see details below) for 2006/07 and 2007/08. The guideline ratio of 1.6 would be breached when the return on RCV falls below around 4.25%. With a return on RCV of 2.5% the Adjusted Interest Cover Ratio would be around 0.8, well below the level that would be consistent with investment grade status. The Adjusted Cash Interest Cover I ratio is considered by the credit rating agencies to be the most significant of the financial ratios.

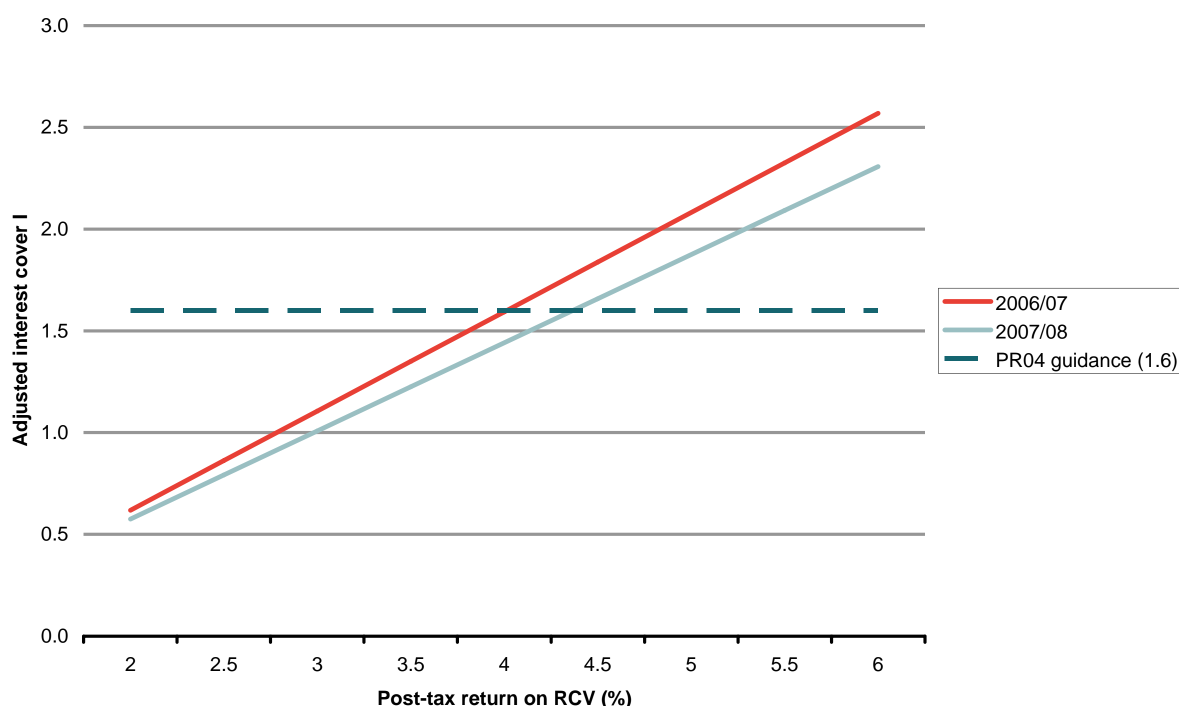

Figure 1: Return on RCV and Adjusted Interest Cover ratio

80. As a result, if the risk-free rate was considered a floor on 'reasonable' returns then, contrary to s. 2(2A)(c), the test of financing functions would effectively become simply an assessment of financial ratios. This is because financial ratios would be breached before the returns reached that level.

81. The analysis was undertaken as follows:

- The starting point was the same financial data for a representative water company used above.
- The financial ratios (interest cover, adjusted interest cover I, adjusted interest cover II, and debt payback) that would be consistent with a post-tax return of RCV equal to the risk-free rate were calculated.
- This was based on average industry gearing levels (62% in 2006/07, 66% in 2007/08) and average interest rates based on net interest paid.
- Due to limitations in the available data the interest cover ratios were based on net interest paid, whereas in practice it should be based on gross interest paid. As a result, for a given level of return the interest cover ratio calculated will be higher than in reality.

Commission has not applied a valid test of reasonable returns

82. The Commission's approach has not applied a valid test of whether the return on capital is reasonable. In all previous cases where the financing functions test has been applied, the term reasonable return on capital has been

interpreted as a return on capital that is equal to or greater than the cost of capital. The Commission is putting forward an alternative view where returns below the cost of capital can be “reasonable”. However, it has not provided any reasoned basis for establishing how far below the cost of capital can be reasonable. The notion of the risk-free rate as the floor for reasonable returns is without merit because:

- it implies a materiality amount that is wholly at odds with the licence; and
- any typical company would breach financial ratios before hitting this level.

83. As a result, **the Commission’s test of reasonable returns boils down to a test of financial ratios. This is a clear breach of the section 2 duty**. Once it is considered reasonable that the rate of return can fall to an unspecified level below the cost of capital whilst remaining above the risk-free rate, it will only be a breach of adequate financial ratios that would result in a conclusion that the company is unable to finance its functions.

5. View on companies' expectations on risk is unfounded

84. The Provisional Determination makes assertions regarding the level of risk that companies' accepted as part of the price control. Those assertions are unfounded and in contradiction to the evidence that is available. Expectations regarding risk were consistent with the previous SAE determinations and this level of risk was allowed for the PR04 cost of capital.

85. In the Provisional Determination the Commission makes reference to the risk that the company was expected to absorb as part of the price settlement. For example at para 4.42:

"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. "

86. And at para 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."

87. The Commission's argument is that the price settlement at PR04, and specifically the allowance for the cost of capital, included an allowance for risk that companies would be expected to bear before any K adjustment from an SAE application could be applied. The Commission has provided no evidence to substantiate this argument nor have they provided any analysis to justify the scale of this allowance for risk.

88. The only statement that the Commission makes in relation to this argument is the observation that SESW's returns were above the risk-free rate. The flawed logic of this statement has been demonstrated in the previous section, while Section 2 demonstrates that actual returns were well below the cost of capital.

89. There are three pieces of evidence that are relevant for assessing the degree of risk (relating to factors outside of management control) that companies are expected to absorb in relation to an SAE application.

- first, evidence from previous SAE decisions;
- second, the materiality amount specified in the licence; and
- third, regulators statements in the run-up to the price determination.

90. An important element of past practice and the only one which was available to companies at the time of PR04 are the two previous SAE determinations.

The Provisional Determination discards these two determinations on the grounds (paragraph 4.6) that they involved the exercise of Ofwat's discretion and that the determinations pre-dated the changes to the WIA which came into effect in April 2005. As to discretion, the Provisional Determination correctly accepts (paragraph 4.37) that the discretion under the SAE clause is limited by the statutory duty under the WIA. Ofwat's discretion was similarly limited. As to the changes under the Water Act 2003, they do not affect reliance on these past decisions as persuasive authority because the Provisional Determination finds against SESW on the basis that it has a reasonable return and that s. 2(2A)(c) is satisfied. Both these past decisions were concerned with precisely this issue, i.e. what is a reasonable rate of return.

91. In any event, Ofwat anticipated the promotion of consumer interests and expressly stated in the BWH statement (p. 9 of Annex A) that it would look to ensure an appropriate balance between ensuring the financing of the proper carrying out of functions; protecting customers' interests and promoting economy and efficiency.

92. The key to the determinations for BWH and NWL is that Ofwat evidently took the view that, properly interpreted, both companies were unable to finance the proper carrying out of their functions (see the closing words of Annex A to the BWH determination on p. 9). So far as BWH is concerned, it is explicit in Ofwat's determination that Ofwat felt bound to allow an efficiently managed and financed business to earn a return at least equal to the cost of capital it determined at PR99 and that this decision was clearly seen as being protective of customers' interests.

93. On the second point, the materiality threshold of 20% defines what is a substantial effect. This has been addressed above.

94. On the third point, the Commission acknowledges the statements made by Ofwat in the run-up to PR04:

"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 its judgement on the cost of capital. 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." [para 4.40]

95. In this paragraph, the Commission quotes Ofwat as saying that it took into account the SAE provisions as one of the mechanisms that protected water companies from significant changes between reviews, by allowing for the possibility for adjustments to K. In other words, because of a company's entitlement to rely on the SAE provision, there was no need to include in the company's K at the price review, any element to cover the risks that that provision was expected to deal with. Thus if there was no SAE provision, the increased risk of operating the business would need to be covered by an

addition to the rate of return, i.e. a higher K than would otherwise have been granted.

96. What the Commission fails to add is that Ofwat's statements were made after it had decided not to proceed with any modifications to the SAE process that had applied to BWH and NWL. The clear implication is that Ofwat took account of the SAE mechanism as it had applied it in these cases.

97. However that reasoning is only correct if the SAE mechanism provides some real protection to water companies. **Judging a projected return on capital of 3.6% or 3.9% to be reasonable is not consistent in any way with past practice either on price reviews or SAE determinations.**

Commission's approach contrary to precedent

98. The following table compares the Commission's Provisional Determination with the two earlier SAE determinations by Ofwat:

Company *(date)*	Materiality	K adjustment	Comment
Northumbrian Water *(2003)*	25%	3.2%	Based on PR99 rate of return plus additional return to improve financial ratios
Bournemouth and West Hants Water *(2003-04)*	40%	3.8%	Financial ratios strong before K adjustment, K adjustment driven entirely by PR99 rate of return
SESW *(2008-09)*	110%	Nil	Financial position close to NWL's, PR04 rate of return not used.

Table 5: Comparison to previous SAE determinations

99. This table provides the clearest demonstration of the perverse approach adopted by the Commission in its Provisional Determination. **This approach fails to achieve consistency or to fulfill companies' expectations at PR04.**

6. Exclusion of power costs from K is unfounded

100. The Commission's Provisional Determination excludes power costs from eligibility for a K adjustment on the grounds that to allow such costs would undermine the incentives for water companies to act efficiently, and this would be to the detriment of consumers.

101. Paragraph 7 of the Provisional Determination states:

"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."

102. We fundamentally disagree with this statement. We consider that the exclusion of power costs as eligible for an SAE K adjustment is unjustified on economic grounds, based as it is on a clear error on the part of the Commission, because the Commission's argument fails to distinguish between costs that are within the control of management and those which are not.

103. Furthermore, in reaching its view, the Commission has neither evaluated the costs and benefits of the options it has considered nor has it reviewed the full range of options available to it. As a consequence it has provided no justification for its decision to exclude power costs from a K adjustment.

104. Finally, we note the Commission's Provisional Determination has the effect of making power costs ineligible for an SAE under any circumstances. For reasons we explain below this is incorrect from a legal point of view as well as from an economic one.

The exclusion of power costs from eligibility for a K adjustment derives from a basic error of economic analysis

105. In paragraphs 4.82 to 4.88 of the Determination the Commission sets out its view that allowing a SAE claim for higher energy prices could undermine incentives to manage energy costs in the long-term interests of consumers.

106. In paragraph.4.84 the Commission states that *"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."*

107. In paragraph. 4.87, the Commission emphasises the need to preserve incentives for water companies to manage power costs efficiently which is *"particularly important because it is so difficult for Ofwat to take a view on what would have been efficiently incurred energy costs"*

108. Without further analysis or quantification of these incentives the Commission then simply concludes that the only available option is to exclude power costs from any K adjustment.

109. The Commission's argument is based on a straightforward error of economics by failing to distinguish between costs that fall within the company's control and those that do not.

110. The Commission's argument is presented as if the level of SES's power costs is determined by the efficiency of energy use (paragraph 4.83) and the efficiency of energy procurement (paragraph 4.85). But this omits the inescapable fact that energy is purchased in a national market with prices determined outside the control of the individual purchaser.

111. While accepting that efficiency of use and procurement are relevant, total energy costs are the product of these factors *and* the market price of energy, which is outside the company's control.

112. As a matter of economics and logic it cannot be the case that unanticipated cost movements that are also completely outside the company's control could be excluded from a substantial effect K adjustment on the basis of making an allowance. **By definition there is no incentive implication if market movements in power costs are allowed.**

113. While identifying the extent to which costs movements are or are not within the company's control may on occasion be problematic, this is not the case with power costs. Indeed, in the specific case of power costs we find it extraordinary that the Commission should argue that the observation of efficient costs is "so difficult" for Ofwat. We would accept that many costs incurred by a water company are for bespoke tasks or equipment the costs of which may be influenced by local physical and economic conditions. But power costs do not fall into this category because there is a national market for electricity with easily-available published prices.

114. The significance of the Commission's error in this case is demonstrated by the evidence SESW has already submitted to the Commission.

115. First we have provided ample evidence in support of the fact that the Company is extremely efficient in its use of power. We note that this has not been denied by the Commission or effectively challenged by Ofwat. Furthermore we have demonstrated that SESW has an efficient and prudent process for procuring power. This is supported by the evidence from the Company's advisers, from its Reporter and by the report of Ofwat's own consultants. Thus there is no evidence put to us that we have been inefficient in the use or procurement of power.

116. As regards the contribution of market energy prices, we have submitted evidence to the Commission that shows that at PR04 Ofwat allowed power

costs of £12.7m for the quinquennium. In practice our forecast power costs will be £19.5m. But, based on month-ahead market prices[18], our power costs would have been even greater at £19.8m[19]. Thus these figures demonstrate that ***all* of SESW's increased power costs can be attributed to movements in market prices** that are outside the company's control.

Commission has failed to perform an adequate cost-benefit analysis of its proposal

117. The Commission states that there may be an incentive issue associated with the efficiency of use and procurement of power were the SAE mechanism to "limit the downside risk" to the company in question and that this would be "to the detriment of customers". Having identified the potential for such a risk, the Commission concludes that the existence of this risk is sufficient to justify the exclusion of power costs from any K adjustment.

118. In reaching this opinion the **Commission has not analysed the costs and benefits of the options it is considering,** nor has it considered any of the alternative options available to it in this case.

119. In practice the Commission has only considered two extreme options: either changes in power costs are allowed in K or they are not. The Commission states that there may be a detriment to efficiency if they are.

120. But the Commission presents no analysis whatsoever to quantify the extent of this alleged inefficiency, in principle or in practice in this case. Thus it has stated that there is a *potential* cost associated with allowing power costs in K, but not quantified this cost.

121. On the other hand, it has said nothing about the costs and benefits of its preferred option: *not* allowing power cost increases in K.

122. **The Commission's proposals imply setting the price of water below the economic cost of supplying it.** Water priced below cost encourages waste and inefficient use with the associated impact that it has on security of supply and the environment.

Commission's approach will result in a higher cost of capital

123. In addition, the Commissions proposed approach clearly reduces the likelihood of a K adjustment (for a given set of circumstances). As a consequence, the proposal results in greater risk being borne by investors

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[18] Which in our view provide a reasonable benchmark for market electricity prices.

[19] See, *Response to issues raised at the Hearing*, paragraph 120, 12th May 2009.

and **will inevitably result in a higher cost of capital[20] in the future**. This is a further cost of the Commission's proposals which it has failed to evaluate. The significance of this is illustrated by the market reaction to the Provisional Determination. A copy of the note emailed by Merrill Lynch to their equity clients is attached as Annex 2. The approach adopted by the Commission is clearly seen to be a change of policy and one that increases risk to investors. In consequence, not making an adjustment is contrary to the Commission's own conclusions in paragraphs 4.39 and 4.94 of the Provisional Determination that an adjustment would be justified for the purpose of the consumer objective if this resulted in reduced risk and lower prices in the long term.

Commission has also failed adequately to evaluate the options available to it

124. In addition to its failure to perform a cost benefit analysis of the options it has considered, the Commission has also failed to consider the available range of alternative options that would address the incentive problem it claims to have identified.

125. If it were accepted that an SAE K adjustment could create incentive issues with regard to efficiency, this does not imply that refusing to allow a K adjustment is the *only* available alternative. In fact the **Commission has failed to consider *any* alternative options in this case**.

126. As we have noted, in the case of power costs there are, in fact, easily available benchmarks that the Commission or Ofwat could use for the efficient price of energy that would entirely avoid any incentive problem with regard to procurement efficiency. Specifically, as we have already pointed out[21], if the Commission or Ofwat were to make allowance for movements in market electricity prices rather than the contract price paid by SESW then there would be no incentive whatsoever for SESW (or a company in a similar position in future) to reduce their efforts to procure energy in the most efficient way. Thus the detriment identified by the Commission is avoided *and* consumers are presented with the correct price signals to use scarce water resources efficiently.

127. Furthermore, even if there remained a concern that full pass through of the energy costs could harm incentives then the Commission could consider the option of a partial adjustment for cost increases. For example, an approach which allowed the recovery of 80% of increased power costs would still provide a clear incentive on the water company to be efficient and to manage its costs. It would even be possible to combine the use of exogenous data

[20] The cost of capital will increase due to a higher Beta (if the risk is a systematic risk factor) or through a reduction in optimal gearing (if the risk is a specific risk).

[21] *Response to issues raised at the Hearing*, paragraphs 106 to 121, 12th May 2009.

and partial recovery to provide even stronger incentives. We note however, that as with other proposals, it would be necessary for the Commission to provide a proper cost benefit analysis to justify the size of any reduction in pass-through. This would require comparing the benefit in terms of improved incentives with the distortion created by deliberately holding prices at a level that does not fully recognise the full economic cost of water at current energy prices.

Commission's position is inconsistent with the Act and the Licence and is unlawful

128. Effectively the Provisional Determination finds that energy costs are not eligible *per se*, whatever their amount or impact. We have explained in the paragraphs above the economic reasons why this finding is incorrect. There are also significant legal reasons why properly incurred electricity costs cannot be omitted from a K adjustment.

129. Firstly, paragraph 12 of the Summary bases the finding in relation to incentives firmly on the s. 2(3) and s. 2(4) duties of economy and efficiency and best regulatory practice. But s. 2(3) is expressly subject to s. 2(2A) and whether action is needed or not depends on applying the correct interpretation of s. 2(2A). In so far as it is based on the consumer objective this is also subject to s. 2(2A)(c) for the reasons given in SESW's "Response to issues raised at the Hearing" dated 14 May 2009, paragraphs 12-26 ('secure' being stronger than 'further'). In any event deliberately setting prices below cost gives priority to the consumer objective and not balancing that objective with the financing of functions.

130. Secondly, the critical error however is to adopt an interpretation which cannot lead to a reasonable return in a world of volatile energy prices because the Commission's analysis deliberately fails to remunerate companies for their power costs. The effect is that consumers do not pay the economic costs of the service provided which either means that future consumers will pay for these costs or the cost of capital will rise. In finding that allowing a price adjustment for power costs is "not consistent with the aims of the WIA" the Commission effectively discards financing of functions as a relevant factor. **This approach is unlawful**.

131. Thirdly, the "rate of return" in s. 2(2A)(c) and in particular the reference to "costs" in clause 13.2 of the licence, do not exclude reference to electricity, nor do they include a test of whether the costs are due to events within management control. **Effectively the Provisional Determination purports to rewrite the licence** by imposing a new condition in the SAE clause, in addition to the "prudent management action" condition, of "within management control". This is beyond the powers of the Commission in the same way what it is beyond the powers of Ofwat. Changes to the licence provisions cannot be made by the regulator (Ofwat or the Commission) unilaterally but require the consent of the licensee. This is a basic requirement of regulatory certainty.

132. Furthermore, there are also serious legal objections to the approach to the consumer objective set out in paragraph 4.39 of the Provisional Determination. This introduces an additional condition to the licence that a price adjustment may be possible if it were to result in a reduction of the level of risk *"such that prices over the longer term were lower than they otherwise would be"*.

133. Firstly, this rewrites the clause contrary to the principles of legal certainty (paragraph 70 above). Secondly, the Commission's new condition ignores the plain meaning of the word "secure" which even Ofwat expressly accepted was stronger than "further" (Ofwat hearing, p. 95 line 21). Therefore the consumer objective is subject to the primary duty in s. 2(2A)(c). The Commission's unreasoned rejection ("We do not agree") of this submission does not take the matter further. This is a wholly inadequate response to SESW's substantial submission on this fundamental issue. Previously the duty was to "ensure" that consumer interests were protected but the duty for the consumer objective is "to further" which is deliberately aspirational. What is striking by its absence is reasoning by the Commission as to why the purposes of s. 2(2A) would justify the adoption of a meaning of the sub-section which is not in accordance with the plain meaning of the words (see further paragraph 69 above). **The Commission is therefore not justified in considering the consumer objective and financing functions duty as equal obligations.** The new condition is therefore unlawful.

134. Thirdly, even the Commission's most extreme position so far is limited to treating the consumer objective as equal to the financing of functions obligation. Yet the introduction of the new condition in **paragraph 4.39 amounts to giving priority to the consumer objective, which on any view is a breach of the Act**.

7. Approach creates perverse incentives

135. While the Commission has highlighted (but not quantified) the potential for SAE adjustments to distort efficiency incentives, it has not considered the impact that the determination would have on incentives on water companies to manage their financial structures in the long-term interest of consumers. This is a significant omission.

136. What the Commission disregards is the fact that the approach adopted in the determination would, in practice, provide the protection of the substantial effect clause *only* to companies with very high gearing levels. As the recent turmoil in the credit market illustrates, it is clearly not in the interests of consumers for water companies to be incentivised to adopt high gearing levels.

137. As explained above, the approach that the Commission has taken to the assessment of reasonable returns and the adjustment of K has the effect of making the substantial effect clause into a shipwreck clause since a K adjustment is assessed by reference to the companies' *actual* financial ratios, as opposed to *notional* ratios as used by Ofwat, and would only be triggered by a significant adverse turn in those actual ratios.

138. This approach creates perverse incentives on companies. In particular **it would encourage companies to increase their level of gearing and therefore reduce the financial resources that they have available to deal with any adverse shocks**. Under the Commission's approach there would be an incentive for companies to increase gearing to the top of any accepted range, as the protection against major unforeseen events would be available only to those companies with stretched financial resources.

139. Furthermore, we have highlighted above that the holding company has intervened to ensure that SESW maintains its financial covenants and this has been ignored in the Commission's Determination. The consequences of this for future company behaviour will be to discourage holding companies from early intervention, as to intervene would apparently damage the prospects of a successful SAE application. It would also encourage companies to apply earlier rather than attempt to mitigate the situation.

140. Related to this the Commission has also cited the proximity of the next price review as a factor in its determination. This decision would also create perverse incentives as it would encourage companies to seek an SAE adjustment earlier in the five year period, knowing that delay in itself reduced the likelihood of a successful application. Thus the Commission's approach would act as a disincentive on companies to try to manage the impact of the circumstances or to "wait and see" if uncertainty relating to the impact of the circumstances is resolved.

8. Process failures by the Commission

141. The Provisional Determination has been adversely affected by defects in process which have led both to the errors identified above as well as an inability of SESW to see or to make submissions on secret submissions and documents put forward by Ofwat (and for all we know, other parties) to the Commission. The result is that the Inquiry has been conducted, in this regard, in a manner which is contrary to the requirements of procedural fairness.

142. A good example is provided by the Commission's introduction of new evidence (the NERA report) in the Provisional Determination which has not been put to the parties in any way. SESW's primary argument in its submission was that the rate of return at PR04 was the relevant benchmark or alternatively that the Commission should look at "all submissions on the cost of capital and the small company premium" made by or on behalf of water companies.

143. However there was no suggestion before the Provisional Determination that the Commission was intending to rely upon the NERA Report. There were:

    - no information requests directed to the NERA report;
    - no indications that the Commission was intending to rely upon the NERA report and no request from the parties for comments on the NERA report; and
    - no requests from the Commission as to what other material may be relevant if the Commission were minded not to follow the PR04 benchmarks but to determine the cost of capital afresh.

144. Such steps were particularly important given that SESW did not provide the Commission with the NERA report, that the NERA report has not been provided to the Commission by Ofwat, at least not in any submission from Ofwat which has been disclosed by the Commission to SESW.

145. The practical impact of this failure of due process is striking:

    - the Commission made an error in the midpoint of NERA's estimate of the after-tax cost of capital which goes to the heart of the Commission's reasoning in paragraphs 4.66-4.72;
    - the Commission's Provisional Determination in relation to the small company premium is based on a misapprehension of the status of the small company premium which leads to a significant mis-statement of the WACC;
    - reference has been made to no other recent evidence on return on capital;

146. Moreover the Provisional Determination does nothing to correct the striking errors of process addressed in our (as yet unanswered) Solicitor's letter of 19 June 2009 which lead, at their lowest, to an inability to put full submissions in relation to the precedent effect of NWL. The adverse effects of any further secret submissions or evidence from Ofwat, or others, are not known given that SESW has not had sight of them. SESW has not even been provided with a list of submissions made to the Commission.

147. In summary SESW considers that **in conducting the Inquiry to date, the Commission has been in breach of due process** which is essential not only to protect the rights of defence of SESW but also to preserve the integrity (in the sense of justice being seen to be done) and accuracy of the Commission's determination.

9. Costs

148. Paragraph 2.17 of the Provisional Determination raises the issue of costs. Whether or not the Commission is persuaded in the light of the above submissions that an adjustment to K is required to fulfil the Commission's duties under the Act and the licence, the Commission is to decide to what extent it is reasonable to take into account the determination costs incurred or borne by SESW. The Commission is also to have regard to the extent to which, in its view, its determination is likely to support SES's claims in relations to the matters referred.

149. Ofwat's Final Determination made substantial deductions from the materiality of the circumstances on the grounds that a substantial proportion of SESW's costs "would have been avoided by prudent management action". This is a serious allegation against management and one which has been rejected by the Commission. This is a substantial factor in favour of the company recovering part of its costs. SESW has been successful on the issue of prudent management, a matter which was said to apply both to power and to income and which occupied a considerable proportion of the time both at hearings, in preparation and in further information requests concerning Utilyx and others.

150. In addition, SESW relies on the fact that several further issues have been decided in its favour: aggregation of circumstances (paragraph 3.11); the fact that the duty is not limited to the future but extends back to the past (paragraph 4.50); the fact that securing a reasonable rate of return does not create an obligation which is separate from the obligation to secure a reasonable return on capital (paragraph 4.51).

151. Moreover the principal evidence which is relied upon to demonstrate the reasonableness of SESW's returns for 2008-9 and 2009-10 is the NERA Report, a report which was not raised or put to the parties in any shape or form either at the hearings or in information requests. Putting aside the process issues and factual errors which arise in this regard, the NERA report forms a critical part of the Commission's reasoning. The position is equivalent to where a party in litigation wins a case on the basis of late evidence. Such a win would result in costs being awarded against the party relying on the late evidence up to the point at which the evidence was adduced. Similarly here, SESW should not be penalised in costs by a determination which places critical reliance on evidence wholly outside the reference process until the Provisional Determination. Without that evidence, the only test of reasonable returns would be by reference to the PR04 rates of return as contended for by SESW.

152. For the above reasons, it is reasonable to take into account of the whole of the reference costs incurred by SESW.

10. Conclusion

153. Given the above errors and misdirections, SESW submits that the Commission should review its decision and adjust K to make reasonable allowance for the substantial adverse effects plus SESW's costs of the reference as submitted.