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Reply to Ofwat’s response dated 9th April 2009

1. Introduction

1. In this paper we provide a brief commentary on some of the issues raised by Ofwat in its response. Many of the points in Ofwat’s response have already been addressed by our initial submission and this reply does not repeat in detail the analysis or arguments that are already addressed in our initial submission. Nevertheless it is important to briefly restate the essence of our SAE application.
2. Ofwat’s determination that no K adjustment should be made is based on a fundamental misinterpretation of its discretion to make SAE determinations under the licence and is in breach of its principal duty under Section 2(2A)(c) of the Water Industry Act 1991 (WIA/91) to ensure that companies can finance their functions (in particular by securing reasonable returns on their capital). Ofwat wholly ignores its own assessment of return on capital and financeability made at the last price review in 2004 and erroneously treats the principal duty as if it were confined to a snapshot view of companies which only requires consideration of the period up until the next price review. This flawed determination has been applied to a situation where the materiality of the adverse effects on the company has exceeded the 20% threshold by a factor of five (i.e. 114%). Even after its erroneous challenges to our costs and revenues Ofwat has assessed that the threshold has been exceeded by a factor of two and still concluded that no adjustment to prices is appropriate.
3. Our commentary on Ofwat’s response is arranged under the following headings:
 - the role of the substantial effect clause as a corrective mechanism;
 - the impact of the substantial effect clause on risk and incentives;
 - the prudent management test;
 - the calculation of revenue shortfall; and
 - the calculation of the K adjustment and securing reasonable returns on capital.

2. The role of the substantial effect clause as a corrective mechanism

Ofwat’s view that a substantial effect determination must be forward looking

4. At various points Ofwat describes the role of the substantial effect clause as a forward looking assessment of the company’s financial resources. For example, at para 7 of its response Ofwat states:

“What the language of the licence and the WIA mean is that once materiality is satisfied, we have discretion, in the light of the section 2 WIA duties, to consider what, if any, adjustment should be made to price limits. We need to satisfy ourselves that the company has sufficient resources to finance its functions until price limits are next formally reset, i.e. the forward looking period up until 1 April 2010. This we have done.”

5. We note that in this paragraph and at other points in their response Ofwat states that the language of the licence and the WIA mean that they have “to consider what, **if any**, adjustment should be made to price limits.” (our emphasis). To be clear there is no reference to “if any” in the licence or in the WIA. 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*”. The normal reading of this phrase, in its context that the materiality threshold for a substantial adverse effect has been passed, would be what is the size of the price adjustment that is needed. While we accept that wording in the licence does not preclude that the change to the adjustment factor could be zero, Ofwat’s interpretation appears to imply that there should be a ready presumption that the change would be zero. This is a reinterpretation of SESW’s licence.
6. At a five yearly price review, the K factors set by Ofwat are based on a forward looking assessment of costs and revenues. Ofwat makes this point in para 28 of their response and we agree with this. Ofwat seeks to foresee relevant circumstances until the next price review. It may or may not succeed. The substantial effect clause, like the standard IDoK, is a corrective mechanism that is intended to deal with circumstances that have not been sufficiently allowed for at the previous price review. The very existence of the correction mechanism recognises that perfect foresight is not possible. Cost factors may not be on Ofwat’s radar at all or alternatively Ofwat may give due consideration to such cost factors but decide that they are sufficiently certain not to be made into a Notified Item (NI).

7. In the past Ofwat has made clear that the substantial effect clause is one of the mechanisms for dealing with events that were not anticipated at the price review. Section 16.1 of the 2004 Final Determination states¹:

“The following mechanisms protect the industry between reviews from material changes in costs that affect the water industry differentially.

- *Interim determinations. These allow the companies, or Ofwat, to seek revised price limits if specified changes occur in the period since price limits were last set which have a total impact on the company amounting to at least 10% of a company’s turnover (the materiality threshold).*
- *Logging up and down. This takes account, at the start of the next price limit period, of changes in outputs required of the companies during the previous price limit period.*

As a further protection companies’ licences allow for substantial effect determinations. These allow companies, or Ofwat, to seek revised price limits if a circumstance beyond a prudent company’s control changes so that the total adverse or beneficial impact on the company amounts to at least 20% of a company’s turnover.” (our emphasis).

8. This statement shows that Ofwat accepted that the substantial effect clause was one of the mechanisms that protected companies against material changes that were not foreseen or the scale of which was not foreseen. A corrective mechanism to deal with events that were not anticipated at the last price review needs to be backward looking. This is how the standard IDoK operates and it is logical and consistent for the SAE clause to operate in the same way. The view that a substantial effect determination must be forward looking is incorrect. There is no requirement in s.2 of the Water Industry Act 1991 (WIA/91), or in the licence, for any such adjustment to be forward looking only.

Financial survival until the next periodic review is not the test for the adjustment

9. Ofwat’s emphasis on a forward looking clause is consistent with their view that the clause should only be used in extreme situations and provides the ultimate protection for companies that are in financial difficulties. This view is not correct.
10. Medium term regulation is based on s. 2 and the requirement for the duty to be fulfilled in the manner best calculated to secure that companies are able, in particular by securing reasonable returns on their capital, to finance the proper carrying out of their functions. This is plainly a medium-term

¹ Ofwat, *Future water and sewerage charges 2005-10*, December 2004, page 240.

endeavour. The legislator has picked out the concept of return on capital as a means of ensuring that companies endure for the medium term. It is common ground that, at a periodic review, the financing of functions involves a two strand approach: adopting the cost of capital and then adjusting upwards dependent on financial indicators.

11. First, the continuing nature of the s. 2 duty and regulatory consistency require the same approach to SAE applications. Secondly, Ofwat has no mandate for departing from the medium term nature of their regulation for SAE applications. The test is not whether a company can manage to finance its functions until the next price review but whether, on an on-going basis, s. 2 is satisfied. The legislator has required specific regard to the return on capital and this cannot be replaced by an approach which asks simply whether a company can raise funds, whether it can use other resources or whether it can survive until the next price review. Accordingly the short-term snapshot question posed by Ofwat in this case as to whether SESW can survive until the next review, fails to apply s. 2.

There is a coherence between the standard IDoK and the substantial effect clause

12. In our submission we explained the strong similarities and the logical coherence between the standard IDoK mechanism and the substantial effect clause. In para 54 of their response Ofwat argue that there is no basis for this position since if this were true then the licence would have applied the same mechanistic approach to adjusting price limits. This argument is not valid.
13. Paragraph 13.3(1) of Condition B of the licence refers to substantial effects on *“the Appointed Business or on its assets, liabilities, financial position, or profits or losses”*. This highlights that the substantial effect is designed to cover a wide range of possible circumstances. This includes unforeseen circumstances that affect the costs and revenues of the Appointed Business in the same way as circumstances that are Notified Items. However, it also includes circumstances that have a major impact on the assets or liabilities of the company. This could include the impact of a major financial crisis or a catastrophic incident at a major operational asset. We accept that the mechanistic formula that is applied to a standard IDoK may well not be appropriate to deal with these types of incidents. Indeed, the circumstances may be so severe and immediate that a price adjustment under the SAE clause is inadequate to deal with the problem and a wider application of relief under s.2 may be appropriate. A substantial effect clause needs to be able to deal with the circumstances which have arisen, of whatever nature and effect.
14. When the circumstance is essentially the same as one that would be covered by a standard IDoK (as is the case in this application) then there is a compelling argument of regulatory consistency and best practice that the price adjustment mechanism operates in the same way, i.e. to compensate the Company for the losses suffered by adjusting its price limits. At that point however, it is accepted that the response to a standard IDoK and an SAE are different in that because of the unpredictable nature and effect of an SAE, there is need for greater flexibility in determining what the amount of the

adjustment should be. This is the issue of the discretion which we believe permits Ofwat, in carrying out its s.2 duty, to take account of everything that has happened to the company during the current review period which is not related to the circumstances giving rise to the SAE application e.g. savings/benefits from outperformance in other areas, so as to determine the net position of the company which needs to be financed in accordance with s.2.

3. Impact of substantial effect clause on risk and incentives

Ofwat’s focus on “business risk” is not meaningful

15. Ofwat refers to “business risks” in many places in its response (for example paras 81-82), without defining this term. As far as the company is concerned, there is no special category of “business risks” falling outside of the corrective mechanisms. The licence makes no distinction between one type of risk and another but contains a series of mechanisms for balancing all risks between the Company (i.e. the shareholders) and its consumers. It is misleading to seek to categorise a special category of “business risks” with the implication that these are outside the balancing framework of the licence.
16. In para 81 Ofwat states that since SESW did not appeal the 2004 price review determination to the CC that we “*accepted the level of risk inherent in the overall package of the determination*”. We would make two comments on this. First, in practice it is out of the question for any company to seek a five year determination by the CC on a single issue (i.e. whether energy costs are made an NI). Second, the company understood that the SAE clause would apply as a corrective mechanism and, in the event of an SAE application, Ofwat is bound by and would apply its s. 2 duties in a consistent way.
17. Para 82 states that risk is reflected in the cost of capital that Ofwat sets. This is true in principle but it is also true that the cost of capital reflects the corrective mechanisms that exist to deal with uncertainty. As a result it is disingenuous of Ofwat to imply that the corrective mechanisms should not apply to a particular situation because it was reflected in the cost of capital.

The materiality threshold determines the allocation of risk between parties

18. In our submission (paras 95 – 99) we explained that Ofwat has in the past acknowledged both that the substantial effect clause does not operate as a shipwreck clause and furthermore that the clause would need to be modified if it were to be so interpreted.
19. In its response Ofwat disputes this assessment (paras 83 – 87) arguing that the 2004 consultation exercise was concerned only with the materiality calculation and not with the approach for the adjustment of K. This is not correct.

20. It is clear from the statements made in 2004 that Ofwat considered that the degree of protection provided by the substantial effect clause was determined by the materiality calculation and not by the approach to K adjustment. In proposing to amend the calculation of materiality (MD189) Ofwat stated as follows:

*“Also, were the clause to remain in its current form, we would have to consider the implications for the risk borne by companies at the coming price review. For example, we might have to consider the risks to which companies would be exposed arising from changes in forecast demand from industrial and commercial customers or from the forecast number of meter optants. **Our overall assessment of the cost of capital for the price determinations would also need to take account of the protection afforded by the current version of the substantial effect clause.** This could involve unnecessary complexity, and could undermine regulatory certainty. We are therefore proposing that the substantial effect clause should be modified to reverse the implications of the 2000 modifications, and return the substantial effect clause materiality calculation to its original form.”* (our emphasis)

21. This paragraph makes two points clear. First, that if the clause were not modified then the implied risk allocation of the current clause would be reflected in PR04. As the clause was not modified we must assume this occurred in practice. Secondly the paragraph identifies the allegedly “unintended” impact of the clause as being on the risk borne by the company, and therefore, implicitly, the allocation of risk between the company and its customers. We note that Ofwat’s proposal to correct this effect was to adjust the materiality threshold, not to adjust the method for calculating K once the threshold is met. Indeed at no time has it consulted on this latter point. The clear implication of this last point is that in MD189 Ofwat accepted that it was the materiality test, and not the K-setting process, that determined the appropriate allocation of risk between the company and its customers.
22. In its determination of our SAE application Ofwat is attempting to reverse this logic by arguing that once the materiality test has been satisfied Ofwat should *then* assess the balance of risks between customer and company.

Our approach does not amount to a guarantee on profitability or a move towards rate of return regulation

23. In its response Ofwat, at para 89, suggests that our approach is equivalent to a cost-pass through or rate of return regulation and therefore operates as a guarantee on profits.
24. This is not our case. By placing a materiality test of 20% of company turnover on an IDoK application under the substantial effects clause, the licence makes a clear allocation of risk between customers and shareholders. In the event that a company suffers an adverse effect that does not meet the 20% materiality threshold then the company and its shareholders meet the full cost of this effect. However, if the effect is sufficiently large that the materiality

threshold is breached then the licence indicates that a K adjustment should be determined.

25. Our approach does not correspond to a guarantee over profitability. We are aware of and accept the risks embodied in the regulatory regime. We would not expect that the K adjustment would compensate the company for any underperformance in other areas. If we had underperformed then our proposed K adjustment would have resulted in an overall return on capital below the cost of capital. Ofwat has misunderstood our case.

Our approach is consistent with incentive regulation

26. Furthermore, Ofwat’s response argues that our approach would reduce incentives on companies to manage costs (e.g. para 92 of the response). We disagree with this view, though it follows from the misunderstanding of our approach referred to above. Our approach would not allow companies to recover underperformance in the event of an SAE application. Therefore it would not reduce incentives to minimise costs.
27. In addition, Ofwat suggests that taking account of outperformance in the K adjustment, as we have done would reduce incentives to outperform. We do not agree with this. We have taken account of our outperformance in our calculation of the K adjustment because this is consistent with the principles of medium term regulation and financing of functions. We consider that this is the appropriate exercise of the discretion that exists in the licence of the adjustment of K. We do not understand how this undermines the system of medium term incentive regulation.

4. The prudent management test

Ofwat “considered it appropriate to examine what SES’s power costs would have been SESW had fixed its energy prices for 2008-2010”. This is fundamentally flawed as an assessment of prudent management

28. The prudent management test must be applied by reference to the processes adopted by SESW and not by reference to outturns. The comparison which the above quotation from Ofwat advocates is between the energy cost outturn arising from a decision to hedge for one year compared with the energy cost outturn arising from a decision to hedge for two years.
29. Para 141 of Ofwat’s response starts by referring to our “approach to energy contracts” and appears under the heading of “energy procurement”. That is a promising start because it suggests that Ofwat will consider the procurement *process* as opposed to outturn which has been the focus of its attention in the Determination. However the balance of para 141 and paras 142 to 157 rely on the knowledge that a one year contract proved to be more expensive than a 24 month contract. This approach is specifically excluded by paragraph 13.3(2)(i) of Condition B of the licence.

30. Ofwat simply does not engage with paragraph 64 of our submission. There is no suggestion that our procurement method “lies outside the range of prudent management action” or that a prudent method was imprudently applied. Para 148 of Ofwat’s response (in which it is said that we argue that companies not following our actions could be considered not prudent) mischaracterises our argument which expressly relies on there being a *range* of prudent management action.

31. As is apparent from its wholly inadequate summary of the Atkins evidence in paragraph 141, Ofwat still persist in ignoring the relevant evidence of Atkins (p. 20 of 21, Annex 5 to our Submission):

“It is clear that the decision to go to market early in 2007 was sound in that the market continued to rise for sometime after this date. The purchase of single year contracts would be very consistent with the supply market behaviour at large, particularly at a time of rising prices, with one year tenor or shorter agreements being favoured with the expectation that prices would fall back over time. The purchase of a single year agreement in 2007 for the period 2008/9 seems very reasonable.”

32. The Atkins Report was commissioned by Ofwat and was fully supportive of SESW’s procurement strategy, in particular as to the duration of the contract. It is therefore odd that Ofwat ignore the Atkins conclusions. Jacobs, SESW’s reporter concluded that our approach is “*designed to achieve best value*” and that “*Without hindsight it is difficult to conclude that the Company should have adopted a different approach*” (Annex 6 to SESW Submission, Sept 2008, p. 6). Also Utliyx’s advice for minimising procurement costs was to buy forward in November 2007 for the year commencing April 2008 and to fix for one year only (pp. 3,7 of their Post Tender Report 13 Nov 2007 at Appendix 2.8 to SESW’s 17 September application). The fact that an unspecified number of companies hedged for a period longer than one year does not render the decision to hedge for one year imprudent. What the evidence shows is that a decision to hedge for one year clearly falls within the range of prudent responses to volatile electricity prices.

33. Para 137 of Ofwat’s response states that SESW did not make the “*step change in its culture or strategy that we might expect to see from a company that was under significant pressure from rising power costs.*” We reject this statement. Annex 9 of our submission contains detailed evidence on our success in energy management over the years. The fact is that the vast majority of our energy usage is from pumping and we already optimise the use of our pumps to a high degree. Pumps are long-lived assets and it is not cost effective to replace pumps prior to the end of their lives solely on the basis of energy efficiency. This was confirmed by the report by Black and Veatch (Annex 7, page 3, para 2) and in the Reporters report (Annex 6, December 2008, p.4).

5. The calculation of revenue shortfall

Circumstance should be retail water income not total appointed revenue

34. In para 187 Ofwat explain why, in their view, it is appropriate to consider total revenue in the assessment of revenue shortfall. We do not agree with this view for two reasons:-
- First, the circumstance is a shortfall in retail water income driven principally by climate events and the rate of meter switching.
 - Second, non-water income is unrelated to retail water income. Combining non-water income and retail water income is no more justifiable or logical than combining, for example, business rates or pension costs and retail water income.
35. Nevertheless, Ofwat’s main argument for focussing on total revenues is that otherwise the K adjustment may result in consumers over-paying. This concern is unwarranted since our approach to K adjustment takes account of all cost and revenue items.

[✂]

36. [✂] In para 182 Ofwat raises a new argument that [✂] is priced below average accounting costs. This is incorrect and SESW has today written separately to the Commission on this matter. As a result there is no basis for a challenge based on prudent management action and the shortfall in revenue should not be adjusted

6. Calculation of the K adjustment and securing reasonable returns on capital

Ofwat lays much stress on the regulatory framework being based on “medium term incentive based regulation” but overlooks the corrective nature of SAE applications

37. We agree that section 2 WIA provides a clear mandate for medium term incentive based regulation. Where we differ from Ofwat however is on the application of s.2 in practice. Ofwat sees s.2 exclusively through the prism of the current regulatory regime, i.e. the five yearly price reviews with any additional mechanism (such as IDoKs or SAE applications) being considered by Ofwat to be exceptional and a departure from the five yearly review. S.2 is however a continuing duty to be implemented by Ofwat at all times and does not refer to five yearly reviews. This does not in any way exclude a five yearly price review period *provided that* the regime includes a correction mechanism which recognises that prediction of every circumstance over the five year period cannot be perfect and resets prices (i.e. re-establishes the s.2 duty) if the difference is material. IDoKs and SAE applications constitute such a

mechanism. SAE applications are permissible by either companies or Ofwat for correction of K where circumstances have occurred which either were not foreseen or were of a scale which was not foreseen.

Ofwat’s assessment that SESW’s return on capital is adequate is without basis

38. In para 210 of the response Ofwat states that its estimated return on capital for SESW for 2009/10 in the Final Determination was [X] (after their significant and flawed challenges to our actual figures which means that this overstates the returns Ofwat knows we will actually achieve). Ofwat states that they were satisfied that this return was adequate. However, Ofwat acknowledges that this return is below the cost of capital set at PR04 and no other estimate of the cost of capital is provided that can be compared to the [X] Ofwat’s satisfaction with the rate of return is based on the proximity of the next price review and the state of the company’s financial indicators.
39. Ofwat has not provided any details of its assessment of whether the return on capital is reasonable. Ofwat’s approach to the assessment of reasonable returns is merely a restatement of its modelling of financial ratios. This is contrary to the s.2 duty, i.e. the approach to reasonable returns adopted at the price reviews where the assessment of financial ratios is a second strand of an approach that sets returns equal to or above the cost of capital. As argued above, and in our submission, there is no basis for such a contradictory approach.

Ofwat’s approach generates regulatory uncertainty

40. Furthermore, Ofwat’s approach to assessing whether returns are reasonable is likely to create regulatory uncertainty. With the concept of reasonable returns divorced from the cost of capital there is no transparent benchmark for the assessment of returns. In our case Ofwat consider that [X] is adequate but there appears to be no basis for knowing at what point Ofwat would consider returns to be inadequate, e.g. whether it would be [X] or [X]? This lack of transparency is inconsistent with regulatory best practice and would increase perceptions of regulatory risk.

Rate of return is the basis for standard IDoKs

41. In paragraphs 203 and 204 of the response Ofwat argue that the rate of return is not the absolute benchmark for a standard IDoK and that for “*the majority of companies including SES’s, standard IDoKs contain no reference at all to ‘reasonable returns on capital’*”. We accept Ofwat’s point that the discount rate to be applied to materiality and a K calculation is the cost of capital for some companies and the cost of debt for others. The relevant point is that the K adjustment for standard IDoKs (using either discount rate) has the effect of restoring the rate of return of the company (before taking account of outperformance or underperformance in other areas).
42. For companies where the discount rate for standard IDoKs is the cost of debt any incremental capital expenditure associated with the NI or RCC will be

remunerated at the cost of debt (or above the cost of debt if the interest cover ratio requires) until the next price review. In normal situations the cost of debt would be below the cost of capital. It should be noted though that the other cashflows associated with the NI or RCC, such as revenue loss or increased opex, will be recovered in full².

43. Therefore in terms of the relationship between a standard IDoK and the rate of return we can say the following:
- For licences with the cost of capital as the discount rate the K adjustment from a standard IDoK will restore the rate of return for the company (before taking account of other outperformance or underperformance).
 - For licences with the cost of debt as the discount rate the K adjustment from a standard IDoK will restore the rate of return for the company (before taking account of other outperformance or underperformance) except to the extent that any incremental capital expenditure will earn the cost of debt and not the cost of capital.

Payment of interest and dividends does not imply a reasonable return on capital

44. Ofwat make the point in paragraph 213 that its assessment of financial indicators assumes that the level of payments to capital providers (interest and dividend) is at the level assumed at PR04. The potential implication of this paragraph is that this is consistent with secure reasonable returns on capital. We do not agree with this view. The return required by equity investors comprises dividends paid and capital reinvested in the company (to be compensated from future dividends). Limiting regulated returns to cover only interest and current dividends would not be sustainable as it would not attract new capital.

² The discount rate will affect the calculation of the NPV of these cashflows and therefore will have a (relatively small) affect on the K adjustment required to achieve full recovery.