

**Sutton and East Surrey Water plc
Substantial Adverse Effect
Application**

**Submission to the Competition
Commission**

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Executive Summary

SESW's Substantial Adverse Effect application to the CC

During the current five-year regulatory period, 2005/6 to 2009/10, SESW's water income is substantially below and its electricity costs are substantially above, what was assumed by Ofwat in its price determination for the period. As these changes exceeded a materiality test of 20% of turnover specified for a Substantial Adverse Effect Claim in SESW's licence, SESW applied to Ofwat for an interim price adjustment to take account of them. Ofwat accepted that the changes had exceeded the materiality test but determined that no price adjustment should be made. SESW considers this determination to be fundamentally flawed and has appealed it to the Competition Commission.

Rationale for the Interim Price Adjustment Mechanism

1. SESW's licence allocates risk between companies and consumers. Companies only carry the risk of differences between what is assumed in Ofwat's price determination and their actual income and costs up to specified thresholds. Once these thresholds are passed, SESW should be given an interim adjustment to its prices to put SESW in the position as if the causes of these differences had not arisen. Whether or not the causes of the differences have been anticipated by Ofwat in its price determination, the safeguard is the same, apart from the threshold.
2. What is not permissible is for Ofwat to make a judgment on who is the "appropriate" person to bear particular risks. A combination of the prudent management test and the materiality threshold in the licence determines who bears what risk. An *ex post* reallocation of risk by Ofwat would both fail to apply the licence and ultimately increase the cost of capital for companies below.
3. Under the licence, items of income or cost which are uncertain at the time of a price determination and which could have a material impact during the regulatory period, should be specified by Ofwat in its price determination. These are referred to as Notified Items ("NIs"). The differences between allowed and actual costs of NIs will trigger a price adjustment if the materiality threshold exceeds 10% of annual income. The materiality amount is measured as the discounted value ("NPV") of 15 years cashflows of the differences. The same mechanism applies for costs arising from Relevant Changes in Circumstances ("RCCs") - new legal or regulatory requirements placed on the company and not allowed for in the price determination
4. If circumstances arise which have not been specified as NIs then they will trigger a price adjustment if their impact on income and costs constitute a Substantial Adverse Effect ("SAE"). An SAE arises if the materiality amount exceeds 20% of annual Income.

5. Interim price determination mechanisms for both NIs and SAEs are two-way (i.e. in addition to producing price increases they can decrease prices if the circumstances have resulted in a material benefit to a company). Income and costs differences which could have been avoided by prudent management, and trivial costs, are excluded from calculations.
6. The NPV of the relevant cashflows arising from SESW's shortfall in income and increased electricity costs is 114% of SESW's income in 2007/08 and therefore far exceed the 20% SAE threshold required for an interim price adjustment. Income contributed 42% and electricity 72%.
7. The price adjustment needed to SESW's 2009/10 prices to correct for the shortfall in water income and increased electricity costs would be an increase of 33%. However, SESW has outperformed its price determination in other areas and believes it is reasonable to offset this outperformance against the income shortfall and increased electricity costs. The price adjustment needed to SESW's 2009/10 prices to correct for the shortfall in water income and increased electricity costs less the benefits of outperformance is an increase of 14.1%. This calculation reflects the most recent projections for 2008/09 and 2009/10.

The reasons for the referral of SESW's Substantial Adverse Effect application to the CC

8. In September 2008 SESW made an SAE application to Ofwat. In its Draft Determination in November Ofwat failed, in several critical respects, to deal with the application in accordance with the relevant statutory and regulatory requirements, and despite extensive representations by SESW, these serious failures were carried through to Final Determination in December. As a result SESW did not accept Ofwat's Final Determination and requested that its SAE application should be determined by the CC.
9. Ofwat's Final Determination was that SESW was not entitled to any price adjustment, even though it accepted that SESW's application had satisfied the demanding materiality threshold of 20% with regard to both income and power. In order to arrive at this conclusion Ofwat improperly disallowed income and costs in its calculations, failed in its continuing duty under the Water Industry Act to provide an appropriate rate of return on capital, and reduced the financial ratios it had used for SESW and the water industry generally at the 2004 price determination.
10. SESW considers that in making such a determination, Ofwat is in breach of its statutory and regulatory duties. In particular, SESW considers that:
 - Ofwat's challenges to the loss of income are based on errors of fact and a manifest misreading and misapplication of the meaning of prudent management action;
 - Ofwat's challenges to the increased power costs are based on a manifest misreading and misapplication of the meaning of prudent management

action and of the legal basis on which it is entitled to make such challenges; and

- Ofwat's determination that no 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 both its principal duty under Section 2(2A)(c) of the Water Industry Act 1991 to ensure that companies can finance their functions (in particular by securing reasonable returns on their capital), and of its further duty under the Act to carry out its regulatory functions in accordance with good regulatory practice and particularly, in a consistent manner. The breach of its principal duty under Section 2(2A)(c) is both as to the meaning and scope of this duty and the period to which it applies. Ofwat wholly ignores its own assessment of return on capital and financeability made at the last price review in 2004 and erroneously treats its 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.

1. Introduction

11. This document sets out the basis for the application and the evidence that supports the K adjustment which SESW considers to be necessary and reasonable, as follows:
 - Section 2 summarises the issues in the case. It provides background to the company and the circumstances that have led to the application. It also addresses the main legal and economic points in the case.
 - Section 3 sets out the legal framework for the SAE application and the reference.
 - Section 4 deals in detail with the circumstances of lost income and increased power costs and the calculation of materiality. It assesses the challenges that Ofwat has to both items.
 - Section 5 addresses the required adjustment to K. It considers the principles that underpin the calculation of the adjustment and the rationale for the adjustment in this case.
12. Additional supporting material is provided in annexes to the submission. There have been a number of relatively minor revisions to the data submitted in the September 2008 application. These reflect updates arising from the business planning process regarding expected out-turns for 2008/09 and 2009/10.

2. Summary of the case

2.1 Introduction

13. This section provides a summary of the case and the main issues. First, it provides a brief background to SESW. Second, it outlines the circumstances that have resulted in the SAE application. Third, it highlights the main legal and economic issues in the case.

2.2 Background to SESW

14. SESW is a water only company which supplies drinking water to 646,000 people in the London Boroughs of Croydon, Merton and Sutton, East Surrey and parts of Kent and Sussex. A full description of the company and its operations are provided in Annex 1. There are a number of factors that differentiate it from other water companies, including:
- SESW has one of the highest average pumping requirements in the UK¹. The high average pumping head results in high electricity costs and the need for standby generation at all SESW's major treatment works.
 - The company has one of the highest levels of household consumption, 158.2 litres/property per day, compared to the England and Wales average of 147.6 litres/property per day. This is a reflection of the relative affluence of SESW's customer base.
 - SESW faces a very high level of peak demand in the summer period due to garden watering. The company believes that its ratio of peak week demand to annual daily average of 1.40 (based on 2008/09 data) is one of the highest of all companies. In order to meet this higher level of peak demand, SESW has to have more mains capacity and treatment and pumping capacity per customer than the average water company.
 - It is the only water company in the UK which is under a legal obligation to soften the naturally very hard water from its boreholes. SESW sees this as providing a unique customer benefit. However, it does result in additional treatment costs including power costs.
15. These factors present significant cost challenges but the company provides a high quality and good value service to customers. This is borne out by the following.

¹ Average pumping head of 197.7m compared to the England and Wales average of 132.5m.

- Between 2000/01 and 2009/10 SESW has only increased its charges by 2.8% in real terms, despite delivering significant investment programmes.
 - SESW has the second lowest customer complaint level in the UK water industry. In their DG Levels of Service Outputs Ofwat have continually assessed SESW as offering the highest level of service to customers.
 - As part of its AMP5 Business Plan quantitative research was carried out on behalf of SESW by Accent (a specialist market research company) in January 2009. This customer survey indicated that 90% of customers were satisfied with the service that they received from SESW. In addition, over two thirds (70%) felt that the Company offered fairly good or very good value for money.
16. To achieve this level of customer service and value, SESW has been, and is, committed to efficiency and innovation.
- SESW has made significant investment in the modernising and automating of its treatment works developing innovative remote computer systems to track treatment works performance to ensure that plant and equipment is fully optimised and used efficiently and cost effectively.
 - The company has achieved considerable success in demand management where the amount of water pumped to supply is approximately 25% less than it would have been without demand management. This has been achieved through a range of measures, including leakage reduction, mains replacement and pressure management.
 - SESW embarked on leakage reduction in the late 1980s when the necessary technology first became available. It pioneered and implemented an innovative technology driven strategy which resulted in leakage being reduced from over 34.5Mld in 1992/93 to its current level of less than 24.5Mld. SESW's leakage level is currently one of the lowest in the country.
 - In April 2000 SESW was one of the first utilities in the UK to offer e-billing, i.e. direct internet access to customers to all their account information allowing them to answer their own routine queries and make payments. In addition to reducing the time the Company's staff spend dealing with routine customers enquiries, e-billing also reduces the cost of postage involved in sending quite large amounts of literature to customers. This not only reduces costs but also makes a significant environmental improvement.
17. More details of SESW's efficiency and innovations are provided in Annex 1.
18. This section demonstrates that SESW is a company that is fully committed to offering its customers the highest possible level of service in the most efficient and cost effective way possible.

2.3 Events leading to the SAE application

19. This section outlines the events that have led to the SAE application. It summarises the actual position compared to the 2004 price review (the PR04 determination) with regard to water income and power costs.
20. A detailed assessment of the materiality of these events is provided in Section 4. A copy of the September 2008 SAE application to Ofwat is provided in Annex 2. Note that some of the figures in this submission have changed slightly from the figures submitted in September. This principally reflects updated information on power costs and revenue loss for 2008/09 and 2009/10.

2.3.1 *Loss of water income*

21. Over the current five-year period SESW's water income is expected to be almost 3% less than assumed by Ofwat in its PR04 Final Determination.
22. There are two reasons why this discrepancy has arisen.
23. The first reason is that measured customers are using less water than was assumed by Ofwat in its PR04 Determination. This is particularly clear from the average amount of water used by metered household customers.
24. The main factors behind the lower than average consumption since PR04 are largely related to exceptional climate conditions. In 2005/06 and 2006/07, average consumption was reduced by the restrictions required because of serious drought conditions caused by the lack in rainfall during the winters of 2005 and 2006 (which necessitated the first Non-Essential Use ban in the Company's history). In 2007/08 and 2008/09 reduced demand is due to the opposite weather conditions: exceptionally wet summers.
25. The second, less significant, reason is that unmeasured customers have opted to take up meters at a faster rate than was predicted at PR04. This has also reduced SESW's revenues compared to the level forecast in the Determination. By the end of 2007/08 the number of customers who had opted for meters was significantly higher than Ofwat's projection. Between the start of 2005/06 and the end of 2007/08, SESW has installed roughly 4,800 more meters in total than projected by Ofwat, of which around 4,400 were additional meter optants.

2.3.2 *Rise in power costs*

26. The increase in power costs is due to the increases in the unit cost of electricity as opposed to increased usage. By 2009/10 SESW's power costs, even on lower than anticipated water volumes to supply, will be almost two and a half times the amount allowed for in the 2004 price determination.
27. To place electricity costs in context, 98% of SESW's power usage is operational while the other 2% relates to SESW's Redhill site (which

comprises head office, works depot and laboratory). The vast majority of operational power (c. 96%) is used to pump water from SESW’s various water sources through water treatment works and on to customers’ taps. The remainder is used by the various water treatment processes.

28. Over the five years of the current regulatory period SESW’s estimate of the additional costs of power/electricity is [redacted] in 2002/03 prices. The following table shows how this difference arose. In terms of the SAE materiality test of 20% of regulated turnover, the additional cost of power/electricity produces a figure of 72%.

2.3.3 Summary of income and power costs

29. A summary of the materiality calculation in the present case is set out in the table below. Annex 12 has a detailed calculation of materiality.

2002/03 prices, £000	2005/06 Year -3	2006/07 Year -2	2007/08 Year -1	2008/09 Year 0	2009/10 onwards Years 1 - 11	NPV as % of appointed turnover*
Reduction in Water Income	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	41.6%
Additional electricity costs	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	72.2%
Total	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	113.8%
Ofwat discount rate	4.69%	4.69%	4.61%	4.61%	4.61%	

Table 1: Summary of materiality calculation

Source: SESW
* Forecast

* Appointed turnover for 2007/08 = £41.963m in 2002/03 prices using Ofwat’s IDoK Model deflator

30. This table demonstrates that under SESW’s application the combined Materiality Amount equalled 114% of last year’s (2007/08) regulated income, compared to the necessary threshold of 20%. Moreover, each element individually exceeded the 20% threshold by a considerable margin.

2.4 Main issues

31. This application, and Ofwat’s determination, involves a number of important legal and economic regulatory issues. These are covered in detail in the remainder of this submission. The most important of these are summarised in this section.

2.4.1 Calculating the adjustment to K

32. If a substantial effect exceeds the materiality threshold of 20%, paragraph 13.3 of Condition B requires Ofwat to assess what change should be made to the adjustment factor (i.e. the K factor). Paragraph 13.3 is less prescriptive than paragraph 13.2, which covers NIs and RCCs, as to the outcome of K adjustment calculation. However Ofwat bears the continuing duty under s. 2(2A) Water Industry Act 1991 to exercise and perform the powers and duties conferred on it in the manner that it considers is best calculated, in addition to furthering the consumer objective, to *secure that*:
- the functions of a water undertaker are properly carried out as respects every area of England and Wales;
 - companies are able (in particular by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and
 - the activities authorised by the licence and any statutory functions imposed in consequence of the licence are properly carried out.
33. Any determination by Ofwat must therefore be directed to *securing* these results. In this case Ofwat concluded that no adjustment to K was required despite the fact that the materiality threshold of 20% was exceeded for both income and power costs². In SESW's view in making this determination Ofwat is in breach of its statutory and regulatory duties.
34. In reaching this conclusion, Ofwat effectively changed its approach to its principal duty. Prior to this determination Ofwat's view of its principal duty, in respect of earlier SAEs was that it had to enable a company to achieve a return at least equal to that Ofwat determined at the last price review. The return could be higher, if it was necessary to make good any inadequacy in a company's financial ratios. In awarding a K factor adjustment to Bournemouth and West Hampshire Water in its 19 February 2004 determination, Ofwat stated that: ***“The proposed change in price limits should increase shareholders' returns to the level anticipated at the last review after adjusting for the decline in revenues.”***³
35. Ofwat's new view, as adopted for this latest SAE determination, was that in order to finance a company's functions it was only necessary to ensure its financial resources were sufficient to get it through to the next price review. It also considered that the return was now apparently no longer relevant and the Final Determination from the 2004 price review could be ignored.

² This was in spite of the inappropriate challenges applied for prudent management action (see below).

³ Copies of the SAE determinations for Bournemouth and West Hampshire Water and Northumbrian Water are provided in Annex 3.

36. There is no proper statutory or regulatory approach which amounts to Ofwat saying that an undertaker has been making very much lower returns than anticipated for three years and so an additional year does not matter provided that the undertaker should be able to finance its functions until the next review date. Such an approach would ignore both the need for a return on capital and the continuing aspect of the principal statutory duty which is designed not to jeopardise the delivery of services and improvements not only for current but also for future years.
37. The application of such an approach could also have perverse and unintended consequences. It would offer protection to companies that had taken on excessive levels of debt and maintained insufficient financial resources, while not protecting companies that had been more prudent. This could affect the behaviour of companies as well as raising investors' perception of risk in the industry.
38. Ofwat also concluded that any adjustment to K would only be based on the impact in 2009/10. Ofwat's position appears to be that, if a company suffers a significant change to income in year 2 of a price review period, e.g. through a drought situation with controls on water usage, and applies for an adjustment under paragraph 13.3 of Condition B on the basis that the loss of income is likely to persist, an adjustment would be considered for each year remaining. However if an application is made in year 4 for the losses of income in years 2, 3, 4 and 5, Ofwat's interim determination would restrict consideration to what is necessary for year 5 only without regard to the effect on returns in earlier years due to the same issue. Such asymmetry is not admissible.
39. The issue posed by paragraph 13.3 of Condition B is whether the circumstance "has or will have" a substantial adverse effect. Ofwat should not be entitled to ignore the effects in earlier years of an issue which breaches materiality and has given rise to a substantial adverse effect. *The earlier years contributing to the relevant effect* within the review period are clearly relevant to materiality for all interim determinations and logically also to the adjustment of K. Indeed Ofwat have accepted the relevance of shortfalls in cashflows in earlier years⁴.
40. This does not mean that the appropriate K adjustment for a substantial effect operates as a "guarantee" or "underwriting" of the company's rate of return (or profitability as Ofwat, incorrectly, maintains SESW is seeking). This is illustrated clearly by two aspects of the process.
- First, the licence balances the risk between the company and its customers. Up to the materiality threshold the risk is borne entirely by the company.

⁴ Ofwat's Note of the Meeting with the Company 13th August 2008, Item 3.

- Second, in calculating the K adjustment Ofwat is entitled (i.e. as part of the proper exercise of its discretion under the licence) to take account of the company's performance in other areas and would not compensate the company for underperformance. This is the same process that is applied at a five year price control. The K adjustment made at a five year price control does not constitute a guarantee on the rate of return.
41. For these reasons, the process for K adjustment set out in the licence and applied in previous SAEs does not contradict the principles of incentive regulation. Companies are incentivised to be efficient in the knowledge that the K setting process will not compensate for underperformance. Ofwat recognised this point in the SAE determination for Bournemouth stating: ***“We do not believe that such an approach will reduce the incentives on companies to become more efficient.”***

2.4.2 Prudent management action

42. In its Final Determination Ofwat made substantial reductions to the loss of revenue or increase in power costs on the basis that the effects could have been avoided by prudent management action. The adjustment is particularly significant in relation to the increase in power costs where Ofwat concludes that 30% of the increase could have been avoided. SESW believes that Ofwat's challenges are not justified. This is borne out by the conclusions of the independent experts that have assessed SESW power costs:
- Ofwat commissioned Atkins to review SESW's power procurement and, in particular, to review the decision to take a one year power contract in 2007. Their report⁵ states:

*“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.**”*
(emphasis added)
 - Jacobs, the independent Reporter for SESW, undertook a review of SESW's representations to Ofwat following the draft Determination. It states⁶:

⁵ The Atkins report is provided in Annex 5.

⁶ The Jacobs report is provided in Annex 6.

“From my knowledge of the Company, I believe that the delegation of responsibility to individual directors and managers is clear including responsibility related to day to day management of operational activities. I consider that the description of the Company structure and operations management given in sections 2.2.2.2 and 2.2.2.3 of the Company’s representations is accurate. Whilst there may be changes that the Company could make to develop its energy management procedures, I do not believe that these would have a material impact on energy consumption.”

43. Ofwat’s conclusions are contrary to the evidence.
44. For an SAE application under paragraph 13.3 of Condition B to be made, a circumstance has to have occurred which “has or will have” a substantial effect on SESW’s business or on its assets, liabilities, financial position or profits or losses, provided that:
 - the effect is not one which would have been avoided by prudent management action;
 - the net extra costs/losses in net present value terms of the relevant circumstance(s) are equal to or greater than 20% of the appointed business turnover for the last financial year.
45. As regards the first proviso, the word “would” must be stressed. First, because the aim of the clause is to distinguish prudent management action from that which is not prudent, it requires that conduct leading to disallowance be imprudent. Second, the words “would have been avoided” require cause and effect to be established.
46. Even in their most recent document (5 March 2009), Ofwat consistently misread “**would** have been avoided” as “**could** have been avoided”, thereby applying the wrong legal test (our emphasis).
47. As to the facts, Ofwat’s challenge to the increased power costs is not consistent with the test for prudent management action. Our understanding of Ofwat’s reasoning for reducing the amount of the electricity costs allowed for materiality is that:
 - first, SESW had the opportunity to fix power costs in 2008-09 for two years but chose to fix the costs for one year only. Ofwat considers this decision was imprudent and as a consequence the company should not be compensated through the SAE IDoK mechanism for the result of this imprudence;
 - second, SESW is inefficient in its use of energy and should not be compensated for that inefficiency. Furthermore, in these specific circumstances, SESW could, and should have done more to manage its energy consumption.
48. SESW strongly contests the suggestion that its decision to sign a one year power deal for 2008/09 was imprudent, given the information that was

available to the company at the time. Furthermore, SESW also rejects Ofwat's view that it is inefficient with respect to energy consumption and the steps the Company has taken to be energy efficient.

49. In SESW's view Ofwat's judgment relies on the benefit of hindsight and is flawed in several respects. In particular Ofwat confuses the unintended outcome of a sound management process with imprudence. Specifically, the terms of paragraph 13.3.(2)(i) of licence condition B prohibit reference to hindsight when it specifies that what constitutes prudent management action "*shall be assessed by reference to the circumstances which were known or which ought reasonably to have been known to the Appointee at the relevant time*".
50. SESW was in receipt of professional advice from a leading firm of energy consultants that stated clearly that the lowest expected cost strategy was to contract for one year only. As shown above, Ofwat's own advisers Atkins also conclude that a one year deal was an appropriate and reasonable strategy.
51. Furthermore, SESW strongly disputes Ofwat's assessment that it has been inefficient in its management of energy use. The company's energy use is determined by its requirements for pumping water through its distribution network and by the necessary processes for treating raw water. The configuration of the company's pumping and treatment assets is designed to provide the required level of service. Contrary to what Ofwat suggest there is very little that can reasonably be done, in the short to medium-term, to alter this configuration or usage. Pumping assets are long lived assets and although there is scope to introduce more energy efficient pumps it is unlikely to be cost effective to replace pumps that have remaining useful life. Annex 9 details the Company's approach to pump replacement and refurbishment. This is borne out by the conclusions of Atkins and Jacobs cited above. Furthermore, a separate report by independent advisers Black and Veatch for the company, included as Annex 7, states that:

"We conclude that energy usage by SESW is efficiently managed and we have not identified any opportunities for significant improvement or that electricity usage is being managed "imprudently" "

2.4.3 Other issues

52. Further issues that are covered in this submission include:
 - That the term "circumstance" in paragraph 13.3 should be interpreted to include "circumstances". This approach is confirmed by the aggregation of circumstances for materiality for interim determinations relating to NIs / RCCs. The issue of whether applications should be single or multiple is one which SESW has raised as a matter of procedure with the Competition Commission. Though three separate applications could be made to the Competition Commission, in accordance with the discussion in the first meeting on 10 March 2009, only one application is being made.

- SESW disagrees with Ofwat's decision to include revenue from rechargeable works in the overall revenue figure it used for its materiality calculation. Income from rechargeable works is not water retail income but has been higher than predicted by Ofwat because SESW has been required to carry out more of these works.

3. The reference and SAE process

3.1 Introduction

53. This section describes the procedure for interim determination on the grounds of substantial effect, as set out in the company's instrument of appointment ("licence"). It then describes the process and timetable of this application and identifies the main flaws of approach in Ofwat's determination and interpretation of its statutory and regulatory duties.

3.2 Interim determination on the grounds of substantial effect

54. Condition B of SESW's licence includes a process for enabling SESW to apply to Ofwat for (in common with all other water companies) a change to its adjustment factor both to allow for Notified Items (NIs), Relevant Changes of Circumstance (RCCs) and circumstances having a substantial effect on SESW's business.

55. These matters are dealt with under Part IV of Condition B under the heading "Interim Determinations".

56. Paragraph 13.2 covers RCCs and NIs. RCCs deal with changes to legal and regulatory obligations on water companies; NIs are those items in respect of which uncertainty is acknowledged and allowed for by Ofwat at a periodic review. Paragraph 13.3 of Condition B is designed to deal with unforeseen circumstances arising between periodic reviews which have a substantial effect on SESW's business. Part IV may therefore be regarded as a code to deal with uncertainty.

57. It is common ground that RCCs are not applicable in the present case and that there was no NI at the last price review for either power costs or income. SESW did however request at PR04 in its Final Business Plan that power costs be made a NI. This request was rejected by Ofwat.

58. For paragraph 13.3 of Condition B to apply the issue is whether a circumstance has occurred which "has or will have" a substantial effect on SESW's business or on its assets, liabilities, financial position or profits or losses provided that:

- the effect is not one which would have been avoided by prudent management action (the first proviso);
- the net extra costs/losses in net present value terms of the relevant circumstance(s) are equal to or greater than 20% of the appointed business turnover for the last financial year (the second proviso).

59. The first point is that this mechanism applies to both substantial adverse effects and to substantial favourable effects. The provision is therefore symmetrical and may be used either in favour of a Company or against it.⁷
60. Second, the provision permits reliance on a substantial effect which has already occurred or which will occur. It is clear from this that costs already incurred due to relevant circumstance(s) are to be taken into account.

The first proviso - Prudent Management Action

61. As regards the first proviso referred to above, the word “would” is most important. First, because the aim of the clause is clearly to distinguish prudent management action from that which is not prudent, it requires that conduct leading to disallowance be imprudent. Second, the words “would have been avoided” require cause and effect to be established. The two issues which must be proven by Ofwat against SESW in order to invoke this part of the Condition are accordingly that:
- SESW’s conduct falls *outside* the range of what may be described as prudent management action; and
 - That even if SESW’s conduct can be correctly regarded as imprudent, that feature of SESW’s conduct which takes SESW outside the range of prudent management action actually *caused* the relevant effect.
62. The focus must be on whether the method or process used in order to procure the electricity is prudent – it cannot be the success or failure of the decision which is relevant because that necessarily involves hindsight. The express terms of the paragraph 13.3(2)(i) of Condition B prohibit reference to hindsight or outturn when it specifies that what constitutes prudent management action “shall be assessed by reference to the circumstances which were known or which ought reasonably to have been known to the Appointee at the relevant time”. This ban on hindsight also confirms the fact that the clause aims to distinguish prudent management from that which is not prudent.
63. It is a manifest error by Ofwat to approach the prudent management test as if it is asking whether costs “could have been avoided” (Ofwat, 5 March 2009, paragraphs 4, 37, 40 and heading to paragraph 61). Quite apart from this being a manifest misreading of the licence, such a test would not distinguish between conduct which is or is not prudent but would inevitably be based on outturn.
64. Ofwat can only legitimately challenge SESW’s actions if it is able to establish, with clear evidence, that the method of procuring the electricity lies outside the range of prudent management action, that the method was prudent but it

⁷ In practice, where items have given rise to a favourable effect (whether or not breaching materiality), Ofwat has approached companies and requested that prices be adjusted through a voluntary abatement of K.

was applied imprudently (given what SESW knew or ought to have known at the time of procurement), and, in either case, that any established imprudence caused the substantial effect on SESW.

65. In so far as advice from external consultants is taken by a water undertaking in such a case, Ofwat would need to show a defect or shortcoming in either the approach taken by the consultant or in the expertise of the consultant *and* that there was something in the course of conduct proposed by the consultant which, having regard to the circumstances which were known or ought reasonably to have been known to the water undertaking at the time, it was outside the range of prudent behaviour of the undertaking to have accepted.
66. The specific challenges that Ofwat applied under this proviso are assessed in detail in Section 4 of this submission.

The second proviso – the materiality threshold

67. The second proviso raises the materiality threshold from 10% for NIs and RCCs to 20% for substantial effect applications.
68. This difference in materiality thresholds between NIs and SAE applications depends on whether Ofwat accepts that there is sufficient uncertainty to classify an item as an NI or whether Ofwat decides that the price determination takes sufficient account of the relevant item. The difference in materiality between 10% and 20% is a risk allocated to companies. In effect Ofwat is permitted a margin for error in not having made the relevant matters an NI. Once 20% materiality is breached however, the risk is no longer allocated to companies.
69. The availability of substantial effect applications if 20% materiality is achieved is important because this is the only effective safeguard for companies against outcomes that were unforeseen or otherwise not allowed for by Ofwat at the previous price control.
70. The Final Determination for PR04, Chapter 16, is entitled “Dealing with uncertainties”. It records Ofwat’s acceptance that a few issues “are too uncertain to be included in our price limits” and in consequence those items were specified NIs.⁸ In contrast, a few lines above, Ofwat states that:

“We have concluded that it is appropriate that companies continue to bear a proportion of the risk arising from uncertainty and if a single issue outside prudent management control is sufficient to have a serious impact on the company then a substantial effect determination may be applicable. ... we have concluded that some of the changes [companies] propose are adequately dealt with in the price setting mechanism, for example power costs and pensions. ... We have reviewed all of the

⁸ Paragraph 16.2 on p. 242.

issues raised by the companies carefully and we judge that the risks are small and even if they appeared, companies should use their management skills to minimise the effects. The cost of capital takes account of this and other forms of business risk.

71. First, Ofwat accepts that companies are only being asked to bear a “proportion of the risk”, not the entirety of the risk which this interim determination allocates to SESW. It was clearly common ground in the Final Determination for PR04 that companies only bear the risk up to the point that an SAE application can be made.
72. Second, Ofwat made a judgment not to make power costs an NI. There is no effective recourse against the failure to make power costs a notified item as the response would be “wait and see” – if Ofwat wrongly assessed the risk of volatility on power costs, then companies can apply for a substantial effect interim determination if the volatility of the item exceeds Ofwat’s expectations subject to bearing the additional risk of the difference between the NI materiality threshold of 10% and that for SAEs of 20%.
73. Third, it will be apparent that Ofwat’s judgment on whether or not to make an item an NI is an important one for the company – materiality needs to be assessed at double that for an NI for Ofwat to consider the adjustment to K. It will be apparent therefore that the basis of Ofwat’s judgment on whether to make an item an NI must be a bona fide assessment of the uncertainty or volatility of the item and not a political desire to minimise the number of NIs.
74. Accordingly, until the effects of identifiable circumstance(s) are sufficiently significant to breach the materiality threshold, the risk is on the company. But once the materiality threshold is breached, the company is entitled to apply for Ofwat to step in and carry out its statutory duty to secure that companies are able to obtain reasonable returns on their capital and to finance the proper carrying out of their functions.
75. In addition, a special factor is present in this case. This is that, though Ofwat refused to make power costs a notified item, SESW’s argument as to the volatility of power costs was accepted to the extent that Ofwat made express allowance of approximately 40% change in power costs for 2005-06 in the Final Determination for PR04. Ofwat’s position is therefore contradictory in accepting on the one hand that power prices are volatile and that the impact of this is sufficiently material to justify adjusting the allowance for power costs by 40% from the first year of the period (2005-06) but on the other hand ignoring the risk of further volatility of power prices for subsequent years in the five year period. The very fact of the special allowance for power costs is a strong indicator that power costs should have been an NI.

The approach to adjustment of K

76. Paragraph 13.3 of Condition B is less prescriptive than paragraph 13.2 as to the outcome of an IDoK application. However Ofwat bears the continuing duty under s. 2(2A) Water Industry Act 1991 to exercise and perform the

powers and duties conferred on him in the manner that he considers is best calculated, in addition to furthering the consumer objective, to *secure that*.

- the functions of a water undertaker are properly carried out as respects every area of England and Wales;
- companies are able (in particular by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and
- the activities authorised by the licence and any statutory functions imposed in consequence of the licence are properly carried out.

77. Section 2(3) provides for additional matters to be taken into account, such as the promotion of economy and efficiency, but these matters are expressly subject to s. 2(2A).

78. Any determination by Ofwat must therefore be directed to *securing* these results. Though the structure of s. 2 was been the subject of amendment, there remains a clear contrast between an obligation to exercise powers in a manner best calculated to *further* the consumer objective and an obligation to *secure* that companies are able to secure reasonable returns on capital and to finance the proper carrying out of their functions. The latter imposes an obligation to exercise powers in such a way as to *secure* a result. It remains therefore the principal duty under the Act.

79. As regards the meaning of securing that companies are able to finance the proper carrying out of their functions (in particular by securing reasonable returns on capital), Ofwat has an established approach which proceeds in two stages:

- First, to set price limits in order that the company can earn a return on capital equal to the relevant company's cost of capital; and
- Second, to consider whether this approach will provide sufficiently positive financial ratios and, if not, to make an adjustment upwards.

80. As Ofwat put it in their Final Determination PR04 (paragraph 15.1):

*“We have a duty to secure that companies are able to finance the proper carrying out of their functions as licenced undertakers (“finance functions”). We look at this as having two strands. One is to secure that, if a company is efficiently managed and financed, it is able to earn a return **at least equal to the cost of capital**. The second is that its revenues, profits and cash flows must allow it to raise finance on reasonable terms in the capital markets. We refer to this second strand as *financeability*.”* (emphasis added)

81. Ofwat also expressly recognised in paragraph 15.1 of the PR04 Final Determination that a consequence of requiring companies to undertake large capital programmes is persistent negative cashflow which could lead to deterioration in credit quality which (even for companies earning their cost of

- capital) could limit access to capital markets and thereby jeopardise the undertaker's ability to deliver services and the improvements required.
82. Such recognition is important for the proper interpretation of s. 2 because it recognises the *continuing* nature of the s. 2 duty as regards securing the reasonable return on capital and financing functions. Taking the logic of Ofwat's description of the chain of cause and effect of requiring large capital programmes, a failure to ensure that companies are earning their cost of capital would make the jeopardising of delivery of services and improvements even more likely than in Ofwat's example.
83. The words "by securing reasonable returns on their capital" in the principal duty provide further support for Ofwat's recognition of the continuing nature of the principal duty. This requirement is not included within other regulatory regimes and its inclusion in the Act recognises the need to act in the way best calculated to secure reasonable returns as the first strand of the financeability criterion. It is clear that, if the rate of return criterion is not fulfilled, a clear link is envisaged between that fact and failing to secure the financeability of functions. Accordingly there is no warrant for a different approach to be taken at PR04 and now with regard to the financing of functions.
84. Reference by Ofwat to paragraph 13.3 applications being "special", "exceptional" or for "extreme situations" (5 March 2009 document, paragraph 16) do not change the nature of the principal duty, nor do they correctly characterise the process envisaged under paragraph 13.3 of the licence.
85. There is also no warrant for an approach which amounts to Ofwat saying that an undertaker has been making very much lower returns than anticipated for three years and so an additional year does not matter provided that the undertaker should be able to finance its functions until the next review date. Such an approach would ignore both the need for a return on functions and the continuing aspect of the principal duty which is designed not to jeopardise the delivery of services and improvements not only for current but also for future years.
86. Ofwat also place much reliance on what it regards as a "broad discretion" (Final Determination, p. 11). Yet it also appears to be common ground that any discretion is subject to Ofwat fulfilling its principal duty. As would be expected, any discretion is not untrammelled but is limited. The absence of a precise calculation methodology means that Ofwat must set out to fulfil its principal duty but may take account of a broader set of factors than would be possible under the standard IDOK procedure. Such factors include any benefits which may have accrued to the Company during the whole of the then current review period but which Ofwat is not otherwise able to claim back on behalf of customers because they have not, cumulatively, met the 20% test. This is central to the discretion granted to Ofwat under the licence. What is not granted by the licence is a discretion to look only at the financial ability of the Company to survive until the start of the next review period. This is an assessment which is unrelated to the substantial adverse effect and which would fail to place SESW in a position as if the causes of the differences had not arisen. SESW fully accepts that the former discretion is

available to Ofwat as a necessary part of the SAE mechanism, which is why it has into account, in its calculation of K, savings achieved over the course of the price review period.

87. In addition, the approach in this interim determination is contrary to Ofwat's approach in two prior interim determinations on grounds of substantial adverse effect: Northumbrian Water Ltd dated 11 December 2003 ("Northumbrian") and Bournemouth and West Hampshire Water of 19 February 2004 ("Bournemouth"). In respect of Northumbrian, Ofwat said:

"Our view of the amount needed for Northumbrian Water to finance the proper carrying out of its functions until [the end of the then current five year period] is that which will enable the company to raise sufficient revenue such that the company achieves an appropriate return on capital and that the financial indicators used at the 1999 review are satisfied. That is a return on your Regulatory Capital Value (RCV) and the appropriate cash interest cover indicator for 2004-5."

88. At page 5 of the Bournemouth determination, there is a statement in very similar terms (see para 34). As would be expected for such an interim determination to comply with the duty under s. 2(2A), Ofwat has adopted the same two-stage approach as is adopted at a periodic review. SESW endorses the clear logic of such an approach which engages with both limbs of s. 2(2A)(c), i.e. securing reasonable returns on capital and the ability to finance the proper carrying out of the functions. The importance of this logic for securing finance is discussed further in Section 5.
89. Such a well-established approach to restoring the return on capital is one which creates a legitimate expectation on water undertakers that it will be followed unless and until adequate notice is given of a decision to vary the practice in accordance with Ofwat's statutory duty to act consistently and in accordance with best regulatory practice⁹. In any event, the statute clearly requires such a dual test which takes fully into account both an ability to secure a reasonable return on capital as well as an ability to finance functions.
90. Furthermore, regulatory consistency plays a key role in ensuring access to capital for the water sector. Conversely, inconsistency of regulation creates additional risk for water undertakers. The risk created by such inconsistency is a material concern for investors and creates a barrier to raising new finance.
91. Ofwat contend that their task in setting K is limited to a snapshot of a company's financial position and answering the question whether the company can finance its functions until the next price review (Final Determination, p. 6). Such an approach would ignore both the continuing nature of Ofwat's principal duty and the medium term nature of the regulatory

⁹ Section 2(4) of the Water Industry Act.

regime which is inherent in Ofwat's repeated reference to the system as being one of "medium-term incentive based regulation". It would also wholly ignore Ofwat's own assessment of its principal duty in the 2004 Final Determination.

92. As regards specifically the period to which Ofwat's duty extends, this raises the issue of retrospection. In essence Ofwat's position appears to be that, if a company suffers a significant change to income in year 2 of a price review period, e.g. through a drought situation with controls on water usage, and applies under paragraph 13.3 on the basis that the loss of income is likely to persist, an adjustment would be considered for each year remaining. However if application is made in year 4 for the events of years 2, 3, 4 and 5, Ofwat's interim determination would restrict consideration to what is necessary for year 5 without regard to the effect on returns in earlier years due to the same issue. Such asymmetry is not admissible.
93. The issue posed by paragraph 13.3 of Condition B is whether the circumstance "has or will have" a substantial adverse effect. Applications for future effects will face significant problems of proof and one would reasonably expect claims to be based on events which have already occurred and which demonstrate the substantial adverse effect. Given that to be the case, in order to be consistent with its continuing statutory duty, Ofwat would not be entitled to ignore the effects in earlier years of an issue which breaches materiality and has given rise to a substantial adverse effect.
94. In any event the earlier years contributing to the relevant effect within the review period are clearly relevant to materiality (both for NIs/RCCs and SAEs) and logically also to the adjustment of K for the reasons set out above.

Ofwat's attempt to rewrite the substantial effect clause

95. Whilst now seeking to interpret the substantial effect clause as confined to "extreme situations" and using the epithet "shipwreck" clause, Ofwat has in the past acknowledged both that the substantial effect clause does not operate as a shipwreck clause and furthermore that the clause needed to be modified if it were to be so interpreted.
96. In making the substantial effect determination for Northumbrian Water in December 2003, Ofwat expressed some concern regarding the operation of the clause:

"We still hold the view that the substantial effect clause, in its current form, has the effect of altering the balance of risk for unavoidable material events between customers and shareholders in a way that was not envisaged. We will consult on possible amendments to the substantial effect clause and other aspects of Licence Condition B in early 2004. We will incorporate views received when we commence our consultation."

97. In March 2004¹⁰ Ofwat consulted on proposed modifications to Licence Condition B. The proposal would have changed the basis of the calculation of the materiality amount. The effect of this would be to make it more difficult for the threshold to be exceeded and thereby reduce the number of events that would trigger an SAE adjustment. Ofwat stated its concern about the calculation of the materiality amount and the implications for risk-sharing between the company and customers:

“When the Standard IDoK materiality calculation was modified to its current form in 2000 (to extend the period for assessing operating costs and revenue losses to fifteen years), this also affected the materiality calculation for substantial effect IDoKs. This was not the intention and was not consulted upon at that time. As a result, the substantial effect clause no longer works in the way that it was intended. The purpose of the clause was to cover 'shipwreck' events. But it now covers progressive changes which would not amount to 'shipwreck' events.

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.”

98. However, after receiving responses to the consultation Ofwat decided not to proceed with the proposed modification. Ofwat's summary of the consultation responses stated¹¹:

“Some companies said that they would resist the proposed modification because it would make it significantly more difficult to meet the materiality threshold and that this would affect the cost of capital. They thought that companies might have to rely instead on invoking the Director's section 2 WIA91 duty, which relates to financing companies' functions. Others pointed out that restoring the original wording would not restore the meaning of the original calculation because price review periods are now normally five years, rather than the ten originally envisaged when companies were privatised. WaterVoice¹² also questioned whether the

¹⁰ Ofwat, MD189, Proposed Licence Modification Consultation, March 2004.

¹¹ Ofwat, MD194, Proposed Licence Modification: Conclusions, August 2004.

¹² WaterVoice was the organisation representing water customers, it has since been renamed CCWater.

proposal would necessarily be in the long term best interests of customers, arguing that it would increase regulatory risk and thereby add to the cost of capital. WaterVoice suggested, however, that we should reassess the materiality calculation to achieve a more appropriate balance between companies' and customers' interests.”

“In view of the opposition to this proposal, we do not intend to pursue it at this stage. However, we agree with WaterVoice that we should reassess the materiality calculation to achieve a more appropriate balance between companies' and customers' interests. We will review this issue along with other further work discussed above.”

99. The decisions that Ofwat made at the PR04 price determination with regard to the cost of capital and other parameters were made after this consultation had been completed and therefore reflected the existing version of substantial effect provision. Ofwat has not made any further attempt to revise the working of the substantial effect clause. The consultation process that Ofwat undertook highlights that Ofwat accepted that the SAE provision does not operate as a “shipwreck” clause and would require modification if it was to do so. The consultation process also showed that Ofwat, the industry and the consumer representative body were aware of the relationship between the workings of the substantial effect clause, investors’ perception of risk and the cost of capital.

3.3 Circumstance or circumstances

100. Whether or not the term “circumstance” in paragraph 13.3 is to be interpreted to include “circumstances” is not a matter which is likely to have a practical impact in this case because both circumstances individually pass materiality.
101. SESW’s application to Ofwat actually consisted of three separate applications. The reason for this was that SESW received advice that loss of water income and increased power costs could be combined in a single SAE application. In essence, the advice was that an SAE K adjustment could be requested if a limited number of specified circumstances together combined to exceed the SAE materiality threshold of 20%.
102. The interpretation of circumstance to include circumstances is in accordance with this purpose that the normal rule under s. 6 Interpretation Act 1978 (as expressly applied to the Licence by Condition A, paragraph 1(1)), i.e. that the singular includes the plural, should also apply here. Furthermore this approach is also confirmed by the aggregation of circumstances for materiality for interim determinations for NIs / RCCs.
103. If this were not the case, an increase in power costs plus a loss of income each individually amounting to 19% and therefore 38% in aggregate would not reach materiality whereas, were either power costs or income losses to hit 20%, then Ofwat would be required to consider what change to make to the Adjustment factor. The 20% materiality level is designed to permit companies to seek relief if they suffer an adverse impact of 20% or greater.

104. The result canvassed in the previous paragraph would also defeat the object of paragraph 13.3 which is clearly designed to ensure compliance with Ofwat's principal duty. It deals either with unforeseeable events or with the case where Ofwat's view of the uncertainty/volatility of relevant circumstances is proved wrong in the period between price reviews. In such circumstances Ofwat is able to step in to ensure the continuing discharge of its principal duty so as to ensure that undertakers are in turn able to discharge their s. 37 duty to develop and maintain an efficient and economical system of water supply within their area.
105. Ofwat did not agree with the advice received by SESW in this regard and maintained its view that each individual circumstance had to pass the materiality threshold of 20%. Therefore, in order to protect its position SESW made separate SAE applications for water income, power/electricity, and water income and power/electricity combined. The K adjustment associated with each application was 11.3 in each case because of SESW's approach of netting off all other items.
106. In the event, Ofwat provided a single Draft Determination for all three applications. That fact alone points against the need for separate applications and in favour of an interpretation of "circumstance" to include circumstances.
107. In any event the definition of circumstance and the boundary between each "circumstance" is insufficiently clear to provide a filter for substantial effect applications which is compliant with legal certainty. Nor, in the light of SESW's analysis of Ofwat's discretion to take account of a wider range of factors when assessing the increase to K (paragraph 86 above), is the difference between circumstance and circumstances required to be such a filter. As argued above, the key feature of paragraph 13.3 is the degree of impact on the company and not whether the impact is due to one or more circumstances.
108. In addition Ofwat's determination in respect of Northumbrian itself refers to the "primary (but not sole)" circumstance being the declining level of demand by large users.
109. The issue of whether applications should be single or multiple is one which SESW has raised as a matter of procedure with the Competition Commission. Though three separate applications could be made to the Competition Commission, in accordance with the discussion in the first meeting on 10 March 2009, only one application is being made.

3.4 Coherence of the interim determination process

110. The analysis of the legal position for interim determinations, taken together with regulatory precedent and best practice, provides a coherent framework for the operation of interim determinations. Figure 1 shows a schematic for the workings of a standard IDoK process (as applied to NIs and RCCs) and a

substantial effect IDoK. It identifies that there is a coherence to the process and strong similarities between the two types of IDoKs.

111. The key points to emerge from this framework are as follows:

- The procedure for calculating the materiality amount is the same – based on the NPV of cashflows over 15 years;
- The materiality calculation can be based on multiple circumstances that satisfy the triviality test. In the case of the standard IDoK the circumstances are limited to the NIs and RCCs; and
- In both cases the process for adjusting K is consistent with the general duties to ensure the financing of functions.

112. It is accepted that, in the case of an SAE, there is a discretion available to Ofwat in setting the K adjustment. However this discretion is limited by Ofwat's principal duty to set K factors to ensure the return on capital and financing of functions and that in so doing, it is able to check if there are benefits in other areas which should be taken into account. The K adjustment for an NI IDoK is more prescribed but is also consistent with this principal duty.

The operation of SAEs as per SESW’s license and the Water Industry

Act 1991

NIs (inc RCCs)

Calculate individual 15-year NPVs for all the NIs specified in the Price Determination

Total the 15-year NPVs of the non-trivial NIs

Does the total of the 15-year NPVs of the non-trivial NIs exceed 10%?

No

No price adjustment

Yes

Price adjustment equal to the cash value of opex elements and the CCD and return on capex elements of all non-trivial NIs i.e. re-establishment of return on capital (plus/minus other out/under performance)

SAEs

Calculate individual 15-year NPVs for the Circumstances

Total the 15-year NPVs of the Circumstances

Does the total of the 15-year NPVs of the Circumstances exceed 20%?

No

No price adjustment

Yes

Price adjustment to re-establish return on capital (statutory duty – Section 2(2)a) i.e. the cash value of opex elements and the CCD and return on capex elements of the Circumstances (subject to other factors; see paras 113-116)

Figure 1: Schematic of interim determination process

113. The limited discretion available in the case of an SAE exists to enable Ofwat to fulfil its duties under the Water Industry Act 1991 in the face of the wide range of circumstances that could arise under the substantial effect clause. Given the range of risks and uncertainties that face the industry a prescriptive approach to the adjustment of the K factor in the case of an SAE may not be fit for purpose in satisfying the duties that Ofwat face. Nevertheless, there is a clear logic following from the legal analysis and the express incorporation of the materiality calculation from paragraph 13.2 of Condition B, that the starting point for the adjustment to K should be the same as for a standard IDoK, i.e. the impact on the operating costs and capital charges of the events that triggered the IDoK. This limited discretion then allows for adjustment to this basis to reflect other legitimate factors.
114. For example, in this case SESW has proposed that the K adjustment take account of the savings that the company has made in other areas. This reduces the K adjustment from 33% to 14.1%. It is appropriate in assessing the K factor that Ofwat should take account of the outperformance:
- it protects the customers' interest by protecting against excessive price volatility and limits the extent of the price increase;
 - it ensures that the company is able to finance its functions; and
 - although it means that the benefits of outperformance are shared with customers earlier than would normally be the case this has no long-term impact on incentives for efficiency and is appropriate given the circumstances of the substantial effect.
115. This is an example of how the limited discretion should be applied in a manner that is consistent with Ofwat's duties to the company and in the interests of customers, both in the short-term and long-term.
116. The strong read across in the IDoK process is also consistent with good regulatory practice. It is important that companies and investors have sufficient certainty regarding the operation of the substantial effect process. In addition, in deciding whether to make specific areas of uncertainty the subject of a NI, Ofwat states that the risk from uncertainties that are not made NIs is addressed by the substantial effect clause. This is consistent with the view that the substantial effect process is a close substitute for the standard IDoK process. The experience with power costs is a good example of this. Ofwat decided at PR04 that power costs should not be a Notified Item, in spite of evidence of the volatility of power costs.

3.5 The application and Ofwat's response

3.5.1 Events prior to the application

117. Section 4 below describes in more detail the reduction in water income and the increase in power costs since 2005/06 that ultimately resulted in the SAE application.
118. By mid 2008 it was clear to SESW that it had to consider an SAE application. By this time it was clear that there would be an income shortfall in 2007/08, following shortfalls in 2005/06 and 2006/07, and that power prices were way ahead of the levels assumed by Ofwat in its Final Determination. SESW's position was informally communicated to Ofwat at a meeting in June 2008.
119. SESW was aware of the previous two SAE applications (Northumbrian and B&WH) and discussed them with a number of people who had been involved. From these discussions it appeared that a number of matters may not have been fully considered or resolved but had not been pursued, probably for pragmatic reasons. In order to obtain an authoritative opinion, SESW approached leading counsel and had a first meeting in June 2008.
120. Leading counsel's advice was that SESW should ask Ofwat to confirm one matter not covered by the two earlier SAE determinations, and raise and seek to resolve a second matter where Ofwat's earlier determinations were flawed.
121. The first matter related to the "circumstance" that gave rise to the SAE application and which had to pass the 20% materiality test. SESW's advice was that "circumstance" should also be read as circumstances, i.e. it was not necessary that a single circumstance arose and whose magnitude has been such that it passed the materiality test, rather it was sufficient that more than one circumstance had occurred and that when taken together they passed the materiality test.
122. The second matter related to Ofwat's principal duty when determining an SAE application, i.e. section 2(2A) of Water Industry Act 1991 provides *inter alia* that Ofwat is to perform his duties in the manner he considers is best calculated to secure that the company is able to finance its functions in particular by enabling it to make an appropriate return. SESW was advised that Ofwat appeared, from the two earlier substantial effect determinations, to understand and accept that this duty under the Act was its principal duty. In those cases, Ofwat had made good the applicants' returns in respect of the one remaining year of the then current five-year period. However, SESW was advised that Ofwat appeared to have failed in its principal duty because it should have made good the applicant's returns for the whole of the then current five-year period in so far as the failure to achieve this return was due to the relevant circumstance ("the retrospection issue").
123. Prior to submitting an SAE application, SESW sought to resolve these two matters with Ofwat. Ofwat disagreed with the leading counsel's advice that SESW had received and appeared reluctant to engage on the issues. SESW

wrote to Ofwat seeking to explain the advice it had received but struggled to get any meaningful response. In short, Ofwat's position as stated to SESW was that Ofwat had taken leading counsel's advice on the "circumstance" point at the time of the earlier SAE applications (around 2003) and that advice was that it could not be read to mean circumstances. SESW is not aware that Ofwat has taken further advice on either matter.

3.5.2 Substantial effect application

124. On 17 September 2008 SESW submitted an SAE application (see Annex 2). The application sought an increase in prices in 2009/10 of 10.2% i.e. sufficient to provide SESW with the same return over the current five-year period that Ofwat determined in its Final Determination. While seeking full recovery of the shortfall in water income and the additional power/electricity costs, SESW did off-set all the large net positive difference between what had been allowed in all other areas of the Final Determination and the actual costs. Without this set-off, the K adjustment sought would have been 31%.

3.5.3 Draft Determination

125. On 4 November 2008 Ofwat issued its Draft Determination of SESW's SAE application. The draft Determination confirmed that water income and power had only just passed the 20% materiality test (reducing the Company's claimed loss of income from 42% to 24% and increased power costs from 64% to 20%), but Ofwat determined that no adjustment was necessary to SESW prices.
126. The major issues that this determination raised were:

1. Ofwat had changed its approach to its principal duty.

Prior to this Draft Determination Ofwat's view of its principal duty, both in respect of earlier SAEs and the periodic price reviews, was that it had to enable a company to achieve the return at least equal to that Ofwat determined at the last price review. The return could be higher, if it was necessary to make good any inadequacy in a company's financial ratios. This view corresponded with the advice SESW received from leading counsel.

Ofwat's new view was that in order to finance a company's functions it was only necessary to ensure its financial ratios were sufficient to get it through to the next price review, and the return was now apparently no longer relevant.

2. Whether duty extended to whole of the five year period

Ofwat had also maintained its earlier position that its principal duty did not extend to the whole of the five-year period, and Ofwat's calculation of the necessary adjustment only considered 2009/10. Still no explanation was provided by Ofwat for taking this view.

3. Incorrect challenges under prudent management

In both its materiality calculation and its modelling of the necessary adjustment factor Ofwat had made, in particular, a 30% reduction to SESW's estimated costs of power/electricity in 2009/10 on the grounds that these costs could have been avoided by prudent management by SESW.

Ofwat's allegation of imprudent management is assessed in detail in Section 4. The size of the reduction essentially relied on the fact that when SESW had purchased its power for 2008/09 it could have taken out a two year contract at about the same rate for both 2008/09 and 2009/10 and this two year contract would have been significantly cheaper than the contract for 2009/10 subsequently concluded.

Ofwat's position was clearly based on out-turns and not on information that was known at the time. In so far as it relied upon the econometric power model to compare SESW against a benchmark company or in so far as it relied upon a specific comparator company, the level of the challenges generated strongly suggest that the comparisons were also based on differences in forecast out-turns in power contracts during a period of exceptional electricity price volatility.

4. Ofwat's failure to engage with the evidence

What is startling is Ofwat's failure to engage with the evidence. In referring to the decision to sign a one year contract as "such speculation", Ofwat completely ignored the fact that at the time of the 2008/09 contract process SESW's expert power advisers explicitly advised that SESW should not enter into the two-year contract. Furthermore, Atkins, the advisers Ofwat appointed to consider SESW's power costs, had explicitly said in their report:

"The purchase of a single year agreement in 2007 for the period 2008/09 seems very reasonable."

The Atkins report was annexed to the draft Determination but there was no attempt to bridge the gap between Atkin's view and Ofwat's Draft Determination.

Similar defects are apparent in respect of Ofwat's treatment of SESW's contract to supply Gatwick Airport with water.

[✂]



5. Ofwat's disregard of Reporter's evidence

In addition Ofwat has appointed a Reporter with responsibility for assisting Ofwat to fulfil its statutory duties in accordance with the Reporters Protocol Issue 2, March 2003. Nowhere in the Draft Determination does Ofwat refer to the Reporter having disputed or contradicted SESW's case in relation to either power or income so as to support the submissions of Ofwat. Given the close knowledge and experience of the Reporter and the role assigned to him by Ofwat, Ofwat must take proper account of the views expressed by the Reporter. There is no evidence of such account being taken here.

6. Use of lower required financial ratios

In its Draft Determination Ofwat lowered the financial ratios from those it has used in its Final Determination in 2004.

The lower financial ratios used in its Draft Determination, along with Ofwat downgrading its view of its principal duty under the Water Industry Act 1991 and disallowing costs for imprudent management, are all necessary in order for Ofwat to be able to reach the conclusion that no adjustment was necessary.

7. Inconsistent approach to other income and costs

The Draft Determination took an inconsistent approach to other income and costs. SESW accepts that one option to calculate an adjustment would be to look only at the changes to water income and power/electricity costs. However if this approach is adopted it needs to be rigorous.

In its calculations Ofwat included non retail water income in its calculations. This is incorrect because SESW's application relates specifically to water income.

Ofwat has also incorporated in its calculations a new lower figure for tax paid, but has ignored higher figure for base opex (excluding power).

3.5.4 Response to Draft Determination

127. The nature of the Draft Determination was such that it started to look inevitable to SESW that its SAE application would have to be referred to the CC. In this context and because it was concerned about the position taken by Ofwat, and before responding to the Draft Determination, SESW took advice from a second leading counsel regarding Ofwat's principal duty under the Water Industry Act 1991. This advice unequivocally confirmed the earlier advice.

128. On 26 November SESW responded to the Draft Determination confirming that it stood by its application and the 10.2% K adjustment it proposed, and concentrated on explaining in detail why Ofwat's approach was incorrect, in particular in relation to the seven issues highlighted above. This response is provided in Annex 3.

3.5.5 Final Determination of SAE application

129. On 16 December Ofwat issued its Final Determination of SESW's SAE application. The result was very similar to the Draft Determination with minor changes to calculations. Again, water income and power had passed the 20% materiality test, but only just, and Ofwat determined that no adjustment was necessary to SESW prices. In its Final Determination Ofwat modified some of the explanations it had given in its Draft Determination, but it addressed none of the material issues raised by SESW in its response to the Draft Determination. The errors in approach already identified above in relation to the Draft Determination therefore remained in the Final Determination and the seven failings identified above apply fully to the Final Determination.
130. Symptomatic of Ofwat's errors in approach is the assertion that SAEs are not symmetrical. In fact any lack of symmetry is in favour of Ofwat. If a benefit to SESW exceeds 20%, the benefit must be returned to customers under paragraph 13.3 of Condition B. Even if materiality is not exceeded, voluntary abatement is likely to occur at the suggestion of Ofwat.
131. Another error by Ofwat was to deduct the increase in rechargeable works from the loss of revenue. While income from rechargeable works has been higher than predicted by Ofwat, this is because SESW has been required to carry out more of these works. Thus the costs associated with these works have also been correspondingly higher. In any event, as rechargeable works are not a retail water revenue they do not fall within the definition of the circumstance (namely loss of retail revenues) giving rise to an SAE.
132. The Determination is addressed in more detail below but SESW draws particular attention to a clear error of approach in relation to the challenge based on a lack of prudent management:
- The question is not whether decisions are outside the "control" of the company – a test of prudent management can only be concerned with conduct which is *within* management control and the question is whether the conduct which gave rise to the effect is prudent or not.
 - The question is also not whether "more could have been done to manage" the relevant item as Ofwat determined – that would restrict the range of permissible decisions to those at the top of the range of quality and would assimilate "prudent management" to efficiency whereas the substantial effect is designed to come to the aid of all companies with risks from specific item(s) giving rise to costs in excess of the materiality threshold. In addition, the fact that more can be done to manage an issue is only relevant if additional management would have avoided the effect.

- Nor is the question whether Ofwat takes the view that a risk taken is a “business risk and should be borne by shareholders”, again as Ofwat claimed. The relevant legal test as to what risk is borne by SESW is set down in the licence as being determined by prudent management. Whereas a judgment on allocation of risk may well be a factor in the formulation of the terms of the licence, once the licence is formulated, it must be applied in accordance with its terms.
133. It is significant that nowhere in the Final Determination does Ofwat refer to the actual test in the licence which is whether the effects are not one which “would have been avoided by prudent management action”. It is quite plain from the word “would” that causation must be established between what is alleged to be imprudent and the significant effect. There is no scope for an “overall challenge” which fails to link what SESW should have done to the substantial effect. Nor is it permissible to reverse the question and to ask, as does Ofwat in the Final Determination, whether all of the company’s power costs were prudently incurred – it is up to Ofwat to establish that the company’s additional power costs are due to imprudent conduct, i.e. conduct falling outside the range of what qualifies as “prudent management action”.
134. In addition, hindsight is a fine thing but is expressly excluded from consideration. An approach which is based on the “company’s power cost performance against the benchmark” to support an “overall challenge” or comparing with a similar company is addressing the wrong issue. We know that power prices did not move as SESW expected and that if SESW is compared for example with a company which did fix its power prices for a two year period, SESW will compare unfavourably. That is not the enquiry mandated by the licence - the focus must be on the process adopted by SESW and not on the outturn for electricity prices.
135. A further major error in approach to be highlighted in the Final Determination is the pre-eminence given to an ability to finance functions over a reasonable return on capital. Compared to the Draft Determination the return on capital is mentioned instead of being wholly ignored but it is not possible to see how the return on capital has truly been taken into account. SESW must therefore await Ofwat’s explanations of how and in what way the return on capital has been taken into account.
136. Criticism of Ofwat’s assessment of SESW’s ability to finance its functions is contained below in Section 5 but what is extraordinary is the reversal of consideration of these two features of Ofwat’s statutory duty. Indeed, not only is the process reversed but the essential basis of the decision appears to be a judgment based primarily or only on an alleged ability to finance its functions. As set out above, the established two-stage test firstly equalises the rate of return with the company’s cost of capital and only then considers whether the financial indicators are consistent with an ability to finance functions. At the second stage, Ofwat uses this as a check to examine whether the rate of return needs to be increased.
137. Given the manifest errors in approach to the challenges to SESW’s increased costs and loss of revenue, the true costs for consideration are much higher

and therefore the company's rate of return much lower than the Final Determination would suggest. But even if one were to take Ofwat's assessment of costs, there is a significant disparity between the PR04 Final Determination return on capital and that effectively allowed by the Determination which is the subject of this application. At PR04 and in the Final Determination, Ofwat should have been applying the same statutory test but has decided that there should be a significantly different rate of return without giving any reasoning, explanation or logic for how that result can be achieved. This is unacceptable particularly in the light of Ofwat's statutory duty under s.2 (4) of the Water Industry Act 1991 to have regard to the principles of best regulatory practice including consistency.

138. In addition Ofwat maintains the error discussed above (paragraphs [92-93]) through restricting its consideration to the "rest of the review period" and not considering or taking into account the continuing nature of the principal duty so as to permit SESW to fulfil its s. 37 duty to maintain a water supply system.

3.5.6 Reference to CC

139. On 9 February 2009 SESW asked Ofwat to refer its application for an interim determination to the CC for determination.

4. Materiality calculation

4.1 Introduction

140. During the current five year regulatory period following PR04 SESW has suffered a significant loss of income and an increase in power costs, in particular electricity costs. These factors have had a significant adverse effect on SESW's appointed business.
141. In SESW's view both of these factors constitute a "substantial adverse effect" as covered by paragraph 13.3 of Condition B of SESW's Licence. Furthermore, each of these effects individually exceeds the materiality threshold specified in paragraph 13.3(2)(ii) of the Condition.
142. Accordingly on 17th September 2008 SESW applied to Ofwat for an Interim Determination of K. Prior to making this application, SESW received advice from Leading Counsel that it was entitled to make a single application for an Interim Determination covering both effects. Ofwat disagreed with this advice. Consequently, as the parties were unable to resolve their differences on this matter, SESW made three separate IDoK applications, one for each of the effects independently and one combined application.
143. In its Final Determination, dated 16th December 2008, Ofwat maintained its view that materiality should be calculated separately. In addition it significantly reduced the value of both effects that it included in its materiality calculation. Nevertheless, even after these adjustments, Ofwat accepted that both effects were individually material under the terms of SESW's Licence.
144. In this Section we reconfirm our view that it is appropriate to treat these income and cost effects together for the purpose of estimating materiality, while noting that the effects are nevertheless individually material. We present our calculation of the joint and separate materiality of the effects.
145. In addition, while recognising that the Commission's duty is to arrive at its own decision on materiality, we also rebut the specific reasons Ofwat gave for reducing its materiality calculation, as we consider that all of these reductions are unjustified.
146. The separate issue of how K should be adjusted in response to a finding of a material SAE is dealt with separately in Section 5 below.

4.2 Overall materiality calculation

147. According to SESW's licence, its application for an IDoK has to pass a materiality test. This test is conducted by calculating the Materiality Amount, which is the estimated net present value of the effect for which the application is being made, calculated over a period of 15 years starting in the year that the effect is claimed to have begun.
148. For future years where the value of the effect is uncertain, Ofwat's approach has been to assume a continuation of the effect in the last year of available data until the end of the 15 year period.
149. In the case of an application under the SAE provision of paragraph 13.3, this Materiality Amount has to exceed 20% of the Company's Appointed Revenue measured in the most recent year for which audited figures are available before an adjustment to K can be allowed.
150. A summary of the materiality calculation in the present case is set out in the table below. This reflects our view, based on advice from Leading Counsel, that both the revenue and cost factors that have adversely affected SESW should be treated as a single application for an interim K adjustment.

2002/03 prices, £000	2005/06 Year -3	2006/07 Year -2	2007/08 Year -1	2008/09 Year 0	2009/10 onwards Years 1 - 11	NPV as % of appointed turnover*
Reduction in Water Income	[✂]	[✂]	[✂]	[✂]	[✂]	41.6%
Additional electricity costs	[✂]	[✂]	[✂]	[✂]	[✂]	72.2%
Difference	[✂]	[✂]	[✂]	[✂]	[✂]	113.8%
Ofwat discount rate	4.69%	4.69%	4.61%	4.61%	4.61%	

Table 2: Summary of materiality calculation

Source: SESW
* Forecast

* Appointed turnover for 2007/08 = £41.963m in 2002/03 prices using Ofwat's IDoK Model deflator

151. This table demonstrates that under SESW's application the combined Materiality Amount equalled 114% of Appointed Revenue, compared to the necessary threshold of 20%. Moreover, each element individually exceeds the 20% threshold by a considerable margin. The detailed calculation of the materiality amount is shown in Annex 12. This includes the output of the materiality calculation in the Ofwat IDoK model.

4.3 Income: differences in retail water income relative to PR04

152. Over the current five-year period SESW's water income will be significantly lower than assumed by Ofwat in its Final Determination. This is because the amount of water used, in particular by metered customers, is significantly less than assumed in the Final Determination. A contributory, but relatively small, factor is that during the drought period customers switched to meters faster than had been assumed in the Final Determination.
153. The reduction in water use principally relates to household consumption, both measured and unmeasured.
154. The following table shows the overall shortfall in water income. In its Determinations Ofwat did not make any challenges or adjustments to the figures for water income for the first three years. Ofwat made only minor adjustments to the figures for the last two years. The significant adjustment that Ofwat did make was to focus on total income instead of water income. The error in this adjustment is considered in Section 4.3.3 below.

Total Water Income (£000) (2002/03 prices)	2005/06	2006/07	2007/08	2008/09*	2009/10*
PR04 Determination	[✂]	[✂]	[✂]	[✂]	[✂]
Actual	40,714	40,888	41,507	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]
Actual as % of Determination	[✂]	[✂]	[✂]	[✂]	[✂]

Table 3: Total water income

Source: SESW
* Forecast

155. There follows an explanation of the major elements of the income shortfall and full details are provided in Annex 11 (Elements of water income). The Annex shows that, in practice, there are numerous differences between the quantities and individual charges that Ofwat assumed in its Final Determination back in 2004 and the actual figures for 2005/06 to 2007/08 and the figures being generated (based on the 2007/08 actuals) for years 2008/09 and 2009/10 by Ofwat's Reservoir model.
156. The fact that there will be a range of differences is therefore unsurprising. However, these will not generate any material difference to overall retail water income unless there has been a significant difference in quantities. In SESW's

case the volume of water used, is significantly lower than assumed and this as would be expected has led to a significant loss of income.

157. A further reason why individual variances in revenue have arisen is due to the workings of Ofwat's tariff basket model. The tariff basket model does not automatically adjust individual charges in line with the 2004 Final Determination K factors. The principal purpose of the tariff basket is to ensure that the weighted average increase in water charges in each year is no greater than RPI plus K. The formulas in the tariff basket specify the quantities that should be used in the calculation of the weighted average. Another feature of the tariff basket is that it maintains the differential between the average measured household bill and the average unmeasured household bill. Changes in the number of meter switchers or in the volumes of unmeasured customers will result in adjustments to measured and unmeasured charges (within the overall RPI+K constraint) in order to maintain the differential. As a result, the changes in charges coming out from the tariff basket will impact upon the out-turn revenues for each group of customers.
158. SESW has used Ofwat's Reservoir model to produce income figures for 2008/09 and 2009/10 because it is being used by all companies as part of the 2009 Price Determination. The income part of the model takes the actual figures for 2007/08 and generates figures for 2008/09 and 2009/10 which are in turn the base for Ofwat's estimates for the five years 2010/15. The income estimates for 2008/09 and 2009/10 produced by Reservoir are consistent with SESW's forecasts for 2008/09 and business planning assumptions for 2009/10.

4.3.1 Lower average consumption

159. The reasons for lower than average consumption since PR04 are largely related to exceptional climate conditions.
160. In 2005/06 and 2006/07 average consumption was reduced by the restrictions that SESW was obliged to place on the use of water for gardening watering and non-essential purposes. These restrictions were required because of serious drought conditions (a one in 75 year drought) caused by the lack in rainfall during the winters of 2005 and 2006 (which necessitated the first Non-Essential Use Ban in SESW's history). These restrictions were in line with SESW's current water resources planning levels which imply that the company would need to impose a ban on Non-Essential use of water in the event of a one in 20 year drought.
161. As regards 2007/08 and 2008/09, reduced demand was due to the opposite weather conditions: because of exceptionally wet weather. Wet summers during both years have resulted in well below average demand during the summer period, primarily because of reduced demand to water lawns and gardens.
162. The following three tables show the extent of the lower than assumed consumption in total and split between unmeasured and measured consumption. The assumption for 2009/10 is that consumption will recover to

the average year figure as per SESW's Water Resources Plan, less an adjustment to bring non-household consumption into line with its forecast consumption for 2008/09. Given the current economic conditions this assumption is still likely to be optimistic, particularly for non-household measured element of volumes.

Total consumption (000 m ³)	2005/06	2006/07	2007/08	2008/09*	2009/10*
PR04 Determination	[✂]	[✂]	[✂]	[✂]	[✂]
Actual	52,092	48,837	49,030	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]
Actual as % of Determination	[✂]	[✂]	[✂]	[✂]	[✂]

Table 4: Total water consumption

Source: SESW
* Forecast

Total unmeasured consumption (000 m ³)	2005/06	2006/07	2007/08	2008/09*	2009/10*
PR04 Determination	[✂]	[✂]	[✂]	[✂]	[✂]
Actual	36,686	33,356	31,743	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]
Actual as % of Determination	[✂]	[✂]	[✂]	[✂]	[✂]

Table 5: Total unmeasured water consumption

Source: SESW
* Forecast

	2005/06	2006/07	2007/08	2008/09*	2009/10*
PR04 Determination	[✂]	[✂]	[✂]	[✂]	[✂]
Actual	15,406	15,481	17,287	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]
Actual as % of Determination	[✂]	[✂]	[✂]	[✂]	[✂]

Table 6: Total measured water consumption

Source: SESW
* Forecast

163. Measured consumption is split roughly evenly between household and non-household customers. The reduction in household consumption has been greater than the reduction in non-household consumption. This is shown in the following two tables.

	2005/06	2006/07	2007/08	2008/09*	2009/10*
PR04 Determination	[✂]	[✂]	[✂]	[✂]	[✂]
Actual	6,173	6,568	8,106	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]
Actual as % of Determination	[✂]	[✂]	[✂]	[✂]	[✂]

Table 7: Measured water consumption – household

Source: SESW
* Forecast

	2005/06	2006/07	2007/08	2008/09*	2009/10*
PR04 Determination	[✂]	[✂]	[✂]	[✂]	[✂]
Actual	9,233	8,913	9,181	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]
Actual as % of Determination	[✂]	[✂]	[✂]	[✂]	[✂]

Table 8: Measured water consumption – non-household

Source: SESW
* Forecast

4.3.2 The impact on income of lower consumption

164. The lower than assumed consumption flows through directly into lower than assumed measured income. There is also an indirect effect which causes unmeasured income to be lower than that assumed. This is because the lower volumes result in Ofwat's tariff basket model weighting of price increases onto measured charges more than was anticipated in the Final Determination.

4.3.2.1 Shortfall in income - measured household customers

165. The shortfall in measured household income is shown in the following table.

Measured household income (£000)	2005/06	2006/07	2007/08	2008/09*	2009/10*
PR04 Determination	[✂]	[✂]	[✂]	[✂]	[✂]
Actual	5,755	6,480	7,761	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]
Actual as % of Determination	[✂]	[✂]	[✂]	[✂]	[✂]

Table 9: Measured household income

Source: SESW
* Forecast

166. As explained above consumption was first reduced by restrictions and then by poor summer weather. The extent of the reduction in consumption is shown in following table of consumption per metered household property. It is significantly less than assumed in the 2004 Final Determination. In particular, customers that have requested that they be switched to a metered supply from the unmeasured basis of charge are using significantly less water than was assumed.

Consumption per household meter (m ³)	2005/06	2006/07	2007/08	2008/09*	2009/10*
PR04 Determination	[✂]	[✂]	[✂]	[✂]	[✂]
Actual	124.2	113.8	120.6	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]
Actual as % of Determination	[✂]	[✂]	[✂]	[✂]	[✂]

Table 10: Consumption per metered household property

Source: SESW
* Forecast

167. The shortfall in total volumes used by household measured customers has been reduced by the faster than anticipated switch to meters by household customers. The movement on switchers is detailed in the next section.
168. The income differences shown above have been mitigated by higher increases in measured charges than was assumed in the Final Determination. This is because lower volumes weight price increase towards measured customers. The counterbalancing impact, lower than assumed prices for unmeasured customers, is also explained in the next section.

4.3.2.2 Shortfall in income – unmeasured household customers

169. The shortfall in unmeasured household income is shown in the following table.

Unmeasured household income (£000)	2005/06	2006/07	2007/08	2008/09*	2009/10*
PR04 Determination	[✂]	[✂]	[✂]	[✂]	[✂]
Actual	27,625	27,164	26,267	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]
Actual as % of Determination	[✂]	[✂]	[✂]	[✂]	[✂]

Table 11: Unmeasured household income

Source: SESW
* Forecast

170. In part the shortfall of unmeasured income has arisen because of the faster rate that customers have switched from unmeasured supplies to meters. The other reason is that the tariff basket has shifted price increases towards metered customers and away from unmeasured customers, i.e. unit charges to unmeasured are less than was assumed in the Final Determination.
171. At PR04 Ofwat made a projection for the number of unmeasured customers that would “opt” for meters during the quinquennium or that would be selectively metered by SESW.
172. By the end of 2007/08 the number of customers who had in fact opted for meters was significantly higher than Ofwat’s projection. In total SESW has installed roughly 4,800 more meters than projected by Ofwat, of which 4,400 related to meter optants. These figures are illustrated in the table below.
173. The rate at which customers opt for meters is outside the company’s control. Customers typically opt for meters when they live in relatively high RV properties that attract high unmeasured bills, but have low water consumption.

When customers opt for meters the functioning of the tariff basket allows SESW to recover part but not all of the loss in revenue that results.

	2005/06	2006/07	2007/08	2008/09*	2009/10*
PR04 Determination					
Selectives Number	2,500	2,500	4,000	[✂]	[✂]
Optants Number	1,500	1,500	1,500	[✂]	[✂]
Total Number	4,000	4,000	5,500	[✂]	[✂]
Cumulative Number	4,000	8,000	13,500	[✂]	[✂]
Actual (JR T8)					
Selectives Number	1,831	4,247	3,282	[✂]	[✂]
Optants Number	1,786	4,624	2,532	[✂]	[✂]
Total Number	3,617	8,871	5,814	[✂]	[✂]
Cumulative number	3,617	12,488	18,302	[✂]	[✂]
Cumulative difference	-383	4,488	4,802	[✂]	[✂]

Table 12: Number of meters: optants and selective

Source: SESW
* Forecast

174. The following table gives an indication of the income loss associated with the difference between the assumed profile of switchers and the actual profile.

(2002/03 prices)	2005/06	2006/07	2007/08	2008/09*	2009/10*
PR04 Determination Revenue £000	[✂]	[✂]	[✂]	[✂]	[✂]
Customers Number	199,235	195,235	189,735	[✂]	[✂]
Revenue/customer £	[✂]	[✂]	[✂]	[✂]	[✂]
Shortfall in cust numbers.	[✂]	[✂]	[✂]	[✂]	[✂]
Revenue loss £000	[✂]	[✂]	[✂]	[✂]	[✂]

Table 13: Reduction in unmeasured revenue

Source: SESW
* Forecast

175. The above revenue losses account for the shortfall in unmeasured revenues up until 2007/08. After 2007/08 the difference between the prices assumed in the 2004 Final Determination and the prices being generated by the tariff basket are significant.

4.3.2.3 Shortfall in income – measured non-household customers

176. SESW’s non-household customer base consists of commercial properties (offices, industrial units, etc), public sector premises (hospitals, council premises, etc), farming, leisure (golf courses, etc).

177. The following table shows the impact of the drought on consumption in 2006/07 when the Non-Essential Use ban which was the first restriction to really impact on non-household customers was introduced. The reason the income particularly in 2008/09 and 2009/10 does not track the lower volumes shown in Table 8 is again due to Ofwat’s tariff basket generating measured price increases higher than those assumed in the Final Determination.

Measured non-household income (£000) – 2002/03 prices	2005/06	2006/07	2007/08	2008/09*	2009/10*
PR04 Determination	[✂]	[✂]	[✂]	[✂]	[✂]
Actual	7,139	7,044	7,284	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]
Actual as % of Determination	[✂]	[✂]	[✂]	[✂]	[✂]

Table 14: Measured non-household income (incl. large users and special agreements)

Source: SESW
* Forecast

4.3.2.4 Cost variations

178. In calculating materiality it is arguably appropriate to reduce the figure allowed by the savings that the company has made in power and chemicals costs as a consequence of the reduced volumes of water pumped.

179. In this case, however, we consider such an adjustment (strictly for the calculation of materiality) would be academic. This is because savings resulting from reduced volumes are treated as an offsetting factor in the materiality calculation for power costs considered below.

180. In any event, in our calculation of the appropriate K adjustment required to respond to these circumstances, we have taken full account of the savings

resulting from reduced volumes. It is also worth noting that the circumstances leading to the imposition of the Drought Order also imposed additional costs upon the Company.

4.3.3 Comparison with Ofwat's SAE Final Determination

181. In its SAE Final Determination, Ofwat arrived at a different, lower estimate of materiality for SESW's revenue shortfall.
182. Although we recognise that the Commission will come to its own determination on this matter, we consider it important to clarify our position on Ofwat's challenges to our calculations.
183. The changes Ofwat made to SESW's materiality calculation were as follows:
 - It defined total revenue to include non-water revenues and revenues from rechargeable works, whereas SESW's application was based on variances between PR04 and actual Appointed Business revenues.
 - It adjusted SESW's outturn revenues to reflect PR04 forecasts of the revenue received from the Special Agreement with Gatwick Airport, rather than actual outturn revenues from that Agreement.
 - It altered some of the assumptions made for the uptake of household meters and average household consumption for 2008/09 and 2009/10.
184. These changes reduced Ofwat's estimate of the materiality of SESW's revenue application from 40.1% of Appointed Revenue to 24.7%.

4.3.3.1 Inclusion of rechargeable works and non-appointed revenues

185. SESW strongly disagrees with Ofwat's decision to include rechargeable works and other non-appointed revenues in the overall revenue figure it used for its materiality calculation.
186. By far the most significant of these adjustments was the inclusion of rechargeable works.
187. The table below summarises the amounts included in PR04 for rechargeable works and the amounts actually recovered by SESW over the same period. Ofwat's adjustment for rechargeable works accounts for almost all of the difference between Ofwat and SESW in the calculation of the Materiality Amount for loss of income, particularly for the first three years of the period.

2002/03 (£000)	2005/06	2006/07	2007/08	2008/09*	2009/10*
Rechargeable Income (Actual)	1,153	1,543	1,168	[✂]	[✂]
Rechargeable Income (PR04)	[✂]	[✂]	[✂]	[✂]	[✂]
Difference	[✂]	[✂]	[✂]	[✂]	[✂]

Table 15: Rechargeable works: allowed v's actual

Source: SESW
* Forecast

188. In our view Ofwat was clearly wrong to deduct the increase in non-retail rechargeable works. While it is true that SESW has generated more income from rechargeable works than was anticipated at PR04, this misses the obvious fact that income from rechargeable works is not a retail revenue, but rather a charge made for infrastructure work performed on behalf of other companies, mainly developers.
189. While income from rechargeable works has been higher than predicted by Ofwat, this is because SESW has been required to carry out more of these works. In any event, as rechargeable works are not a retail revenue in our view they do not fall within the definition of the circumstance (namely loss of retail revenues) giving rise to the SAE. Consequently, even leaving aside the issue of countervailing costs, rechargeable works as a whole should not be included in the calculation of the Materiality Amount for the loss of revenue claim.
190. More generally, Ofwat is keen to resort in other cases (see Gatwick Airport, below) to the argument that certain matters are commercial risks that the shareholders should bear. Yet Ofwat's position appears to be inconsistent in this regard. In the case of Gatwick a shortfall in actual revenue relative to the PR04 forecast is considered a commercial risk and the actual loss is excluded from the Materiality Amount. But in the case of income from rechargeable works (and abstracting from the issue of costs related to this activity) Ofwat chooses to deduct revenues received in excess of the PR04 forecast. Thus Ofwat's approach is wholly inconsistent and asymmetric. In fact Ofwat's approach appears to resort to the commercial risk argument when the numbers favour the company and ignore that argument when numbers go in Ofwat's favour. This is not a proper approach to commercial risk, which needs to recognise the possibility of gains as well as losses in the outcome and is not consistent with Ofwat's duty to act in a consistent manner.

4.3.3.2 Special agreement income for Gatwick Airport

191. Ofwat has made a minor adjustment to SESW's actual revenue with regard to the income the Company received from Gatwick Airport under its Special Agreement for that supply.

192. Gatwick is by far SESW's largest customer taking around [REDACTED] [REDACTED] The history of the company's relationship with Gatwick is as follows:

- In the early 1990's British Airports Authority (BAA), the owners of Gatwick Airport, approached SESW and said it was looking for lower water charges. At this point in time all SESW's metered customer were charged at the same volume rate for water,

[REDACTED]

This cost related tariff was agreed with Ofwat.

In January 2001 SESW was approached by BAA

[REDACTED]

[REDACTED]

At the same time SESW had to submit its Final Business Plan for 2005-10 to Ofwat as part of the price review process. In this PR04 FBP, SESW assumed that the BAA contract would continue,

[REDACTED]

193. At PR04 it was necessary for Ofwat to make an assumption regarding the escalation of all Special Agreement revenues, which are netted off against regulated revenues in the calculation of K. This process is similar to the functioning of the “single till” in airport regulation, but very much smaller as a percentage of the regulated company’s total revenue than is non-aeronautical revenue in that case.

Ofwat applied a generic assumption to all companies that Special Agreement prices [✂] SESW never accepted Ofwat’s position, but there was no method to challenge it except by an appeal of the whole price determination to the Competition Commission, which was clearly inappropriate. [✂]

195. Ofwat disallowed this shortfall in SESW’s Materiality Amount, providing the following rationale:

“The company has chosen to deviate from [Ofwat’s assumption]. This is a management decision and a business risk and we therefore consider that the company, and not its customers, should bear the cost of this.”

It is not clear whether this continued challenge to the shortfall is intended as a challenge based on the contention that it would have been avoided had the Company taken prudent management action with regard to it. If it is not, then there is no other basis under the SAE provisions which permits such a challenge. If it is, then SESW’s disagrees with this interpretation. SESW did not choose to deviate from Ofwat’s assumption. Rather Ofwat’s assumption was merely a necessary forecast in the overall regulatory settlement.

[✂]

SESW’s position is that its management and the retention of its major customer Gatwick Airport has been professional, commercial and prudent.

[✂]

[✂]

199. Accordingly there are no grounds for a reduction to be made from SESW’s income on the basis that the loss of income would have been avoided by prudent management action.

4.4 Power: differences in costs relative to PR04

200. SESW's application for an SAE IDoK is based in part on the significant increase in actual and forecast electricity costs experienced by the company over the five years covered by the PR04 Determination. This increase resulted from an increase in unit electricity prices paid by SESW that was not anticipated by Ofwat in 2004.
201. To place electricity costs in context, 98% of SESW's power usage is operational while the other 2% relates to SESW's Redhill site (which comprises head office, works depot and laboratory). Of the operational power 97% is provided by electricity suppliers. The remaining 3% comes from diesel which is used to power operational and standby generators. The vast majority of operational power (c. 96%) is used to pump water from SESW's various water sources through water treatment works and on to customers' taps. The remainder is used by the various water treatment processes.
202. SESW's annual cost of electricity is summarised in the table below for the whole five year period. This shows that overall power costs exceeded Ofwat's projection by c. [redacted], measured in 2002/03 prices. SESW estimates that this variation is equal to 72% of regulated revenue, thus passing the 20% materiality test for an SAE IDoK contained in paragraph 13.3 of Condition B of the Company's Licence. The change in the materiality amount compared to the September application (64%) reflects more up-to-date information on the projected out-turns for 2008/09 and 2009/10.

Power costs (2002/03 prices, £000)	2005/06	2006/07	2007/08	2008/09*	2009/10*
Ofwat PR04 Determination	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Actual	2,458	3,226	2,902	[redacted]	[redacted]
Difference	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

Table 16: Power costs – actual and final determination

Source: SESW
* Forecast

203. The increase in costs has been so severe that in 2009/10 we forecast that electricity costs will be 2.5 times Ofwat's allowance, notwithstanding the fact that electricity consumption is forecast to be somewhat reduced due to lower than anticipated volumes of water being pumped.
204. The problem of predicting energy costs is not a new one. Electricity prices have increased considerably over the last few years as well as becoming much more volatile. During the run up to PR04, there was significant discussion between SESW and Ofwat on the topic. At the time SESW, in line with other companies, requested that electricity costs be made a Notified

Item, because of the impossibility of anyone, including Ofwat, accurately forecasting these costs¹³. Ofwat declined to make electricity a Notified item but did allow for a [✂] increase in electricity prices from 2004/05 to 2005/06. This increase is therefore built in to Ofwat's figures, but only goes to underline how much costs have risen in practice.

205. Looking forward, SESW believes that volatility remains a fundamental aspect of electricity prices, which makes their accurate prediction over a five year regulatory period almost impossible. By way of illustration, we refer the Commission to the recent analysis of future electricity prices prepared by [✂] This report, while being unable to conclude on a clear trend for future energy prices, gives a range for energy prices [✂] by end of the period covered by PR09.
206. While the uncertainty over future energy prices may not seem to be directly relevant to the Commission's review of the present IDoK, it provides an important context to the Commission's considerations. When costs are volatile it will be impossible for companies, or Ofwat, to predict them accurately over a five year period. Under such conditions decisions will be made from time to time that prove, with the benefit of hindsight, to be wrong. The present case represents one of those instances.
207. It is essential for the regulatory system to distinguish between a decision, carefully taken using all the information available at the relevant time, which subsequently proves to be incorrect because of an adverse turn of events, and a decision that was demonstrably unsupportable at the time it was taken. This is a vital test which SESW believes Ofwat has misapplied in its Final Determination.

4.4.1 SESW power procurement process

208. SESW recognises that it is for the Commission to come to its own determination of SESW's IDoK application, and that the Commission's role is not to adjudicate or arbitrate between SESW and Ofwat. Nevertheless we consider it helpful to structure our comments on this issue around Ofwat's Final Determination of 16th December 2008.
209. In its Determination Ofwat has accepted that SESW's claim regarding increased energy costs is material under the terms of the Company's Licence, but that the extent of this materiality is much less than SESW has claimed, specifically 21% as opposed to 64%. This difference was achieved by reducing SESW's additional costs by 10% for 2005/06 to 2008/09 and 30% in 2009/10.

¹³ See section A1.4.13 of SESW's Final Business Plan.

210. Our understanding of Ofwat’s reasoning for reducing the amount of the electricity costs allowed for materiality is that:

- SESW had the opportunity to fix power costs in 2008-09 for two years, which would have meant that power costs in 2009-10 would have been significantly lower than in reality they will be. Ofwat considers that SESW’s failure to do so was imprudent and as a consequence the company should not be compensated through the SAE IDoK mechanism for the result of this imprudence.
- SESW is inefficient in its use of energy and should not be compensated for that inefficiency. Furthermore, in these specific circumstances SESW could, and should have done more to manage its energy consumption.

211. SESW strongly contests the suggestion that its original decision to sign a one year power deal for 2008/09 was imprudent, given the information that was available to the company at the time. It is worth noting that in their report Atkins, who were commissioned by Ofwat to review the decision to take a one year power deal, stated that: **“The purchase of a single year agreement in 2007 for the period 2008/9 seems very reasonable.”** (see Annex 5). Furthermore, SESW also challenges Ofwat’s assessment of its inefficiency with respect to energy consumption and the steps the Company has taken to be energy efficient.

212. Since 2000 SESW has employed specialist advisors to assist in the purchasing of electricity. [✂]

After meeting three companies as part of a formal procurement process, SESW appointed Utilyx. Utilyx’s status as one of the top rank of specialist advisers is acknowledged in Atkins’ report to Ofwat. For the last two years Utilyx, [✂]

213. SESW’s electricity purchasing process can be summarised as follows. Utilyx advises SESW as to an appropriate time to purchase electricity. Then three processes happen in parallel.

- SESW prepares its usage data (full details for the preceding twelve months of daily usage for small works and half-hourly data for every day for large works) which is required by tenderers to optimise their bids.

[✂]

- Utilyx prepares the tender document including a tender date and contacts suppliers.
- A report is considered by SESW's Board and SESW's Executive Directors are either authorised by the Board to proceed or not proceed with the process.

214.



the Executive Directors and the Chairman or another Non-Executive Director, as agreed by the full Board, make the decision to buy or not buy. A subcommittee of the Board is used because once the auction process is complete, the suppliers' offers only remain open for 30 minutes to an hour.

215. SESW's view is that its procedure for purchasing electricity is entirely appropriate for the business and the process is conducted in a professional and responsible manner. Atkins confirms this in its report to Ofwat (see para 223 below).

216. Annex 9 (Electricity usage and costs) provides more details of the purchasing process. This annex includes two graphs which compare the prices SESW has paid for electricity over the last ten years, 2000/01 to 2009/10, to the average day-ahead and month-ahead prices for those years. They show that on balance, over the years, the forward contracts recommended by the consultants are very close to the average market price (even assuming that the current low market price will continue until the end of 2009/10). This comparison provides some indication that SESW's procurement process during this ten-year period has not been inappropriate.

217. Annex 10 contains a description of the process and timetable involved in the decisions on the power contracts for 2008/09 and 2009/10. It shows that the process is robust and rigorous and that the advice from the expert advisers is carefully considered before a decision is taken.

4.4.2 Responding to Ofwat's challenges

4.4.2.1 The decision to sign a one-year contract

218. In our view Ofwat's judgment relies on the benefit of hindsight and is flawed in several respects. In particular Ofwat confuses the unintended outcome of a sound management process with imprudence.

219. Ofwat has noted that it would have been cheaper for SESW to sign a two year deal. But this observation can only be made with the benefit of hindsight. The fact that prices for 2009/10 are, in practice, higher than was reflected in forward contracts that could be signed in 2008 is a demonstration that the market as a whole, not just SESW, failed to anticipate the movement in energy prices that subsequently occurred.

220. SESW is confident that its management practices were and are sound as regards the procurement of electricity. These processes are set out in detail, in Annex 10. In this particular case, SESW took specialist advice from Utilyx, which is a leading provider of energy procurement services. This advice, provided in an appendix as part of Annex 2, clearly indicated that signing a one year power purchase agreement was the most prudent course of action at that point, given expectations over future energy prices.
221. Ofwat has argued that it is the Company's responsibility to make such decisions "in the wider context in which it operates" and that it should have fixed its costs for two years because this would have reduced risk for both the business and customers. SESW emphatically disputes, given the state of knowledge at the time the contract was signed, that this would have been the less risky or more prudent decision.

The decision was not imprudent given the state of knowledge at that time

222. First, SESW was in receipt of professional advice from a leading firm that stated clearly that the lowest expected cost strategy was to contract for one year only. In those circumstances we consider that it would have been irresponsible, other things being equal, for the Company to sign a two year deal. Had SESW signed a two year deal having received such advice, and this had subsequently proved to have given rise to additional costs, Ofwat would have relied on the fact that the Company had ignored expert advice to disallow costs on the grounds of imprudent management.
223. The view that it would have been irresponsible to sign a two year rather than a one year deal is reinforced by the advice provided to Ofwat by Atkins. Ofwat makes use of this report with regard to its conclusions on the company's energy efficiency (on which we will comment below) but with regard to SESW's policy on power purchasing, the Ofwat conclusions are contrary to Atkins' evidence, a point not even addressed by Ofwat in its Final Determination. The Atkins report states the following:

"The general approach to power purchasing adopted by SESW is highly standard, in as much as SESW is seeking 12-month contracts on a fixed price basis with an April start date. SESW has aggregated together all of its HH and NHH metered sites again to ensure that the best available prices are obtained.

*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.***

SESW has also ensured that prices be sourced via a tender process, and it is clear that there is a good level of participation of major suppliers in the competition for their business. The tender process has been organised

through Utilyx which is very prominent in the market along with firms such as EIC, John Hall and Energy Quote. Utilyx advise in their post contract report that they are FSA authorised and regulated.

In summary the procurement arrangements appear to be in line with market norms and reasonable in approach.” (emphasis added)

224. Given these comments from Ofwat’s own advisers we believe that Ofwat has no justification whatsoever for alleging that the decision to contract electricity for one year in 2008/09 was imprudent. There has also been no suggestion, either by Ofwat or Atkins, that SESW failed to take account of any knowledge it had or ought to have had on power costs. Consequently there is also no justification for reducing the materiality amount to reflect any alleged imprudence.

The decision was not more risky than signing a two-year contract

225. We reject Ofwat’s suggestion that by signing a one year power contract we were exposing the business and customers to undue risk. Rather the opposite is true.
226. Based on the evidence available at the time the cost forecast for the two year contract would already have placed SESW very close to the threshold for an SAE IDoK. By contrast, given the cost forecasts available at that time, signing the one year contract left the company with an expectation of being *further* from the IDoK threshold, not nearer.
227. SESW therefore took a decision which reduced the risk to customers (i.e. of materiality thresholds being breached) at the expense of shareholders. Again, Ofwat’s interpretation of the facts is based on hindsight, taking into account information that was not and could not have been known at the time SESW made its decisions.

4.4.2.2 *SESW’s alleged inefficiency*

228. Ofwat reduced SESW’s materiality allowance to reflect its judgment that the Company was inefficient in its purchasing of electricity and that it failed to take appropriate steps to improve its efficiency. To reach this judgment we understand that Ofwat used a range of evidence, but placed significant weight on the results of its econometric modelling and on the findings of the Atkins report.
229. We dispute strongly both of these pieces of evidence.

SESW’s general efficiency

230. With regard to efficiency more generally and the steps SESW has taken to be more energy efficient, we note that Ofwat relies heavily on the conclusions of the Atkins report.

231. Our view is that this report gives a misleading impression of SESW's management of energy costs and of its efficiency more generally.

[REDACTED]

[REDACTED]

234. To place the observations about SESW's efficiency in a more general context, we start by noting that, excluding power costs and FRS17 adjustments, SESW has consistently outperformed Ofwat opex targets. This is illustrated in the Table below.

	Price base	2005/06	2006/07	2007/08	2008/09**	2009/10**
FD PR04 Total opex	02-03	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
FD PR04 Power costs	02-03	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
FD PR04 Opex excl power costs	02-03	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
FD PR04 Opex excl power costs	Outturn*	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Actual opex excl power and FRS17	Outturn*	19.7	20.8	21.0	[REDACTED]	[REDACTED]
Outperformance	Outturn*	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Table 17: Opex performance

Source: SESW

* costs from 2007-8 onwards are based on the RPI index for 2007-08.

** Forecast

235. This Table above shows that for the first four years of the PR04 period SESW has beaten the Ofwat targets by £ [REDACTED] cumulatively. In 2009/10 SESW will overspend the FD by £ [REDACTED] due to a number of factors including additional chemical costs (some of which is explained by increased power costs in the manufacture of chemicals), rates, abstraction charges and additional employment costs associated with additional requirements.

236. This shows that SESW is constantly acting to improve its efficiency, which is a fact at odds with the picture painted in the Atkins report. This is also borne out by the material presented in Annex 1.

Steps SESW takes to improve energy efficiency

237. SESW disputes Ofwat's assessment that it has been inefficient in its management of energy issues. A detailed summary of its practices and processes is set out in Annex 9.

238. In this Annex we clearly demonstrate that:

- Plant maintenance is carried out to the highest standard.
- Electricity tariffs and billing control are well managed.
- The treatment process and the pumping of water into the distribution network is fully automated, computer controlled, fully optimised and carried out as efficiently as possible.
- Electricity costs are minimised, within the constraints of maintaining supplies and adequate pressure in the distribution network.
- Maximum use of electricity is made at night in order to take full advantage of lower charge "off- peak" electricity tariffs.
- Appropriate pumping regimes are in place to ensure that service reservoirs are only filled to the level necessary to meet anticipated demand.
- Inter water resource zone transfer capability is fully optimised in order to ensure that supplies to customers are maintained at "least cost".
- Appropriate use is made of pumps commensurate with their required output.
- SESW has invested heavily in new plant at its treatment works and pumping stations in order to ensure that its plant operates as cost effectively as possible.

239. We note that the Atkins report is not critical of SESW's position in relation to electricity purchasing and its management of electricity usage in relation to pumps and the pumping of water. This is important because, as we have already highlighted, pumping accounts for c. 94% of SESW's total electricity usage. Hence any negative comments in the Atkins report must be interpreted relative to the importance of pumping in the total assessment.

240. We were also surprised at the limited consideration that appeared to be given in the Atkins report to energy saved as a result of its performance in the area of leakage reduction. As a result of its leakage reduction programme SESW is currently pumping to supply about 25% less water than would have been the

case had SESW let the status quo continue. The amount of electricity used is directly proportional to the amount of water supplied. SESW remains an industry leader in this area. This matter is considered in more detail in Annex 1.

241. We believe therefore that Ofwat has no basis for claiming that SESW could have taken more steps to control energy costs. SESW's submissions to Ofwat gave an outline of SESW's practices which it believes shows a good knowledge of the issues and indicates good professional management. This area is now expanded in Annex 9 to this submission.

242. Furthermore, following Ofwat's conclusions, SESW has also commissioned Black and Veatch to perform an independent analysis of the Company's management of electricity usage.

243. This report, included as Annex 7 states that:

"We conclude that energy usage by SESW is efficiently managed and we have not identified any opportunities for significant improvement or that electricity usage is being managed "imprudently" ."

244. In light of these findings we consider that Ofwat's reductions in actual power costs to reflect supposed inefficiency are unjustified and should be rejected.

Econometric modelling

245. With regard to the econometric modelling presented in the confidential annex to the SAE Final Determination, we note that SESW is considered by Ofwat to be [✂] inefficient compared to the other benchmarks, but this is a false argument.

246. We note that, historically SESW has tended to score *between* [✂] and [✂] from the efficiency frontier on energy costs. This increases to around 30% in Ofwat's modelling for the Final Determination.

247. We believe Ofwat's latest conclusion is invalid. There is no reason to believe that SESW would have varied relative to the efficiency frontier from 2008/09 to 2009/10 for any reason other than the impact of its power procurement contract. But if this is the case then the interpretation of SESW's movement away from the frontier hinges on the previous issue, whether or not the company's decision in relation to that contract was prudent.

248. If that decision were, for the purpose of argument, found to be imprudent, then it would be right to strike the amount from the materiality amount for that reason. In such a case the econometric analysis would add nothing, because it would simply be repeating the same assessment.

249. If, on the other hand as we have argued, the decision was prudent given the information available to the Company at the time, then the econometric comparison is false and also cannot be used to adjust the materiality amount. In this case, if it is accepted that SESW's costs have increased despite

prudent management, those costs validly enter the IDoK materiality test and any subsequent K adjustment. To also penalise the Company because those costs make it appear less efficient in an econometric model is clearly wrong because it is a misuse of that model.

250. In conclusion therefore it is our view that Ofwat's econometric modelling is irrelevant as in practice all matters depend upon on how SESW's original decision is interpreted.

4.4.2.3 PR04 energy cost allowance and link with RPI

251. At the PR04 Final Determination Ofwat allowed an increase in energy costs of [X] In its modelling of K factors, Ofwat adjusted for this increase in two ways.

- a proportion of the increase in energy costs was included as an increase in the energy costs within base service operating costs; and
- the remainder of the increase would be reflected in an increase in the Retail Price Index, this was assumed to 0.5% higher than it would otherwise be.

252. In the SAE Final Determination, Ofwat based its PR04 allowed energy costs on the sum of these two components. SESW has significant reservations about this approach, given that it relies on the critical assumption that other cost items would not be affected by the increase in RPI. In practice SESW would not expect this to be the case although clearly the links between changes in RPI and changes in other costs (such as wages, material costs and interest rates) are complex.

253. Although the calculation of the materiality amount is affected by the inclusion of the RPI element of the allowed power costs, in both cases the materiality amount is significantly higher than the 20% threshold. If the RPI element is included in the allowed energy costs, as Ofwat has claimed, then the materiality amount is reduced from 72% to 66%. This remains substantially in excess of the 20% threshold.

254. However, SESW notes that the treatment of the RPI element of energy costs does not affect the proposed K adjustment in this submission. The reason for this is that the proposed K adjustment takes account of offsetting savings in other operating costs. If the RPI element is included in the calculation of allowed energy costs then the savings in other areas of operating costs are corresponding lower.

5. Determining the appropriate K adjustment

5.1 Introduction

255. This Section covers the calculation of the required adjustment to K. It begins by presenting the calculation of the appropriate K adjustment. It then addresses the main methodological issues underpinning the K adjustment. It explains why Ofwat's assertion that allowing a K adjustment removes all business risk from the company is incorrect. Specifically, it explains why companies do bear business risk but that the substantial effects clause is a mechanism for allocating risk between customers and regulated businesses. Section 5.4 discusses why any adjustment to K must reflect the impact of substantial adverse outcomes over the full regulatory period rather than narrowly focussing on the remaining duration of the cycle. Section 5.5 outlines SESW's view on the appropriate cost of capital for the purposes of assessing the SAE.

5.2 Required adjustment to K

5.2.1 *Summary of materiality*

256. Section 4 of this submission has presented the calculation of materiality. Under SESW's application the combined Materiality Amount equalled 114% of Appointed Revenue, compared to the necessary threshold of 20%. Moreover, each element individually exceeds the 20% threshold by a considerable margin (72% for power costs and 42% for income reduction). The calculation is shown in detail in Annex 12.

257. In calculating the required K adjustment SESW has taken account of other differences compared to the 2004 Final Determination. This is consistent with the limited discretion incorporated into the SAE adjustment mechanism to ensure that adjustments take account of any benefits that might have arisen in areas unrelated to the relevant SAE.

5.2.2 *Other differences from the 2004 Final Determination*

258. During the current five-year period there are significant net positive differences between SESW's actual costs and latest estimates compared to the amounts allowed in the PR04 price determination in all other areas of income and cost. Some differences arise as a result of strict control of controllable costs, some because of delays in capital expenditure, and some like third party income just depend on third-party demand. Tax differences are a result of a robust approach by SESW and, in the early years, the lower profits caused by the reduced water income and higher power/electricity costs. We have also included an adjustment relating to the increases during

the period to SESW’s RCV resulting from Ofwat’s application of the COPI price index to capital expenditure. The following table summarises the differences.

Other difference (2002/03 prices, £000)	2005/06	2006/07	2007/08	2008/09	2009/10
Income – non-water	[X]	[X]	[X]	[X]	[X]
Opex (excluding power)	[X]	[X]	[X]	[X]	[X]
Tax paid	[X]	[X]	[X]	[X]	[X]
Delayed capex – excess return	[X]	[X]	[X]	[X]	[X]
Delayed capex – excess depreciation	[X]	[X]	[X]	[X]	[X]
Delayed capex - infrastructure	[X]	[X]	[X]	[X]	[X]
COPI increase in RCV	[X]	[X]	[X]	[X]	[X]
Total differences	[X]	[X]	[X]	[X]	[X]

Table 18: Other variations from 2004 Final Determination

Source: SESW

5.2.3 Calculated adjustment to K factor

259. In order to arrive at the adjustment factor cash differences have been used. This approach is consistent with the cash modelling that is used in determining k factors at price reviews.
260. The first table below summarises the impacts of the income shortfall and the additional power/electricity costs and deducts the positive differences that have arisen elsewhere.
261. The second table presents the same figures but after discounting them at the cost of debt used in the 2004 Final Determination. It also totals the figures to give the full five-year impact on SESW. The discounted total of £[X] equates to income of [X] in 2009-10 prices.

Overall differences (2002/03 prices, £000)	2005/06	2006/07	2007/08	2008/09	2009/10
Shortfall in water income	[X]	[X]	[X]	[X]	[X]
Additional power costs	[X]	[X]	[X]	[X]	[X]
Other differences	[X]	[X]	[X]	[X]	[X]
Total differences	[X]	[X]	[X]	[X]	[X]

Table 19: Impact of variations between actual and 2004 Final Determination

Source: SESW

262. A 2002/03 price base has been used in this SAE application because it is the price base used in Ofwat’s Final Determination for the current five-year period.

Overall differences (2002/03 prices, £000)	2005/06	2006/07	2007/08	2008/09	2009/10	Total
Shortfall in water income	[X]	[X]	[X]	[X]	[X]	[X]
Additional power costs	[X]	[X]	[X]	[X]	[X]	[X]
Other differences	[X]	[X]	[X]	[X]	[X]	[X]
Total differences	[X]	[X]	[X]	[X]	[X]	[X]
<i>Discount factors (cost of debt – 4.69%)</i>	1.047	1.096	1.147	1.201	1.258	

Table 20: Impact of variations between actual and 2004 Final Determination - discounted

Source: SESW

263. The adjustment to K for 2009-10 is the required adjustment to prices in 2009/10 that would eliminate this calculated shortfall. This factor is calculated to be 14.1%. This calculation is shown in more detail in Annex 13¹⁷. Annex 13 also includes shortfall calculation using Ofwat’s IDoK model which produces a K factor of 14.5%.

¹⁷ Annex 13 includes extracts from the Ofwat IDoK model. Note that the IDoK models calculates a slightly different value for the K adjustment, 14.5%.

(£000)	
Total shortfall (2002/03 prices)	4,557
Total shortfall (2009/10 prices)	7,093
Forecast tariff income for 2009/10	50,468
K adjustment (shortfall / forecast income)	14.1%
Table 21: Calculation of K adjustment	
<i>Source: SESW</i>	

5.3 The substantial effects clause allocates risk

264. Ofwat’s challenge to the increase in power costs is based on a view that the decision to opt for a one year deal was a business risk and that the company should not be able to pass this risk onto customers. This is not correct because risk is allocated by the terms of the licence. Whether or not costs can be disallowed is solely a matter of the prudent management test under the terms of the licence. Section 4.4.2 above explains in detail why the one year deal was not an imprudent decision.

265. The way in which risks are to be shared between the company and customers is determined by the regulatory regime as a whole. This reflects the provisions of the Water Industry Act 1991, the company’s Licence and Ofwat’s price control methodologies. Ofwat’s methodology paper for the 2009 price review¹⁸ summarised the elements of the regulatory regime that addressed the allocation of risk:

- 5 yearly price control reviews;
- Indexation (RPI and COPI);
- Interim determinations, including NIs / RCCs /SAE;
- Logging up and logging down; and
- The change protocol.

¹⁸ Ofwat, Setting price limits for 2010-15, March 2008.

266. The nature of these mechanisms as evolved over time has Ofwat has responded to changes in uncertainties regarding costs and revenues. For example, at each price review Ofwat will consider which elements of uncertainty should be considered as NIs. Another example is the move to a revenue correction mechanism from 2010, which will reduce companies' exposure to revenue variance.
267. Changes to the allocation of risk will feed through into investors' perception of risk and the required cost of capital. In determining that it is appropriate for customers to share a risk the regulator will consider the benefits from lower risk for investors against the cost in terms of increased volatility of customer bills. Ofwat has acknowledged the links between risk mechanisms and the cost of capital in its consultations regarding modifications to the substantial effects clause (see Section 3.2).
268. Ofwat should not then reject an application for an SAE on the basis that some element is considered a "business risk". Ofwat should apply the regime for allocating risk that has been put in place. To do otherwise undermines confidence in the regulatory regime and ultimately is not in customers interests. Ofwat's statutory duty to act in a consistent way in accordance with regulatory best practice is aimed to ensure that decisions are made in the long-term interest of customers. This would also be contrary to the principle of legal certainty. This is quite separate from the equally valid argument that rejection based on business risk is not permitted under the Licence save only to the extent that any such risk equates to failure to take prudent management action which would have resulted in the SAE being avoided.

5.4 Adjustment should address impact over the regulatory period

269. Ofwat does not consider that proving a breach of the 20% materiality threshold obliges it to make an adjustment to K to compensate for under-recovery over the full regulatory period. SESW firmly rejects this position, in terms of both Ofwat's statutory duties and in terms of sound regulatory practice.
270. The legal analysis is set out in Section 3.2. The issue posed by paragraph 13.3 of Condition B is whether the circumstance "has or will have" a substantial adverse effect. Consistent with its continuing statutory duty, Ofwat would not be entitled to ignore the effects in earlier years of an issue which breaches materiality and has given rise to a substantial adverse effect.
271. The remainder of this section explains why the legal analysis is also consistent with sound regulatory principles.

5.4.1 Impact of incentives for efficiency

272. Ofwat argues that allowing full recovery would undermine the principles of incentive based medium term regulation; and could allow a company more

than needed to finance its functions in the period until the next review. This is a curious statement given that full recovery is the prescribed remedy for all NI / RCC claims under the licence.

273. SESW firmly supports a regulatory approach that encourages efficiency-based incentives. Such a framework has, over time, motivated the water industry in England and Wales to provide high quality services at lower costs to consumers. SESW supports the continuation and development of incentive based regulation.
274. However, it is unclear why Ofwat believes that restoring a company that has proved materiality to a position as if the circumstances had not arisen undermines the principles of incentive based medium term regulation. In its calculation of the relevant adjustment to K, SESW has included any efficiency savings made in the relevant years, which has the effect of considerably dampening the required adjustment factor (i.e. from 33% to 14.1%).
275. The substantial effect process is intended to protect the company against significant unforeseen events. SESW does not consider that the existence of this process in any way reduces the incentives upon the company and its management to operate as efficiently as possible.

5.4.2 *K adjustment would increase rate of return above the cost of capital for a given year*

276. Ofwat further argues that providing a K adjustment in response to a materiality threshold breach could allow a company more than needed to finance its functions in the period until the next price review. This is not a relevant consideration. Allowing the rate of return to exceed the cost of capital in a given year is consistent with the operation of the IDoK process for NIs / RCCs. It is also consistent with other regulatory methodologies that are employed by Ofwat.
277. As Ofwat explains in its PR04 Final Determination, there are several reasons why a firm's actual returns in any given year may deviate from those allowed under price limits. These include the outperformance of efficiency and/or service targets. Further, adjustments for financeability that front-load allowed revenues in a NPV-neutral fashion can also alter the time profile of returns so that in any given year there may be over- or under-recovery of costs. These are perfectly acceptable outcomes under a sound regulatory framework, so there is nothing inherently harmful in allowed returns exceeding the cost of capital in any given year as a result of the application of a regulatory methodology.
278. In any case, as discussed below in Section 5.5, it appears that even on the most conservative estimates the required rate of return for SESW is currently above the level set at the Final Determination at PR04. This means that the gap between SESW's actual returns and those required to finance its functions until the next price review has actually widened, in contradiction to Ofwat's assumption. However, SESW does not propose that Ofwat reset its returns to the current cost of capital. A pragmatic, transparent and defensible

action would be for Ofwat to restore the cost of capital to the most recently-determined (PR04) level.

5.4.3 *It is common for regulatory mechanisms to allow full recovery*

279. There are a number of existing regulatory provisions that allow recovery of losses over the full regulatory period. These include:

- The RCC and Notified Item clause that permits full recovery of the specified items over the complete five year period of a review.
- In 2004 Ofwat introduced its change protocol. This protocol provides full recovery for certain RCCs even though their impact is not sufficient to pass the materiality threshold.
- An adjustment mechanism that Ofwat has recently introduced for variations in income over the regulatory period (starting in 2010), and under which full recovery of lost income would be possible for the whole of the review period¹⁹.

280. As a result, there is no basis in regulatory principle for Ofwat to claim that it is inappropriate to take account of the full impact of the circumstances.

281. By focussing exclusively on prospective under-recovery, Ofwat has essentially taken the view that the impact of its erroneous price-setting assumptions on SESW's past cash flows does not matter. This is an arbitrary judgment. The substantial effects clause exists to provide protection against extreme outcomes over the entire regulatory period, not just selected years. Although the allowed rate of return is not guaranteed, the existence of the substantial effects clause places an onus on Ofwat to consider the effect of regulatory error on all relevant years. Nothing in the substantial effects clause supports Ofwat's approach of focussing exclusively on 2009-10.

5.5 Financeability and the cost of capital

282. This section explains why, in SESW's view, the relevant cost of capital for the SAE is the cost of capital set by Ofwat in PR04. The section goes on to discuss why the implied cost of capital used by Ofwat (i.e. by refusing to allow an adjustment to K) is not reasonable.

¹⁹ Ofwat, Setting price limits for 2010-15, March 2008, page 55.

5.5.1 **SESW's position on the cost of capital**

283. The cost of capital set by Ofwat for the 2005-10 period at PR04 is the relevant benchmark rate of return to calculate the K adjustment for the SAE application. There are three important reasons for this position.
284. First, investors require clear signals about the rate of return they can reasonably expect to earn over the medium term, in order that they have sufficient confidence to commit capital to the industry. At the present time, the regulator ought to be encouraging and incentivising efficient investment in the industry. The industry and investors use the cost of capital set by Ofwat as a benchmark when evaluating specific projects, and when making day-to-day business decisions. Stability, transparency, and consistency over expected rates of return are particularly important given the present economic climate, when general market volatility may deter investors from committing funds²⁰.
285. Ofwat argues in its Final Determination that investors would take a longer term view of the position of a company and would not expect to see returns in each year exactly matching the cost of capital allowed at a price review.
286. SESW agrees that investors take a long-term view of investments when deciding whether to commit capital. However, Ofwat does not appear to recognise that this long-term planning horizon is heavily influenced by the actions of the regulator. If investors cannot foresee or understand likely regulatory outcomes over their planning horizon, their confidence in the industry may be greatly undermined. Apparently inconsistent determinations over time help reinforce this perception, particularly in the light of the regulator's duty to act consistently.
287. Furthermore, when the regulator allows actual returns to deviate substantially from allowed levels, without any redress, investors receive a clear signal that the industry is a risky one to finance.
288. Second, as a matter of good regulatory process, the PR04 cost of capital is the only rate of return that can reasonably apply over the period 2005-10. Having undertaken extensive consultation, Ofwat finally settled on the PR04 cost of capital for price-setting purposes. The consultation process thoroughly tested the appropriate rate of return for the water industry for the current control period. The SAE is essentially a price-setting mechanism, albeit one designed to produce expeditious outcomes and remedies. By setting aside the PR04 cost of capital in favour of a lower rate of return, which is essentially what Ofwat has done by refusing to restore the allowed cost of capital via an adjustment to K, Ofwat has effectively applied a 'new' cost of capital that has

²⁰ In the Indepen 2009 Investor Survey commissioned by Water UK, (equity and debt) investors were asked to rank the top five risks they viewed as most important. Of those who mentioned regulatory risk, 57% considered it to be the most significant risk. A common view expressed by many of the respondents canvassed by the study was that Ofwat had become less transparent and consistent in its decision-making over time.

not received the same scrutiny as the PR04 rate. This is poor regulatory practice.

289. Third, one of the aims of the substantial effects clause is to provide expeditious outcomes, without imposing the substantial regulatory burden that would arise from re-opening a full price limits inquiry. Consistent with this goal, the simplest and most transparent course of action would be to apply the PR04 allowed cost of capital.
290. For these reasons, the annual allowable amount for the remainder of the regulatory period should be adjusted so that the return on capital is restored to the cost of capital allowed at PR04.

5.5.2 Why the denial of an adjustment by Ofwat is unreasonable

291. Ofwat states in its final determination that SESW's "return on capital is reasonable" without providing any analysis to show that the company's realised rates of return are in line with its cost of capital. Ofwat provides only two reasons in order to support its view, neither of which is defensible from an economic standpoint.

The first explanation given by Ofwat is that a financeability test suggests that SESW has "favourable financial indicators". In other words, Ofwat appears to argue that because the company seems to have a reasonable level of cash balances, a prudent level of gearing, and looks to be in a good position to service its debt commitments, its returns will be sufficient to cover investors' required rates of return. There is no basis for this view.

[✂]

293. In order to claim that SESW's "return on capital is reasonable", Ofwat should have *first* estimated the Company's cost of capital and compared that to the business's realised rates of return. Ofwat does not appear to have done this. A *secondary* step would be to check the financeability of the company using the ratios described by Ofwat.
294. As part of the analysis for PR09 Frontier Economics has estimated SESW's current cost of capital (i.e. the required rate of return), taking into account recent economic developments, such as the financial crisis, since PR04.

²¹ The recent financial crisis has affected *both* the cost of equity *and* the cost of debt. Since the company's cost of capital is a weighted average of the two, it is important to consider the overall impact of economic shocks on required rates of return for the total business (not just the equity portion or the debt portion). A financeability assessment only provides an indication of the company's ability to raise debt capital. Such assessments say very little about its ability to raise equity capital.

Frontier's approach was to first estimate a short-run cost of capital by updating key cost of capital parameters, such as the equity risk premium and debt spreads, to reflect some measure of the current financial crisis. The analysis indicates that a plausible range for the current cost of capital for SESW is [x] to [x] per annum (real, post-tax). The short-run cost of capital may in fact be higher than this range suggests because Frontier has taken quite a conservative view on the difficulties in raising finance in the present economic climate.

295. The PR04 allowed cost of capital for a company the size of SESW was 6.6% per annum (real, post-tax, and including a small company premium).
296. Owing to the circumstances surrounding SESW's rise in energy costs and fall in revenues, realised rates of return over the 2005-09 period have been well below the PR04 cost of capital, and the prospective rate of return for the 2009-10 period is well below the updated cost of capital suggested by the Frontier analysis. In other words, the gap between realised and required rates of return has actually widened since PR04. Therefore, Ofwat's claim that the "return on capital is reasonable" is not supported by the empirical evidence.
297. For the avoidance of doubt, SESW is not arguing that the required adjustment to K should bring its rate of return in line with an up-to-date cost of capital (even if though, in principle, that might be the theoretically correct course of action). For pragmatic reasons, such as simplicity and transparency, SESW argues that its returns should be brought in line with the previously determined PR04 cost of capital.
298. Ofwat points to the short remaining duration of the current regulatory term as a second justification for not providing an adjustment to price limits. For instance, when interpreting its duties under s2 of the Act, Ofwat states that:
- "In particular this means satisfying ourselves that the company has sufficient resources until prices are next set, even though this may result in a rate of return on capital lower than originally provided for in the 2004 final determination"*
299. Ofwat's suggestion is that it seems unlikely that the company will fail before price limits are next reviewed and, therefore, realised rates of return (no matter how far below allowed levels) are sufficient. This is not a sound economic basis on which to assess the adequacy of returns. A reasonable rate of return is one that allows investors to cover at least their expected opportunity cost of committing capital, and also the risks they bear. A reasonable rate of return cannot sensibly be interpreted as one that just allows the company to avoid financial default. For this reason, the implied cost of capital allowed by Ofwat in the final determination cannot be viewed as reasonable.
300. Ofwat seems to view the substantial effects provision as a means to guard against financial default. This is clear from Ofwat's narrow focus on SESW's financial position being sufficient to see the company through to the next price

review. As argued earlier, in SESW's view, that is a misinterpretation of the provision. The substantial effects provision is a mechanism for allocating risks between regulated companies and consumers. The materiality threshold specifies a limit within which the company must bear the risk of unforeseen events. Beyond that point, the cost of any substantial, unforeseen adverse outcomes borne by customers. In a symmetrical fashion, the materiality threshold allows companies to benefit from favourable circumstances up to a point. Once this threshold is reached, however, customers are entitled to share in the benefits from any substantial, unforeseen favourable outcomes to the company. The substantial effects provision should not be treated by Ofwat merely as an instrument of last resort, to rescue regulated firms from impending failure. Applying the provision in this manner ignores the risk-sharing goal outlined above, which is an essential feature of the regulatory regime.

301. SESW objects to Ofwat's 'sufficiency of financial resources' test for another reason. Notwithstanding the fact that this test is inconsistent with Ofwat's duties under s2 of the Act (as discussed earlier in Section 3), such an approach has the potential to either introduce harmful distortions, or to render the substantial effects clause ineffective, as the following thought experiment shows.
302. Consider two water companies, who are identical in all respects except one. Company 1 has chosen to retain a large proportion of its earnings (so has the financial resources to continue operating until the next review period) and is able to comfortably service its debt commitments. In contrast, Company 2 has little cash balances, is heavily geared and has failed on its interest cover ratios, thus placing it in a weak position to finance its operations until the next price reset. Suppose further that both firms face an identical set of circumstances that causes their rates of return to drop substantially below allowed levels, and lead them to each submit SAE applications. Ofwat, having determined the materiality of the adverse effects for both companies, must determine what adjustments to prices, if any, are to be awarded.
303. On Ofwat's description of its decision process (as applied to SESW's application), Company 1 would be denied any relief, given its relatively strong financial position. The question is, what would be the outcome for Company 2? One of two things might occur. Under one scenario, Ofwat might apply its financeability criterion and grant the company a positive adjustment factor on the grounds that, given its lack of financial resources, it may be unable to continue its functions. However, this creates the potential for perverse incentives on all firms within the industry, including well-financed ones such as Company 1, to become over-geared (thus raising their credit risk) and to hold imprudently low reserves of cash, in order to be successful in gaining regulatory concessions. Such a moral hazard outcome is clearly inconsistent with the efficiency goals of a sound regulatory framework, and the substantial effects clause does not exist to promote such outcomes.
304. A second, and quite plausible, scenario is that Ofwat reject Company 2's calls for price relief on the grounds the company has been managed imprudently (i.e. its executives should have taken on a more sensible level of leverage and

maintained sufficient cash to continue its functions successfully). But then, neither Company 1 (which was managed prudently) nor Company 2 (which was managed imprudently) would receive any adjustments. In other words, the substantial effects clause would be quite ineffective and therefore completely at odds with its purpose.

305. This simple example reveals the flaw in Ofwat's approach to determining SESW's application. Ofwat has incorrectly applied a financeability analysis by primarily considering the likely financial position of the company until the next review, rather than recognising that unforeseen circumstances have caused the company's actual returns to fall considerably below those allowed under price limits.

306. Ofwat further justifies its refusal to adjust K on the grounds that SESW has previously indicated that it does not need to raise further finance or refinance any debt in 2009-10.

307.



The fallacy of Ofwat's position is obvious when one recognises that at the time of most price reviews, it is difficult to predict accurately whether firms require additional finance over the coming five year period. Nevertheless, Ofwat still goes through the process of setting an appropriate cost of capital.

308. Under no circumstances would it be sensible to argue at a price review that a company probably requires no further (or renewed) financing over the coming control period and, therefore, a rate of return below its cost of capital is appropriate or reasonable. There should be no difference in treatment in the present case.

5.5.3 Ofwat's determination on rate of return

309. This Section outlines Ofwat's key challenges on the appropriate cost of capital, and on financeability issues, and SESW's responses to these views.

Allowing SESW greater resources than those to finance its functions is not consistent with furthering the consumer objective

310. This statement may seem plausible but is misleading. As discussed above there are legitimate reasons why a regulator might allow a company to earn a return above the cost of capital. These reasons are entirely consistent with furthering the consumer objective. It is also true that permitting persistent under-recovery of returns, with no regulatory correction, is inconsistent with furthering the consumer objective. Consumers benefit not only through lower prices, but also through the delivery of reliable, high quality services. If investors, who provide the capital required to undertake maintenance, upgrades and efficient expansion cannot be confident that the regulator will even permit cost recovery, they will not commit funds. As discussed below, such regulatory outcomes have ramifications not only in the short-run (i.e. the 2009-10 period that Ofwat has focussed its attention on), but also the

medium-to-long term over which investors evaluate the risks associated with participating in the industry.

Ofwat considers that its duty under section 2 of the Water Industry Act 1991 is to satisfy itself that the company has sufficient resources until prices are next set, even though this may result in a rate of return on capital lower than originally provided for in PR04.

311. [✂]

However, the purpose of both a SAE determination and a price review is essentially to set prices. Therefore, Ofwat should, in accordance with its statutory duty, take a consistent approach to the treatment of cost of capital and financeability. Unfortunately, Ofwat has not done this.

312. [✂]

First, it is unclear from Ofwat's explanation exactly how it has taken the return on capital into account. Ofwat has not provided any assessment of the cost of capital. Ofwat acknowledges the possibility that SESW's realised returns have fallen well short of allowed returns, yet it has chosen to leave prices unadjusted. [✂]

This approach is clearly inconsistent with the duty outlined in section 2 of the Water Industry Act 1991, which obliges Ofwat to ensure that operators are able to finance their functions, "in particular, by securing reasonable returns on their capital". Ofwat acknowledges that it would not have taken such an approach when setting price limits so, from the standpoint of good regulatory practice, it is unclear why it should do so for the purposes of determining a SAE.

313. The approach that Ofwat applied at previous five year price controls was summarised clearly in their Final Determination PR04 (paragraph 15.1):

*"We have a duty to secure that companies are able to finance the proper carrying out of their functions as licenced undertakers ("finance functions"). We look at this as having two strands. One is to secure that, if a company is efficiently managed and financed, it is able to earn a return **at least equal to the cost of capital**. The second is that its revenues, profits and cash flows must allow it to raise finance on reasonable terms in the capital markets. We refer to this second strand as financeability."* (emphasis added)