

9 Views of the Director

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Introduction

9.1. In this chapter we set out in general terms the broad approach which the Director adopted in respect of the different elements which contributed to his final determinations and to the proposed licence modification. The Director's views were put to us both in written evidence and at hearings. The company's views are set out in Chapter 11.

9.2. Much of the detailed reasoning and judgements which lay behind the Director's determination for MKW are considered in other chapters of this report.

9.3. The Director said that, for MKW, there was no single area of difference that could account, on its own, for most of the total difference between the price limits assumed by the company and those set by the Director. There was a range of differences of varying degrees across all policy areas.

9.4. The Director said that the biggest areas of difference were in expenditure required for capital maintenance, base operating costs, and optional metering under the supply/demand balance category. There were less significant differences in expenditure on future efficiency assumptions, enhanced service levels and the acceptable rate of return. The least significant areas of difference were in projected base revenues and quality enhancements.

The Director's overall approach

9.5. The Director told us that the package he had presented to MKW on 25 November 1999 was, he believed, realistic, appropriate and consistent with other companies. It had delivered significantly lower prices for customers of MKW for the first time since 1989. In determining price limits for MKW he had, as for all companies, applied fair and consistent policies which had been developed in an open and transparent manner over a number of years. He had also taken into account the particular circumstances of the company. He told us that the P0 adjustment had been greater than the industry average because MKW had one of the highest returns on capital (RCV) in the industry.

9.6. The Director said that the price determination included three Notified Items, which provided for interim price determinations in the event of particular uncertainties arising. It was also accompanied by a proposed licence modification which significantly reduced the threshold for interim determinations relating to opex and revenue. He said that the combination of price determination, including the Notified Items, alongside the licence modification, provided a package that adequately allowed the company to finance its functions, provided the company with an appropriate degree of protection for uncertainty and gave the best possible deal for customers.

9.7. The Director said that MKW had rejected the package. His view was that the two elements of his package should be considered in parallel. He said that the areas of uncertainty covered by the Notified Items all arose from the 1999 Act. The 1999 Act placed new legal requirements on all companies. His licence modification provided a mechanism for dealing with the uncertainties arising from the following changes, while minimizing the costs to customers:

- (a) companies were required from 1 April 2000 to offer a free water meter to customers on request;
- (b) companies had been prohibited from disconnecting domestic customers for non-payment of bills from 1 July 1999; and
- (c) companies were required to introduce special charges capped at the average household charge for the company for vulnerable measured customers. The revenue lost from such preferential charges might be recouped from the generality of customers through the tariff basket but the administrative costs might not.

9.8. The Director said that the proposed licence modification allowed companies to seek an interim determination if either costs in these areas exceeded those already allowed for in price limits, or revenues fell below those allowed in price limits by an amount in excess of or broadly equal to 1 per cent of revenue. This was in addition to the provisions for interim determinations in the companies' existing licences.

9.9. The Director believed that the uncertainty surrounding the ban on disconnections, metering and vulnerable customers was best dealt with through the mechanism of the licence modification. He believed that his proposal provided the company with a measure of protection against the uncertainties in question. It was not intended to be, and should not be, a mechanism that provided for automatic corrections to all variances from the charging base assumptions made in the final determination.

The Periodic Review process

9.10. In describing the Periodic Review process, the Director said that, in October 1996, he had announced his intention to review prices during 1999. Since then, a phased process had allowed timely debate of the issues and enabled stakeholders to make informed contributions. He had published two consultation papers in the summer of 1997 seeking the views of stakeholders on the approach to the methodology of setting price limits, the business planning process, customer consultation and information requirements. In February 1998 he had set out his intended approach to setting prices. In October 1998 he had published *Prospects for Prices*, identifying the key issues in quantitative terms for progressing the review. During this period, a number of technical papers and open letters had been issued, clarifying methodological and process issues.

9.11. The Director told us that he had worked closely with Ministers, the EA and the DWI to clarify the nature and timing of current and future quality obligations and the scope for other improvements.

9.12. His view was that the methodology and process had been open and transparent to companies and to other stakeholders. He had taken account of the views of his CSCs, his panel of senior industrialists and his financial advisers, Singer & Friedlander. He had also consulted the financial markets about the methodology for considering financial viability.

9.13. Senior staff from each water company had met the Director's officials in the autumn of 1998 to discuss *Prospects for Prices*. He had met twice with each of the companies, first during January/February 1999, when the companies were preparing their BPs, and then in September/October 1999, to hear representations on the draft determinations that he had published in July 1999.

9.14. The Director told us that he required companies to appoint independent professionals, known as Reporters, to scrutinize and comment on all aspects of the information submissions prepared by the companies. Usually Reporters were consulting civil engineers with other qualifications relevant to the water industry. Where financial accounting expertise was required, this was provided by the companies' auditors who were appointed in accordance with the Companies Act 1985. Reporters, supported as necessary by the auditors, had worked closely with companies during the formulation of their information returns to check that they complied with the Director's reporting requirements and guidelines, and to ensure that all material assumptions had been exposed. The scrutiny and reports by Reporters had enabled the Director to make informed comparisons between companies, taking account of factors affecting the consistency and comparability of individual company information. The Reporter for MKW had provided the Director with a report on each of several key information returns and on the BP.

Statutory duties

9.15. The Director said that his primary duty was to act in the manner which he considered best calculated to ensure that the functions of WaSCs were properly carried out in an efficient manner and that the companies were able to finance their functions. He did this by ensuring that the price limits that he set allowed companies sufficient revenue to cover their costs and provide a reasonable return on the company's capital base. Subject to this primary duty, he also had a duty to protect customers by ensuring that the revenue collected was no more than necessary and by giving companies incentives to increase the efficiency of the carrying out and financing of their operations. The final determination should enable MKW to secure a reasonable return on its capital and to finance the proper carrying out of its functions. The Director told us that he was not obliged to guarantee the financial viability of each water company regardless of whether it was carrying out its functions properly.

9.16. The Director said that he had paid due regard to the comments of all parties, including those of MKW. His approach had included cross-company comparisons but had paid particular attention to company-specific arguments and issues. It was only after such a fully consultative process that the Director could be confident that he had set price limits consistent with his duties.

Service performance adjustment

9.17. The Director told us that he had included in price limits an adjustment for service performance. His approach had been widely consulted on and had gained broad acceptance across the industry and was supported by customer representatives and the DETR. The general approach for adjustment for service performance was now being emulated in other sectors.

9.18. The analysis of a wide range of aspects of service, together with both positive and negative adjustments to price limits, provided incentives to companies to maintain and improve customer service and discouraged them from achieving efficiencies by cutting service levels. The Director considered that the scale of the price adjustment was reasonable. Others had, however, suggested that the adjustment might have been greater.

9.19. The Director told us that, during the summer of 1999 (after the publication of draft determinations), there had been a well-publicized supply failure in the MKW area at Kemsing. His formal investigation had concluded that this had not been primarily due to lack of resources or to infrastructure

limitations, but had resulted from a failure of management to assign a high enough priority to customer service. He had already concluded that MKW's overall service to customers was poorer than that of most other companies and, consequently, draft determinations had included an adjustment to the initial price limit of -0.5 per cent to reflect this. The Director's view that there should be an adjustment to the initial price limit for service performance was confirmed in the final determination.

Competition in the water industry

9.20. The Director's view was that, at present, competition in the industry was still in its formative stage. Both the potential risks and the potential benefits to companies arising from the current framework for market competition had been understood when he had made his assessment of the cost of capital.

Top-down/bottom-up approach

9.21. The Director told us that the ability to make cross-company comparisons was a key element in the price review. The comparative analysis was invaluable in achieving a satisfactory outcome.

9.22. The Director said that his approach to determining prices had looked at the company's projections in its BP in relation to comparative cross-company analysis and historical trends. He told us that he had carefully examined the representations made by MKW both in the months before it submitted its BP and following the publication of his draft determination in July 1999. He had noted the large differences between the company and himself early in the process. He had sought to understand these differences and, as a result of company representations on the draft determination, had made a number of changes to the price limits in favour of MKW.

Operating expenditure

9.23. The Director said that his general approach to maintaining base service levels to customers had assumed that all companies would be able to maintain services over 2000 to 2005 at expenditure levels prevailing in 1998/99 less efficiency savings. The detail of the assumptions for MKW's opex is set out in Chapter 7.

Capital expenditure

9.24. The Director told us that his approach to capital maintenance expenditure assumed that serviceability could be maintained if historical levels of capital maintenance activity were continued over the next price limit period, subject to efficiency savings. The detail of the assumptions for MKW's capex is set out in Chapter 6.

Efficiency

9.25. The Director said that the general approach he had taken to assessing relative efficiency across companies, and the scope for achieving efficiency improvements, was consistent across all areas and provided incentives for companies to reduce costs.

9.26. He had made assumptions on the rate of improvements in future efficiency for the water industry as a whole, but the assumptions applied to individual companies had depended in part on his assessment of their efficiency relative to other water companies (ie their ranking). Discussion of the efficiency assumptions for opex are discussed in Chapter 7 and for capex in Chapter 6.

Financial issues

Cost of capital

9.27. The Director said that the cost of capital was a critical parameter in his assessment of price limits. The debate on the cost of capital had been largely carried out at an industry level with many companies using the same advisers.

9.28. The Director said that section 10.3 of *Future water and sewerage charges 2000–05* set out his assumptions regarding the cost of capital. Appendix C of the same document amplified the reasoning set out in Section 10.3. MKW had assumed in its BP a post-tax cost of capital of 6.21 per cent, including a small company premium of 0.41 per cent. MKW's calculation had been based on two components:

- (a) A calculation of the industry cost of capital. This was based upon recent published documents, principally *Prospects for prices* and the MMC report on mobile telephony, *Cellnet and Vodafone*.
- (b) An assessment of the small company premium. This was based upon an analysis of the companies' financing costs undertaken by LE—*Report on the Cost of Capital: Position of small companies 1999 periodic review for MKW* (January 1999).

9.29. By contrast, the final determination for MKW had assumed a post-tax cost of capital of 5.5 per cent, including a small company premium of 0.75 per cent, and a further increase in respect of an adjustment for embedded fixed-rate debt of 0.24 per cent (applied to the existing asset base).

9.30. The Director told us that the difference in the cost of capital in the final determination compared with that assumed by MKW was mainly attributable to the cost of equity and to the average level of gearing assumed. The cost of equity is calculated from the ERP, the equity beta and the risk-free rate. The ERP was the additional return required by investors to reflect the extra risk of equity instruments compared with government securities. The equity beta was a measure of the riskiness of the company's shares relative to the overall equity market. The risk-free rate was measured as the return on government securities. In its calculation of the cost of equity, MKW had assumed higher values for these components than assumed by the Director in the final determination, resulting in a higher cost of capital overall. This was partly offset by the assumption by MKW of a higher level of debt, the cost of which was cheaper than the cost of equity.

Current cost depreciation and broad equivalence

9.31. The Director told us that CCD was an important component of price limits. It was depreciation that was remunerated through price limits, not expenditure. The Director said he recognized that depreciation charges could have many profiles but, because of its impact on bills, it was appropriate in some measure to assess whether the profile of depreciation was reasonable. This was the purpose of BE. BE tried to secure that depreciation charges were reasonably allocated over time (in relation to past and future maintenance expenditure) so that customers' bills reflected a fair charge for the use of assets.

9.32. The Director said that section 7.3.8 of *Future water and sewerage charges 2000–05* set out his approach to depreciation and BE. As explained there, he had assumed that the CCD for an existing pool of above-ground assets should be broadly equivalent to expected levels of capital maintenance expenditure for those assets.

9.33. The Director's approach to BE, for this review, was first consulted on in a letter to companies in February 1997 (MD124).¹ The industry was consulted on BE on a number of further occasions, most particularly in the two methodology papers published by Ofwat: *The proposed framework and approach to the 1999 periodic review* (June 1997) and *Setting price limits for water and sewerage services* (February 1998). The Director noted that the vast majority of companies agreed with the principle of BE and, in fact, during their referral to the CC, MKW confirmed that it considered the principle was sensible. The Director confirmed that BE was not a wholly new idea for the 1999 Periodic Review. The

¹MD124, *1999 Periodic Review*, Ofwat, February 1997.

principle had been applied, in a rather less rigorous way, as a check on the depreciation allowed in price limits in the 1994 Periodic Review.

9.34. In determining the size of adjustment to be made to achieve BE, the Director said that the assets existing at 31 March 1993 had been taken as the base pool of assets to be considered. All capital maintenance expenditure projected for above-ground assets had been assumed to relate to this pool of assets. The depreciation charge, which had been compared to this expenditure to assess the BE position, consisted of two elements:

- (a) depreciation on assets existing at 31 March 1993. This was a declining stream, as depreciation reduced when assets became fully depreciated; and
- (b) depreciation on new capital maintenance expenditure incurred. This was an increasing stream as additional expenditure was incurred each year.

The two streams in total would be expected to give a broadly constant amount of depreciation over time.

9.35. The Director said that, in its BP, MKW had not included an adjustment for BE. In the BP it had stated that: 'The company is currently considered to be broadly equivalent in terms of current cost depreciation and capital maintenance expenditure'. The Director said that applying his methodology to the projections of depreciation and maintenance expenditure contained within the plan had shown this assumption to be valid and that no adjustment would be required on the basis of those projections and the company's assumption on apportionment and asset lives.

9.36. In his final determination, the Director said that he had made a downward adjustment to CCD of £0.8 million (May 1999 prices) for BE purposes. This had resulted primarily from differing views about the level of capital maintenance required, the appropriate asset lives and the apportionment of expenditure across these.

Capital structure and the trend of financial indicators

9.37. As set out in Chapter 10 of *Future water and sewerage charges 2000–05*, the Director said that, in determining price limits, it had been assumed that companies would achieve efficient balance sheet structures. This chapter and Appendix C of that document also addressed the levels and trends of financial indicators which the Director considered should be maintained in order for companies to continue to finance their functions.

9.38. The Director said that he considered that price limits should be set to allow companies to maintain both an adequate level and trend of critical financial indicators, consistent with maintaining a solid credit rating (within investment grade), as well as ensuring that they were able to earn, on average, a return at least equal to the Director's assessment of the cost of capital.

9.39. Table 9.1 sets out the net debt and gearing position from MKW's BP and the final determination.

TABLE 9.1 **Gearing and net debt assumptions**

	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
Gearing (debt:debt + equity):						<i>per cent</i>
Final determination						
BP		<i>Figures omitted. See note on page iv.</i>				
Net debt (1997/98 prices):						<i>£ million</i>
Final determination						
BP		<i>Figures omitted. See note on page iv.</i>				

Source: Ofwat.

9.40. In setting final price limits, the Director said that he had considered the average levels of gearing (defined as debt:debt + equity) for the period 2000 to 2005 as part of the package of financial indicators. His initial assumption had been that companies would gear up naturally as a result of the investment programmes that they were required to undertake. In the case of MKW, however, the payment of special dividends in the past had resulted in an increased level of net debt and weak financial indicators in the period 2000 to 2005. The Director had therefore adjusted the company's opening balance sheet, writing back £15 million of the special dividend paid in 1997/98 and thereby reducing the opening level of debt.

9.41. The Director said that, in its BP, MKW had set constant K factors in the years 2001/02 to 2004/05. The company had assumed an additional constraint to ensure that historic cost interest cover did not fall below 2.3x. However, the need to ensure constant K factors had resulted in historic cost interest cover falling to 2x in 2002/03.

9.42. The Director's view was that historic cost interest cover, as part of the package of financial indicators, should be a minimum of 2.5x for MKW. In the final determination the write-back of special dividends had not fully alleviated the problem of weak financial indicators. In order to ensure that critical financial indicators (including historic cost interest cover) were preserved, the final determination had included an increase in the rate of return over and above the cost of capital. This was equivalent to an additional £[§] million of revenue over the period 2000 to 2005.

Standard infrastructure charge

9.43. The Director said that he considered the standard infrastructure charge should remain at current levels indexed by inflation. This was the same limit that he had set in 1994, but increased for inflation. He said that the amount calculated for the year commencing 1 April 2000 should be £229.23; for subsequent years that amount would be adjusted by the RPI.

The licence modification

9.44. The Director said that the existing licence provided each company with protection from substantial changes in quality obligations such that material implications for the company costs would enable it to seek an interim determination of price limits. The existing licence specified the Relevant Changes of Circumstance and a materiality threshold that must be cleared. This mechanism had been used by a number of companies during the last ten years. There was also a provision for the Director to specify Notified Items where outcomes different from his assumptions at a Periodic Review could, subject to the same materiality test, lead to an interim determination.

9.45. As part of the determination package, the Director said that he had reviewed the protection given by the existing licence both in terms of Relevant Changes of Circumstance/Notified Items and the materiality threshold.

9.46. The Director said that the final package had extended the protection in two areas: first, through setting down three Notified Items arising from the implications of the 1999 Act and, secondly, a revision to the calculation of the materiality amount that had had the effect of lowering the threshold for changes affecting opex or loss/gain in revenue. He stressed that the licence provided no protection for general business risks.

Notified Items

9.47. In making his price determination, the Director had identified (in addition to the current provisions regarding Relevant Changes of Circumstance) three Notified Items which could qualify as issues triggering an interim determination should the price determination have made insufficient allowance for:

- (a) changes in expenditure (including loss of revenue) attributable to the greater take-up of the option of a meter free of installation charge by household customers than the Director had assumed;
- (b) the consequences (debt-recovery costs and bad debt) of removal of each company's right to disconnect domestic customers for non-payment of charges; and
- (c) the cost to each company of operating the new scheme under which designated vulnerable customers who paid on measured tariffs would be protected against significantly increased water bills, attributable to the presence in the household of three or more children under the age of 16, or the fact that a member of the household suffered from a particular medical condition and a member of the household was in receipt of one of a specified list of benefits.

The Director's proposed modification

9.48. The Director said that he believed it was inappropriate to allow for such uncertainties within the price determination because price limits would be making allowance for costs (including revenue loss) that were difficult to evaluate on the basis of current information. It was more prudent to allow for any such costs as and when better comparative out-turn information was available. Such an approach avoided customers being required to pay for risks which might never happen. The Director had made it clear from the outset that he considered the price determination and the licence modification to be a package.

9.49. The Director said that, within the water companies' licences, there was a mechanism to trigger an interim determination of prices between five-year reviews in the event of the company incurring additional costs with a NPV in excess of 10 per cent of turnover.

9.50. However, the Director said that the uncertainties arising from the 1999 Act affected primarily revenue and operating costs. For uncertainties relating to revenue loss and operating costs he had concluded that the existing trigger mechanism provided insufficient protection to company finances. In MD149¹ he had published, with the draft determinations, a proposed modification that would increase the protection offered by the interim determination mechanism against uncertainties over revenue loss and spending cost.

9.51. The licence modification proposed by the Director revised the calculation of the materiality amount for either revenue loss or operating costs associated with the Notified Items (in effect lowering the threshold). This revision would enable a company to request an interim determination should specified changes, in aggregate, affect opex (or revenue) which exceeded, or were broadly equal to, 1 per cent of annual total revenue. This was equivalent to NPVs exceeding the 10 per cent threshold which had been retained.

9.52. The Director said that the proposal modified the NPV calculation of base cash flows relating to revenue and/or opex. The final proposed licence modification had been issued to companies in MD157² on 20 January 2000, following company responses to the draft proposal sent to companies on 24 November 1999. This was published in a press notice on 25 November 1999. MD157 clarified that:

- (a) the NPV of base cash flows that related to capex would continue to be assessed using the present calculation; and
- (b) the NPV base cash flows that related to revenue loss and opex would be assessed using a 15-year calculation.

9.53. The Director said that MKW had rejected the licence modification proposal since the final determination.

¹The Notified Item for household optional metering and a proposed modification to licence condition B.

²Licence modification—condition B.