



# **Sutton And East Surrey Water plc Interim Price Determination**

Final determination



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Material has been omitted from the text of this report pursuant to section 15(6) of Water Industry Act 1991. Omissions are indicated by the insertion of the symbol ✂ in the text.

# Final determination

## SUTTON AND EAST SURREY WATER PLC INTERIM PRICE DETERMINATION

### Contents

	<i>Page</i>
Summary.....	3
Final determination .....	6
1. The reference.....	6
2. Background.....	6
Regulation of the water sector .....	6
The legal and regulatory framework.....	8
Principles applicable to the reference .....	9
Duties of the regulator .....	9
Licence conditions.....	10
SES's claim under the substantial effect clause .....	12
Previous SAE claims.....	13
3. Our assessment of SES's claim.....	14
Circumstance .....	14
Aggregation.....	14
Jurisdiction .....	15
The prudent management action test .....	16
Energy costs.....	16
The materiality test.....	26
Ofwat's adjustments .....	26
Definition of 'relevant income' .....	26
Special agreement income.....	27
Assessment of SES's claim: materiality .....	27
Power .....	27
Income .....	28
Our assessment of the materiality requirement .....	29
Offsetting.....	30
Conclusion as to the eligibility of SES's claim .....	30
4. The appropriate adjustment to K.....	31
The purpose of the substantial effect clause.....	31
Previous substantial effect claims .....	32
The parties' views.....	33
Our view .....	33
SES's position—submissions made before provisional determination.....	34
SES's response to the provisional determination.....	37
Ofwat's position .....	39
Our assessment and application of what change to make to K .....	42
The applicable principles.....	42
Section 2(2A)(b)—to secure that functions of the claimant company are properly carried out .....	43
Section 2(2A)(c)—to secure that the claimant company is able to finance the proper carrying out of its functions.....	43
Evaluation of the section 2(2A)(c) duty .....	51
Section 2(2A)(a)—furthering the consumer objective .....	51
Risk that the cost of capital will increase.....	52
Implications for incentives to adopt less robust financing methods.....	56
Timing of applications.....	57
Maintaining incentives to manage costs.....	57

Evaluation of the section 2(2A)(a) duty .....	58
Sections 2(3) and 2(4)—the duties to promote economy and efficiency and to have regard to the principles of best regulatory practice .....	59
Other issues .....	59
Conclusion .....	60
Costs .....	61

*Appendices*

- A. Terms of reference
- B. Condition B of SES's licence
- C. SES's SAE claim
- D. Power model
- E. Materiality threshold sensitivity analysis
- F. Financial analysis

Glossary

## Summary

1. On 5 March 2009, The Water Services Regulation Authority (Ofwat) made a reference to the Competition Commission (CC) to determine the disputed determination of a substantial adverse effect (SAE) claim by Sutton and East Surrey Water plc (SES). The reference was made under section 12(3) of the Water Industry Act 1991 (WIA91) further to a notice from SES, issued under the terms of its licence, requiring Ofwat to refer the disputed determination to the CC. Our terms of reference require us to report to Ofwat by 4 September 2009.
2. SES made its SAE claim to Ofwat on 17 September 2008, seeking an interim increase in its K factor (and so its price limits) for supply of water in its area. SES said that this was required to recover costs related to two circumstances, each of which, it stated, had a substantial adverse effect on SES's business. The claimed circumstances were (i) an increase in power costs (in particular, electricity costs); and (ii) loss of income arising from the consumption of water being lower than forecast in the 2004 regulatory settlement.
3. On 16 December 2008, Ofwat issued its final determination of SES's claim that no adjustment to SES's price limits was required. SES disputed Ofwat's determination of its claim and served a notice requiring Ofwat to refer the matter to us.
4. In determining this SAE claim, we were required to answer two questions:
  - (a) first, whether a circumstance has occurred which has or will have a substantial adverse effect on SES's business, not being one which would have been avoided by prudent management action; and
  - (b) second, if so, what change should be made to K.
5. In relation to the loss arising from an increase in power costs, Ofwat's view was that some of SES's increased power costs would have been avoided by prudent management action relating to electricity procurement and energy efficiency. We did not agree with Ofwat on this and concluded that SES's procurement decision was a calculated commercial decision which was towards the riskier end of the spectrum of a range of prudent actions for a regulated utility and that there was no evidence that SES was imprudent in failing to take steps to improve its energy efficiency in response to the increases in electricity price. We found that SES's loss of income would not have been avoided by prudent management action.
6. We agreed with Ofwat and SES that the claim satisfied the materiality test. We concluded that the purpose of the materiality test was a jurisdictional one. We did not agree with SES that there was a presumption from the fact that the test was satisfied that a change should be made to K. We considered that the degree of materiality of a particular effect may be a relevant factor to our second stage assessment on particular facts; but that the materiality amount may not give a good indication of the impact of claimed substantial effects on a company's business.
7. In answering the question what change should be made to K, we were of the view that we had a wide discretion, and that we were required to make our determination in accordance with the principles set out in section 2 of the WIA91. This meant that we had to make our determination in the manner which we considered was best calculated to achieve the main principles listed in subsection (2A). In addition, we had regard to the secondary principles in subsection (3) and the general principle in subsection (4) that in exercising these powers we must have regard to the principles of best regulatory practice.

8. We first considered the section 2(2A)(b) duty (to secure that SES's functions are properly carried out). We received no evidence to suggest that SES was failing properly to carry out its functions or is at risk of failing to do so. Accordingly we considered that the section 2(2A)(b) duty was satisfied.
9. We then considered the section 2(2A)(c) duty (to secure that SES is able, in particular by securing reasonable returns on its capital, to finance the proper carrying out of its functions). We looked at SES's business as a whole, rather than considering the substantial adverse effects in isolation, and took account of SES's actual capital structure rather than the notional structure used by Ofwat in its 2004 regulatory settlement. We looked at SES's returns on capital as compared with the cost of capital and risk-free rates of return used at the time of the 2004 regulatory settlement, current estimates of the cost of capital, and industry average performance. We also considered SES's performance against other financial indicators, assessed against guideline ranges from both the regulator and a credit rating agency. We took note of SES's credit rating and its current funding position.
10. We noted that SES's return on its regulatory capital value (RCV) had fallen below the 2004 regulatory settlement assumptions, but that SES's return on RCV was, in our view, reasonable. Furthermore, our review of SES's financial ratios and credit rating agency reports indicated that they were within investment grade guidelines.
11. We noted that Ofwat's 2009 price settlement review will re-set pricing from April 2010 in line with a revised assessment of the cost of capital. As Ofwat is required to have regard to the section 2 duties in setting the price control, we expect this to secure the ability of SES to finance its functions and to achieve a reasonable rate of return in the medium- to long-term.
12. We did not agree with SES that the section 2(2A)(c) duty had the effect of requiring us to restore SES's rate of return to that assumed in the 2004 regulatory settlement. Nor did we agree with SES that (for reasons of regulatory consistency) Ofwat's approach in the two previous SAE determinations required us to restore SES's rate of return. Such a view would be inconsistent with our discretionary power, and our duty to have regard to all the section 2 principles.
13. We considered the section 2(2A)(a) duty (to further the 'consumer objective'). In our view, in general, it is in the interests of consumers to keep prices, in the short term, within the limits of the 2004 regulatory settlement, but it might be in consumers' interests to allow an increase in SES's price limits if that is required in order to avoid higher prices for consumers in the medium to long term.
14. We assessed the effect of the substantial adverse effects on SES's business over the 2005–2010 price control period against the cost of capital used at the time of the 2004 regulatory settlement and on the financial ratios used by Ofwat to consider companies' investment grades. We thought that the impact on SES was of a scale that was unlikely to have implications in the longer term for the cost at which SES can obtain capital.
15. Sections 2(3) and 2(4) of the WIA91 require us to have regard to the principles of promoting economy and efficiency and of best regulatory practice. In our view, the section 2(4) duty is an overarching duty to which we had regard in carrying out our assessment under all other WIA91 duties relevant to SES's SAE claim (ie our assessment under sections 2(2A)(a) and (c)). We judged the principles of best regulatory practice (in particular, those of transparency and accountability) to have been fulfilled by the process and procedure adopted by the CC and the detailed reasoning provided by this report.

16. Our analysis led us to conclude that the consumer objective would not be furthered by a positive adjustment to K and that SES is able to finance the proper carrying out of its functions. Having regard to the section 2(2A)(a) duty, the section 2(2A)(c) duty and the regulator's other duties as identified in the WIA91, we have determined that no adjustment to K should be made.

# Final determination

## 1. The reference

- 1.1 On 5 March 2009, Ofwat referred the disputed determination of an SAE claim by SES to the CC for determination. The reference was made under section 12(3) of the WIA91. We are required to report to Ofwat by 4 September 2009. Our report must provide 'definite conclusions on the questions or other matters comprised in the reference, together with such an account of their reasons for those conclusions as, in the opinion of the CC, is expedient for facilitating a proper understanding of those questions or other matters and of their conclusions'. Our terms of reference are set out in Appendix A.
- 1.2 SES disputed Ofwat's determination of the questions raised in SES's substantial effect applications dated 17 September 2008 and required that Ofwat refer the matter to us in accordance with paragraph 15 of Condition B of its Instrument of Appointment.<sup>1</sup>
- 1.3 In conducting the determination, we have taken evidence both in writing and orally from SES and Ofwat. Written submissions from the parties and from third parties have been placed on our website.<sup>2</sup> We have also taken account of additional correspondence from both SES and Ofwat. Whilst we have examined correspondence related to the disputed determination, including Ofwat's final determination, our role is not to assess the merits of that determination but to determine the questions afresh. Prior to the publication of our provisional report, we received and took into account submissions from Water UK<sup>3</sup> and the Consumer Council for Water (CCWater).<sup>4</sup>
- 1.4 On 17 June 2009 we published a provisional report in order that SES, Ofwat and any other interested persons could comment.<sup>5</sup> We received written submissions from SES, Ofwat, CWater and one private individual.

## 2. Background

### *Regulation of the water sector*

- 2.1 There are currently 21 regional monopoly water companies in England and Wales. Ten provide both water and sewerage services (WASCs) and 11 provide only water services (WOCs). We refer to the WASCs and WOCs together as 'the water companies'. Ofwat is their economic regulator. The 1989 Water Act enabled the privatization of the WASCs and conferred on the Secretary of State the power to appoint companies to be the water or sewerage undertaker for any area of England and Wales. The WASCs were appointed as water and sewerage undertakers. The former privately-owned statutory water companies (WOCs) were also appointed as water undertakers for their geographic areas and became subject to the same regulatory system.
- 2.2 Regulated WASCs and WOCs own their assets, such as reservoirs, treatment works, distribution pipes and sewers. WOCs are generally smaller businesses with historically lower capital expenditure requirements. In general, the water companies operate

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<sup>1</sup>Commonly known as a licence, the terminology adopted elsewhere in this report.

<sup>2</sup>[www.competition-commission.org.uk](http://www.competition-commission.org.uk).

<sup>3</sup>A water industry association, representing UK statutory water supply and wastewater companies.

<sup>4</sup>See paragraph 2.9.

<sup>5</sup>The CC was not obliged to publish provisional findings for this reference.

as monopolies within the geographical area in which they operate. Competition is not as well developed in the water sector in the UK as in other privatized utility sectors. Competition in the water industry is available through two routes: 'inset' appointments, where an existing undertaker or new entrant replaces another undertaker for a specific area; and water supply licensing, which allows new companies to compete to supply water to large customers using at least 50 megalitres a year (Ml/yr). The inset process has led to the creation of five new undertakers that together supply both industrial customers and mixed-use developments. Six companies currently hold water supply licences. No customer has yet switched supplier under this regime, but Ofwat is working with the Government to reform this market. Proposed changes include reducing the 50 Ml/yr threshold.

- 2.3 In the UK, the industry regulators for water, gas, electricity and airports all currently use variants of RPI-X regulation which allow regulated companies to increase prices in line with inflation less a factor which reflects an assessment of the scope for efficiency savings. Ofwat uses a formula of RPI+K where K represents the changes in revenue needed to allow an efficient company to finance the delivery of services and other outputs each year. Different K factors are set for each company which, among other things, reflect Ofwat's assessments of the relative efficiency of the water companies and therefore the ability of each company to achieve efficiency savings.
- 2.4 A system of comparative competition underpins this regulatory system. Ofwat aims to take account of objective differences in the operating environments of the companies before making comparisons between them. These comparisons enable Ofwat to come to an informed assessment of how each company's performance compares with that of the most efficient companies. On this basis Ofwat compares levels of customer service and efficiency assumptions and these are incorporated into price controls specific to each company which require the company to become more efficient. Companies have the incentive, once these price limits have been set, to achieve additional cost savings by operating even more efficiently as they can keep the gains from doing so for five years. These savings are then passed on to customers at subsequent periodic reviews. The benefits achieved are thus both local and national, since a well-performing company will help to set future targets for others.
- 2.5 Charge controls are implemented through a water company's licence.<sup>6</sup> Permissible changes (in real terms) to price limits are referred to as the 'adjustment factor' in the licence and, as above, are also known as K factors. The last completed periodic review took place in 2004 (PR04<sup>7</sup>), and set price limits for the period from 1 April 2005 to 31 March 2010. The next periodic review is currently taking place in 2009 (PR09) and will set the price limits to apply from 1 April 2010 to 31 March 2015. As part of the PR09 process, Ofwat released a document entitled *Future water and sewerage charges 2010–2015: Draft determinations* on 23 July 2009; final determinations will be published on 26 November 2009.
- 2.6 There are a number of mechanisms in the water regulation regime which are intended to protect companies and customers from material changes in costs and revenues. In the 2004 regulatory settlement these were set out as follows:

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<sup>6</sup>Clause 3.2 of Condition B of SES's licence defines the 'Charges Limit' as the percentage calculated as RPI + K (where RPI is the percentage change in the Retail Prices Index and K is the Adjustment Factor).

<sup>7</sup>The PR04 process concluded in 2004 and set water companies' price limits for the current price control period (ie 1 April 2005 to 31 March 2010).

- (a) *Interim determinations.* These allow the water companies, or Ofwat, to seek revised price limits if specified changes occur in the period since price limits were last set.
- (b) *Logging up and down.* A process by which, at a periodic review, Ofwat deals with the changes in outputs required of companies since the last periodic review. This process deals primarily with smaller changes and provides a mechanism for Ofwat to 'log up' any 'reasonable net additional' costs and take these into account at the next periodic review. Similarly reductions in outputs (eg changes to quality enhancement programmes) required are 'logged down'. The logging up and down mechanism is not specifically included in companies' licences.
- (c) *Substantial effect determinations.* These allow the water companies, or Ofwat, to seek revised price limits if a circumstance beyond a prudent company's control changes, providing that the total adverse or favourable impact on the company satisfies a prudence condition (which differs depending on whether the circumstance is favourable or adverse) and also passes a materiality threshold. If so, Ofwat has to consider what change should be made to the price limits.
- (d) *Five-yearly periodic review process.* This process resets price limits every five years to reflect any variation from efficient costs and revenues as forecast at the previous review.

### ***The legal and regulatory framework***

- 2.7 The regulation of water supply in England and Wales is controlled by the WIA91 which consolidated, with amendments, earlier legislation. The WIA91 has been amended, in particular by the Water Industry Act 1999 (which provided new entitlements for water customers) and by the Water Act 2003 (whose aims included the sustainable use of water resources and strengthening the voice of consumers).
- 2.8 The functions of the Secretary of State under this legislation in relation to any water undertaker or sewerage undertaker whose area is wholly or mainly in Wales have largely been transferred to the Welsh Ministers.<sup>8</sup>
- 2.9 As from 1 April 2006, the Director General of Water Services has been replaced as regulator by a body corporate, called the Water Services Regulation Authority.<sup>9</sup> However, the regulator has continued to be known as Ofwat. In addition, the Water Act 2003 set up a new independent statutory consumer council for water, CCWater, and amended the general duties on Ofwat as regulator.
- 2.10 If a water company disputes an interim price determination made by Ofwat, it is able, under the terms of its licence, to require Ofwat to refer the disputed determination to the CC to determine. Section 12 of the WIA91 requires the CC to determine the reference applying the same statutory principles as Ofwat applied to its determination; so the CC is of the view that its duty is to carry out a re-determination of the claim made by the water company, rather than to carry out a review of the determination made by Ofwat.
- 2.11 Section 12(3C) of the WIA91 requires the CC to make our report and determination to Ofwat. On receiving the report and determination, Ofwat must send a copy to the water company and to the Secretary of State. The Secretary of State then has

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<sup>8</sup>By the Government of Wales Act 2006.

<sup>9</sup>Section 1A WIA91.

14 days in which to direct Ofwat to redact any matter in the report which appears to be against the public interest or the commercial interests of any person; and after this 14-day period has expired, Ofwat must publish another copy of the report to bring it to the attention of interested persons.

### *Principles applicable to the reference*

- 2.12 Section 12(3) of the WIA91 requires the CC to determine this reference in accordance with the same principles, set out in Part 1 of the WIA91 that Ofwat was required to apply. These principles are considered further in paragraphs 2.14 to 2.19 below.
- 2.13 Where the reference to the CC concerns the review of a price control,<sup>10</sup> and the CC is to decide to what extent it is reasonable to take into account in its determination costs incurred or borne by the company in connection with the reference, the CC must also have regard to the extent to which, in its view, its determination is likely to support the company's (rather than Ofwat's) claims in relation to the questions referred to it.

### *Duties of the regulator*

- 2.14 Section 2 of the WIA91 sets out general duties with respect to the water industry which are imposed on the Secretary of State and Ofwat (and, for the purposes of this determination, on the CC) as to when and how they should exercise their powers and duties relating to the regulation of the water industry. The principles which apply when exercising these powers and duties were substituted, as from 1 April 2005, by new provisions introduced by the Water Act 2003.
- 2.15 In particular, new subsection (2A) provides that Ofwat (and so the CC) must exercise and perform its relevant powers and duties in the manner which it considers is best calculated:<sup>11</sup>
- (a) to further the consumer objective;
  - (b) to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out in respect of every area of England and Wales;
  - (c) to secure that companies holding appointments are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and
  - (d) to secure that the activities authorized by the licence of a licensed water supplier and any statutory functions imposed on it in consequence of the licence are properly carried out.
- 2.16 The 'consumer objective' is defined<sup>12</sup> as being 'to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services.'

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<sup>10</sup>As from 1 October 2004, by virtue of section 12(3A) WIA91.

<sup>11</sup>Section 2(2A) WIA91 as substituted by the Water Act 2003.

<sup>12</sup>Section 2(2B) WIA91.

- 2.17 For these purposes, Ofwat (and so the CC) is required to have regard to the interests of:
- (a) individuals who are disabled or chronically sick;
  - (b) individuals of pensionable age;
  - (c) individuals with low incomes;
  - (d) individuals residing in rural areas; and
  - (e) customers of companies holding an appointment under Chapter I of Part 2 of the WIA91, whose premises are not eligible to be supplied by a licensed water supplier;

However, regard may also be had to the interests of other descriptions of consumer.

- 2.18 Section 2(3) requires Ofwat, subject to its primary duties in subsection (2A), to exercise and perform its powers and duties in the manner in which it considers is best calculated to promote economy and efficiency on the part of water companies in carrying out their functions.
- 2.19 Section 2(4) requires Ofwat, in exercising its powers and duties under section 2, to have regard to the principles of best regulatory practice (including the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed).

### *Licence conditions*

- 2.20 There are two mechanisms for interim adjustments to price limits between periodic reviews: standard interim determinations of K (standard IDoKs) and the substantial effect clause (through substantial effect IDoKs).

#### *Standard IDoKs*

- 2.21 Ofwat told us that standard IDoKs could deal with:
- (a) forecasts or inputs which are so uncertain at the time of a periodic review that it is impossible to take them into account with sufficient confidence at the time of that periodic review; and
  - (b) any new legal obligations specific to water companies.<sup>13</sup>
- 2.22 Under a standard IDoK, changes in costs and revenues associated with specific items or circumstances (known as 'Relevant Items') that occur between periodic reviews can, if they satisfy a materiality threshold, entitle the company to request an interim adjustment to price limits.<sup>14</sup> There are two types of Relevant Item:
- (a) Notified Items (NIs) are items which are notified by Ofwat to a water company as not allowed for (either in full or not at all) in price limits; and

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<sup>13</sup>Ofwat's 'Introduction to reference to the Competition Commission', 5 March 2009, paragraph 15.

<sup>14</sup>Clauses 13.1 and 13.2 of Condition B of SES's licence set out the mechanism by which the company can ask Ofwat for a standard IDoK, and sets out in detail how it should assess any claim.

(b) Relevant Changes of Circumstance (RCCs) which are defined in the water companies' licences; these include changes to legal obligations placed on the company and the failure by a company to deliver an output included in price limits.

2.23 The materiality threshold is achieved if the net present value (NPV) of the total impact on a company's base cash flows, of costs and savings reasonably attributable to the Relevant Items identified, is at least 10 per cent of the turnover of the regulated or 'Appointed' business. The methodology for assessing the materiality of a claim, in accordance with the requirements of licence Condition B, is set out in Appendix B. In summary, the Condition B approach is to:

- calculate the NPV of the base cash flows (costs, receipts and savings) of each of the Relevant Items for 'the relevant year';
- multiply the NPV calculated across the remainder of the current five-year periodic review period for capital costs and a 15-year period for operating costs or revenue losses, both starting from 'the relevant year';<sup>15</sup>
- disregard costs or savings which are trivial or which would have been avoided by prudent management action; and
- aggregate the value of each Relevant Item to determine a 'materiality amount' which is then compared with the materiality threshold of 10 per cent to determine whether the materiality threshold has been passed.

2.24 In practice, in following the approach set out above, Ofwat has normally regarded:

- costs or savings to be trivial if they have a NPV of less than 1 per cent of service turnover; and
- the 15-year NPV period to comprise the five years of the current pricing period with the cost/savings for the fifth year projected forward for ten years.

2.25 If the materiality threshold is met or exceeded under a standard IDoK, Ofwat is required to make adjustments to K calculated in accordance with the method set out in the licence.<sup>16</sup>

#### *The substantial effect clause*

2.26 The substantial effect clause provides for both substantial adverse effects and for substantial favourable effects.

- *Substantial adverse effects*

2.27 A company may apply to Ofwat, under a substantial effect IDoK, for an interim adjustment to its price limits, if a circumstance has occurred which has, or will have, a substantial adverse effect on the company or on its assets, liabilities, financial position, or profits or losses, not being one which would have been avoided by prudent management action. What constitutes prudent management action 'shall be

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<sup>15</sup>The approach to the discount rate differs between companies; it is not standard across all licences.

<sup>16</sup>Clause 13.2 of Condition B of SES's licence.

assessed by reference to the circumstances which were known or which ought reasonably to have been known to the Appointee at the relevant time'.<sup>17</sup>

- 2.28 If the materiality threshold has been reached,<sup>18</sup> Ofwat has to consider what change should be made to the price limits. There is no mechanism prescribed as to how to work out the adjustment factor, unlike with the standard IDoK process.
- 2.29 A company may submit an SAE claim at any point within the relevant periodic review period. Ofwat then has three months within which to make a determination.
- *Substantial favourable effects*
- 2.30 A substantial favourable effect claim could be brought by Ofwat to adjust the K factor if there was a material circumstance that was fortuitous and not attributable to prudent management action. At the present time Ofwat had brought no such cases.

### ***SES's claim under the substantial effect clause***

- 2.31 On 17 September 2008, SES referred a claim to Ofwat for determination in relation to two claimed circumstances, each of which, it stated, had a substantial adverse effect on its business. The first claimed circumstance was an increase in power costs and the second a loss of income. SES requested that its price limits be increased by 10.2 per cent in 2009/10, rather than reduced by 1.1 per cent, as determined by Ofwat in 2004.
- 2.32 The increase in power costs circumstance arose from an increase in actual and forecast electricity costs experienced by SES during the five years covered by the current price control period, over and above that anticipated and allowed for when price limits were set in 2004. SES submitted forecasts to the CC which indicated that, in 2008/09 prices, its power costs had increased in 2008/09 to £3.8 million and would increase to £6.0 million in 2009/10 (from £2.6 million each year allowed for in 2004).
- 2.33 The loss of income circumstance was attributed by SES to two events:
- (a) Metered customers had used less water than anticipated. SES said that this was mainly because of weather conditions. Lower rainfall in the winters of 2005/06 and 2006/07 caused drought conditions which resulted in SES imposing a Non-Essential Use ban. The summers of 2007 and 2008 were exceptionally wet which reduced demand for water, in particular for gardening use.
- (b) Unmetered customers had opted to switch to a metered service at a faster rate than had been assumed at the previous price review (PR04).<sup>19</sup>

SES estimated the income shortfall to be £2.4 million in 2008/09 and £1.3 million in 2009/10 (both in 2008/09 prices).

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<sup>17</sup>Clauses 13.1 and 13.3 of Condition B of SES's licence sets out the provisions of the substantial effect clause. The wording of the licence is set out in Appendix B.

<sup>18</sup>Clause 13.3 of Condition B of SES's licence provides that in determining whether the materiality threshold has been reached, the NPV of the net extra costs or revenue shortfall is to be calculated in the same way as for the standard IDoK process, except that the materiality threshold is set at 20 per cent rather than 10 per cent.

<sup>19</sup>SES's SAE application—submission to the CC, 23 March 2009, section 2.3.1. In addition, SES told us that the operation of Ofwat's tariff basket model had contributed to its income shortfall because, the model operates across a number of customer groups, it ensures an overall RPI plus K constraint and therefore changes driven by the substantial adverse effects will result in adjustments being made to measured and unmeasured charges in order to maintain the required differential. Changes in the charges coming out from the tariff basket model will therefore impact on the out-turn revenues for each group of customer. SES's SAE application—submission to the CC, 23 March 2009, paragraph 157.

- 2.34 In considering SES's claim under the substantial effects clause, Ofwat was required to determine two questions (see paragraphs 2.27 and 2.28). The first question was whether any circumstance had occurred which had or would have a substantial adverse effect on SES's business, or on its assets, liabilities, financial position, or profits or losses. In addressing this question, Ofwat was required to exclude effect(s)<sup>20</sup> which would have been avoided by prudent management action and to determine whether the claimed effects at least equalled or exceeded the materiality amount, as defined in the licence. If such a circumstance had occurred, Ofwat had to determine what change it considered should be made to the adjustment factor (K).<sup>21</sup>
- 2.35 Ofwat determined that each of the circumstances constituted an SAE. However, it adjusted the claim to disallow some of the increase in power costs and some of the income shortfall. Ofwat determined that no adjustment to SES's price limits was required because, in its view, SES would still be able to finance its functions until price limits were reset for the period 2010 to 2015.
- 2.36 On 9 February 2009, SES gave notice to Ofwat that it disputed the determination and required Ofwat to refer the disputed determination to the CC.

### **Previous SAE claims**

- 2.37 Two previous interim price determinations have been made by Ofwat in response to SAE claims: Northumbrian Water (NES) and Bournemouth & West Hampshire Water (BWH) (the 2003 claims). Both claims were made in 2003 for adjustments for 2004/05, the last year of the 2000–2005 price control period.
- 2.38 Whilst these claims may have some relevance, and have been cited by SES, we note that these determinations involved the exercise of Ofwat's discretion, having regard to the particular facts of each claim; and that the determinations were made before 1 April 2005, when amendments to section 2 of the WIA91, introduced by the Water Act 2003, came into effect (see paragraphs 2.14 and 2.15). We consider the implications of these previous claims on our determination in paragraphs 4.5, 4.6 and 4.15.
- 2.39 Both claims were made in respect of lower-than-expected revenues. In NES's case, the revenue reduction was driven primarily by a declining level of demand from large users. In BWH's case, revenues were lower than expected for both metered domestic customers and for non-households (mainly caused by local business failures).
- 2.40 The corresponding K factors were changed to enable price increases following both claims, although Ofwat made various adjustments to the parties' claims. Ofwat stated in both cases that the amount needed for the company to finance the proper carrying out of its functions was 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'.<sup>22</sup>

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<sup>20</sup>SES and Ofwat disagreed as to whether the two circumstances could be aggregated. See paragraph 3.7.

<sup>21</sup>Clause 13.3 of Condition B of SES's licence.

<sup>22</sup>BWH ('Calculation of change to the adjustment factor') and NES ('Outcome of your claim') interim determinations, pp11–12, 16–19.

### **3. Our assessment of SES's claim**

- 3.1 We have first to determine the question whether any circumstance has occurred which has or will have a substantial adverse effect on SES's business or on its assets, liabilities, financial position, or profits or losses. The effect(s) must not be one(s) that would have been avoided by prudent management action and must be equal to, or exceed, the materiality amount as calculated in accordance with clause 13.2.

#### ***Circumstance***

- 3.2 SES made its claim, and Ofwat its determination, on the basis of two claimed circumstances: (1) increases in power costs; and (2) loss of income. In its determination letter, Ofwat does not discuss what constitutes a 'circumstance' or whether 'increases in power costs' and 'loss of income' were, in themselves, a 'circumstance'.
- 3.3 The word 'circumstance' is not defined in SES's licence. Clause 13.3(1) of Condition B concerns 'any circumstance other than a Relevant Change of Circumstance'. In clause 13.3, the word is used differently: "prudent management action" shall be assessed by reference to the circumstances which were known or which ought reasonably to have been known to [SES] at the relevant time'.
- 3.4 As the question in clause 13.3(1) requires us to consider whether any circumstance has occurred which has, or will have, a certain effect, it appears that there must be a causal link between the claimed circumstance and the claimed effect. We consider that 'circumstance' for the purposes of the substantial effect clause is likely to have a wide meaning, which would include external factors which are outside the company's control. In other words, and for the purpose of illustration, we consider that drought is a 'circumstance' for these purposes, but a decision to install new pumps, even if not foreseen in the relevant settlement, would probably not constitute a 'circumstance'. The action taken by management to avoid the effects of a 'circumstance' is relevant for deciding whether a circumstance has had a 'substantial adverse effect'.<sup>23</sup>
- 3.5 SES claimed that the 'loss of income' circumstance arose because its customers had used and had continued to use less water than was assumed by Ofwat in the 2004 regulatory settlement, and because the rate at which customers had opted to switch to meters had been faster than was assumed by Ofwat in the 2004 regulatory settlement. SES also claimed that this was because of the weather—a drought in 2006/07 which had led to SES making a Non-Essential Use ban, followed by poor summer weather.
- 3.6 We are of the view that the 'loss of income' is not itself strictly a 'circumstance' but the outcome or effect of more than one circumstance, or external factors.

#### ***Aggregation***

- 3.7 SES said that the effects of its two claimed circumstances could be aggregated for the purposes of determining this question. Ofwat considered that this issue had no practical impact on the claim because Ofwat concluded that the claims in relation to higher power costs and loss of income individually passed the materiality test. We noted, however, that the SES claim in relation to the shortfall in income is itself an

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<sup>23</sup>Clause 13.3 (1)(a) says: 'which has ... a substantial adverse effect ... not being one which would have been avoided by prudent management action.'

aggregation of the effects of more than one circumstance. For this reason, it was necessary for us to consider further whether the licence permitted the aggregation of circumstances in the calculation of the materiality amount.

- 3.8 We noted that the wording of paragraph 13.3(1) of SES's licence is in the singular: whether any circumstance has occurred which has or will have a substantial adverse effect. However, Condition A 1 (Interpretation and Construction) of SES's licence includes a provision that: 'Unless the contrary intention appears: words and expressions used in these Conditions shall be construed as if they were in an Act of Parliament and the Interpretation Act 1978 applied to them.' Section 6(c) of that Act states that: 'In any Act, unless the contrary intention appears words in the singular include the plural and words in the plural include the singular.'
- 3.9 In considering the different views of SES and Ofwat, we noted that, in practice, Ofwat appears to have accepted aggregation of different circumstances which have similar effects (eg 'loss of income'). It may be difficult for a company to identify satisfactorily the particular effects of each circumstance, in contrast to the cumulative effect of connected circumstances (eg different weather occurrences). Also, we noted that, if no aggregation were permitted, it would prevent the regulator from having jurisdiction to consider a claim from a company which had suffered loss arising from, say, three different circumstances, each of which had a materiality amount of 19 per cent. Such an outcome might be contrary to the aims of the provision.
- 3.10 On the other hand, if such aggregation is permitted, it would mean that a regulator would have jurisdiction to consider a reference from a company that had suffered loss from, say, three different circumstances, even though each had a materiality amount of only 10 per cent, and would make it easier for a company to make a claim which satisfied the materiality amount test.
- 3.11 The words of paragraph 13.3(1), if given a literal interpretation, suggest that no aggregation of different circumstances is intended. However, applying a purposive approach to the construction of these provisions, and with reference to the statutory aims, we are of the view that a relatively liberal interpretation of these provisions may be appropriate to achieve these policy aims.

### ***Jurisdiction***

- 3.12 The first question that we have to determine is whether any circumstance has occurred which has or will have a substantial adverse effect on SES's business. For these purposes, by virtue of clause 13.3(ii), an effect must not be regarded as a substantial adverse effect unless the materiality amount mentioned in clause 13.2(7), when calculated in accordance with clause 13.2, is equal to or exceeds 20 per cent of the turnover attributable to SES's business. We consider that the purpose of the materiality amount provision is to establish jurisdiction, by eliminating claims which fall below the specified threshold from being considered further by Ofwat.
- 3.13 In our provisional determination, we stated that the 'materiality amount' was 'simply' a jurisdictional test. This could be taken to mean that, in our view, whether the relevant circumstance had caused adverse effects that satisfied the materiality test by a wide or, conversely, narrow, margin was not a relevant consideration for our assessment of the second stage (what change should be made to K). For the avoidance of doubt we remain of the view that the materiality amount is a jurisdictional test and that there is, therefore, no necessary read-across or presumption, from the fact that this test is satisfied, that a change to K should be made.

- 3.14 The method for calculating the materiality amount, as described in paragraphs 2.23 and 2.24,<sup>24</sup> may not quantify reliably the impact of the relevant effect, especially where the adverse circumstance is temporary or is reflected in later price settlements. One reason for this is because the calculation projects forward for ten years the substantial adverse effect in the final year of the relevant price control period, and this may have little relation to the actual scale of the substantial adverse effect on a business. We note also that, in the case of a standard IDoK claim (for which the materiality amount test is primarily intended) the method of calculating any necessary change to K is specified in Condition 13.2, is independent of that for calculating the materiality amount.
- 3.15 We consider that the degree of materiality of a particular effect may be a relevant factor to our second stage assessment on particular facts. However, as we explain above, the calculation of the materiality amount may not give a good indication of the impact of claimed substantial effects on a company's business. In addition, the evidence of the materiality amount is, in any event, only one factor for us to take into account in our overall assessment, which must be made in accordance with the principles laid down in Part I of the WIA91.

### ***The prudent management action test***

- 3.16 Clause 13.3(1)(a) states that a substantial adverse effect for these purposes is not one which would have been avoided by prudent management action, and clause 13.3(i) states 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 SES at the relevant time. We assess the claim against this test to ensure that it is a relevant circumstance. Additionally, we are required by clause 13.2(3), when calculating the materiality amount, to take no account of costs that would have been avoided by prudent management action.
- 3.17 We review both aspects of the prudent management test collectively with respect to power procurement and power efficiency in paragraphs 3.18 to 3.68. In its original determination of SES's claim, Ofwat made adjustments to SES's claim with regard to shortfall in income and has included comments on these under the 'Prudent management' heading in its response to SES's submission to us. We consider the adjustments regarding the inclusion of non-water income and rechargeable works<sup>25</sup> income and the pricing of the special agreement contract, not to be adjustments concerning prudent management action. We have therefore considered the adjustments made by Ofwat that relate to shortfall in income in our assessment of the claim in paragraphs 3.70 to 3.76.

### ***Energy costs***

- 3.18 Ofwat took the view that, to some extent, SES's claim relating to energy costs could have been avoided by prudent management action in the areas of:
- (a) power procurement; and
  - (b) energy efficiency.

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<sup>24</sup>But with a materiality threshold for SAE claims of 20 per cent.

<sup>25</sup>Rechargeable works are works performed by one water company on behalf of a third party (eg a developer or fire brigade); and so 'recharged' to the third party.

- 3.19 SES did not agree. We consider below Ofwat's challenges in each of these areas and SES's views. We then set out our own assessment of each of these points. We then consider whether the energy costs effect would have been avoided by prudent management action.

*Power procurement*

- *Ofwat's determination*

- 3.20 Ofwat stated that it considered 'whether all of the company's power costs were prudently incurred'.<sup>26</sup> In relation to power procurement, this assessment focused on SES's purchase in 2008 of electricity contracts for 2008/09 and 2009/10 in which it fixed its electricity costs for 12 months.
- 3.21 Ofwat argued that by opting for a 12-month contract for 2008/09 instead of hedging for a longer period, the company sought to pass on the risk of further price increases to customers.<sup>27</sup> Ofwat stated that:

If the company was concerned that a further rise in power costs might place the company under, what it believed to be, unacceptable financial pressure it could have taken a more cautious approach and taken a two year fixed contract. Such an approach would have reduced the risk to both the business and customers.<sup>28</sup>

- 3.22 SES disagreed with Ofwat's assessment that its actions had not been prudent.

- *Ofwat's view*

- 3.23 Ofwat argued to us<sup>29</sup> that its regulatory approach had always been that it would not expect to protect companies from normal business risk and that increasing power prices were normal business risks. In 2004, in response to SES's request that power costs be classified as an NI, Ofwat allowed for a 40 per cent increase in power costs in price limits. Ofwat said:

We judge the risk of these items [ie the risks associated with power costs and other NIs proposed by water companies but not allowed by Ofwat] to be small and to be either covered by the general inflation part of the price limits or to be a part of normal business risk. Companies should use their management skills to minimise these risks. The cost of capital takes account of this and other forms of business risk.<sup>30</sup>

- 3.24 Ofwat told us in its response that 'We consider that it is common business practice that when companies are faced with volatility in an item that is not a key trading factor in their business (such as energy prices), management can remove this volatility ex ante by using hedging instruments'.<sup>31</sup> Ofwat also told us that there had been several examples in the water sector of companies that had hedged power costs during the current price control period and gave the example of [X], which has

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<sup>26</sup>Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination', Confidential Annex, p1, paragraph 1.1.

<sup>27</sup>Ibid, Annex, p3, fourth bullet; Ofwat's introduction to reference to the Competition Commission, 5 March 2009, paragraphs 38 & 39.

<sup>28</sup>Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination', p4.

<sup>29</sup>Ofwat's response to SES's submission to the CC, 9 April 2009, paragraph 29.

<sup>30</sup>SES supplementary report to Ofwat's 'Price Review 2004—Final Determinations', p28.

<sup>31</sup>Ofwat's response to SES's submission to the CC, 9 April 2009, paragraph 146.

similar operational characteristics to SES and employed two-year hedges during the period. It also noted that for the next price control period (PR09) companies were again considering hedging costs for the period.<sup>32</sup>

3.25 Ofwat also noted that:

Once we had made our PR04 final determination each company knew the allowance in price limits for power costs, all had to consider how to manage these costs over the five year period. These companies faced the same energy price challenges as SES over the five year period yet they managed their procurement strategies in such a way as to avoid similar increases in power costs over the period.<sup>33</sup>

3.26 In response to SES's argument<sup>34</sup> that it had followed professional advice from a leading firm, Ofwat stated that it did:

not dispute that SES's procurement strategy was based on the advice of its consultant and that it had a process in place to procure energy. However ... companies must make their own decisions after considering the wider context in which they operate ... it was SES's choice to expose itself whilst other companies made management decisions to remove the risk.<sup>35</sup>

3.27 Ofwat noted<sup>36</sup> that during the PR04 process SES argued that power costs should be made an NI. Ofwat argued that this showed that, whilst SES had argued that energy prices would be volatile, it did not remove its exposure to this volatility. Although power costs were not made an NI in the 2004 regulatory settlement, Ofwat noted that it had allowed for a 40 per cent increase in power costs. In the 2004 settlement, Ofwat stated that in coming to the 40 per cent figure, in addition to evidence from the water companies, it had considered the conclusions of Oxera (which had been commissioned by Water UK) and current market evidence.<sup>37</sup> Ofwat told us that the Oxera report suggested an increase in power costs of between 22 to 47 per cent. We note that Oxera did not look at forward markets beyond one year's duration in its report and that it also said that actual cost changes might vary significantly due to differences in characteristics of individual companies.<sup>38</sup>

3.28 Ofwat estimated that, given SES's decision to take out a 12-month contract, its power costs in 2009/10 were likely to be around 50 to 60 per cent higher than they would have been had the company taken out a 24-month contract. As a result, Ofwat considered what SES's 2009/10 costs would have been had it taken out the 24-month contract in November 2007, which was available to SES at that time. Ofwat estimated that this suggested that SES's 2009/10 costs would have been 36 per cent lower than its claimed costs.<sup>39</sup>

3.29 Ofwat also argued that the decision should have been taken in the wider context of SES's business. Ofwat told us that:

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<sup>32</sup>Ibid, paragraph 149.

<sup>33</sup>Ibid, paragraph 150.

<sup>34</sup>SES put the same point to Ofwat during the course of the disputed determination.

<sup>35</sup>Ibid, paragraph 154.

<sup>36</sup>Ofwat's response to SES's submission to the CC, 9 April 2009, paragraph 147.

<sup>37</sup>Ofwat's *Future water and sewerage charges 2005–10—Final Determinations* ('Price Review 2004—Final Determinations'), p160.

<sup>38</sup>Oxera study of energy prices 2004, p6.

<sup>39</sup>Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination', Confidential Annex, p2, paragraph 1.1.2.

[SES] are a regulated monopoly. They are not a competitive company [or] commodity trader. That is the broader environment within which they operate ... We are saying, in this context, the level of risk that the company, the management, decided to bear did not seem to have been scrutinised in the context of whether that level of risk was appropriate for this business.

3.30 In addition, Ofwat argued that the risk profile of power costs should have led SES to do more to manage this cost actively over the five-year period of the current price control. Ofwat argued that SES should have 'done more' with the knowledge of the risks of which it was aware at the time. Ofwat highlighted that power costs represented a significant proportion of SES's operating expenses (due to its high average pumping head)<sup>40</sup> and that SES was aware of the risk of large price fluctuations as shown by its lobbying of Ofwat to have electricity costs classified as an NI.

3.31 Ofwat further stated that:

We take the view that the absence of any evidence that they addressed risk and had processes in place to understand risk, took advice on risk, even put the question of risk to their consultants—there is no evidence of that either—points, it seems to us, very, very strongly indeed that this was a company that acted imprudently.

- *SES's view*

3.32 With regard to its overall approach to risk, SES told us that the water industry provided an essential service and therefore a low-risk approach was adopted for its operational activities. At the same time it sought to minimize the cost of delivering its service which was consistent with the efficiency objectives of an incentive-based regime.

3.33 SES argued that Ofwat needed to prove that SES acted 'imprudently'; or that its external consultant's advice was defective or expertise was lacking and that SES was aware of the defect or lack of expertise and had acted imprudently in accepting the consultant's advice. SES argued that to establish that SES acted 'imprudently', Ofwat must prove that SES's conduct fell outside the range of what may be described as 'prudent management action'. SES argued that it was the processes adopted by SES that had to be considered, not the outcome from the application of those processes; and that its licence prohibited reference to hindsight and out-turn in the assessment of prudent management action.<sup>41</sup>

3.34 SES argued that its decision in 2007 was taken using all the information available at that time and the advice of an expert (Utilyx). SES argued that Utilyx's advice indicated that signing a one-year power purchase agreement was the most prudent course of action at that point, given expectations over future power prices, and it followed this advice. SES told us: 'We are a small company and therefore we employ the experts ... to give us advice, we assess the advice, we review the advice, we then make our decisions and we then take the action we have decided to do' and

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<sup>40</sup>See Appendix D.

<sup>41</sup>SES's SAE application—submission to the CC, 23 March 2009, paragraphs 61 & 62.

“There was potentially a greater chance of securing cheaper rates [in 12 months time]”. That seemed ... very firm advice to us, and these are the experts’.<sup>42</sup>

- 3.35 In response to being asked whether it had told Utiyx to adopt a low-risk strategy when it had established the terms of its engagement as energy advisers, SES stated that ‘they know we are a water company, they deal with water companies, they know we are low risk ... I am sure it came out that we were low risk, yes, I am sure that was discussed’. SES also told us that:

Utiyx has worked for a lot of water companies, they understand the industry, we had had discussions with them, Mike [SES’s Operations Director] had had discussions with them about the contract, discussions whether to go to tender, they understood our attitude to risk. They understood that we were a low-risk business and we wanted certainties, as far as we could get them. They understood that.

- 3.36 SES contended that Ofwat’s judgement relied on the benefit of hindsight and that ‘Ofwat confuses the unintended outcome of a sound management process with imprudence’.<sup>43</sup> It argued that the fact that the outcome of its decision led to higher costs in 2009/10 compared with what could have been achieved in 2008/09 was not relevant as its actions must be assessed in accordance with the circumstances which were known or which ought reasonably to have been known to SES at the relevant time in accordance with the terms of its licence.<sup>44</sup>
- 3.37 SES argued that ‘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 SES, failed to anticipate the movement in energy prices that subsequently occurred’.<sup>45</sup>
- 3.38 As noted above, in the consultation prior to the 2004 regulatory settlement, SES requested that electricity costs be made an NI. SES stated that the fact that this increase was included underlined how much costs had actually risen in practice and argued that: ‘The very fact of the special allowance for power costs is a strong indicator that power costs should have been an NI’.<sup>46</sup>
- 3.39 SES made the following points about Ofwat’s 40 per cent adjustment in the 2004 settlement:
- (a) First, it noted that the 40 per cent allowance was applied to actual power costs in 2003/04 and that, given Ofwat’s comments in the PR04 settlement, that energy costs would rise by this amount ‘over the next two years’, this meant that Ofwat was forecasting power costs for 2005/06 only. SES noted that its 2005/06 actual power costs ‘were around 44 per cent higher than in 2003/04’.
- (b) Second, SES also stated that in practice, although Ofwat’s headline allowance was 40 per cent, it actually received ‘only 29 per cent’ and that ‘Ofwat assumed that the other 11 per cent would come through as additional income via a higher than otherwise RPI.’ SES argued that any additional income was theoretical as ‘the net benefit of a higher RPI would be reduced by its impact on other costs and that any remaining benefit would be received with a significant lag.’

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<sup>42</sup>See also paragraph 3.48.

<sup>43</sup>SES’s SAE application—submission to the CC, 23 March 2009, paragraph 49.

<sup>44</sup>SES licence Condition B, clause 13.3.(2)(i).

<sup>45</sup>SES’s SAE application—submission to the CC, 23 March 2009, paragraph 219.

<sup>46</sup>SES’s SAE application—submission to the CC, 23 March 2009, paragraph 75.

3.40 Finally, in respect of the 40 per cent allowance in the 2004 settlement, SES stated that:

the 40% was neither an adequate allowance for increases in energy costs in 2005/06 nor for the volatility in energy costs thereafter. There is no indication that the 40% was intended to include a premium to cover the costs of hedging for five years and, in any event, the market data strongly suggests that it would not have been possible to secure hedging at that time for that period.

The latter comment was made following discussion by SES with [redacted] and, SES argued, was supported by the fact that no other water company fixed its energy prices for five years in 2003/04.

3.41 SES noted that Atkins, which was commissioned by Ofwat to perform an independent assessment of SES's approach to energy management and procurement, stated that: 'The purchase of a single year agreement in 2007 for the period 2008/9 seems very reasonable'<sup>47</sup> and that Jacobs, SES's reporter, concluded that 'Without hindsight it is difficult to conclude that the Company should have adopted a different approach'.<sup>48</sup> SES therefore concluded that 'What the evidence shows is that a decision to hedge for one year clearly falls within the range of prudent responses to volatile electricity prices'.<sup>49</sup>

3.42 SES told us that for the four years to March 2009 its approach had resulted in electricity being purchased at an average of 14 per cent less than both the average spot and one-month hedge prices. Similar procedures for the preceding five years (the five years to March 2005) had resulted in electricity being purchased at an average of 13 per cent less than the average spot price and 12 per cent less than the average one-month hedge price. SES also noted that it did not consider these figures to be relevant to any assessment of its power purchasing processes in relation to whether it had acted prudently.

3.43 SES told us that, even if it had signed a two-year contract, it would still have exceeded the threshold for a substantial effect IDoK.<sup>50</sup> It said that:

Based on the evidence available at the time the cost forecast for the two year contract would already have placed SES 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.<sup>51</sup>

In subsequent correspondence, SES provided calculations to show that electricity prices based on the then two-year contract would have resulted in a materiality measure of 32 per cent without Ofwat's RPI adjustment,<sup>52</sup> or 26 per cent after making that adjustment.

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<sup>47</sup>Atkins *Energy Cost Review of Sutton & East Surrey Water—A report for Ofwat*, p14 (the Atkins report).

<sup>48</sup>Reporter Report, September 2008, p6: Reporters are independent professionals who are appointed by each water company but have a duty of care to Ofwat. Ofwat approves the reporter appointments and the reporters act as professional commentators and certifiers on the regulated activities of the companies.

<sup>49</sup>Reply to Ofwat's response dated 9 April 2009, paragraph 32.

<sup>50</sup>SES calculated that if it had contracted for 24 months at the rates tendered in 2007 the increase in total power costs would have still been greater than the 20 per cent materiality threshold.

<sup>51</sup>SES's SAE application—submission to the CC, 23 March 2009, paragraph 226.

<sup>52</sup>Ofwat in the 2004 regulatory settlement included an adjustment of 40 per cent in its Final Determination for power costs. This adjustment comprised a 40 per cent increase in the allowance for power costs within operating costs and a 0.5 per cent adjustment to RPI. Ofwat in its assessment of SES's power cost claim adjusted SES's base cost (as set in 2004) by £0.193

- *Our assessment*

- 3.44 We consider that this test involves deciding two questions: first, has there been a failure of prudent management action?; and second, would avoidance of that failure have avoided the relevant adverse effect? It appears that these questions are largely ones of fact—was there a failure and is there a material causal connection between the failure and the adverse effect.
- 3.45 With regard to the first of these points we considered whether SES fell below the standard of a reasonably competent board of management in some respect. This question must be answered without the benefit of hindsight—by reference to the circumstances known to SES at the relevant time—so the issue is whether the management action was prudent, not whether it succeeded in avoiding the adverse effect. In other words, there may be a range of prudent actions, not all of which would be successful in avoiding the adverse effect, but so long as SES has taken action which comes within this range, there has been no failure of prudent management action.
- 3.46 We examined various documents relating to SES’s power procurement decision and its decision to appoint Utilyx, including proposal documents, board minutes, the Utilyx Master Agreement together with its related Customer Service Agreement covering the services provided, and contemporaneous email discussions regarding pricing and timing of tendering. We noted that the emphasis of much of the documentation related to the electricity price and that little emphasis had been placed on risk.
- 3.47 SES appointed Utilyx<sup>53</sup> in October 2007 to assist management in the purchasing of electricity. For the years 2008/9 and 2009/10, Utilyx advised SES on its procurement strategy and ran on SES’s behalf a web-based auction to supply SES with electricity. In November 2007 SES signed two contracts (Half-hourly with [⌘] and Non half-hourly with [⌘]) to supply it with electricity for the 12-month period starting April 2008, and in August 2008 SES signed a further two contracts for the 12-month period starting April 2009.
- 3.48 For the 2008/09 contract agreement, Utilyx advised SES in November 2007 in relation to the 24-month contract offers that ‘there was potentially a greater chance for securing a cheaper rate for the second 12 month period in 2008/early 2009’.
- 3.49 With regard to SES’s actions, the board minutes supplied to us by SES indicate that SES followed the procedures agreed by its board for the tendering and agreement of contracts, and SES followed Utilyx’s advice that to contract for one year only might result in the lowest expected cost. The minutes relating to this discussion do not expressly record any consideration of risk; however, SES told us that Utilyx’s advice was provided under the terms of a proposal circulated to the Board to provide advice on the implementation of an effective risk management policy and procedures for managing SES’s ongoing energy price risk.
- 3.50 We approached Utilyx directly to attempt to establish its terms of reference and whether it had been told to take the risk profile of SES into consideration. The only specific references to risk in the advice provided by Utilyx to SES were included in correspondence that relates to the period after the 2008/09 contract agreement upon which Ofwat’s adjustment for prudence was based. Despite its timing, we consider

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million a year to take account of the RPI adjustment and ensure a like-for-like comparison. SES has contested the validity of making this adjustment, on the basis that it was not possible to separate out the power element of the RPI adjustment from changes in other operating costs, and has therefore added it back in its calculations of the adjustment required to power costs.

<sup>53</sup>Prior to this, Atkins was SES’s adviser.

that this correspondence sheds some light, albeit limited, on the understanding between SES and Utilyx. In relation to the potential move to a flexible contract basis, an email from Utilyx to SES stated:

We do recommend ... [SES] to put in place a minimum 36 month or even 60 month contract to ensure that when budgets are set by OFWAT for the next determination period you are in a position to continually monitor your price exposure and put in place the appropriate risk management strategy to support the individual objectives and requirements of your business.

- 3.51 In addition, we note that Utilyx's April 2008 note on SES's annual contracting strategy contains the following: 'If as a business you cannot deal with any further increase in cost then this is the equivalent of hitting a stop-loss and you should lock out now protecting your business against further increase in energy prices regardless of market outlook ...'.
- 3.52 SES placed much emphasis on the fact that it was following expert advice. We considered this to be a relevant and important factor, provided that the advice took account of the circumstances of the company (particularly with regard to risk) and that management did not act on advice uncritically.
- 3.53 We note that the Atkins report concluded that a one-year deal was an appropriate and reasonable strategy and that the purchase of single-year contracts was consistent with the wider supply market behaviour.
- 3.54 SES argued that the market as a whole failed to anticipate the upwards movement in energy prices from 2008, drawing attention to the fact that two-year fixed contracts were priced at a slight discount to one-year fixed contracts (1 to 2 per cent) at the time of its November 2008 auction. In our view, it is clear that energy prices are far from completely predictable and that the possibility of relatively large price movements is always present, even if such events are infrequent.
- 3.55 SES also argued that on balance, over the years, the forward contracts recommended by the consultants had been very close to the average day-ahead and month-ahead prices for the first four years of the current price control period. SES therefore suggested that this comparison indicated that SES had paid less than the average market price for electricity overall in the first four years of the current period and therefore it was important not to take electricity costs for one year in isolation when considering the issue of prudent management.
- 3.56 We consider that the risk that SES took, by choosing to fix prices from April 2008 for one year, rather than for a longer period, was one where the upside potential was likely to benefit SES and its shareholders, but the downside risk might be borne by SES's customers.<sup>54</sup> We also note the lack of evidence from the board minutes supplied to us by SES to support SES's claim that in taking this decision management considered the risks appropriately.
- 3.57 Whether SES, or another water company in the same position, should in 2008 have fixed its electricity prices for 12 or 24 months was a commercial decision. In making this decision there was a balance to be struck between ensuring certainty with regard to its power costs and minimizing the price that it would expect to pay. We do not consider that water companies should be expected to reduce risk to the minimum,

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<sup>54</sup>The extent to which this risk would be borne by customers depends upon the application of the SAE provision. Under SES's reading of the appropriate application of the SAE provision, this risk could be borne by customers to a considerable extent.

regardless of cost, but we do consider that prudence requires an emphasis on caution rather than speculation. That SES decided in 2008 to sign a 12-month contract does not seem to us to be imprudent in the light of the advice from an expert, based on market rates at the time, that electricity prices were expected to fall. In the event, this did not happen, but the licence conditions require that whether an action was reasonable at the time cannot be judged in the light of information received after the time the decision was taken.

- 3.58 Taking all the evidence presented into account, we conclude, with respect to the materiality threshold, that SES's procurement decision was a calculated commercial decision which, while not imprudent, was towards the riskier end of the spectrum of a range of available actions for a regulated utility.

#### *Energy efficiency*

- *Ofwat's view*

- 3.59 Ofwat also challenged SES's claim on the basis that Atkins suggested that SES could have done more to manage its power usage. Ofwat stated that:

- there was no indication that SES was a leading company in its management of energy use; and
- it was not clear that SES had made, or attempted to make, the step change in its culture or strategy that we might expect to see from a company that was under significant pressure from rising power costs.<sup>55</sup> Ofwat explained that 'we would have expected them to have a look at it [power usage] given that they were dealing with a rise in energy prices'.

- 3.60 Ofwat's conclusion on SES's power cost circumstance was informed by a number of analyses, including an independent assessment of SES's approach to energy management and procurement (the Atkins report); use of its own econometric power model to compare SES's power costs against those of the benchmark company in each year of the current period 2005–10; and a comparison of SES's performance against a specific company within the industry which it identified as having 'broadly similar characteristics' to SES. Ofwat was also provided with a report commissioned by SES (the Black & Veatch report).

- 3.61 Ofwat noted that, although SES had argued that the Atkins report was not critical of the company in relation to pumps and the pumping of water, Atkins had commented on SES's overall strategy, and suggested some shortfalls in SES's approach to pumps and pumping operation.<sup>56</sup>

- *SES's view*

- 3.62 SES rejected Ofwat's suggestion that it was inefficient. It argued that:

- (a) The Atkins report commissioned by Ofwat was not critical of the company in relation to pumps and the pumping of water, which account for 94 per cent of SES's electricity usage.

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<sup>55</sup>Ofwat's response to SES's submission to the CC, 9 April 2009, paragraph 137.

<sup>56</sup>Ofwat's response to SES's submission to the CC, 9 April 2009, paragraph 140.

- (b) The relatively minor negative impressions reported by Atkins were not well founded. SES argued that any negative impressions were the result of Atkins only doing a 'desk' exercise, and would have been avoided if Atkins had spoken to SES.
- (c) The Black & Veatch report concluded that 'energy usage by SES is efficiently managed and we have not identified any opportunities for significant improvement or that electricity usage is being managed "imprudently"'.
- (d) SES's practices were efficient.
- (e) SES had taken particular steps to minimize leakage—a strategy that was most appropriate to reducing its energy costs as the amount of electricity used was directly proportional to the amount of water supplied. SES told us that it estimated that its leakage reduction had reduced energy consumption by about 25 per cent. The Atkins report noted that SES's leakage performance was in the upper quartile of industry performance.
- (f) Ofwat's econometric modelling did not add any weight to Ofwat's argument; instead it merely restated the effects of SES's procurement decision since the econometric model examined monetary expenditure on power and conflated procurement and efficiency issues.

- *Our assessment*

- 3.63 We have considered evidence relevant to the question of whether SES, or another company in a similar position, should, in response to the increase in the price it was going to have to pay for its electricity, have taken steps which SES did not take to improve its efficiency in the use of electricity made.
- 3.64 We would not necessarily expect water companies to be able to respond in the short term to increasing energy prices by improving their energy efficiency, as this will be driven largely by capital expenditure in reducing leakage and the maintenance and replacement of pumps which will be agreed with Ofwat and be reflected in the regulatory settlement.
- 3.65 We also note, in particular, that:
- (a) the broad thrust of Atkins' analysis (in its report to Ofwat) supports SES's position; we take the view that the existence of some opportunities for improvement is not of itself sufficient to demonstrate a lack of prudence; and
  - (b) the requirement to demonstrate a step change in its culture or strategy does not in this case seem justified given the circumstance of short-term energy price movements or in the context of a company that already has a high exposure to energy prices and might be expected already to give substantial management attention to energy efficiency.
- 3.66 We are also of the view that in the particular circumstances of this claim, limited weight should be given to the output from Ofwat's power model in a volatile market as the effect of procurement decisions is likely to distort the comparison of energy costs. We acknowledge that Ofwat's assessment of SES's energy costs compared with the frontier company and the similar company was intended to capture differences in costs due to both procurement decisions and energy efficiency. However, the frequent changes in the identity of the frontier company that Ofwat uses as a benchmark may indicate that SES performance was being compared

against a benchmark that no individual company did or could have achieved. The concerns that we have with Ofwat's use of the results of its power model in the assessment of this claim are discussed in more detail in Appendix D.

- 3.67 We conclude that there is no evidence that SES was imprudent in failing to take steps to improve its energy efficiency in response to the increases in electricity price.

#### *Assessment of the energy cost circumstance*

- 3.68 As discussed in paragraphs 3.58 and 3.67, we consider that SES's approach to energy procurement and energy efficiency was within the range of prudent actions. We conclude that the increased power costs effect would not have been avoided by prudent management action.

### **The materiality test**

- 3.69 In this section we review the parties' assessments of the materiality test and conclude as to the eligibility of SES's claim.

#### *Ofwat's adjustments*

- 3.70 In considering SES's submission, Ofwat considered that a number of adjustments were appropriate. This section discusses the more significant adjustments. Ofwat also identified some relatively minor adjustments, which included Ofwat's assessment of likely forecast performance of SES and differences in adjusting for the actual RPI (compared to that forecast in the 2004 regulatory settlement); we have not found it necessary to conclude on these.

#### *Definition of 'relevant income'*

- 3.71 In assessing SES's income shortfall, Ofwat considered an income figure that included non-water income and rechargeable works. Ofwat argued that it was necessary to consider all income together as it was not possible to separate out the associated costs for various income streams and this could lead to unsatisfactory outcomes. Ofwat also argued that SES's original claim framed its income circumstance in terms of 'loss of income' and not 'loss of retail water income'.<sup>57</sup> This approach was said to be consistent with that it had adopted in assessing the 2003 claims.
- 3.72 SES disputed this definition of income, arguing that the relevant revenue measure was the shortfall to 'water income' by which it meant tariff basket, large user and special agreement income. SES argued that the higher rechargeable works entailed additional costs, and that in any case these revenues were not part of the circumstance it claimed.<sup>58</sup>
- 3.73 As discussed in paragraphs 3.2 to 3.6, the reasonable definition of a 'circumstance' may raise certain difficulties. We consider that in this example Ofwat's concern about cost identification is of limited relevance and that it is reasonable for us to treat the circumstance as relating to 'water income' at least for the assessment of materiality. Our reading of SES's substantial effect claim does not suggest that 'loss of income' was intended to suggest that the circumstance should be assessed over all income,

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<sup>57</sup>Ofwat's response to SES's submission to the CC, 9 April 2009, paragraph 186.

<sup>58</sup>SES's SAE application—submission to the CC, 23 March 2009, paragraph 189.

including rechargeable works. SES attributed the loss of income to the consumption of water being lower than forecast in the 2004 regulatory settlement.

### *Special agreement income*

- 3.74 The adjustments Ofwat made to SES's revenue shortfall included a specific adjustment made by Ofwat regarding the shortfall in income incurred in relation to special agreement customers. Ofwat excluded the shortfall that had arisen due to SES charging [redacted] the contracted price rather than the price assumed in the 2004 regulatory settlement (which assumed a price increase). Ofwat noted that 'The substantial effect claim on revenue relates to the shortfall against the assumptions we made at that time. While the company has chosen to deviate from these assumptions it is appropriate to continue to measure the revenue recovered against the assumption accepted as part of the price limit determination'.<sup>59</sup>
- 3.75 We consider that the claim made by SES did not include a claim that the [redacted] contract was a circumstance or that 'loss' from the pricing of this contract formed part of the claimed 'loss of income' circumstance, as this was specified to arise from customers using less water, and switching to meters more rapidly, than was assumed by Ofwat in its 2004 regulatory settlement.<sup>60</sup>
- 3.76 We consider that no claimed losses arising from the pricing of the [redacted] contract can properly form part of SES's claim or be included in the calculation of the materiality amount.

### **Assessment of SES's claim: materiality**

- 3.77 SES's calculations indicated that the NPV of the impacts of increases in power costs and income shortfall, over a 15-year period, were equal to 65 per cent and 41 per cent of annual Appointed Business turnover in 2007/08 respectively.
- 3.78 On the basis of Ofwat's determination—which included certain adjustments to SES's claim to reflect Ofwat's position on prudent management action and to reflect the issues discussed in paragraph 3.70—the NPV of the additional power costs the company faced was 25<sup>61</sup> per cent of the Appointed Business turnover and that the NPV of the income shortfall was equal to 30<sup>62</sup> per cent of the Appointed Business turnover. Thus, although Ofwat did not agree with SES's figures, it agreed with SES that both of the circumstances in SES's claim met or exceeded the materiality threshold of 20 per cent.

### **Power**

- 3.79 Table 1 sets out SES's claim in relation to power.

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<sup>59</sup>Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination', p5.

<sup>60</sup>SES letter to Ofwat of 17 September 2008, p2 (see Appendix C): 'In essence, this loss of income has arisen because SESW's customers have used and are using less water than was assumed by Ofwat in its Final Determination. This is particularly clear from the lower than assumed average amount of water used by metered domestic customers. In addition the rate at which customers have opted to switch to meters occurred sooner than was assumed in the Final Determination.'

<sup>61</sup>The materiality amount for excess power costs was calculated by Ofwat in the Substantial Effect—Final Determination to be 20.7 per cent. This incorporated an error and has subsequently been corrected to 25.3 per cent.

<sup>62</sup>The materiality amount for income shortfall as calculated by Ofwat was noted in the Substantial Effect—Final Determination to be 24.7 per cent. This has subsequently been corrected to 30.0 per cent.

TABLE 1 SES's SAE claim: power

	<i>£ million (2002/03 prices)</i>				
	2005/06	2006/07	2007/08	2008/09	2009/10
Actual	2.455	3.223	2.902	3.088	4.828
PR04*	2.221	2.180	2.140	2.100	2.062
<b>Excess costs</b>	<b>0.234</b>	<b>1.043</b>	<b>0.762</b>	<b>0.988</b>	<b>2.766</b>
Materiality amount					64.8%

Source: Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination'.

\*Includes efficiency assumption adjustments made by Ofwat which SES accepted.

Note: The materiality amount has been calculated based on SES's IDoK model using the 5<sup>th</sup> year forecast extended for 10 years as is consistent with SES's methodology.

3.80 SES subsequently accepted Ofwat's challenge regarding inclusion of head office costs within the PR04 comparative figures and made updates regarding the estimated excess power costs in the forecast years (2008/09 and 2009/10).<sup>63</sup> The effect of these adjustments is to increase the materiality amount to 66.2 per cent.

3.81 Table 2 sets out Ofwat's assessment of SES's SAE claim in relation to power.

TABLE 2 Ofwat's assessment of the SAE claim in relation to power

	<i>£ million (2002/03 prices)</i>				
	2005/06	2006/07	2007/08	2008/09	2009/10
Actual	2.182	3.088	2.600	2.792	3.380
PR04	2.460	2.418	2.377	2.337	2.297
<b>Excess costs</b>	<b>(0.278)</b>	<b>0.670</b>	<b>0.223</b>	<b>0.455</b>	<b>1.083</b>
Materiality amount					25.3%

Source: Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination' and subsequent correspondence.

Note: Ofwat calculated the materiality amount using its IDoK model, actual/forecasts for the current pricing period and extending the 2009/10 forecast out for ten years.

3.82 Both Ofwat and SES's assessments of the claim in relation to power meet the 20 per cent threshold.

## **Income**

3.83 Table 3 sets out SES's SAE claim in relation to income.

<sup>63</sup>The estimated power costs as submitted to the CC (in 2002/03) prices were £3.2 million (2008/09) and £4.9 million (2009/10) compared with £3.1 million (2008/09) and £4.8 million (2009/10) as was submitted to Ofwat.

TABLE 3 SES's SAE claim in relation to income

	£ million (2002/03 prices)				
	2005/06	2006/07	2007/08	2008/09	2009/10
Actual	40.713	40.889	41.508	41.080	41.440
PR04	41.163	42.209	42.981	42.752	42.514
<b>Revenue shortfall</b>	<b>0.450</b>	<b>1.320</b>	<b>1.473</b>	<b>1.672</b>	<b>1.074</b>

Materiality amount 41.0%

Source: Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination' and for materiality SES income application 170908.

Note: SES's materiality amount was calculated using the IDoK model, using actual results for the current prices period (to 2007/08) and extending the last year of actual results forward for 12 years. This is a different approach to that taken by Ofwat and SES for the power circumstances and different to Ofwat's treatment of income circumstances; where in all cases the last year of forecast results (ie those for 2009/10) are projected forward for a further ten years.

3.84 SES submitted forecasts<sup>64</sup> that had been updated compared with those submitted to Ofwat for its income for 2008/09 and 2009/10. These updates do not have an impact on SES's calculation as they were not used in SES's assessment of the materiality amount. That assessment projected forward the last year of actual results which at the time of the claim was 2007/08.

3.85 Table 4 sets out Ofwat's assessment of SES's SAE claim in relation to income.

TABLE 4 Ofwat's assessment of SAE claim in relation to income

	£ million (2002/03 prices)				
	2005/06	2006/07	2007/08	2008/09	2009/10
Actual	42.261	42.164	42.422	42.068	42.842
PR04	42.478	42.989	43.537	43.736	43.805
<b>Revenue shortfall</b>	<b>0.217</b>	<b>0.825</b>	<b>1.115</b>	<b>1.667</b>	<b>0.964</b>

Materiality amount 30.0%

Source: Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination' and subsequent correspondence.

Note: Ofwat has calculated the materiality amount using its IDoK model, actual/forecasts for the current pricing period and extending the 2009/10 forecast out for ten years.

3.86 Both SES and Ofwat's assessments of the claim in relation to income exceed the 20 per cent materiality threshold.

### **Our assessment of the materiality requirement**

3.87 Given that both parties believe the materiality threshold to have been met, we considered whether a further detailed assessment of materiality amounts was necessary. The most significant difference between the two parties' claims was Ofwat's dismis-

<sup>64</sup>Provided in 'SES's SAE application—submission to the CC, 23 March 2009'. The estimated income shortfall (in 2002/03 prices) as submitted to the CC was £40.7 million (2008/09) and £41.5 million (2009/10) compared with £41.1 million (2008/09) and £41.4 million (2009/10) submitted to Ofwat. Additionally, the shortfall entered into the materiality amount for revenue has been altered slightly by SES in its submission to the CC (from its original submission to Ofwat). The shortfalls in 2006/07 and 2007/08 have increased by £0.02 million and £0.03 million respectively (in out-turn prices). These alterations impact marginally the materiality amount for revenue as calculated by SES. The materiality amount is now calculated as 41.6 per cent of 2007/08 turnover (an increase from 41.0 per cent).

sal of a large part of the excess power costs incurred by SES on the grounds that 'the company could have done more to manage its power costs, in other words, this is an issue that we consider was within management control and it was a choice by management as to the strategy adopted and the risks taken'.<sup>65</sup> Since we do not agree with Ofwat's adjustments for prudent management action (see paragraph 3.68), our assessment of the size of the materiality amount is greater than Ofwat's.<sup>66</sup>

- 3.88 Because of the 15-year nature of the materiality amount calculation, the effect of the forecast adverse performance in the years beyond the current pricing period and hence beyond the current detailed forecast is a key driver of the overall materiality amount.
- 3.89 Although both SES and Ofwat calculated the NPV by using the fifth year figure<sup>67</sup> as the basis for subsequent years, the licence condition does not specify that this is how the calculation should be carried out. In our view, this approach to calculating the NPV may be considered unreliable if the factors affecting the fifth year are unlikely to be sustained. Accordingly we reviewed the sensitivity of the 2010/11 to 2019/20 cash flows to alternative plausible forecasts for the fifth year. The results of these sensitivities are set out in Appendix E. Given the size of any reduction (to the shortfall in income or excess in costs) that would need to be made to SES's figures in order for either claim to not meet the SAE materiality threshold, we do not believe that a recalculation of the materiality amounts is necessary. We accept the view of the parties that the threshold has been met with regard to both circumstances, but note that, for the reasons given in paragraphs 3.12 to 3.15, that the materiality amount may not quantify reliably the impact on SES's business.

### *Offsetting*

- 3.90 Clause 13.2 of Condition B requires claimants to offset any reduced costs associated with lower income. In this case, we agree with Ofwat's view<sup>68</sup> that any adjustment would not be significant enough to alter the outcome of the materiality threshold test. SES stated that any such adjustment 'would be academic ... because savings resulting from reduced volumes [were] treated as an offsetting factor in [SES's] materiality calculation for power costs ...'.<sup>69</sup>

### *Conclusion as to the eligibility of SES's claim*

- 3.91 We consider that the power and income effects would not have been avoided by prudent management action and that SES's claim satisfies the materiality test set out in the licence. We therefore conclude that SES's claim is eligible for consideration as a substantial effect.

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<sup>65</sup>Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination', p3.

<sup>66</sup>The other differences between the parties were in relation to revenue from [X], the treatment of RPI and various assumptions made in estimating income from households. We agree with Ofwat that it is appropriate to exclude from the materiality test the impact of lower revenue attributable to the pricing of the [X] contract.

<sup>67</sup>Except for SES's treatment of income shortfall where it projected the last known actuals (2007/08) forward to the end of the 15-year period, ie for 12 years.

<sup>68</sup>Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination', p5: 'Our view remains that the complex interaction between power costs and revenue means that, for the final determination, we cannot calculate the net impact with a great degree of certainty. Our view also remains that any impact is not likely to be material.'

<sup>69</sup>SES's SAE application—submission to the CC, 23 March 2009, paragraph 179.

#### **4. The appropriate adjustment to K**

- 4.1 The second stage of our determination is to decide what change should be made to the adjustment factor (K). We first consider evidence presented to us as to the purpose of the substantial effect clause. We then go on to discuss the principles relevant to this case. This is followed by a section in which we apply the principles to the determination of K; we then set out our conclusion.

##### ***The purpose of the substantial effect clause***

- 4.2 Both SES and Ofwat provided submissions as to the purpose of the substantial effect clause.
- 4.3 The substantial effect clause is included in the licences of all the water companies. This has not always been the case and both SES and Ofwat drew attention to various aspects of how the clause had developed. In the early years of the clause it was at various times referred to as a 'long-stop provision' and a 'shipwreck clause'. Both Ofwat and SES suggested that we should be wary of attaching particular significance to these descriptions.
- 4.4 Ofwat told us that, at first, the substantial effect clause was 'one way'—that is to say, it allowed companies to make a claim for a substantial adverse effect, but it did not allow Ofwat to make an adjustment if a circumstance had had a substantial favourable effect on a company.<sup>70</sup> From 1994, companies were offered a choice between having a 'two-way' clause, that covered both substantial adverse effects and substantial favourable effects, or having no substantial effect clause at all. Some companies therefore had a licence which included such a clause, and some did not. In 2002, most of the companies that did not have a substantial effect clause agreed to include such a clause in their licence, and the remaining companies modified their licences to include such a clause in 2005. A chronological outline of the history of the clause is given in Table 5.

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<sup>70</sup>Ofwat's response to SES's submission to the CC, 9 April 2009, Annex 2, Detailed history of the SAE clause.

TABLE 5 **Chronological outline of the history of the substantial effect clause**

August 1989	Original appointments of WOCs and WASCs granted by the Secretary of State for the Environment or the Secretary of State for Wales include a one-way substantial adverse effect clause (that is, Ofwat cannot use to recover a substantial favourable effect).
1993/1994	Each company is offered the option of accepting a 'two-way' substantial effect clause (covering both substantial adverse and favourable effects) or having the clause removed completely. Some companies (including what is now SES) chose the former, others the latter.
2000	The standard IDoK materiality calculation was modified to its current form in 2000 (to extend the period for assessing operating costs and revenue losses from 5 to 15 years). This change affected the materiality calculation for substantial effect claims, which had been the same (with different thresholds) since 1994. According to Ofwat, this was not the intention and was not consulted on at the time.
January 2001	Ofwat consults on the possibility of incorporating the substantial effect clause into the licences of the 12 water companies which did not then have it (following a request in relation to Dwr Cymru Cyf (Welsh Water) to have the clause included in its licence).
2002	As a result of the January 2001 consultation and responses, the substantial effect clause was inserted into the licences of those water companies (except for Thames Water Utilities Limited and United Utilities Water plc) who did not then have it.
2004	Ofwat consulted on a number of licence modifications, including a proposal to return the substantial effect materiality calculation to its original form (following the first substantial effect claims in 2003). Some companies opposed the proposal and Ofwat subsequently decided not to pursue this proposal at that stage.
2005	The substantial effect clause was inserted into the licences of Thames Water Utilities Limited and United Utilities Water plc.

Source: CC based on Annex 2 to Ofwat's response.

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### *Previous substantial effect claims*

- 4.5 We were told by Ofwat that, prior to the disputed determination of SES's claim, it had made two determinations of SAE claims, but it had not made a substantial favourable effect determination.
- 4.6 The 2003 claims (see paragraphs 2.37 to 2.40) have been cited by SES in support of its case. In both cases Ofwat made a change to K, increasing the prices that the relevant water companies could charge. However, Ofwat told us that these cases did not set a precedent, and drew our attention to the fact that Annex A of the public versions of each decision states: 'It may be that following detailed analysis and proper consideration of all of the Director's Section 2 duties we might decide that a material application should not result in any change to the Adjustment Factor'.

### *Previous statements about the purpose of the clause*

- 4.7 In its 2004 regulatory settlement, Ofwat stated that the SAE provision provided water companies with some protection from external events that had a substantial adverse effect on companies' costs or revenue:

[I]f there are significant changes to specified outputs or if very significant events occur that are outside the control of an efficient company we have mechanisms to allow for changes to price limits (up and down). These mechanisms are known as interim determinations and substantial effect determinations respectively.<sup>71</sup>

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<sup>71</sup>Ofwat's 'Price Review 2004—Final Determinations', p25, section 1.7.

4.8 In addition, Ofwat stated that:

As a further protection companies' licences allow for substantial effect determinations. These allow companies, or Ofwat, to seek revised price limits if a circumstance beyond a prudent company's control changes so that the adverse or beneficial impact on the company amounts to at least 20% of a company's turnover.<sup>72,73</sup>

### *The parties' views*

4.9 SES told us that the substantial effect clause allocated risk between companies and customers. It said that although the clause had previously been characterized as a provision that would only apply in extreme circumstances, following the change to the materiality amount calculation clause in 2000, this was not an appropriate characterization. In SES's view, the clause was intended to allocate to customers risk associated with any effect that satisfied the materiality and prudent management action tests.

4.10 SES argued that the purpose of the clause was corrective, to restore companies to the position whereby they received a sufficient return to ensure they could finance their functions, and not to provide protection in the case of extreme, 'shipwreck', events as the clause also provided for substantial favourable events for which there was no 'shipwreck' analogy.<sup>74</sup>

4.11 Ofwat told us that:

The key purpose of the substantial effect clause is to constitute the ultimate reassurance to the company, its shareholders and hence the capital markets, that in the extreme situation of a prudently managed company having insufficient resources properly to carry out its functions, an appropriate adjustment can be applied.

In Ofwat's view, passing the materiality test meant only that it had to consider whether an adjustment to K was necessary. There was no presumption that an adjustment should be made.

4.12 Both parties made submissions to us in relation to a consultation Ofwat undertook in 2004 concerning the substantial effect clause (see Table 5). Ofwat told us that its view held during the 2004 consultation was that the materiality threshold was too easy to trigger and 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'. SES drew attention to the same statements as evidence of how Ofwat accepted that risk was allocated by companies' licences.

### *Our view*

4.13 In our view the SAE provisions are not intended to operate solely as a 'shipwreck' clause in the sense that they are intended to assist only those companies that have

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<sup>72</sup>Ofwat's 'Price Review 2004—Final Determinations', pp240&241.

<sup>73</sup>Ibid. on p231 states: '[T]he package of financial indicators we have used to assess the price limits does not represent a "floor". There remains scope for companies to absorb unanticipated downside risk and still remain within the investment grade credit rating range. We have assumed a cost of capital in price limits that is towards the high end of the possible range and well above one based solely on current market levels. This in itself allows for the possibility of unexpected cost shocks.'

<sup>74</sup>SES's SAE application—submission to the CC, 23 March 2009, paragraph 95.

experienced a total financial disaster. We share the views of the parties that the use of descriptive labels such as ‘shipwreck’ is therefore misleading.

- 4.14 We take the view that the SAE provision is not intended to operate as a mechanical risk allocation mechanism in the way that SES suggests. In our view, if this had been the intention then clause 13.3(2) would have prescribed how to calculate what change to make to the adjustment factor (as has been done in clause 13.2(8) and 13.2(9) as regards standard IDoK claims). This has not been done.
- 4.15 As regards the earlier SAE determinations made by Ofwat, we note that these involved the exercise of Ofwat’s discretion, having regard to the particular facts of each claim; and also that the determinations were made before the legislative changes to section 2 of the WIA91, introduced by the Water Act 2003, came into effect. These changes included adding a new duty on Ofwat to make SAE determinations ‘in the manner it considers is best calculated to further the consumer objective’ (section 2(2A)(a) WIA91). For these reasons, we regard these earlier decisions as being of very limited assistance to us in determining the questions raised by SES and the disputed determination. We consider that, as our function is to exercise a discretionary power in determining the disputed determination, the need for consistency cannot constrain our freedom to make our own analysis of the relevant legal provisions and their application to the particular facts of SES’s claim, and that we cannot be bound by the views of Ofwat, expressed in either the disputed determination or in earlier determinations.
- 4.16 We consider that, in answering the clause 13.3(2) question - what change should be made to the Adjustment Factor - we are exercising a discretionary power. In doing so, as a matter of general law, we have a wide discretion to decide what factors are relevant and what weight to give to those factors. However, section 12(3) WIA91 requires us to determine this question in accordance with the principles which apply, by virtue of Part I of the WIA91, in relation to such determinations made by Ofwat. These principles are described in more detail in paragraphs 2.14 to 2.19 above.
- 4.17 In the following paragraphs we consider the submissions made to us by SES and Ofwat on how these principles apply to the determination of SES’s SAE claim. We then analyse in detail how to answer the question in condition B13.3(2) (what change should be made to K?) applying the relevant WIA91 principles namely:
- section 2(2A)(c) WIA91—the duty to secure that SES is able (in particular, by securing reasonable returns on its capital) to finance the proper carrying out of its functions;
  - section 2(2A)(a)—the duty to further the consumer objective;
  - section 2(3)—the duty to promote economy and efficiency on the part of SES; and
  - section 2(4)—the duty to have regard to the principles of best regulatory practice.

*SES’s position—submissions made before provisional determination*

- 4.18 SES acknowledged that there was no automatic mechanism that applied in relation to SAE claims and that Ofwat therefore had discretion in considering SAE claims. However, SES argued that this discretion was limited by section 2(2A)(c) WIA91,

which, SES argued, was Ofwat's principal duty relating to the financing of the water undertakings, and required Ofwat to set K factors that ensured the return on capital in order to finance functions.<sup>75</sup>

- 4.19 SES contrasted the language of section 2(2A)(a) WIA91, which required Ofwat 'to further the consumer objective' with that of section 2(2A)(c), which required Ofwat 'to secure that companies ... are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions'. It argued that the grammatical and ordinary meaning of the term 'to further' was less prescriptive than 'to secure', that this was consistent with the purpose of the statute, with the legislative history of the consumer objective and with legal certainty and that accordingly section 2(2A)(c) was the principal duty under the WIA91. SES also argued that there was, in any event, no conflict between the consumer objective and financing functions as the long-term interest of consumers was met by allowing companies to recover their costs, including returns on investment and by encouraging and rewarding efficiency.
- 4.20 SES stressed its view that the section 2(2A)(c) duty was a continuing duty and accordingly did not only apply up until the end of the current price control, but also beyond it. Although the adjustment to K would only apply within the current price control, SES argued that the adjustment would affect investors' expectations of returns beyond this point, thereby affecting the availability of capital and companies' ability to make the necessary investments for benefits to accrue to consumers over decades with a view to providing good and reliable services for current and future generations. SES argued that, were our decision to depart from the methodology adopted by Ofwat with regard to the 2003 claims, it would not conform to the requirement for regulatory consistency as required by section 2(3) of the WIA91. SES argued that Ofwat, in the disputed determination, had only concerned itself with the remainder of the current price control period. For the reasons given in paragraph 4.15 above, we do not agree with SES's view that the need for regulatory consistency requires us to treat Ofwat's earlier determinations as precedents which are binding on us.
- 4.21 SES told us that it had sufficient financial resources and facilities in place in the period to operate until the next price determination. It told us that these resources were dependent on it meeting its required financial ratios which it expected to do. However, it stated that 'those ratios will be very tight' and that in respect of its bond covenants 'we can only draw down the banking facilities providing we are meeting our bond covenants ... we should just about be able to meet the bond covenants but it will be fairly tight'.
- 4.22 SES argued that the relevant consideration was not whether or not it had sufficient resources in place to finance the proper carrying out of its operations until the next review. It argued that it 'cannot finance its functions within the true meaning of section 2 of the [WIA91] which requires a return to be secured in order to secure that it is able to finance its functions'.
- 4.23 SES argued that the substantial effect clause allocated risk between the company and its customers. It argued that this risk allocation (subject to the prudent management action proviso) was specified by the materiality threshold, such that the risk of a variation within the range determined by the materiality threshold was borne by the company, and the risk of a variation outside the range determined by the materiality threshold was borne by customers.

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<sup>75</sup>SES's SAE application—submission to the CC, 23 March 2009, paragraph 112.

- 4.24 SES argued that the substantial effect clause had a corrective function to correct for material changes either not foreseen at the periodic review or of a scale not foreseen. SES argued that Ofwat's approach to standard IDoKs (characterized by SES as fixing return equal to the cost of capital and verifying financial indicators to see whether it is necessary to increase the return) applied to substantial effect claims. SES argued that, in a case where there was no underperformance, the correct interpretation of the substantial effect clause would adjust for the circumstance in such a way as to ensure a reasonable return on capital, that both historic and future actual returns on regulatory capital value (RCV) should be assessed; and that any adjustment to K should compensate for the effect across the full 2005–2010 price control period. It argued that Ofwat's approach would not do this as Ofwat ignored the effects of the SAE in earlier years.<sup>76</sup>
- 4.25 SES argued that its approach was in line with section 2 WIA91, was consistent with Ofwat's approach to the 2003 claims (noting, in particular, that SES (in its view) was in a worse financial position than at least one of the 2003 claimants, which had been partially successful in its SAE claim for an adjustment) and was consistent with the framework for other types of IDoK (NIs and RCCs). SES, however, also argued that in the previous substantial effect decisions Ofwat had erred in not taking account of returns over the whole price control period in its calculation of K (see paragraph 4.20).
- 4.26 SES considered that in making this calculation it would be appropriate for Ofwat to take account of performance in the rest of the business, where SES had outperformed its price determination, and offset this against the substantial effects and therefore reduce the K adjustment accordingly.<sup>77</sup>
- 4.27 SES argued that the rate of return projected in the 2004 regulatory settlement was the relevant benchmark rate with which to assess its actual return on RCV, since:
- (a) such an approach would be consistent with Ofwat's assessment of the 2003 claims;
  - (b) this rate provided clear signals to investors as to the return that could be expected to be earned over the medium term. If the regulator allowed actual returns to deviate substantially from this the perceived level of risk of the industry would increase;
  - (c) the rate had been the subject of extensive consultation and scrutiny; and
  - (d) a re-evaluation of a benchmark rate of return would be burdensome which was not the intention of the SAE process.<sup>78</sup>
- 4.28 SES also said that if we wished to consider the reasonable rate of return to be a cost of capital other than that determined at the 2004 Final Determination, Ofwat's current analysis of the cost of capital for the water sector was the most relevant. This should include all the submissions on the cost of capital and the small company premium made by, or on behalf of, water companies.

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<sup>76</sup>SES's SAE application—submission to the CC, 23 March 2009, paragraphs 269 & 275.

<sup>77</sup>SES's SAE application—submission to the CC, 23 March 2009, paragraph 7.

<sup>78</sup>SES's SAE application—submission to the CC, 23 March 2009, paragraphs 283–290.

## *SES's response to the provisional determination*

- 4.29 In response to our provisional determination, SES made a number of points. Some of these points are summarized in paragraphs 4.30 to 4.33.<sup>79</sup>
- 4.30 SES said that our use of the risk-free rate as a benchmark was flawed:
- (a) The risk-free rate cannot be an appropriate benchmark for return since any typical water company would be in breach of financial ratios before returns hit this level.
  - (b) Its use as a benchmark implied that materiality would need to be around 240 per cent before a K adjustment would be considered appropriate. (The figure of 240 per cent was derived by calculating the shortfall in turnover that would have reduced SES's return on RCV in the years 2006/07 and 2007/08 to the real risk-free rate of 2.5 per cent and then using this shortfall amount to calculate a materiality threshold.<sup>80</sup>) As a result the test would effectively become an assessment of financial ratios.
  - (c) In addition, SES argued that 'it is clear that investors bear some risk of earning actual returns below the risk-free rate. However, this may relate to risks that fall outside of the substantial effects clause'.
- 4.31 In relation to the effect of our provisional determination on the materiality test, SES argued that the effect of our provisional decision would be to increase the materiality test from 20 per cent of relevant turnover to more than 110 per cent (SES's estimate of the materiality amount of its claim). SES argued that, in provisionally rejecting its application, we had therefore raised the materiality threshold to this figure as the provisional determination implied that a substantial effects claim of this scale would never be allowed.
- 4.32 SES raised the following issues, with regard to the principles that we had adopted:
- (a) In making any assessment of SES's financial position under sections 2(2A)(a) or 2(2A)(c) WIA91, only its performance over the longer term is relevant and any assessment should therefore be limited to its returns on RCV. Performance against the other financial ratios is relevant only to short-term financing issues.
  - (b) The level of risk that a company would be expected to bear in relation to a substantial adverse effect is informed by the previous SAE cases, the materiality test and statements made by Ofwat in the run up to the price determination.<sup>81</sup>
  - (c) The assessment of SES's returns on capital must take account of the company's outperformance and efficiency in other areas. Failure to do so could penalize companies that have suffered an adverse shock but had outperformed in other areas and would therefore damage incentives for efficiency.<sup>82</sup>
  - (d) The assessment of its financial position under section 2(2A)(c) WIA91 must be based on the notional financial structure. This is not a matter of discretion: SES said that we were obliged to have regard to consistency, and section 2(3)(b) WIA91 shows that the principle on non-discrimination is an integral part of the

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<sup>79</sup>A non-confidential version of SES's written response is available on our website.

<sup>80</sup>SES's response to provisional determination, paragraph 73.

<sup>81</sup>SES's response to provisional determination, paragraphs 84–99.

<sup>82</sup>SES's response to provisional determination, paragraph 43.

regulatory regime. To use the actual financial structure could reward inadequately-capitalized companies or companies that had adopted inefficient levels of gearing or used inefficient debt instruments.<sup>83</sup> In addition, SES said that our approach to the assessment of reasonable returns, and the adjustment of K, had the effect of making the substantial effect clause into a shipwreck clause since a K adjustment would be assessed by reference to a company's actual financial ratios-as opposed to notional ratios as used by Ofwat-and would only be triggered by a significant adverse turn in those actual ratios.<sup>84</sup>

- (e) Comparing performance against that of the whole industry might lead to a view that, if other companies' returns had been depressed by higher energy costs, did not take into account adequately the effects of the circumstance on SES. In addition, SES argued that such an approach would have the effect of excluding the protection of the SAE provision from companies that have suffered disproportionately from an industry-wide circumstance.<sup>85</sup>
- (f) In relation to the incentive issues raised by making an adjustment to K for power costs, we had not analysed the costs and benefits of the options considered and had not considered alternative options available in this case. SES also said that we had only 'considered two extreme options either changes in power costs are allowed in K or they are not';<sup>86</sup> and that our approach was derived from a basic error in our economic analysis; namely that we failed to distinguish between costs that fall within a company's control and those that do not.<sup>87</sup>

4.33 More specifically, with regard to our assessment of its financial position under section 2(2A)(c) WIA91, SES said that:

- (a) The assessment must be based on RCV set in 2004 and a return calculated using depreciation<sup>88</sup> as assumed in 2004 and not actuals.<sup>89</sup> SES expressed concern that depreciation in the return should correspond to changes in the capital value. SES's view was that actual depreciation played no part in the price-setting process, calculation of RCV or subsequent capital expenditure adjustments to RCV.
- (b) Post-tax returns should be compared with the vanilla weighted average cost of capital (WACC);<sup>90</sup> in conjunction with this the vanilla small company premium should be used.
- (c) The specific small company ratios should be included when assessing its financial position; the NERA *Evidence for a Small Company Premium* report<sup>91</sup> was cited as evidence.
- (d) The appropriate cost of capital to use as the benchmark for an SAE application was that from the previous price control, as this is what Ofwat did in the Northumbrian Water and Bournemouth and West Hampshire SAE applications

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<sup>83</sup>SES's response to provisional determination, paragraphs 53–56.

<sup>84</sup>SES's response to provisional determination, paragraph 140.

<sup>85</sup>SES's response to provisional determination, paragraph 42.

<sup>86</sup>SES's response to provisional determination, paragraph 119.

<sup>87</sup>SES's response to provisional determination, paragraphs 105 to 110.

<sup>88</sup>We have used the term depreciation to represent infrastructure renewals charge (IRC) and current cost depreciation (CCD).

<sup>89</sup>SES had made this point previously and we recognized this in paragraph 4.66 of the provisional determination. Our assessment in the provisional determination included actual depreciation in the return and assumed depreciation (as assumed in the 2004 regulatory settlement) in the RCV.

<sup>90</sup>The vanilla WACC is a particular approach to calculating an estimate of the cost of capital. This is discussed in Appendix F, paragraph 10.

<sup>91</sup>NERA. March 09. *The Evidence for a Small Company Premium in the Cost of Capital at PR09. A report for the water only companies.*

and this approach also provides greater certainty to the company and investors. SES stated that this approach 'avoids the need to undertake a potentially complex assessment of the cost of capital'.<sup>92</sup>

(e) The earlier determinations had determined a reasonable return to be a return at least equal to the cost of capital (as determined at the previous price review).<sup>93</sup>

4.34 SES also argued that the CC's assessment of financial ratios had not taken into account steps taken to ensure that SES's financial ratio covenants had not been breached. SES stated<sup>94</sup> that:

(a) the ordinary dividend to shareholders in 2008/09 had been reduced by 40 per cent;

(b) accumulated profits in the non-appointed business had not been distributed to shareholders in order to preserve cash; and

(c) SES had withheld amounts due to its holding company for tax losses it had surrendered.

### *Ofwat's position*

4.35 Ofwat told us that the water industry's regulatory framework was based on medium-term incentive-based regulation, and that it incentivized companies to outperform regulatory forecasts because shareholders retained any outperformance for an appropriate period. The risk of underperformance was left largely with companies' shareholders. It told us that there were mechanisms in the regime to deal with uncertainty between reviews of price limits and that therefore the allocation of risk between consumers and shareholders was central to the regime. It argued that aspects of SES's claim would, if accepted, distort significantly the allocation of risk and would disadvantage consumers.<sup>95</sup>

4.36 Ofwat argued that the cost of capital set at a five-year price review needed to be 'sustainable over the period and investors must have adequate comfort in the transparency of the regulatory regime to invest in the sector over the long term'.<sup>96</sup> Ofwat argued that investors took a longer-term approach when assessing investment performance and as such they accepted that the actual return on capital might fluctuate from that forecast in any given year. Ofwat also noted that the cost of capital it used in the 2004 regulatory settlement reflected its views on the general business risks companies faced and its views on items such as power costs and revenue losses as a result of competition.

4.37 Ofwat argued that there was no reason to expect different types of IDoK to be treated in the same way as one another (except as specified by the licence) and noted the differences between the types of situation these provisions were designed to deal with. Ofwat noted that for some companies, including SES, the key financial indicator in a standard IDoK was a simple interest cover. It also noted that standard IDoKs made no reference to 'reasonable returns on capital' and that competition and power

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<sup>92</sup>SES's response to provisional determination, paragraph 30.

<sup>93</sup>SES's response to provisional determination, paragraph 90.

<sup>94</sup>SES's response to provisional determination, paragraph 59.

<sup>95</sup>Ofwat's 'Introduction to reference to the Competition Commission', 5 March 2009, p4, paragraph 8.

<sup>96</sup>Ofwat's response to SES's submission to the CC, 9 April 2009, paragraph 194.

costs were explicitly excluded as NIs in 2004 because the cost of capital took account of this and other forms of business risk.<sup>97</sup>

- 4.38 In the disputed determination Ofwat, having made certain adjustments (described in paragraphs 3.70 to 3.76) to SES's claim, assessed the result of the substantial effects on SES's rate of return and a package of financial indicators in 2008/09 and 2009/10. Ofwat concluded that SES was able to finance the proper carrying out of its functions. In forming this view, it took account of the exceptional nature of the substantial effect clause and the short time period to the next review. It also took account of the fact that price limits would be reset in 2010 and considered that in the short time period until then SES would be in a position to raise additional funding if required. Ofwat noted that the 'published financial information strongly suggests that [SES did] not currently need to access capital given [its] high level of cash balances and committed liquidity facilities'.<sup>98</sup>
- 4.39 In response to SES's argument that Ofwat's approach ignored the effects of the substantial adverse effects in earlier years (see paragraph 4.24), Ofwat argued that its approach to assessing the SAE claim accounted for the historic cost of any adverse effect. The financial modelling was based on actual costs and therefore the cash flows of historic under- and overperformance had been incorporated into its assessment of SES's ability to finance the proper carrying out of its functions for the remainder of the price control period.<sup>99</sup>
- 4.40 Ofwat argued that section 2(2A)(c) WIA91 referred to 'reasonable returns on capital' but that the licence did not prescribe or define reasonable. It argued that what was reasonable depended on all the circumstances of the case, including the resources available to SES, its financial standing, its capital expenditure commitments, likely operating costs, the imminence of the next price review and other factors. It also argued that allowing SES greater resources than those which were needed to finance its functions would not be consistent with Ofwat's duty to further the consumer objective. Ofwat did not agree with SES that section 2(2A)(a) WIA91 should be accorded less weight than section 2(2A)(c). Ofwat considered that the duties were compatible with each other, as securing that the functions of water companies were properly carried out, and securing that they could effectively do that by financing the proper carrying out of their functions, were both in the long-term interests of consumers.
- 4.41 Ofwat stated that its methodology for assessing a company's ability to access financial markets was set out in its methodology papers for both the PR04 and PR09 processes. It was based on a consideration of the return on capital<sup>100</sup> and a set of financial indicators. In assessing SES's financial position, Ofwat argued that, whilst it may have given less weight to the return on capital and more to the other financial indicators, its judgement was based on both the rates of return and financial indicators assessed as a package.
- 4.42 Ofwat assessed the claim by reviewing overall business performance (on a notional<sup>101</sup> capital structure basis) for the first three years of the current price control period, adjusted for its assessment of the substantial effects. Using this opening position, Ofwat assessed the effect of the circumstances (adjusted appropriately) in

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<sup>97</sup>SES supplementary report to Ofwat's 'Price Review 2004—Final Determinations', p28.

<sup>98</sup>Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination', p7.

<sup>99</sup>Ofwat's response to SES's submission to the CC, 9 April 2009, paragraph 197.

<sup>100</sup>In this report, we assess 'return on capital' by assessing the rate of return on RCV. Ofwat and SES use the term 'ROCE' to refer to this measure.

<sup>101</sup>Ofwat adjusted the business performance to reflect its 2004 assessment of 'notional capital structure', ie an assumption regarding the appropriate level of debt and equity in a water company.

the final two (forecast) years assuming that all other aspects of the business develop in line with the 2004 assumptions. It told us that in its determination of SES's claim it had excluded all costs and savings not related to the claim itself. It believed it to be more appropriate to deal with these other factors at the PR09 periodic review where they would receive the appropriate level of scrutiny. It argued that to do otherwise would be to expand the scope of the determination towards a detailed, line by line, challenge of each additional cost or saving in a manner very similar to the periodic review process. Such an approach would not be compatible with the short, three-month, time frame in which the licence stated a substantial effect claim should be completed.

- 4.43 Ofwat told us that it assessed financial performance against a range of indicators. It considered there to be no ranking of these indicators (with the exception of setting a notional gearing) because there was no consensus in the use or definition of financial ratios between the rating agencies and within capital markets generally.<sup>102</sup> However, Ofwat stated that one of the indicators, adjusted cash interest cover II, was less important for an SAE claim because the ratio was disproportionately affected by the timing and size of actual as opposed to forecast capital expenditure (ie that assumed in 2004). It told us that as a result, it did not give this ratio much weight in its decision.
- 4.44 Ofwat stated that it did not see the guideline PR04 ratios as 'a floor beneath which [it] considered companies as unfinanceable'.<sup>103</sup> Ofwat concluded that 'On the basis of the same financial ratio package that was used for PR04 ... as a package, the financial ratios for SES are consistent with investment grade status. We considered the level of the ratios in the package was adequate'.<sup>104</sup> Ofwat also stated that 'it does not focus on the level of any particular indicator in any particular year'.<sup>105</sup>
- 4.45 If a company's financial profile were adequate and future pricing reviews adjusted for actual costs, then Ofwat considered that these fluctuations would not unduly influence investors' assessment of performance. In light of this, Ofwat considered that SES's rate of return was reasonable and that it did not need to be equivalent to any previously determined cost of capital.<sup>106</sup>
- 4.46 Ofwat told us that subsequent to its determination of SES's SAE claim the credit rating agency Moody's did not consider that this had adversely affected the credit quality of SES and hence its ability to access financial markets. Moody's stated that 'Ofwat's decision to reject the company's application for an interim price determination does not affect SES's underlying bond rating of Baa1, which reflects the combination of SES's business and financial risk profile'.<sup>107</sup>
- 4.47 Ofwat noted that the calculations of return on RCV that we had used in the provisional determination were consistent with data reported in Ofwat's *Financial performance and expenditure (FPE)* report. Ofwat told us that it considers the returns to reflect the position that a company reports in its regulatory accounts; and that this position captures all aspects of its actual financial performance and is presented not just to Ofwat but to its investors and the wider financial community'.
- 4.48 Ofwat made a further submission with regard to the calculation of return on RCV. This reiterated Ofwat's position that the return on RCV as calculated in the FPE report was most appropriate. With regard to the CC's suggestion (see Appendix F) to

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<sup>102</sup>Ofwat's response to SES's submission to the CC, 9 April 2009, paragraph 215.

<sup>103</sup>Ofwat's 'Introduction to reference to the Competition Commission', 5 March 2009, paragraph 57.

<sup>104</sup>Ofwat's response to SES's submission to the CC, 9 April 2009, paragraph 218.

<sup>105</sup>Ofwat's 'Introduction to reference to the Competition Commission', 5 March 2009, paragraph 56.

<sup>106</sup>Ofwat letter to SES dated 16 December 2008 '13.3 Substantial effect application—final determination', p7.

<sup>107</sup>Moody's Investor Services. Credit opinion. SESW plc 16 March 2009.

adjust RCV to reflect actual capital expenditure and depreciation Ofwat ‘strongly believe[d] that the RCV should not be adjusted’. Ofwat considered the current cost profit before tax and interest to be the appropriate return, as this reflected the company’s view of the appropriate depreciation charge, including the timing of expenditure. The actual depreciation informs Ofwat’s view of depreciation for price setting.

- 4.49 Ofwat noted in response to SES’s comments on its holding company’s actions (see paragraph 4.34) that ‘the points which the company makes in relation to dividends in 2008–09 must be considered in light of the total level of dividend payments it has made since 2005’. It also stated that ‘SES has continued to pay its normal level of dividends on the non-appointed business in 2008–09’.<sup>108</sup>

## ***Our assessment and application of what change to make to K***

### *The applicable principles*

- 4.50 As discussed in paragraph 4.16, our view is that in determining what change to make to K we have a discretionary power which must be exercised in accordance with the principles which apply by virtue of Part I of the WIA91.
- 4.51 Section 2 WIA91 has been substantially amended by the Water Act 2003. In its current form, it specifies that Ofwat must exercise its relevant powers and duties in the manner which it considers is best calculated to achieve the principles listed in subsection (2A). There are secondary aims in subsection (3), which are expressed to be ‘subject to subsection (2A)’; and there is a general principle in subsection (4) that in exercising these powers Ofwat must have regard to the principles of best regulatory practice.
- 4.52 Case law shows that the order in which principles are listed does not in itself create a hierarchy and that, faced with such a range, we are able to decide the means by which the legislative aims are to be achieved. However, in doing so we must bear in mind the entirety of our relevant duties and the need to fulfil all these duties so far as is practicable.<sup>109</sup>
- 4.53 SES put it to us that the different wording of section 2(2A)(a) WIA91 ‘to further’ the consumer objective, and of section 2(2A)(c) WIA91 ‘to secure’ that companies are able to finance the proper carrying out of their functions indicated that section 2(2A)(c) WIA91 was the more important aim.<sup>110</sup> We do not agree with this view. The words ‘to further’ and ‘to secure’ have different meanings. The effect of the word ‘secure’ may be that it would not be consistent with the section 2(2A)(c) WIA91 duty for the CC to decide on action which jeopardized SES being able to finance the proper carrying out of its functions. However, we consider that there is no priority involved in this, and that it is not irrational to view the aims of section 2(2A)(a) WIA91 and section 2(2A)(c) WIA91 as being equally important.

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<sup>108</sup>We note that SES has disputed this statement.

<sup>109</sup>*R v Director General of Telecommunications, ex p. Cellcom* [1999] ECC 314 per Lightman J:  
In my view it is plain that the various duties imposed by s.3(2) [of the Telecommunications Act 1984] may pull in different directions and may conflict; there may be a conflict between the duties in s.3(2)(a) and s.3(2)(b); there may be a conflict between the interest of the consumers, purchasers and other users specified in s.3(2)(a) [...]. The Director is not paralysed because such a conflict arises: rather he is given the choice how that conflict is to be resolved and to decide priorities, and so long he bears in mind the entirety of his duties, has a predisposition to fulfil all the duties so far as this is practicable and with those duties in mind makes a decision which promotes one or other of the objectives specified (and is rational) his decision stands and is not open to challenge.

<sup>110</sup>Paragraph 4.19.

- 4.54 In the paragraphs which follow, in order to assist our analyses, we have first considered the application of the section 2(2A)(b) principle; then the application of the section 2(2A)(c) principle; and then the application of the section 2(2A)(a) duty as it applies to this assessment.
- 4.55 We note that Ofwat made various adjustments to SES's substantial effect claim when assessing the appropriate adjustment to K. Whilst we agree that an adjustment could be made to reduce the size of the substantial adverse effects with regard to the pricing of the special agreement customer contract (see paragraphs 3.75 and 3.76), this would not have a material impact on our assessment, and in assessing SES's claim we have used the figures SES submitted to us, without any adjustment.

*Section 2(2A)(b)—to secure that functions of the claimant company are properly carried out*

- 4.56 Section 2(2A)(b) requires us when assessing what change to make to K to consider what is best calculated to secure that the functions of the water company are properly carried out in respect of every area of England and Wales.
- 4.57 We received no evidence to suggest that SES is failing properly to carry out its functions or is at risk of failing to do so. Accordingly we considered that the section 2(2A)(b) duty is satisfied.

*Section 2(2A)(c)—to secure that the claimant company is able to finance the proper carrying out of its functions*

- 4.58 Section 2(2A)(c) requires us to decide an SAE claim in the manner we consider is best calculated to secure that the claimant company is able (in particular, by securing a reasonable rate of return) to finance the proper carrying out of its functions.
- 4.59 We consider that the reference in section 2(2A)(c) WIA91 to 'in particular by securing reasonable rates of return on their capital' forms part of the duty set out in subsection (2A)(c) to secure finance, and does not form a separate obligation to secure reasonable rates of return.
- 4.60 We do not agree with SES that the effect of section 2(2A)(c) WIA91 is that, in the event of an SAE, Ofwat has a duty to change K to restore SES's rate of return to that assumed at the last price review. Ofwat said in the 2004 regulatory settlement that the settlements should allow an efficiently managed and financed business to earn a return at least equal to its cost of capital.<sup>111</sup> However it is our view that this statement must be understood in the context in which it was made, ie prospectively at the time that K, and the price that water companies would be allowed to charge for the next five years, was set. We consider that realized returns could and would be expected to vary upwards or downwards from this and that this is implicit in the methodology adopted by Ofwat to establish the target returns. We consider that there is no basis for interpreting Ofwat's statement as providing a guarantee as to the actual return that each company would deliver, whether or not there was an SAE.
- 4.61 We have assessed the company's ability to finance the proper carrying out of its functions by looking at the appointed business's performance as a whole, rather than considering the substantial effects in isolation. We have taken account of the company's actual capital structure, rather than the notional structure used by Ofwat

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<sup>111</sup>Ofwat's 'Price Review 2004—Final Determinations', p217.

in its analysis, to ensure that the section 2(2A)(c) duty is satisfied with regard to the business as it is today. We therefore include over- and underperformance in the non-SAE affected areas of the business in our analysis. We have used actual figures based on the company's actual capital structure to assess financial ratios. The returns we consider when assessing return on RCV include the actual depreciation charged to the regulatory accounts. We have assessed RCV within the period using actual capital expenditure and depreciation rather than the RCV set at the beginning of the regulatory period by Ofwat; this approach is discussed further in more detail in Appendix F. We have used current assessments of the cost of capital alongside the assumptions used in the 2004 regulatory settlement to ensure that we are considering the cost of capital to the business today. Whilst this may in some cases prove burdensome it would be inconsistent with our approach of assessing the actual financial performance and position of the company to have regard only to the assumptions made at the start of the current price control period.

- 4.62 We note SES's comments (see paragraph 4.32(d)) with regard to consistency and the principle of non-discrimination. However, we do not consider that we could adequately assess the fulfilment of the section 2(2A)(c) duty without looking at the company's actual circumstances.<sup>112</sup> We address SES's argument that use of actual financial structure could result in the inconsistent and discriminatory treatment of SAE claims in paragraphs 4.117 to 4.120.
- 4.63 We considered whether and to what extent it would be appropriate to take into account the actions by the holding company to avoid SES breaching its financial covenants (see paragraph 4.34). Our view remains that we should assess SES's actual financial position to ensure that the section 2(2A)(c) duty is satisfied with regard to the business as it is today. The potential incentive issues raised by SES with regard to not placing weight on these actions in our determination are discussed in paragraphs 4.117 to 4.120 and paragraphs 4.121 to 4.122. Furthermore, holding company actions to increase cash balances in a given year and hence protect the bond covenants are responses which relate to both the performance of the business in the given year and historic performance and associated dividend payments.
- 4.64 SES argued that, in assessing its financial position, only its performance over the longer term was relevant, and that assessment should be limited to considering returns on RCV (see paragraph 4.32(a)) The benchmark for this should be the PR04 assumed returns (see paragraph 4.33(d)).
- 4.65 In our view, however, a wider range of factors than return on RCV should be assessed to reach a balanced judgement on the ongoing section 2(2A)(c) duty. The wording of this duty in WIA91 does not limit the relevant considerations to the return on capital. The approach that we have taken is also consistent with that adopted by Ofwat in setting the price controls. In particular, Ofwat considered that the duty to secure that companies are able to finance the proper carrying out of their functions had two strands: The first strand is that an efficiently managed and financed company was able to earn a return at least equal to the cost of capital. The second is to ensure that revenues, profits and cash flow must allow companies to raise finance on reasonable terms in the market. With regard to this second strand, Ofwat said that it was important that companies maintained their investment grade credit rating. We have assessed the same core financial indicators as assessed by Ofwat in 2004.

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<sup>112</sup>We note that in SES's response to Ofwat's draft determination, prior to its challenge of Ofwat's decision, SES raised a similar argument stating that 'Ofwat's modelling has created a company with a capital structure that does not exist and a cost structure that ignores known costs e.g. power. This hypothetical company is then declared to be financeable'.

- 4.66 In our assessment we considered SES's financial performance and position across the 2005–2010 price control period. In our view, SES's historic performance helps to inform assessment of the current situation and the remainder of the current price control period. SES's claim relates only to the PR04 price control period, but with regard to the longer term, in our view the PR09 settlement will ensure the ability to finance the proper carrying out of its functions going forward. We also note that the five years covered by PR09 are likely to be more significant to investors' views going forward than the remainder of the current price control period.
- 4.67 In considering the ability of SES to finance its functions during the current price control period, we looked at a range of comparative indicators such as cost of capital, financial ratios of interest to credit rating agencies, and the returns of other companies. We assessed SES's financial position and performance in the following areas:
- (a) SES's historic and forecast return on RCV compared with estimates of cost of capital made at the time of the 2004 regulatory settlement and in the context of the current PR09 price-setting process;
  - (b) SES's historic and forecast return on RCV compared with other water companies;
  - (c) SES's historic and forecast return on RCV compared with the risk-free rate;
  - (d) SES's funding position, including SES's own statements about its ability to finance the proper carrying out of its functions and actual debt position;
  - (e) SES's historic and forecast financial performance across the current price control period against a range of financial measures set out at the time of the 2004 regulatory settlement including cash interest cover and other financial ratios;
  - (f) SES's financial ratios compared with credit rating agencies' requirements for achieving investment grade status; and
  - (g) SES's current and historic credit rating.
- 4.68 We consider the section 2(2A)(c) duty by reviewing each of these measures in turn.
- (a) *Return on RCV—compared with estimates of the cost of capital*
- 4.69 We have considered the cost of capital for SES set by Ofwat for the current price control period, and recent estimates of the cost of capital made by the industry<sup>113</sup> and Ofwat as part of the PR09 review process. These estimates are discussed further in Appendix F. In our view the cost of capital set by Ofwat as part of the 2004 regulatory settlement provides a useful comparator to SES's historic returns and the recent estimates are relevant when reviewing SES's current and forecast return on RCV as they provide an estimated range for the current cost of capital. Both the industry and regulator have provided recent estimates for the cost of capital, which are around 0.5 per cent lower than estimates made at the time of the PR04 process.<sup>114</sup>

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<sup>113</sup>Represented by a report from NERA prepared for Water UK, a water industry association, representing UK statutory water supply and wastewater companies.

<sup>114</sup>For the water industry before small company premium (all post-tax): Ofwat's cost of capital (as assumed in 2004) was 5.1 per cent compared with 4.5 per cent draft PR09. NERA's PR04 estimate was 5.5 per cent compared with PR09 range of 4.6 to 5.1 per cent.

4.70 Table 6 sets out the post-tax return on RCV achieved and forecast to be achieved by SES across the current price control period, and compares these returns on RCV to the cost of capital assumed at the 2004 regulatory settlement. We have used pre-interest post-tax return on RCV as this is the return available to debt and equity investors after tax.<sup>115</sup>

TABLE 6 SES's real return on RCV (pre-interest and post-tax): out-turn compared with PR04 cost of capital

	<i>per cent</i>					
	2005/06	2006/07	2007/08	2008/09	2009/10	Forecast (4+1) <sup>116</sup> Average <sup>117</sup>
SES — Outturn* Post-tax	6.7	6.9	5.7	6.1	3.3 <sup>118</sup>	5.7
PR04 assumed cost of capital	6.6	6.6	6.6	6.6	6.6	6.6
Difference	0.1	0.3	(0.9)	(0.5)	(3.3)	(0.9)

Source: CC based on data supplied by SES and Ofwat.

\*2005/06 to 2008/09 actual results, 2009/10 forecast performance.

4.71 SES's returns on RCV in 2005/06 and 2006/07 were above the cost of capital used in setting its price controls in 2004. The return on RCV in the next three years was below the cost of capital assumed in 2004. On average across the 2005–2010 price control period the return on RCV was [£] percentage points lower than the cost of capital assumed in 2004. The recent estimates of cost of capital show a range for comparison to post-tax returns of 5.5 to 7.3 per cent, refer to Appendix F. SES's performance in 2008/09 fell at the lower end of the range of estimates the 2009/10 forecast performance is [£] per cent below the lower end of the range and [£] per cent below the upper end of the range.

4.72 For the purposes of our analysis we have not adjusted the cost of capital benchmarks to reflect SES's actual gearing, which is higher than the notional gearing levels assumed within these assessments of the cost of capital. We would generally expect a company with a higher level of debt in its financial structure to have taken this action to benefit from the tax advantages of debt compared with equity and thus reduce its overall cost of capital. We therefore consider that the cost of capital faced by SES may be lower than the benchmarks. We have not attempted to quantify this benefit for SES, we consider the effect to be small and that it would not affect our assessment. We discuss cost of capital in further detail in Appendix F.

<sup>115</sup>As we are assessing an accounting-based measure of return on capital rather than a cash flow measure, we have calculated the post-tax return based on the tax charged in the period (and not the tax paid). The 2004 assumptions assume tax charged is the same as tax paid. SES submitted figures based on tax paid. These showed an average return of [£] per cent (based on equally weighted annual average return on RCV figures across the current price control period: 4 years actuals, 1 year forecast).

<sup>116</sup>Forecast (4+1): 4 years actual, 1 year forecast.

<sup>117</sup>In this and subsequent tables the average figure is calculated as an equally weighted mean of the preceding figures, ie the five years of the 2004 price control period.

<sup>118</sup>In correspondence after our provisional determination, SES submitted revised forecast tax charged figures for 2009/10 of £[£] million from £[£] million taking the return down from 3.7 to 3.3 per cent post tax.

(b) Return on RCV—comparison to other water companies

- 4.73 Table 7 shows SES's and the water industry's average pre-tax returns on RCV<sup>119</sup> compared with estimates made as part of the 2004 regulatory settlement. For the reasons given in paragraph 4.61 (and discussed further in Appendix F) we consider the best approach to assessing return on RCV to be on an actual<sup>120</sup> basis. However we recognize that water companies do not update RCV on an annual basis for actual capital expenditure and depreciation,<sup>121</sup> but that this is done every five years as part of Ofwat's periodic review.
- 4.74 The data in Table 7 has been prepared on the same basis as Ofwat's FPE report which it prepares and uses to assess general levels of industry performance. It is calculated using a return figure based on actual depreciation but the RCV is calculated on the basis of capital expenditure and depreciation as assumed in the 2004 regulatory settlement.
- 4.75 Table 7 shows that all sectors of the industry have underperformed compared with the 2004 projections and that they are also expected to underperform for the remainder of the current price control period. SES's return on RCV for the first three years of the period was broadly comparable to the industry as a whole, delivering [X] per cent of 2004 projections compared with the industry average of [X] per cent of 2004 projections. In the final two years of the current price control period, SES's performance is below that of the WOCs and the industry as a whole; bringing SES's forecast return across the period to [X] per cent of 2004 projections, compared with an industry average of [X] per cent.

TABLE 7 Return on RCV (real rate of return, pre-tax, pre-interest)

	<i>per cent</i>					
	<i>Actual</i>				<i>Forecast</i>	<i>Forecast</i>
	<i>2005/06</i>	<i>2006/07</i>	<i>2007/08</i>	<i>2008/09</i>	<i>2009/10</i>	<i>(4+1) Average</i>
SES—Outturn	7.1	7.0	6.5	6.1	4.1	6.1
PR04	7.1	7.6	7.8	7.8	7.8	7.6
WASCs—Outturn	[X]	[X]	[X]	[X]	[X]	[X]
PR04	[X]	[X]	[X]	[X]	[X]	[X]
WOCs—Outturn	[X]	[X]	[X]	[X]	[X]	[X]
PR04	[X]	[X]	[X]	[X]	[X]	[X]
Industry—Outturn	[X]	[X]	[X]	[X]	[X]	[X]
PR04	[X]	[X]	[X]	[X]	[X]	[X]

Source: Ofwat.

- 4.76 We accept that, for all companies the datasets used in Table 7 may include amounts reflecting the differences between actual and assumed depreciation. We also note SES's concerns about using industry data as a comparator (see paragraph 4.32(e)) and we agree that we cannot draw strong conclusions from this data without knowing the specific circumstances which affected the water industry. However, we consider that investors and other observers take account of developments in the industry as a

<sup>119</sup>Pre-tax return on RCV has been used in preference to post-tax return on RCV as this removes the effect of different gearing/capital structures when actually comparing returns of different companies.

<sup>120</sup>Where both the return and RCV reflect the actual depreciation charges incurred by the company (see Appendix F for further discussion).

<sup>121</sup>We use the term depreciation to reflect both IRC and CCD.

whole. We consider that the data in Table 7 provides useful information on SES's relative performance against industry averages.<sup>122</sup>

*(c) Comparison with the risk-free rate*

- 4.77 We would expect the returns that a company achieves to vary year on year and think that an efficient company may not achieve expected rates of return over a price control period. In assessing the cost of capital, risk premia are included, which reflect these uncertainties. SES has made a return on RCV above the risk-free rate in all completed years of the current price control period, and is forecast to make a return on RCV above the risk-free rate in 2009/10, see Appendix F for details.
- 4.78 For the avoidance of doubt, we consider that the risk-free rate does not constitute a floor as to what is a reasonable return, nor a threshold for materiality. It is implicit within the risk premia that realized returns can from time to time go below the risk-free rate. We regard the risk-free rate as one indicator which we take into account in making a balanced judgement as to whether SES's returns are reasonable. We agree with SES that the risk premia over the risk-free rate in its cost of capital takes into account many types of risks, but this does not in our view invalidate the use of the risk-free rate as an indicator.

*(d) SES's funding position*

- 4.79 SES holds £133.2 million<sup>123</sup> of long-term debt (ie due for repayment in more than one year) of which the majority<sup>124</sup> is an index-linked bond. SES has estimated its inherent<sup>125</sup> rate of interest on this bond to be 3.8 per cent. This compares with 4.7 per cent real pre-tax cost of debt allowed in the 2004 regulatory settlement and current estimates of the real pre-tax cost of debt of 3.8 to 4.3 per cent.<sup>126</sup> This would suggest that SES's actual cost of capital is lower than the 2004 estimate and at the lower end of the PR09 estimated range. If SES is paying less for its actual debt than is assumed in the cost of capital estimates, then there is more return available to equity investors. We note that there may be incentive implications when assessing returns on RCV based on a company's actual capital structure (including the actual level of embedded debt); these are considered in paragraphs 4.117 to 4.120.
- 4.80 We note that SES told us that it had sufficient financial resources for the remainder of the current price control period. After our provisional determination, SES told us that SES's financial resources were only sufficient because of significant financial support provided by SES's holding company (see paragraph 4.34).

*(e) Other financial indicators*

- 4.81 Table 8 sets out the financial ratios reviewed by Ofwat for all water undertakings in 2004 (see Appendix F for details and definitions of ratios), based on SES's financial

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<sup>122</sup>We also note the return on RCV calculated on an actual basis (as in Table 6) is not significantly different to return on RCV calculated as set out in Table 7, due to the small proportional impact of the difference in actual and assumed depreciation on underlying RCV (see Table 1, Appendix F).

<sup>123</sup>2008/09 accounts for SES.

<sup>124</sup>88 per cent is a 2.9 per cent index-linked bond redeemable 2027 to 2031.

<sup>125</sup>SES has used the term inherent to reflect the interest charge to the business incorporating the interest paid, issue costs and the bond repayment safeguard fund.

<sup>126</sup>As part of the PR09 process, NERA has estimated a range of 3.8 to 4.3 per cent; Ofwat's PR09 draft determination included a figure of 4.0 per cent for SES.

structure.<sup>127</sup> We consider that, in the short term, cash interest cover is the most important interest cover ratio, as it highlights any immediate issues with cash flow: We note Ofwat's view (see paragraph 4.43) that the adjusted cash interest cover II ratio is particularly sensitive to the timing of capital expenditure and should not be given particular weight. Both adjusted cash interest cover ratios take account of the ongoing need for capital expenditure to sustain the business. For this reason it is more relevant to look at these across a number of years; a low average would indicate financial difficulties over a sustained period of time. We would not therefore place weight on a single year's ratio. We consider the average of these ratios across the current price control period to be helpful indicators alongside the indicators for individual years.

TABLE 8 SES financial ratios based on actual and Business plan forecast

	2005/06	2006/07	2007/08	2008/09	2009/10	Forecast (4+1) Average	PR04 guidelines <sup>128</sup>
	<i>Actual</i>	<i>Actual</i>	<i>Actual</i>	<i>Actual</i>	<i>FBP* forecast</i>		
Cash interest cover	5.56	5.71	5.18	5.18	4.23	5.17	Around 3
Adjusted cash interest cover I	2.54	2.49	2.06	2.15	0.93	2.03	Around 1.6
Adjusted cash interest cover II	3.67	1.45	1.27	2.07	0.67	1.83	Around 2
Gearing (debt/RCV) (%)	59	68	71	77	77	70	<65%
Debt payback (%)	23	19	17	16	12	17	>7%

Source: Data provided by SES

\*FBP—Final Business Plan (as submitted to Ofwat for the purposes of the ongoing PR09 process).

Note: SES noted that there were some inconsistencies with data previously submitted to Ofwat as the method for treating preference dividends had changed. The figures above include preference dividends as interest paid in all years for trend comparability.

4.82 In relation to SES's financial ratios we note the following:

- (a) The cash interest cover ratio is above Ofwat's PR04 guidelines throughout the five-year period.
- (b) The adjusted cash interest cover I ratio is consistently above the guidelines across the current price control period until 2009/10 when there is forecast to be a significant drop; however, it is on average above Ofwat's guideline.
- (c) Adjusted cash interest cover II varies both above and below the guidelines across the period and is forecast to be particularly low in 2010, on average, it is just below Ofwat's guideline.
- (d) Whilst gearing has increased and is above Ofwat's guidelines, we note that it is below 80 per cent, which is the 'covenant level under the structured financing that triggers a restriction in dividend payments and additional indebtedness'.<sup>129</sup>
- (e) The debt payback ratios reduce across the five-year period but are above Ofwat's PR04 guidelines throughout.

4.83 In its PR09 draft determination Ofwat has provided separate guideline ratios for WOCs. These are slightly higher than for WASCs but do not alter overall our assessment of SES's position in the current price control period (see also Appendix

<sup>127</sup>This takes account of SES's levels of debt and equity. For much of its analysis Ofwat used a notional capital structure in order to exclude the effects of financing decisions taken by SES. We are assessing the 2(2A)(c) duty which requires us to assess the ability of the company to finance its functions and as such we need to assess the actual company.

<sup>128</sup>Note that Ofwat refer to these as 'Ranges for financial indicators'.

<sup>129</sup>Standard and Poor's: Sutton and East Surrey Water Plc, 5 November 2008.

F). We note that Ofwat has replaced the adjusted cash interest cover II ratio with funds from operations to debt ratio in the core package of financial indicators for PR09.<sup>130</sup>

*f) Comparison of financial ratios with credit ratings agencies' investment grade guidelines*

- 4.84 The ratio guidelines provided by Moody's<sup>131</sup> for regulated business credit ratings (see Appendix F) are not significantly different from Ofwat's PR04 guidelines. The Moody's thresholds for investment grade (Baa2 and above) are slightly less onerous than those set by Ofwat in 2004, which were intended to ensure the water companies were comfortably within investment grade. We note that Moody's does not list the adjusted cash interest cover II ratio as part of its key ratios reviewed in its credit reports. SES's ratios are assessed against the Moody's guidelines in Appendix F. [X]
- 4.85 SES argued that its financial position should be assessment against financial ratios relevant to small companies (see paragraph 4.33(c)). Our review of the NERA report does not suggest that the ratio guidelines used in Table 8 need to be adjusted significantly (see Appendix F). NERA suggests that the rating agencies require the post-maintenance interest cover ratio (PMICR), which is equivalent to adjusted cash interest cover I, to be [X] for smaller companies. This ratio is one which SES passes comfortably in 2005/06 through to 2008/09.<sup>132</sup> We note the significant drop in this ratio in 2009/10 but as outlined in paragraph 4.81, we are not unduly concerned by low performance in one year; in our view, the more important short-term measure for the purpose of assessing financeability is cash interest cover, which remains clearly above Ofwat and credit ratings agencies' guidelines.

*g) SES's current and historical credit ratings*

- 4.86 Investment grade is defined in SES's collateral deed (which relates to its index-linked bonds) as 'a rating of at least BBB- by Standard & Poor's (S&P), Baa3 by Moody's or BBB- by Fitch'. Currently SES is rated BBB+ by S&P,<sup>133</sup> Aa3 by Moody's<sup>134</sup> and BBB+ by Fitch.<sup>135</sup>
- 4.87 Having shared the latest forecasts with the credit ratings agencies, SES has not suffered from any recent changes to its credit rating. This indicates that the credit rating agencies consider the financial position of SES to support an investment grade.
- 4.88 We note that S&P has placed SES's BBB+ rating on 'Watch Negative' following Ofwat's PR09 draft determination; indicating that if the PR09 final determination is similar, SES's credit rating may be downgraded.<sup>136</sup> S&P has two lower ratings (BBB

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<sup>130</sup>Ofwat continues to calculate the adjusted cash interest cover II ratio in its financial model but has removed it from the core package as 'it is not a key ratio for the credit rating agencies and can be materially influenced by the timing of lumpy capex'.

<sup>131</sup>As reported in the NERA report.

<sup>132</sup>[X]

<sup>133</sup>S&P RatingsDirect 5 November 2008.

<sup>134</sup>Moody's Investor Services. Credit opinion. SESW plc 16 March 2009.

<sup>135</sup>FitchRatings. SESW plc Credit Update 19 August 2008.

<sup>136</sup>SES said that S&P's rating was based on our provisional determination, as well as Ofwat's PR09 draft determination for the company. We do not agree with this interpretation. The note does not mention SES's SAE claim or our provisional determination. In addition, the note comments on a number of companies' PR09 draft determinations, and is not focused on SES particularly.

and BBB–) that are classed as investment grade. Moody's has retained SES's Baa1 underlying rating and has noted a stable outlook.<sup>137, 138</sup>

### *Evaluation of the section 2(2A)(c) duty*

- 4.89 In assessing the ability of SES to meet the 2(2A)(c) duty we are required to decide an SAE claim in the manner we consider is best calculated to secure that the claimant company is able (in particular, by securing a reasonable rate of return) to finance the proper carrying out of its functions. In exercising this judgement we have considered SES's financial performance and position using a number of reference points.
- 4.90 In terms of the past and forecast performance of SES until the end of the current price control period, we note that SES's return on RCV has fallen below the 2004 assumptions (particularly that forecast in 2009/10). We would, however, expect returns to vary year on year and that average returns over a five-year period may diverge from those assumed in 2004. SES is forecast to achieve a return of RCV of 5.7 per cent compared with the cost of capital assumed in 2004 of 6.8 per cent and SES's returns on RCV are above the risk-free rate. If we take account of current estimates of the PR09 cost of capital, embedded debt and the fact SES is more highly geared than the allowed cost of capital assumes, SES's actual cost of capital is likely to be below that forecast in 2004. We also note that the water industry's returns in general are below PR04 guidelines and, whilst lower industry returns would not necessarily imply that SES's return was reasonable, in this case we consider this fact supports our view that average return on RCV is reasonable.
- 4.91 In addition, SES's other financial indicators (the financial ratios used by Ofwat in 2004) are largely within investment grade guidelines in individual years, except for the 2009/10 forecast, and on average are within the investment grade guidelines. Cash interest cover is a key short-term measure of ability to finance functions and this is comfortably above the Ofwat PR04 guidelines. SES's credit rating has not been downgraded as a result of its historic or forecast financial performance. SES told us that it had sufficient financial resources for the remainder of the current price control period.
- 4.92 With regard to the future, we note that Ofwat's PR09 review will shortly (from April 2010) reset pricing in line with Ofwat's assessment of the current cost of capital. We expect this to secure the future ability of SES to raise finance and to achieve a reasonable rate of return.
- 4.93 For all these reasons we consider that the section 2(2A)(c) duty is satisfied.

### *Section 2(2A)(a)—furthering the consumer objective*

- 4.94 We are required, in making this determination, to exercise our discretionary power in the manner we consider is best calculated to further the consumer objective.<sup>139</sup> For these purposes, section 2(2B) states that "the consumer objective" ... is to protect the interests of consumers.' We consider that, in general, it is in the interests of consumers not to allow SES to increase prices, in the short term, beyond the limits

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<sup>137</sup>Moody's Investor Services: Global Credit Research Announcement 23.7.09.

<sup>138</sup>Moody's has put the Aa3 rating for the FSA guaranteed bond under review for possible downgrade; Fitch made a similar move in May 2009 when it downgraded the FSA-insured bond to AA+ Ratings Watch Negative (RWN) from AAA RWN. The FitchRatings announcement followed the previous day's announcement that the FSA's Insurer Financial Strength (IFS) had been downgraded to AA+ on RWN from AAA. (Source: FitchRatings—Fitch Downgrades FSA-Insured Utility Bonds to 'AA+'; remains on negative watch 12 May 2009).

<sup>139</sup>Section 2(2A)(a) WIA91.

set out in 2004 unless that is required in order to avoid higher prices for consumers in the medium to long term.

- 4.95 In response to our provisional determination, SES suggested three reasons why prices may rise in the longer term if its claim did not succeed: (i) its cost of capital would increase (because, SES argued, our approach reduced the likelihood of a K adjustment, for a given set of circumstances, and this would result in greater risk being borne by investors);<sup>140</sup> (ii) there would be an incentive for companies to adopt less robust financing arrangements (for example, by increasing their debt financing);<sup>141</sup> and (iii) there would be an incentive for companies to make SAE claims earlier in the five-year settlement period, in case delay in making an application itself reduced the likelihood of a claim succeeding.<sup>142</sup>
- 4.96 Ofwat has argued that aspects of SES's application would, if accepted, disadvantage consumers because they would reduce incentives on companies to manage costs between reviews and pass the risk for management decisions to consumers.<sup>143</sup> SES responded that its approach would not allow companies to recover underperformance in the event of an SAE application and so would not reduce incentives to minimize costs.<sup>144</sup> With regard to power costs SES argued that the increase in market rates for electricity was outside its control and that, as such, there could be no incentive issues with allowing an adjustment to K to reflect these.
- 4.97 We consider these arguments within the discussion below.

#### *Risk that the cost of capital will increase*

- 4.98 In our view the SAE provision was expected to reduce the risks to which water companies were exposed and this was reflected in the 2004 regulatory settlement. Ofwat said at the time of the PR04 review that the SAE provision was one of a number of mechanisms that protected water companies from significant changes between reviews by allowing for the possibility of adjustments to K. Ofwat also said that it took into account that these mechanisms were in place when making its assessment of risk and its judgement on the cost of capital.<sup>145</sup> We therefore consider it possible that a zero adjustment to K could result in an increase in the cost of capital if SES was required to carry more of the risk associated with external events than reflected in its price settlement.
- 4.99 SES argued that the extent to which the SAE provision was expected to protect companies is informed by statements made by Ofwat in the lead up to PR04. As we have already noted, Ofwat said in the 2004 regulatory settlement that the SAE clause was one of a number of mechanisms that protect companies between reviews from material changes in costs.<sup>146</sup> Ofwat also said, however,

We have ...assumed a cost of capital in the price limits that is towards the high end of the possible range and well above one based solely on current market levels allowed for the possibility of

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<sup>140</sup>SES's submission to the CC, paragraphs 267 and 268, and SES's response to provisional determination, paragraph 123.

<sup>141</sup>SES's submission to the CC paragraph 37 and SES's response to provisional determination, paragraph 56.

<sup>142</sup>SES's response to provisional determination, paragraph 140.

<sup>143</sup>Ofwat's response to SES's main submission to the CC, paragraph 88.

<sup>144</sup>SES's reply to Ofwat's response, paragraph 26.

<sup>145</sup>Ofwat's 'Price Review 2004—Final Determinations', p240.

<sup>146</sup>Ibid., p240.

unexpected costs shocks. This in itself allows for the possibility of unexpected cost shocks<sup>147</sup>

4.100 In addition, in SES's supplementary report, Ofwat said in relation to energy costs:

We judge the risk of these items to be small and to be either covered by the general inflation part of the price limits or to be a part of normal business risk. Companies should use their management skills to minimise these risks. The cost of capital takes account of this and other forms of business risk.<sup>148</sup>

4.101 It is our view that these statements are inconclusive as to the question of how much protection the SAE clause was expected to give to external events.

4.102 Given this, our approach has been to establish the scale of the claimed substantial effects on SES's financial performance over the period of the price controls by isolating the effects that these had on SES's rate of return and other ratios; and to then take a view on whether this is of a scale which could have long-term implications for the cost at which SES can obtain capital. We note that the materiality amount may appear to provide some indication of the scale of the substantial effects, and may suggest that these may be relatively great compared to the materiality threshold; however as discussed in paragraphs 3.12 to 3.15, and 3.89 we do not think it quantifies reliably the effect on SES's business.

4.103 Table 9 shows how SES would have performed over the price control period against the PR04 guidelines had the only deviation from the assumptions used by Ofwat in setting the price controls been the claimed substantial effects (ie had all other aspects of the business, including capital structure, costs and non-water income, been in line with the PR04 assumptions). The figures presented in Table 9 are different from those presented in our assessment of the financing duty as they isolate the effects of the SAE claim rather than looking at SES's actual performance. A key distinction between the figures in Table 9 and those presented earlier is that those in Table 9 are based on a notional financial structure as used by Ofwat for much of its regulatory processes rather than SES's actual financial structure.

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<sup>147</sup>Ibid, p231.

<sup>148</sup>SES supplementary report to Ofwat's 'Price Review 2004—Final Determinations', p28.

TABLE 9 SES financial ratios based on SAE isolated effects and a notional financing structure

	2005/06	2006/07	2007/08	2008/09	2009/10	Average	PR04
	Reported	Reported	Reported	Reported	Forecast	Forecast	guidelines
						(4+1)	
Return on RCV (pre tax and interest)*	6.7%	5.9%	6.2%	5.6%	4.9%	5.9%	
PR04 assumptions (from Table 7)	7.1%	7.6%	7.8%	7.8%	7.8%	7.6%	†
Cash interest cover	4.14	3.73	3.77	3.45	3.24	3.7	Around 3
Adjusted cash interest cover I	1.64	1.32	1.38	1.21	1.07	1.3	Around 1.6
Adjusted cash interest cover II	1.31	1.19	1.70	1.51	1.52	1.4	Around 2
Gearing (debt/RCV)	57%	59%	60%	62%	64%	60%	<65%
Debt payback	20%	18%	19%	17%	16%	18%	>7%

Source: Ofwat.

\*Line 1 in Table 1 of Appendix F would in principle be equivalent to this line if SES had chosen the same capital structure as assumed by Ofwat in 2004 and delivered everything as assumed as in the 2004 regulatory settlement save the substantial adverse effects.

†The average pre-tax cost of capital of 7.6 allowed for in SES's 2004 settlement recognized that there would be variability in rates of return but there is no guidance on how much.

- 4.104 We noted a comment from Ofwat that the financial indicators presented in Table 9 overstate the impact that the adverse effects have had on SES since the income figures on which these are based do not capture the effect that higher energy prices have had on RPI (and therefore upon the prices that water companies have been able to charge). We accept that this may be so, but it would not have a material effect on our analysis. Our assessment is based on the results presented in Table 9.
- 4.105 Table 9 shows that these adverse effects have reduced significantly SES's return on RCV over the price control period. Comparing the forecast pre-tax return in 2009/10 with SES's projected actual pre-tax return for 2009/10 (see Table 1, Appendix F) we note that this actual return is below that which SES would have earned, had the only reason for variation from the figures assumed in the 2004 regulatory settlement been the claimed adverse effects. This suggests to us that SES's projected underperformance in this year is not solely a consequence of the substantial adverse effects. Furthermore, we note that in the earlier years (2005/06 to 2008/09) the returns shown in Table 9 above are lower than the actual returns shown in Table 1, Appendix F. This suggests to us that SES has outperformed in some parts of its business as well as underperforming in other parts.
- 4.106 In our view, in considering the impact of the substantial effects on SES's returns on RCV, we should not put undue weight on performance in any given year. For any company we would expect returns achieved to vary year on year. Returns that are averaged over a number of years are an indicator of overall performance. Table 9 suggests that the claimed adverse effects would have reduced SES's average annual return on RCV (pre-tax) to 5.9 per cent (had all other aspects of the business performed as assumed in 2004) against an average target rate of return of 7.6 per cent. However, the risk premium included in the cost of capital used by Ofwat in setting price controls reflects the fact that even efficient water companies may not achieve their target rates of return (see paragraph 4.59). Our view is that an average pre-tax return on RCV of around 6 per cent is reasonable having regard to these factors and the target rate of return.
- 4.107 Table 9 also shows that cash interest cover, gearing and debt payback ratios are all above the PR04 guidelines. As noted in paragraph 4.84 these guidelines are close to, but slightly more demanding than, credit rating agency guidelines for investment grade status.

- 4.108 These ratios were used by Ofwat to check that water companies which meet their efficiency targets would be able to maintain a corporate credit rating comfortably in the investment grade status. In our view, assessing whether a substantial adverse effect would affect a company's credit rating gives an indication as to whether it might affect the cost at which it can obtain capital. For these purposes we look at SES's average position across the period.
- 4.109 The adjusted cash interest cover ratios are generally below the guidelines. The average adjusted cash interest cover I ratio is 1.3 and the average adjusted cash interest cover II ratio is 1.4. We have noted previously that Ofwat said that the guidelines were not floors or guarantees and, in particular, that although it was a requirement that water companies maintained an investment grade rating, there remained scope for companies to absorb unanticipated downside risk and still remain within the investment grade rating range.
- 4.110 We note that the average adjusted cash interest cover I is within Moody's criteria for investment grade rating<sup>149</sup> and for this reason, in our view 1.3 for adjusted cash interest cover I to be acceptable. We are also of the view that the level of adjusted cash interest cover II, which is not used as a key ratio by Moody's in its credit reports, would not on its own cause investment grade status to be called into question.
- 4.111 In response to the provisional determination, SES said 'the Commission's proposed approach clearly reduces the likelihood of adjustments to K (for a given set of circumstances). As a consequence, the proposal results in greater risk being borne by investors and will inevitably result in a higher cost of capital in the future'.<sup>150</sup> As evidence of this, SES submitted a Merrill Lynch email of 29 June 2009 advising its equity clients to sell interests in three publicly listed companies, following the publication of our provisional determination of SES's application.
- 4.112 Our view is that this email does no more than record one commentator's view as to the value of certain shares. It does not provide substantial support for SES's contention that a zero adjustment to K in response to its claim would result in an increase in the cost of capital.
- 4.113 Ofwat provided us with a number of broker and credit rating agency reports prepared since SES's claim was referred to us. Seven of these have been issued since the publication of our provisional determination. We note that only two of these reports, (one from Merrill Lynch/ Bank of America dated 1 April 2009 and one from Moody's dated June 2009) refer to SES's SAE application. Other reports discuss the risks to which water companies are exposed including regulatory risk.
- 4.114 The Merrill Lynch/Bank of America report says that given the state of debt markets and the prospect of negative RPI, 'the whole issue of risk has moved to new levels'. Ofwat's starting position is said to be that companies, and not consumers, should bear business risks—this being an integral tenet of incentive regulation—but that the licences include a substantial effects clause which has been successfully triggered. It then reports details of SES's SAE claim and that it had been referred to the CC. The Moody's report simply states the facts related to the SES claim.<sup>151</sup>

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<sup>149</sup>Moody's Baa1 rating guideline is >1.4 and <1.6 and its Baa2 rating guideline is >1.2 and <1.4.

<sup>150</sup>SES's response to provisional determination, pp28&29.

<sup>151</sup>The Moody's report states 'We note however that Ofwat will not adjust revenues simply because the materiality test has been met. Sutton and East Surrey Water made a substantial effects application in 2008 related to increases in power costs and reduced consumption and Ofwat found that, although the 20 per cent test had been met, price limits did not need to change. This decision was based on the regulator's view that the company would still be able to finance its functions for the remainder of AMP 4' and makes no further comment.

- 4.115 In our view these reports do not support SES's argument. In addition, we would be generally wary of allowing our decision as to the appropriate adjustment to K to be unduly influenced by commentators' assessments of our decision.
- 4.116 On balance, assessing the impact of the substantial adverse effects on SES's business over the current price control period, we think that the impact on SES is not likely to be of a scale that would have implications in the longer term for the cost at which it can obtain capital.

*Implications for incentives to adopt less robust financing methods*

- 4.117 SES said that our approach of looking at actual returns on capital in our assessment under the section 2(2A)(c) WIA91 may penalize companies that have suffered a financial shock, but have otherwise outperformed their price controls. It also said that assessing performance against the other financial ratios by reference to the actual financial structure could favour companies that have adopted inefficient levels of gearing or taken inefficient debt instruments (see paragraph 4.32(d)). Similarly, SES argued that the CC should take account of the steps taken by its holding company to conserve cash and thereby ensure that SES did not breach the terms of its covenants (see paragraph 4.34).
- 4.118 SES also said that a consequence of our approach would be to encourage companies to increase their level of gearing and so reduce the financial resources that would be available to deal with adverse shocks. SES added that companies would have an incentive to increase gearing to the top of any accepted range as the protection provided by the SAE clause against unforeseen events would be available only to those companies with stretched financial resources.
- 4.119 We recognize that in principle there may be a concern as to the effect on incentives arising from assessing a claim by reference to a company's actual financial structure. Firstly we note that our assessment of SES's SAE claim has regard to both its actual financial structure and to its performance under Ofwat's notional financial structure. Moreover, for incentives to be damaged in the way SES claims, a company would need to be sure that if it were to increase its level of gearing it would still be able to maintain its investment grade rating (a requirement under its licence conditions) and that it would be able to recover its losses by means of an SAE application.
- 4.120 In addition, this would, in our view, be a very risky strategy for a company to adopt. In contrast to a standard IDoK claim, where recovery of losses is automatic once the materiality threshold is reached, recovery of losses in an SAE claim is, in our view, not automatic but is at the discretion of Ofwat (see paragraphs 4.14 and 4.16). In exercising its discretion, Ofwat is required to have regard to a number of considerations (such as furthering the consumer objective, promoting economy and efficiency on the part of water companies, and having regard to the principles of best regulatory practice) in addition to whether the company is able to finance the proper carrying out of its functions. Another risk of such a strategy is that it would also render a company vulnerable to situations that result in a poor performance but for which it could not make an SAE claim.

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### *Timing of applications*

- 4.121 SES said that failure to consider the steps taken by its holding company to ensure that SES maintains its financial covenants would discourage early management intervention as this would damage the prospects for a successful application.<sup>152</sup> SES added that it would encourage companies to submit applications earlier rather than attempt to mitigate the situation.
- 4.122 We do not accept this argument. It is far from clear to us that the consequences of considering the actual financial position of a company, including any steps taken to maintain the financing position of a company, would create this incentive. Acting in the way SES suggests would in our view be a risky strategy for a company to adopt particularly given the discretionary nature of the SAE provision and as Ofwat would, in exercising this discretion, have regard to a number of considerations. We note that the actions taken by SES's holding company, to which SES referred, do not pre-date the date of its SAE application to Ofwat and we have seen no evidence that SES's decision to make an SAE application was contingent on the outcome of these steps.
- 4.123 SES also said that if the proximity of the next price review were to be a reason for the CC to determine that no change to K was needed as a result of SES's application, this would create a perverse incentive for companies to seek an SAE adjustment earlier in the five-year period, knowing that delay in itself would reduce the likelihood of a successful application.<sup>153</sup> SES said that this would act as a disincentive on companies to try to manage the impact of the circumstances or to 'wait and see' if uncertainty relating to the impact of the circumstances is resolved.
- 4.124 We are not persuaded by SES's argument that our approach would encourage companies to submit claims earlier than they might otherwise have done. In particular, we cannot see why a company that considers that it is in a position to make a good claim would not do so. We also note, in relation to the uncertainty point, that SES's claim was based on forecasts for a period of, initially, two years.

### *Maintaining incentives to manage costs*

- 4.125 Ofwat has argued that to make an adjustment to K in relation to SES's higher electricity costs claim would be against the long-term interests of consumers as it would reduce the incentives on companies to manage costs between reviews.<sup>154</sup> SES did not accept this.<sup>155</sup> SES argued that the increase in the market price of electricity was outside its control and that, as such, there would be 'no incentive implications if market movements in power costs are allowed'.
- 4.126 We accept that there is little that SES can do in the short term to reduce the amount of electricity it uses. In particular, we accept SES's argument that in the case of energy efficiency this is largely driven by capital expenditure to reduce leakage and the maintenance and replacement of pumps which will be agreed with Ofwat and be reflected in the regulatory settlement.
- 4.127 However, the amount SES paid for its electricity was something that could be managed. In fact, the commercial decisions taken by SES to opt for a 12-month contract for 2008/09 resulted in it paying a higher price for its electricity in the final

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<sup>152</sup>SES's response to provisional determination, paragraph 139.

<sup>153</sup>SES's response to provisional determination, paragraph 140.

<sup>154</sup>Ofwat's response to SES's main submission to the CC, paragraph 88.

<sup>155</sup>SES's reply to Ofwat's response, paragraph 26.

two years of the price control period than it would have done had it taken a two-year contract (see paragraph 3.28).

- 4.128 SES argued that comparison of its power costs with those that it would have paid had it purchased electricity at one-month hedge prices<sup>156</sup> demonstrated that all the increase in its power costs could be attributed to movements in market prices that were outside the company's control. In particular SES said that its forecast power costs for the five-year period would be £19.5 million but if it had paid the month-ahead market price its power costs would have been even greater at £19.8 million. We do not accept this. Indeed the £0.3 million difference demonstrates that there was scope for SES to manage its costs through the commercial decisions it took, and we note SES's claim that it had performed well compared with the one-month hedge prices.
- 4.129 For a company to manage the price paid for its electricity effectively, particularly when prices are volatile, it may have to incur costs in respect of management time and procurement costs, including any premium paid, for example, for long-term energy contracts. It is a matter of commercial judgement whether a water company decides to incur these additional costs. But if a company faces only a limited risk of exposure (as would be the case if an SAE claim which satisfied the materiality threshold automatically resulted in a change to K and higher consumer prices) this may reduce the company's willingness to incur such costs, and weaken its incentive to manage efficiently the risks it faces.
- 4.130 With regard to the shortfall in income, we considered whether there might be implications for incentives to invest in the capacity required to avoid the need for water supply restrictions during droughts and concluded that this was unlikely as these decisions are likely to be driven by other regulatory processes (under which companies propose investments for inclusion in their asset management plans and Ofwat agrees or disagrees to their inclusion in the RCV).

#### *Evaluation of the section 2(2A)(a) duty*

- 4.131 We consider that, in general, it is in the interests of consumers not to allow SES to increase prices, in the short term, beyond the limits set out in the 2004 regulatory settlement unless this would result in higher prices for consumers in the medium to long term. On balance, after assessing the impact of the substantial adverse effects on SES's business over the current price control period, our view is that the impact is likely to be of a scale that would not have implications in the longer term for the cost at which SES can obtain capital.
- 4.132 As regards the risks to regulatory incentives which may arise, our view is that: (a) any risks arising from assessing SAE claims by reference to a company's actual financial structure are outweighed by other considerations, in particular the need for a company to maintain an investment grade rating, and the risk that its SAE claim, being a discretionary remedy, would fail; (b) a determination not to make a change to K, is, on balance, unlikely to encourage companies to make SAE claims earlier in the five-year settlement period than might otherwise be the case, as companies could only make such a claim when they were in a position to assess the impact of the adverse effects, and whether such effects were equal to or above the materiality amount; (c) it may undermine regulatory incentives if the SAE provisions are applied in a way which encourages water companies to pursue commercial strategies on the

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<sup>156</sup>Said by SES to provide a reasonable benchmark for market electricity prices.

basis that the potential upside consequences of commercial decisions would accrue to shareholders but any downside would be borne by customers.

- 4.133 Overall, taking all these considerations into account, we conclude that an adjustment to K in relation to either or both the power or income circumstances would not be in the short- or longer-term interests of consumers.

*Sections 2(3) and 2(4)—the duties to promote economy and efficiency and to have regard to the principles of best regulatory practice*

- 4.134 We have had regard to the regulator's other duties as identified in the WIA91, and in particular, the duty under section 2(3) to promote economy and efficiency by the water companies, and that under section 2(4) to have regard to the principles of best regulatory practice.
- 4.135 It is our view that our conclusions under section 2(2A)(a) in relation to maintaining incentives to manage costs are also relevant to the section 2(3) duty to promote economy and efficiency of the water companies. We do not consider that further assessment is therefore required or that a positive adjustment to K is necessary or appropriate to comply with this duty.
- 4.136 We consider the section 2(4) duty to be an overarching duty to which we must have regard in carrying out our assessment under all other WIA91 duties relevant to SES's SAE claim (ie our assessment under sections 2(2A)(a) and (c)). We have followed a procedure (see paragraphs 1.3 and 1.4) which in our view gave the maximum transparency and so satisfies the principles of transparency and accountability required by section 2(4) WIA91. We have taken detailed evidence from SES, Ofwat and interested parties and (as required by section 12(3C) of the WIA91) have given such an account of our reasons as in our opinion is expedient for facilitating a proper understanding of the questions we had to determine and our conclusions.
- 4.137 SES argued that our approach was not consistent with previous regulatory practice and, in particular, with the approach Ofwat took to the two previous claims.<sup>157</sup> We have addressed this argument in paragraph 4.15.
- 4.138 SES also said that our approach did not satisfy the duty to have regard to consistency or the principle of non-discrimination under section 2(3)(b). In particular, SES said that the assessment of its actual financial position would favour inefficient companies or inadequately-capitalized companies but not efficient or well-capitalized companies when subject to the same substantial adverse effects. We have addressed these arguments in paragraphs 4.117 to 4.120.

*Other issues*

- 4.139 SES said in response to our provisional determination that we had failed to carry out an adequate cost benefit analysis of the proposal not to allow an adjustment to K in relation to power costs. SES said that we had concluded that the existence of this risk was sufficient to justify the exclusion of power costs from any K adjustment and that in reaching this opinion we had not analysed the costs and benefits of the options considered, nor considered any of the alternative options. SES said that in practice we had considered two extreme options: either changes to K in respect of power costs were allowed or they were not.

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<sup>157</sup>SES's response to provisional determination, paragraphs 98 and 99.

- 4.140 In our view these suggestions by SES do not accurately represent the CC's position. We did not exclude power costs from consideration of the substantial adverse effects that SES has claimed, when we considered what change to make to K, and we did not exclude the possibility that, in appropriate circumstances, an adjustment to K may be made in consequence of the substantial adverse effects of power costs. In the context of an SAE claim, it appears that the cost benefit analysis mentioned by SES involves balancing the cost to consumers of higher prices, arising from an adjustment to K, against the benefit to SES, arising from an adjustment to K which allowed SES to increase its prices and recover some or all of its losses. But, in effect, this is what we have done in applying the section 2(2A)(a) principle (to further the consumer objective), where we considered whether SES's cost of capital was likely to increase if no adjustment to K was made following this SAE claim; whether, in consequence, consumers were likely to be faced with higher prices in the medium to long term, if no adjustment was made to K; and whether, in the light of this analysis, it was furthering the consumer objective to make an adjustment to K.
- 4.141 SES also said that our proposals would imply setting the price of water below the economic cost of supplying it and that this encouraged waste and inefficient use, with the associated impact that it had on security of supply and the environment. We do not think that is a significant issue, for two reasons. Firstly, the economic cost that SES refers to is an average cost that includes many fixed cost components. The relevant economic cost for assessing whether water use is economically inefficient is likely to be substantially lower than this. Secondly, that the prices a company is allowed to charge may be above or below its accounting costs is a feature of incentive-based regulation. As explained in paragraph 2.4, companies have an incentive, once price limits have been set, to achieve additional cost savings as they keep the gains from doing so for a period of time. These gains are passed on to consumers in subsequent periods. Any short-term inefficiency associated with prices being above or below costs is a necessary consequence of this regulatory approach which provides incentives for longer-term efficiency gains.
- 4.142 SES claimed that the approach that we have adopted will have the effect of increasing the materiality threshold and mean that, where the materiality amount is less than 240 per cent or 110 per cent of the relevant turnover, claims for adjustments to K would never be allowed. However, we do not agree, as in our view each application must be assessed on its particular facts. The materiality amount calculation establishes jurisdiction to consider whether an adjustment should be made, but may not, and often does not, closely reflect the true impact of the adverse effects on the business of the water company concerned. An adjustment to K might be appropriate in any case where the materiality amount is passed, but there can be no expectation that an adjustment to K should be made solely because the materiality test has been passed.

## **Conclusion**

- 4.143 We conclude that, in general, the consumer objective set out in section 2(2A)(a) WIA91 is furthered by ensuring, over time, low prices, to the extent that these are consistent with the aims of the WIA91 and Ofwat's other duties. It might be in consumers' interest that a positive adjustment to K be made, for example, if this were required to avoid an increase to SES's cost of capital. However, our analysis suggests that making a zero adjustment to K would not result in an increase in SES's cost of capital and that this would be consistent with preserving the incentives that SES has to be cost efficient. Our analysis leads us to conclude that the consumer interest would not be furthered by a positive adjustment to K.

- 4.144 We have seen no evidence to suggest that SES is failing to properly carrying out its function as a water undertaker nor that it will not continue properly to carry out its functions as a water undertaker in the future, and we therefore consider that the duty set out in section 2(2A)(b) WIA91 is met with regard to SES.
- 4.145 We conclude that having taken account of a range of factors including, in particular, its return on capital, SES is able to finance the proper carrying out of its functions with K at its current level and that a positive adjustment to K is not necessary in order to satisfy the duty set out in section 2(2A)(c) WIA91.
- 4.146 We have had regard to the regulator's other duties as identified in the WIA91, and in particular to the duty to promote economy and efficiency by the water companies, and to have regard to the principles of best regulatory practice. Our conclusion in relation to the potential impact on incentives is also relevant to the section 2(3) duty to promote economy and efficiency of the water companies. We consider that a positive adjustment to K is not necessary or appropriate to comply with these.
- 4.147 On the basis of these considerations, our determination is that no adjustment to K be made.

## **Costs**

- 4.148 We are required by section 12(3A) WIA91 to decide to what extent it is reasonable to take into account in our determination costs incurred or borne by SES in connection with the reference. In doing so, we must have regard to the extent to which, in our view, our determination is likely to support SES's (rather than Ofwat's) claims in relation to the questions referred to us.<sup>158</sup>
- 4.149 We agreed with SES and with Ofwat that circumstances have occurred that have substantial adverse effects on SES's business, and that these are not ones which would have been avoided by prudent management action. As regards the second question, we supported Ofwat's claims that no change should be made to K, and have not supported SES's claims.
- 4.150 We have not supported Ofwat's reasoning and methodology in all respects. For example, we said that we consider limited weight should be given to the output from Ofwat's power model in assessing SES's performance compared with other water companies as regards energy costs (see paragraph 3.66), and we did not agree with Ofwat's adjustments for prudent management action in assessing the materiality amount for the energy costs circumstance (see paragraph 3.68). As both Ofwat and SES claimed that circumstances having such effects had occurred, and as our determination supports these claims, in neither case did our lack of support for Ofwat's reasoning and methodology affect our determination of the first question.
- 4.151 However, our determination of the second question does not support SES's claims. We did not find, for example, that in the event of an SAE, Ofwat has a duty to change K to restore SES's rate of return to that assumed at the last price review (see paragraph 4.60), and that in making our assessment of this interim price determination only SES's longer-term financial position is relevant (see paragraphs 4.64 and 4.65).

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<sup>158</sup>Section 2(2A) WIA91 as substituted by the Water Act 2003.

4.152 For these reasons, as overall our determination supports the common view of SES and Ofwat as regards the first question, and does not support SES's claims in relation to the second question referred to us, we have decided that none of SES's costs should be taken into account in our determination.