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Andrew Chesworth
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7th November 2013

Dear Andrew,

Thames Water Favourable Effects Determination

We should like to make some comments on the informal consultation about a possible substantial favourable effects determination for Thames Water.

As a general comment, we support Ofwat's decision not to seek re-determination of all companies' price limits under the substantial effects provisions. The consultation acknowledges that most companies have suffered adverse changes as well as beneficial ones but have opted not to seek recovery of them through higher prices.

It also recognises that many companies have unilaterally shared gains with customers. We described in our 2013 annual report how we have reinvested £255m of capital and operating expenditure efficiencies in additional outputs for customers, including schemes to protect customers from the impact of future drought and reduce leakage below our regulatory target. These efficiencies also helped us to absorb the additional costs of private sewers, rising bad debt and increases in the Environmental Improvement Unit Charge. We think it right that regulatory action should be contemplated 'in the round', taking into consideration all relevant factors.

We are also supportive of an approach that considers companies individually, rather than as a group, and reflects differences between players in the sector. We look forward to this approach being applied in the assessment of companies' PR14 business plans. An approach which differentiates between companies is essential to incentivise responsible corporate behaviour.

Moving to the detail of the case, we are concerned that a supposed lack of representativeness of the Retail price Index (RPI) since 2010 is being contemplated as a favourable substantial effect. Ofwat is aware of the importance of the indexation of the RCV to investors and notes in the consultation document the contribution that this makes to the continuation of low cost finance for the sector. In particular, index-linked debt (which is an efficient source of finance) is directly linked to RPI and therefore maintaining the link with consistent RPI in regulation is crucial.

Given this, and Ofwat's stated commitment to using RPI to index wholesale revenues, we find it inconsistent for Ofwat to question the underlying basis of RPI's calculation. Few people would defend RPI as a perfect benchmark of water companies' costs but the fact that it provides an imperfect hedge of inflationary risk to companies is less important than that it provides an independent, well established and widely recognised reference point which enables efficient financing.

The source of error identified by Ofwat as causing the current lack of representativeness of RPI is in the use of the arithmetic formulation (the 'Carli' formula) in the calculation of the Index. However there are a number of other factors which may also cause a lack of representativeness, and these are as likely to give an adverse as a favourable outcome. During the early 2000s, for example, it is widely recognised that the RPI was suppressed by the transfer of much British manufacturing activity to low-wage parts of the globe. Water companies had limited ability to benefit from the reduced price of consumer products manufactured overseas but still experienced the impact of this 'imported deflation' on their revenues via the Index. Identifying and quantifying the numerous influences – positive and negative - on the Index is, to say the least, difficult and trying to do so undermines positive sentiment towards the sector.

It is possible to make allowances for the lack of representativeness of the RPI when setting prices. At PR09 consultants working for both the industry and Ofwat utilised an approach which combined forecast input price movements for individual cost elements with forecast RPI movements to derive real price effects, which were in turn factored into revenue assumptions. We have taken a similar approach in developing RPE values for our PR14 business plan. This approach effectively acknowledges RPI as a token benchmark but effectively compensates for the fact.

Turning to the impact of monetary interventions on financial markets, we acknowledge the effect of these in suppressing the market costs of debt and equity since 2010. However, like the RPI, movements in these in comparison with levels assumed at previous price reviews can be adverse as well as favourable for companies. We support Ofwat's long-held principle – upheld in the methodology for PR14 -- that companies are best placed to manage financing risk and should bear or enjoy the consequences of rates varying from allowed levels. The methodology notes how the tendency for Ofwat to fix costs of debt at levels which exist at a price review means that customers are likely to enjoy favourable benefits in a rising finance market.

We urge care also in quantifying the impact of monetary interventions. Firstly, a significant proportion of company debt is of course embedded at historical higher rates. Secondly, reductions in our borrowing costs have been offset to a material extent by the cost of carry of cash (returns we earn for money held on deposit). Thirdly, the Bank of England's policy of quantitative easing (QE) has had a significant the impact on pension fund deficits. In October 2012 the National Association Pension Funds (NAPF) said that nearly half of the £229bn deficit currently being carried by 6,432 final-salary schemes had been due to QE.

I hope these comments are helpful and if you wish to discuss any of them please do not hesitate to contact me.

Yours sincerely,

Jean Spencer
Regulation Director