Possible notice to determine Thames Water's price limits for 2014-15 - an informal consultation from Ofwat

Consumer Council for Water Response

November 2013

Introduction

1. The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and sewerage consumers in England and Wales. CCWater has four regional committees in England and a committee for Wales.

2. We welcome Ofwat's publication of its informal consultation on the issues to consider in a possible notice to determine Thames Water's price limits for 2014-15. Our general view of the proposal and responses to the three consultation questions is set out below.

General view

3. We support Ofwat's consideration of the use of the substantial effect mechanism in this case, due to favourable effects (outside of Thames Water's control) that may have led to financial gains of a value that is at least 20% of the company's turnover.

4. While the use of the substantial effects mechanism is a separate process to Ofwat's draft interim determination for Thames Water, use of the notice to mitigate a potential price increase would be welcomed by many customers. Our research shows that an increasing number of customers are experiencing water affordability problems.

5. We note that Ofwat can issue a notice to use the 'substantial effect' provision in a company's licence should a company seek a re-opening of its price settlement due to unforeseen high impact changes of circumstance. We would like to see consideration of the sustainable favourable effects provision as and when companies ask for price limits to be reopened in the future. This will ensue a full assessment of a company's circumstances (favourable and/or detrimental) are assessed to help ensure an acceptable outcome is achieved.

Q1: Do you agree that the basis of RPI in the current control period may have resulted in significant revenue gains not anticipated when price limits were set?

6. We agree that the basis on which RPI was calculated prior to 2010, and used during the current control period, has led to revenue gains for companies, including Thames Water.

7. In addition to this, during the period 2010-11 to 2013-14 water companies, including Thames Water, have also received significant gains because RPI has been higher than was forecast in 2009.

8. Our analysis[1] shows that actual RPI over the two years 2010-11 and 2011-12 was significantly higher than HM Treasury projections which Ofwat used in price control in 2009. RPI forecast (2010-12 average) was 3.0% whereas actual RPI inflation for the same period averaged 4.46%. As such, Thames Water was able to achieve investor gains of £60.3m through its non-index linked 'legacy' debt for the two years alone. If this is extrapolated across the remaining three years of the price control period, this may represent circa £150m of investor gains from higher than anticipated RPI.

[1] 'Analysis of water companies' financial performance since 2010-11', Economic Consulting Associates (ECA) for CCWater. (To be published shortly)

9. We note that Ofwat considers that some water company costs can rise at the level of RPI or higher, including energy and business rate costs. However, on balance, Thames Water's revenue and investor gains from the higher than anticipated RPI may outweigh any impact on operating costs. As the consultation paper states at section 4.1, the impact of the way in which the ONS changed the way it compiled RPI indices has little impact on water company costs.

Q2: Do you agree that the impact of sustained monetary interventions on the market costs of finance may have had significant favourable effects on the market costs of finance for an efficiently financed company, relevant to a review of Thames Water's price limits in 2014-15?

9. We agree that, due to various factors, the cost of finance for water companies generally has been more favourable than the assumptions made in the 2009 final determinations. The cost of new debt has been substantially lower than that assumed by Ofwat (or the Competition Commission) at the 2009 price review.

10. In the 2009 final determinations, Ofwat assumed a real cost of debt of 3.6%, based on companies' existing debt in 2009 and forward projections (Ofwat assumed 'forward looking' debt of 4.1% to 4.3%) within this calculation[2].

11. The actual cost of new debt achieved by Thames Water was 3.1%. This 0.5% difference accounts for gains of £50.4m for the two years 2010-11 and 2011-12 alone[3]. Across the five year period this could mean gains of circa £125m.

Q3: Are there other relevant changes and effects we should consider?

12. We also agree with Ofwat's view that any significant adverse impacts from lower than anticipated revenues in 2010-15 (due to the effects of the recession) should not be considered in the possible notice as the Revenue Correction Mechanism protects the company and its investors from changes due to unforeseen factors.

13. Should Ofwat proceed with a notice, and assess that the value of the favourable effects represents at least 20% of turnover, this should trigger a review of the company's price limits. If and when a review is triggered, consideration should then be given to Thames Water's response to CCWater's call for the sector to share the gains achieved from lower debt costs and unanticipated higher RPI. The company has committed to advancing £80m of investment from future pricing periods to the final 18 to 24 months of this pricing period. We would expect Ofwat to take account of any legitimate expenditure made at shareholders' expense.

14. We believe this 'benefit sharing' by Thames Water should be considered <u>after</u> Ofwat has calculated the value of the favourable effects.

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[2] Ofwat final determinations 2009

[3] 'Analysis of water companies' financial performance since 2010-11', Economic Consulting Associates (ECA) for CCWater. (To be published shortly)

Enquiries

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