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Dear Andrew

Please find below our response to the informal consultation in relation to the possible notice to determine Thames Water's price limits for 2014-15.

Background

Ofwat's consultation in relation to substantial favourable effect ("SFE") raises a number of important points of principle which are potentially of significant relevance to existing and potential investors in the UK Water Sector. In this regard we welcome Ofwat's confirmation that

- in considering the application of the regulatory framework, it is important that Ofwat have full regard to the principles of best regulatory practice, including that actions are targeted and proportionate, and
- the price limits Ofwat set and the frameworks Ofwat put in place for considering these matters apply to each appointee.

Applicability of SFE to Thames Water

Ofwat have indicated that Ofwat are only looking at whether Thames Water has benefited from economic circumstances beyond its control, such that Ofwat should consider these gains through the complementary established substantial favourable effect mechanism, in IB 20/13, Ofwat's response to Thames Water's IDoK application.

Furthermore Ofwat have suggested that any SFE will only be applied to Thames Water. Given the confirmation from Ofwat that these matters apply to each appointee we find these two alternative positions difficult to reconcile.

Consultation Questions

Specifically Ofwat have requested feedback on

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?

We do not agree that the basis of RPI in the current control period has resulted in significant revenue gains not anticipated when price limits were set.

In our view, application of RPI within the water sector's regulatory framework is a designed to provide;

- a general measure of inflation in the overall economy, not mirror the cost structure in each and every water company, and
- a real price increase within which price controls can be set and which individual companies can efficiently manage their business

Given our view that the purpose of RPI is to provide a real level of price limits (and hence revenue) throughout the price control period, we don't believe that it is possible for revenue gains in excess of what was contemplated when the price limits were set, to have occurred.

Moreover Investors place considerable importance on the stability and transparency provided by the automatic application of RPI to price limits (and hence revenues) and to the RCV, however the suggestion in the consultation that, rather than being automatic, the application of RPI in practice may be subject to a review of the impact of the frequent statistical changes to the composition or calculation of RPI, would significantly undermine this stability and transparency.

Companies' licences give Ofwat the ability to use a different measure of indexation should there be a material change in the calculation of RPI; however the consultation acknowledges that the change in question is not material in this context

In view of the above, seeking to amend Thames Water's price limits to take account of these changes in the RPI formula would not be appropriate, targeted, proportionate or represent best regulatory practice.

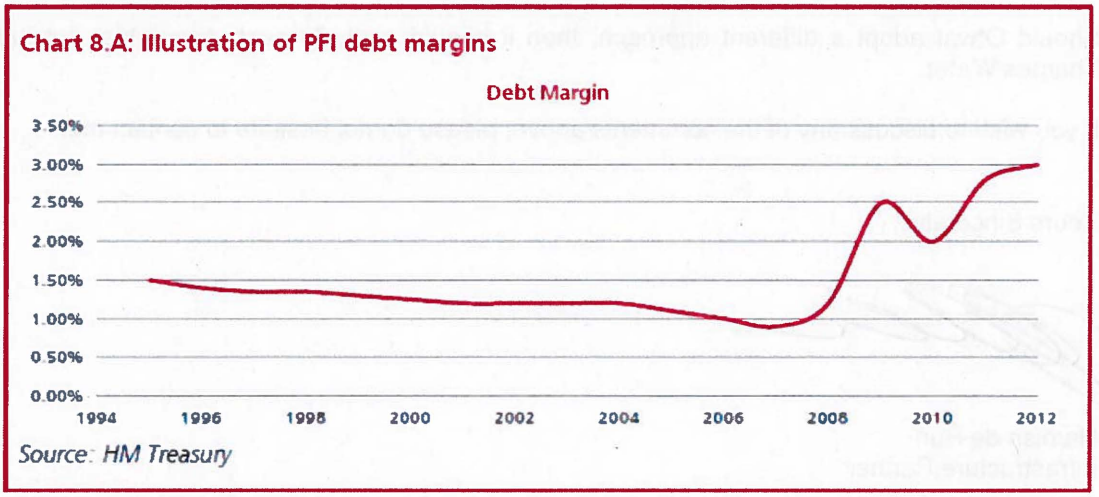
Should Ofwat adopt a different approach, then it should apply to each appointee, not just Thames Water.

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?

The market costs of finance is comprised of various components including but not limited to

- prevailing risk free rates
- hedging and liquidity costs
- credit margins

We would argue that most market evidence suggests that whilst there has been a reduction in prevailing risk free rates during this price control there has also been a significant increase in hedging and liquidity costs and credit margins. The following extract from HM Treasury's recent publication "*A new approach to public private partnerships*" issued in December 2012 illustrates this as follows;



The impact of monetary interventions on the cost of equity is also far from clear. It is hard to argue that the required equity returns have been reduced by the world becoming less risky in recent years, given the ongoing volatility and uncertainty in the UK and global economy, being the very reason behind monetary interventions from central banks. The more generally accepted view is that there has been significantly more risk.

Furthermore the costs of finance for individual companies during any price control period is in turn impacted by a range of matters, including its capital structure which in turn is impacted by a variety of factors, including but not limited

- mix of funding (nominal or indexed linked)
- tenor
- source of funding
- hedging profile
- construction programme scale and funding implications

Given the above, the extent to which a company could reasonably be expected to have taken advantage of this low-interest rate environment is less clear.

A well established principle of the regulatory framework is that the cost of capital is set for a fixed period at price reviews, and companies are expected to live within the weighted average cost of capital (WACC) set at price reviews, which is an overall assessment, and is part of a package that companies either accept or reject taking into account risks and uncertainties at the time.

We therefore believe that seeking to reopen the WACC calculation within a price control period is a significant departure from the established stable and predictable regulatory framework that investors value, risking undermining investor confidence and increasing the future cost of finance

In view of the above, seeking to amend Thames Water's price limits by opening up the WACC calculation mid-period would not be appropriate, targeted, proportionate or represent best regulatory practice.

Should Ofwat adopt a different approach, then it should apply to each appointee, not just Thames Water.

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

We would strongly encourage Ofwat to refrain from changes that impact, or could be perceived to impact on the stability and transparency provided by the automatic application of RPI to the RCV. As noted above investors place considerable importance on these elements of UK water regulation.

Should Ofwat adopt a different approach, then it should apply to each appointee, not just Thames Water.

If you wish to discuss any of the comments above, please do not hesitate to contact me.

Yours Sincerely

Hamish de Run
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