Ofwat informal consultation on a possible notice to determine Thames Water's price limits for 2014-15

Response from Northumbrian Water Limited

Introduction

This technical consultation paper raises a number of important points of principle. We felt it was important to respond to these. By contrast, the draft determination of Thames Water's standard interim price determination (IDoK) dealt principally with company specific issues which appeared to be handled in accordance with the ground-rules set out in the Licence and by previous precedent. We therefore do not express any comment in this regard.

Although the consultation paper makes it clear that Ofwat is only considering the application of the favourable substantial effect clause for Thames Water, the paper recognises that the points of principle it raises are of more general importance.

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

Ofwat suggests there are two areas where Thames Water, and by implication others, may have materially benefited from circumstances that are beyond prudent management control; changes to the RPI formula and movements in the cost of capital. We consider each of these points below.

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?

The consultation paper notes that in June 2010 the Office of National Statistics (ONS) amended some aspects of the calculation of the Retail Price Index. It argues that this change had the effect of increasing calculated RPI but not of changing the costs of Thames Water thereby creating an unearned benefit.

It is important to recognise that changes to the precise specification of the RPI index are made relatively frequently with changes or re-weightings to the basket components being the most common changes. The change in June 2010 may be slightly more significant than other changes but in our view is not fundamentally different in nature.

The Licence already provides Ofwat with the ability to change the index used for prices should there be a material change in the calculation of RPI. Ofwat acknowledges that the change in question does not qualify as a material change in this context. We feel there is an element of double jeopardy in proposing that non material changes in RPI may also result in a price adjustment. This does not appear to have been what was envisaged when the Licence was drafted nor what investors would understand the Licence to mean.

The RPI is a general measure of inflation and as such does not perfectly represent the actual cost pressures faced by a water company. At specific times actual real price effects may be greater or lower for a water company than the RPI for the economy as a whole, however over a price control period any such effects would generally even themselves out.

Even where movements in RPI are generated by cost pressures not directly relevant to water companies there may be some impact on water company costs. For instance, some supply contracts may have an RPI index clause and index linked debt will increase in line with the published RPI, it should also be recognised that significant elements of our cost base particularly those linked to power and chemical costs generally increase by more than RPI over a contract cycle.

We feel that trying to correlate specific movements in RPI with water company costs is a significant move away from the principle of establishing a headline price control in real terms and expecting, in normal circumstances, the regulated company to manage within this control.

The question of whether RPI is less representative of water company costs in a recession seems to be an entirely different point and one that is not followed through in the consultation paper. We are not aware of any evidence that the RPI is any more or less representative of water company costs at any particular point in the business cycle. As we acknowledge above, RPI is not perfectly representative of water company cost pressures but nor was it ever intended to be when included in the price control formula.

Some of Ofwat's comments appear to question how well RPI represents the general movement of prices in the economy, relative to say the alternative Consumer Price Index. This does not appear to sit well with Ofwat's stated commitment to continue with RPI indexation as part of the wholesale price control. Also there is no evidence or suggestion that we are aware of, that would point another indexation measure used by other similar sectors as being deemed to be a more appropriate mechanism than RPI.

Investors place considerable importance on the relative stability, surety and transparency provided by the application of RPI indexation to revenues and to the Regulatory Capital Value (RCV). This plays an important role in ensuring that low cost finance can be attracted to finance the investment required by water companies. If the application of RPI was in fact made conditional upon a review each time any statistical change is made to the composition or calculation of RPI this would reduce the stability of the regulatory framework and risk undermining investor confidence which in turn would increase the required cost of capital for the sector.

Given all of the above, in our view seeking to adjust the prices of Thames Water with respect to changes in the RPI formula would not represent regulatory best practice and would not be targeted or proportionate.

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 Weighted Average Cost of Capital (WACC) set at price reviews is an overall assessment and it would be inappropriate to focus on individual elements, such as the cost of debt, in isolation. Furthermore, the WACC is part of an overall price settlement that is accepted, or rejected, as a package taking into account the associated deemed risks and uncertainties as viewed at that time.

It is accepted that monetary interventions have had the effect of depressing UK interest rates over the last few years. It is not clear how long these conditions will persist. The prevailing lower interest rates would tend to cause the actual cost of debt to be lower than that assumed by Ofwat in the 2009 price determination for those companies who do not have a high proportion of fixed rate borrowings. However, the extent to which companies are able to take advantage of this low cost of debt environment is limited to the new financing or refinancing required in this price control period, and the level of existing non-fixed rate borrowings a company has. It is simply not economical to load up new debt now to take advantage of low rates to pre-finance investment in future price control periods. This is because negative real interest rates on deposits create a very high cost to carry. Also whilst yield curves have fallen, credit spreads have adjusted accordingly and many institutional investors have focussed on all in returns, which has meant that all in new issue costs for long term fixed rate debt have not fallen significantly. Furthermore, some credit rating agencies will recognise the increase in debt but will ignore the cash associated with pre-funding on the basis it cannot be guaranteed that this cash will be used to finance future investment and not be distributed. This means significant pre-funding would have a detrimental impact on financial ratios.

It is far from clear that monetary interventions have reduced the cost of equity. Evidence tends to suggest the required return on equity investment is very stable over time. The fact that ex post equity returns may have fallen cannot be taken as demonstrating that ex ante required equity returns have reduced. The fall in equity returns requires careful consideration. It is difficult to sustain a view that the world has become less risky in recent years and therefore required market returns have reduced. In fact there appears to be greater volatility and uncertainty in the world economy. A more reasonable description would be of a world where equity returns have generally been disappointing and there has been a flight to safety (i.e. a willingness to accept unusually low returns for a relatively low risk asset). In this case, there is no sustained shift in equity investor expectations and these conditions would not persist once economic growth approaches anything like 'normal' conditions.

A real strength of the regulatory framework is that the cost of capital assumption is set for a fixed period and companies are expected to live within this other than in exceptional circumstances. Even a standard interim price determination for a cost shock will normally use the cost of capital set at the previous price review. In our view, opening up the WACC calculation mid period risks undermining the stable and predictable regulatory framework and increasing future cost of capital requirements. We believe this would not represent regulatory best practice and would not be targeted or proportionate.

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

We agree that revenue shortfalls should be excluded from consideration given the very clear commitment to the application of the Revenue Correction Mechanism in the 2014 price review.

We agree with Ofwat's conclusion that it should not adjust the RCV for any shorter term gains from RPI indexation because of the impact this would have on regulatory stability and investor confidence. We think that the same arguments apply to revisiting the composition of RPI more generally. We welcome the reiteration of Ofwat's commitment to the RCV,

We agree with Ofwat's conclusion not to adjust for the possible effects of the recession on operating costs. It is difficult to assess what the impact of changes in economic growth or RPI on water companies' operating costs may be. These are likely to vary from company to company based on their operating area and the nature of their capital programme amongst other things. This sort of adjustment would involve a great deal of judgement and would risk undermining the basic incentive for companies to manage costs relative to RPI.

We have not identified any further favourable changes and effects that we believe Ofwat should consider.