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Dear Andrew

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

Thank you for inviting Thames Water Utilities Limited ("TWUL") to comment on Ofwat's informal consultation on a possible notice to determine TWUL's price limits for 2014-15. We welcome the opportunity to respond to Ofwat's initial thinking on this matter.

We understand that Ofwat has not yet taken a decision to proceed with a Substantial Favourable Effects ("SFE") claim, and that its thinking is still in its formative stages. Nevertheless, we note that the rationale and evidence presented for an SFE claim, especially one that is applied solely to Thames Water, stops well short of that which would be necessary for Ofwat to justify such action.

Our principal concern is that it would be unreasonable for Ofwat to target an SFE claim based on the effects of 'wider macro-economic circumstances' on TWUL alone. If there was evidence that such economy-wide effects were material, and the informal consultation does not contain evidence that they are, then Ofwat should consider an SFE claim for all companies, not just TWUL, since by definition all companies would likely have benefited from such effects to a comparable degree.

We note that Ofwat currently considers that targeting such regulatory action against TWUL would be justified on the grounds that TWUL is the only company to have applied for an IDoK in AMP5, whilst stating that other companies have opted not to apply for an IDoK. However, we do not believe that these arguments justify such intervention, for the following reasons:

- first, Ofwat has provided no reason why price limits that have been adjusted in accordance with the statutory duties set out in the Water Industry Act 1991 following a standard IDoK application, would warrant subsequent corrective intervention to reverse such an adjustment. If the mere fact of applying for an IDoK were to justify such corrective action, it would undermine the standard IDoK mechanism;

- secondly, for Ofwat to apply an SFE only to companies that apply for a standard IDoK would undermine IDoKs as a mechanism for allowing the recovery of categories of costs that were explicitly excluded from the price control in the event that certain pre-defined criteria are met. Such a change would send a strong signal to those preparing business plans that they cannot rely on being able to recover excluded costs incurred in respect of Notified Items and Relevant Changes of Circumstances; and
- thirdly, by taking action that effectively undermines the standard IDoK mechanism at such a late stage in the five year regulatory period, Ofwat would be demonstrating that it is willing to unravel the basis upon which five year regulatory settlements are determined. Such a move would have significant implications for the stability and predictability of the regulatory regime, with implications for the cost of capital and, ultimately, customers' bills.

We also cannot understand why the choice made by one or two companies not to apply for a standard IDoK has any bearing on the question as to whether an economy-wide SFE claim should be focused solely on TWUL. Should Ofwat choose to proceed with an SFE claim, we would welcome further clarification of this specific point.

Setting aside our serious concerns about Ofwat's proposal to focus an SFE based on wider macro-economic circumstances on TWUL alone, we question whether Ofwat could justify an SFE claim at all. The informal consultation paper does not address many of the questions that would need to be addressed. For example, it does not define clearly the circumstance (or circumstances) that have occurred, it does not identify or assess all the relevant effects, and it provides no analysis of the extent to which the effects are fortuitous, or are the result of prudent management action.

For these reasons, we are not in a position to answer the specific questions raised in the consultation in detail. However, our high level observations on Ofwat's questions are as follows:

- **Question 1: 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 would caution Ofwat against revising price limits on the 'basis of RPI' without having a very strong case for doing so. Ofwat will be aware that the attractiveness of the water sector to many investors is at least partially driven by the link to RPI, and thus retrospectively tampering with the definition of RPI would risk invalidating hedging strategies entered into in good faith. We also note that the basis for RPI was not changed last year (notwithstanding ONS' initial recommendations), and also that Ofwat has underlined its commitment to

retaining RPI for the indexation of the RCV, so it would appear to be inconsistent for Ofwat to adopt a different view in respect of price limits for AMP5. Before proceeding along this route, we therefore strongly advise Ofwat to undertake a full regulatory impact assessment and consider how such action would be consistent with the messages communicated by Ofwat's Chief Executive Officer in City Briefings during the course of AMP5, which underlined Ofwat's commitment to RPI, and determination not to 'meddle' whether unexpected changes in RPI were upwards or downwards.

- **Question 2: 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?**

We accept that TWUL, along with other companies across the industry, has seen lower borrowing costs during the course of AMP5. However, it is important to recognise that these savings arise only in respect of the incremental debt issued during the course of the AMP (given that TWUL, like other companies, prudently manages its debt maturity profile to contain refinancing risk). In addition, it should be noted that the majority of the gains from lower cost long term borrowing can be expected to flow through to customers in future regulatory periods. For these reasons, we do not understand how Ofwat could calculate that the gains from lower borrowing costs would reach levels that could justify an SFE claim. Instead, gains from lower borrowing costs appear to us to fall well within the range of gains and losses that TWUL accepted when it accepted the AMP5 determination. Should Ofwat choose to pursue the SFE claim, we would thus welcome further explanation of its position on this issue.

- **Question 3: Are there other relevant changes and effects we should consider?**

As noted elsewhere in this response, we feel strongly that an SFE claim based on wider macro-economic effects should not be applied solely to TWUL. As also noted above, if Ofwat wishes to proceed with an SFE claim, it would also need to carry out a much clearer and more comprehensive exercise to determine all the relevant upward and downward effects to establish whether materiality thresholds have been met and, if so, how K should be adjusted. The only other point we would make at this stage is that we would question whether it is reasonable for Ofwat to judge so-called 'gains' by reference to the AMP5 determination, as to do so effectively undermines incentives for



outperformance. (This is a point which Ofwat articulated clearly in its evidence to the Competition Commission in relation to the Substantial Adverse Effect claim made by Sutton & East Surrey Water in 2009.)

In conclusion, we would encourage Ofwat to reflect before applying an SFE claim based on wider macro-economic circumstances to TWUL. To proceed with regulatory action targeted at reversing the outcome of a relatively mechanistic and well-understood standard IDoK process, would risk bringing into question the stability and predictability of the regulatory framework with detrimental consequences for customers and investors across the industry for many years to come.

Yours sincerely

A handwritten signature in blue ink, appearing to read "M. Baggs", written in a cursive style.

**Martin Baggs**  
**Chief Executive Officer**