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Dear Sonia

This letter is in response to your informal consultation on a possible notice to determine Thames Water's price limits.

The role of equity is to take risk and absorb cost shocks. In considering whether to ask customers to take some additional risk by paying more in a price control for unexpected events, a company must look at its cash flows in the round. A company must also be sympathetic to the views of its customers and the circumstances in which they find themselves. In our view, a company not taking this kind of approach could justifiably expect to face significant criticism and scrutiny.

The substantial effects clause is an important part of the regulatory regime, and has historically helped reduce the cost of capital for the industry.

The proposal to begin to use it to reimburse customers for fortuitous events is understandable in the current economic and political context – but we must ensure that this does not impinge unduly on the perceived risk of the sector over the long term.

Regulatory practice has to date determined that its use in favour of companies is strictly limited to situations where the company is in danger of becoming unfinanceable – so if used in reverse consideration should be given to showing a symmetry of application. For example, if it is reasonable for a company to suffer from an unfortunate event in its entirety up to the point of unfinanceability it might not be appropriate for a company to receive no benefit from a fortuitous event simply because its quantum has breached a materiality threshold. Some form of tramline approach for upsides should be considered.

Quantitative Easing (QE)

The consensus is that QE has successfully kept the cost of debt low since 2008. Water companies have clearly benefitted from this when raising new debt through the period - as has the wider economy. But given that this was the desired impact of QE we do not believe a regulator should unwind these beneficial effects in their entirety. The fortuitous effect should be limited to any disproportionate benefit gained by water companies compared to the wider economy.

When water company Boards accepted Ofwat's price determination in 2010 they did so at a time when QE had been in place for some time and this would have influenced their decisions accordingly. The fortuitous event should be limited to any increase in the impact of QE on the financial markets post this date.

Sharing Outperformance

Ofwat needs to be explicit that it will take into account companies' own proposals to share outperformance with customers in a substantial effects determination. We are pleased that your consultation mentions this as a factor.

RPI

Indexation of the RCV by RPI is fundamental to the regulatory contract in water and in other regulated sectors. We agree that it would be to the ultimate detriment of customers to call this link into question by making ex-post adjustments to the RCV value. While we note your comments about the change in the way that RPI has been calculated, companies can, and do, take management action to hedge against RPI. In our case the increase in revenue associated with an increase in RPI is offset in its entirety by increased interest costs on index linked bonds.

I hope you find this helpful. As ever, we would be happy to discuss any issues further.

Yours sincerely

Best regards,
Andy

Andy Pymer
Director Customer & Retail Services