Ofwat's decision not to pursue a substantial favourable effect notice on Thames Water's price limits for 2014-15 – position note

This position note explains our decision not to pursue a re-opening of Thames Water's price limits for 2014-15 using the 'substantial favourable effect' mechanism.

Our decision has been made following:

- consideration of responses to our informal consultation on the application of substantial favourable effect mechanism; and
- Thames Water's decision not to challenge our determination of the application it made to us in August 2013 to re-open its price limits for 2014-15.

We have published the public responses to our 'Informal consultation on a possible notice to determine Thames Water's price limits for 2014-15' on our website.

A particular consequence of our determination of Thames Water's application has been that, like other companies, Thames Water has now accepted that its investors can absorb cost increases that have occurred in 2010-15 above the allowances assumed in existing price limits. In this context, we consider it to be proportionate that we do not issue a substantial favourable effect notice on Thames Water.

We remain committed to the continued use of the interim determination and substantial effects mechanisms that are included in company licences where their use is justified and appropriate, in the context of a company's wider package of uncertainty mechanisms and incentives in the regulatory framework. We confirmed this in 'Setting price controls for 2015-20 – risk and reward guidance' (our 'risk and reward guidance') and set out detail on our expectations on risk and reward and the appropriate use of uncertainty mechanisms as part of a wider risk and reward package in the next price control.

1. Background

In August 2013, Thames Water applied to us to re-open its price limits for 2014-15 through the interim determination of K ('IDoK') mechanism. In September 2013, we set out our plan to consider the application. At that time we said we would examine whether there was also a case for adjusting these price limits through a parallel regulatory process known as the substantial favourable effect mechanism.

In October 2013, we published an informal consultation[1] which set out our initial thinking on whether we should make a determination of Thames Water's 2014-15 price limits through this substantial favourable effect mechanism, to reflect the favourable effects on the company arising from certain specific changes since its price limits were set in 2009. The informal consultation closed on 7 November 2013.

Separately, we published our determination on Thames Water's IDoK application on 8 November 2013. We determined that the net relevant cost increases did not pass the materiality threshold in Thames Water's licence, and that its 2014-15 price limits should not therefore be adjusted in response to the IDoK application. The company confirmed it would not challenge this determination in December 2013.

2. Regulatory uncertainty mechanisms

The licences of each of the price-regulated water and sewerage and water only companies in England and Wales contain regulatory uncertainty mechanisms. These allow for price limits to be re-opened if certain defined circumstances change within the period of the existing price limits, subject to materiality thresholds defined in the licence.

These materiality thresholds protect customers and investors – neither a company nor Ofwat can seek to re-open price limits unless the intervening changes (beyond prudent management control) have had 'material' financial effects; a re-opening of price limits can only be sought if the materiality test is passed. There are such two uncertainty mechanisms.

[1] 'Informal consultation on a possible notice to determine Thames Water's price limits for 2014-15'.

- The **interim determination mechanism**, which can only be triggered by 'relevant items'[2]. These relevant items are typically one-way, but the licence also allows us to trigger a counter-notice to recover for customers funding previously allowed for outputs that are no longer being delivered or are not being delivered to the original timetable. The total net present value of changes from these relevant items must exceed 10% of a company's turnover. We adjust price limits using this mechanism in a way set out in the licence, having first established that the net additional costs are above the materiality threshold, have been efficiently incurred and are beyond prudent management control, in accordance with our statutory duties[3].

- The **substantial effect mechanism** is a two-way mechanism. It allows us to consider adjusting price limits where there have been other changes in circumstances, the net present value of which are greater than a different, higher, materiality threshold of 20% of a company's turnover. If this threshold is passed, we then decide whether and if so how price limits need to be changed. Unlike the interim determination mechanism, the licence does not prescribe a particular adjustment mechanism. In reaching our conclusions we must have regard to our duties, including those to customers and to secure that efficient companies can finance the proper carrying out of their functions. But this does not mean we must restore company profitability to the levels anticipated when we set price limits.

The materiality threshold for the substantial effect mechanism is higher than for the IDoK mechanism as it is only intended to address relatively rare and extreme deviations from the package of price determinations. Therefore, it is rarely used.

We discuss the role of uncertainty mechanisms in the context of the 2014 price review more generally in our risk and reward guidance.

[2] Relevant items are defined in the licence as either notified items or relevant changes of circumstance ('RCC'). Notified items are items that we specify when setting price limits, that are not allowed for in full, or at all, in the price limits concerned. RCCs comprise, for all companies:

- new or changed legal requirements;
- differences in the proceeds of land disposals from those assumed at a price review; or
- failure to achieve an output for which funding was provided.

Some companies (excluding Thames Water) have an additional RCC relating to the movement in the construction price index ('COPI') in their licences.

[3] Further detail on the IDoK process is set out in chapter 2 of 'Final determination of Thames Water's IDoK application'.

3. Ofwat's informal consultation

Our informal consultation set out two areas where we considered that Thames Water may have materially benefited from circumstances beyond prudent management control, not anticipated when its existing price limits were set in 2009.

- The reduced representativeness of the Retail Prices Index (RPI), as a result of formula effects, following a change to the way in which the ONS compiled its RPI indices in 2010, which has little impact on water company costs.

- The impact on market costs of capital of monetary interventions to help address the recession.

We said that our initial analysis suggested these circumstances were in combination sufficient to pass the materiality threshold to trigger consideration of using the substantial favourable effect mechanism. We asked for stakeholder views on these circumstances and asked if there were any others we should also consider.

We consider that investors in the water sector have benefited from the higher impact of the formula effect in the calculation of RPI. However, respondents raised concerns over any retrospective targeting of one 'technical' change in the calculation of RPI for only one company. While we have concluded not to issue a substantial effect notice in this instance, in developing our guidance on the cost of capital for the 2014 price review (PR14), we incorporated an adjustment to historical measures of total equity returns to allow for the change in size of the formula effect in the calculation of RPI in our risk and reward document.

In relation to the impact of monetary interventions by Governments and central banks on the market costs of capital:

- respondents agreed that the monetary interventions had resulted in a lower market cost of debt than envisaged when price limits were last set in 2009, and that companies have benefited from this. But respondents noted that the effects on individual companies will have varied; and
- respondents raised particular concerns over any retrospective re-opening of the market cost of equity assumptions used in setting existing price limits, noting that the extent of any changes arising from recent monetary interventions was not clear and a matter of judgement.

Respondents did not identify other changes we should consider.

We have taken careful note of respondents' more general views that any re-opening of existing price limits should not be undertaken lightly, particularly in this instance where the assessment of the overall impact of the circumstances we have been considering is a matter of judgement. .

4. Sharing of pain and gain

We considered the application of the substantial favourable effect mechanism in parallel to Thames Water's IDoK application. We restricted our consideration to Thames Water as, in the context of sharing pain and gain with customers in 2010-15, it was the only company we regulate that asked us to re-open the existing price limits and so increase customer bills above the caps we set in 2009.

Consultation responses received from Thames Water and the investor that responded suggested that consideration of the substantial effects notice should have been made to all companies. However, we note the comments from two companies and the Consumer Council for Water (CCWater), which supported our approach – in particular, that adopting such an approach differentiates companies and is essential to incentivise responsible corporate behaviour.

Where companies demonstrably share gains with customers, and deal with risks in the round without requiring regulatory intervention, more flexible responses to changes in circumstances can occur that align with customers' expectations. Many other companies have done this in the existing control period, sharing gains with customers in different ways – for example, through more price restraint and more investment.

For the next control period, we have asked companies to take account of risk in developing their business plans and to put forward appropriate proposals to manage and mitigate risk. Our risk and reward guidance sets out further detail on our expectations in respect of addressing risk and reward and the use of uncertainty mechanisms for PR14. The guidance reaffirmed our commitment to using existing uncertainty mechanisms in companies' licences to the extent they balance the interest both of customers and investors in dealing with circumstances that are beyond prudent management control.

A consequence of our determination of Thames Water's IDoK application has been that, like other companies, Thames Water has now accepted that its investors can absorb cost increases that have occurred in 2010-15 above the allowances assumed in existing price limits.

Following consultation on the application of substantial favourable effect mechanism and the outcome of our determination in respect of the IDoK, we have decided that it is proportionate that we do not pursue further the substantial favourable effect mechanism for Thames Water in this instance. Therefore, the company's existing price limits will remain in place for 2014-15.

Ofwat
February 2014