October 2013

Water today, water tomorrow

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

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About this document

This informal consultation sets out our initial thinking on whether we should make a further determination of Thames Water's 2014-15 price limits to reflect the effects for the company of certain changes in the macroeconomic environment since its price limits were set in 2009. The regulatory framework provides a mechanism for us to examine whether there has been a favourable effect for Thames Water because of factors that rest largely outside of its management's control. For us to examine this, a certain threshold of materiality must be met. This is a separate consideration to the interim determination relating to cost pressures that Thames Water identified (and to which we identified challenges in our recent draft determination document).

We are inviting interested stakeholders to make any representations to andrew.chesworth@ofwat.gsi.gov.uk as soon as possible, and in any event by **7 November 2013**. Any determination on these matters will then apply to bills for 2014-15. So, we are intending to conclude our thinking on these matters by early 2014. If, following this informal consultation, we do issue a notice to Thames Water, there will be a further opportunity for interested stakeholders to offer their views.

This document sets out important background information, including the relevant regulatory framework, before discussing the potential changes in the macroeconomy and effects that we might reflect in a substantial favourable effects determination. We conclude by setting out our proposed next steps in considering these issues.

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1. Background

Ofwat operates under a statutory framework with key statutory duties to protect the interests of consumers, and secure that water and sewerage undertakers' functions can be carried out and financed. It is important that we consider that our duty to finance relates to efficient firms carrying out their functions.

Since privatisation, we have set price limits every five years for each of the monopoly water and sewerage and water only companies that we regulate. In accepting the price limits we set, companies agree what they will deliver for customers, in return for the revenues that they can expect to recover under these price limits. They also accept the risk associated with delivering in line with those price limits.

In setting price limits every five years, we need to make assessments of the projected costs of efficient companies. These assessments require us to make assumptions for the wider macroeconomic circumstances that are likely to affect these future costs. All such projections are uncertain – and the macroeconomic environment was particularly uncertain at the last periodic review of price limits ('price review') in 2009. We recognised that fact in our final determinations.

So, the existing regulatory framework includes provisions for dealing with the uncertainties associated with setting price limits, and the risks they create for investors and customers. It seeks to allocate these risks to the parties best able to manage them. This is a necessary part of any incentive-based regulatory framework where price limits are fixed for a number of years.

Most regulatory frameworks include mechanisms to help sustain an efficient allocation of risks between investors and customers when circumstances change. They also help to address concerns that efficient companies may face circumstances where they are unable to finance their functions.

Where particular identified expenditures are difficult to predict and manage efficiently, the existing regulatory framework in the water sector in England and Wales includes provisions for price limits potentially to be re-opened if the combined net effects of actual changes are assessed to be material enough. These specific items, which are specified in each water company's licence, may qualify for an interim determination of K (IDoK).

The IDoK mechanism allows companies to request price limits to be re-opened to the extent that certain, defined, costs materialise that were uncertain or unknown at the time price limits were set (notified items), or so that costs associated with relevant changes of circumstance (RCCs) can be remunerated. It also allows Ofwat to claim back for customers certain, defined, costs that will no longer be incurred, according to the same criteria.

The framework also includes more general provisions (the 'substantial effects' provisions), to allow the broader impacts on companies of other intervening changes beyond management control to be reflected in a consideration of re-opened price limits, if such impacts are material enough. The materiality thresholds are higher for these provisions. These more general provisions complement the more specific ones in ensuring efficient allocations of the relevant risks between investors and customers. The substantial effects provisions offer protection both to customers and investors to the extent that a company receives a large financial benefit or loss as a result of circumstances that are largely outside of prudent management control, if the effect of the circumstances passes the materiality threshold that is set down in the licence.

Using these complementary mechanisms, companies bear and manage the risks of changes of circumstance up to the relevant materiality thresholds. But we can then review whether customers should share the costs and rewards ('pain and gain') of more substantial unanticipated changes beyond these thresholds, in considering the re-opening of price limits within a control period.

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.

2. Price limit re-opening mechanisms

The mechanisms in the licence allow price limits to be re-opened within the five-year period in specific circumstances where the assumptions underlying the periodic reviews change. Unless some opportunities to adapt price limits to significant changes were provided, companies would have to bear inefficient levels of risks and rewards (which would drive up finance costs and – as a result – customers' bills in the longer term). But re-opening mechanisms only allow price limits to be re-opened in defined circumstances and subject to **materiality thresholds** that are pre-specified in the licence.

These thresholds protect both customers and investors – neither a company nor Ofwat can seek to re-open price limits unless intervening changes (beyond management control) have had 'material' financial effects; these thresholds apply to both increases and reductions in costs and prices.

The licence provides for two re-opening mechanisms for this purpose.

- The **standard interim determination mechanism**, which allows a company, or Ofwat, to trigger a review of price limits for specific items that have a total net material impact on the company of at least **10%** of relevant turnover[1]. Specific items that can be included in assessing net material impacts are either:
  - items that are not allowed for in full, or at all, in price limits (notified items); or
  - RCCs that comprise new or changed legal requirements, differences in the proceeds of land disposals than assumed at a price review or failure to achieve an output for which funding was provided[2].

[1] The materiality threshold is defined in condition B of water and sewerage or water only company licences. To qualify as material, specific items must have a total net material impact on the company, in present value terms, of at least 10% of the company's appointed business turnover. Only non-trivial changes are taken into account for these purposes. To qualify as being non-trivial, each individual item must be in present value terms equal to at least 2% of relevant service turnover or, if a change does not relate exclusively either to the water or the wastewater service, 2% of combined water and wastewater turnover.
[2] All companies have the three RCCs referenced here. A small number of companies (which exclude Thames Water), have an additional change of circumstance that relates to movement in the construction price index, COPI.

Thames Water's application to re-open its 2014-15 price limits through the IDoK was based on its view that RCCs had increased its costs (in net terms) by more than this 10% threshold.

- The **substantial effect mechanism**, which allows a company, or Ofwat, to trigger a review of price limits, to the extent that a circumstance (other than covered in the standard IDoK mechanism) that is beyond prudent management control has a favourable or adverse effect on the company. The materiality threshold for the trigger of a price review based on substantial effects is higher than for the standard interim determination mechanism, as the value of effects must be at least **20%** of a company's turnover.

By their nature, changes of circumstances that are addressed by the substantial effect mechanism are less easy to pre-specify in the licence than those that the standard interim determination mechanism covers. Without a high materiality threshold, a provision to re-open price limits for unspecified reasons (beyond prudent management control) could undermine the stability benefits of setting price limits through regular periodic reviews. Accordingly, this 'substantial effect' provision in the licences has rarely been used – there have only been three relevant applications by companies since privatisation, while Ofwat has not previously issued a notice under this provision.

But the protections against the more substantial changes that this licence provision offers are an important element of securing an efficient allocation of risk between investors and customers. Similar provisions exist in other regulatory frameworks to secure an efficient share between customers and investors of the risks associated with inflexible price caps in the face of less frequent, high-impact changes of circumstance. While companies have the opportunity to seek a re-opening of price limits in the event that a circumstance arises that is outside of prudent management control that has a substantial adverse effect, the water licence framework has been intentionally balanced to afford Ofwat the same opportunity to use the substantial favourable effects provision for customers if required.

That is why we re-confirmed our commitment to these provisions in 'Future price limits – statement of principles', which we published in May 2012. We agreed with companies that we would continue to have these provisions in our regulatory framework, when adapting their licences to enable separate retail and wholesale price controls in the forthcoming price review, covering the 2015-20 period.

3. Thames Water's IDoK application

On 9 August this year, Thames Water asked us to increase the limits on its prices in the last 12 months of the current period (from April 2014 to March 2015). The company said that it has experienced changes to certain specific costs of which Ofwat did not take account when price limits were set in 2009. Thames Water did this by applying for an IDoK. It indicated that this application would add around a further 8% – about £29 – to the average household bill. The current average Thames Water household bill is about £354.

We are still assessing Thames Water's IDoK application. During our assessment, we identified that there were some specific offsetting changes that the company did not take into account in its application. We gave notice to Thames Water on 13 September that we intended to take account of these changes when determining the consequences of its application to increase price limits.

We published our technical consultation on our draft determination of Thames Water's application and our counter-notice (which relates to costs associated with outputs that are no longer being delivered or are not being delivered to the original timetable) earlier this month. This has now closed. We will be announcing our final decisions on this application and our counter-notice in early November, having considered the additional evidence provided to us in the technical consultation on our draft determination.

Also, in IB 20/13, 'Ofwat confirms process for challenging Thames' application for bill increases', we said that we were looking at whether Thames Water had benefited from economic circumstances beyond its control, such that we should consider these gains through the complementary established substantial favourable effect mechanism.

Thames Water's licence requires us to consider its own application for an increase in bills separately from any claim we might trigger under the substantial favourable effect mechanism. So, we are now consulting on issues relevant to the substantial favourable effect provision separately.

As Thames Water is the only company to have applied for an additional increase in bills before the next price review, we explained in IB 20/13 that we would only examine whether there is a case for clawing back gains through this substantial favourable effect mechanism from Thames Water within the framework for existing price limits that apply to 2014-15 prices. We consider this to be proportionate and targeted.

We are continuing to look into whether the benefits to Thames Water that arise from circumstances that are beyond its control make it appropriate for us to trigger the substantial favourable effect mechanism for the company in the existing price control period.

We confirm that we have made no decisions in relation to a substantial effect notice at this stage, and that we are only considering such a notice for Thames Water.

4. Initial thinking on changes of circumstance with substantial favourable effects on Thames Water

In general, we prefer not to initiate changes in price limits when there have been different and potentially offsetting impacts from different intervening changes between price reviews, as this could risk undermining the stable basis of risk allocation and bill expectations created for customers and investors in the existing regulatory framework.

We are considering a substantial favourable effect determination as a targeted approach for Thames Water for its 2014-15 bills as it is the only company that has asked us to review its price limits in the current control period, because of intervening changes in its costs since current price limits were set.

In the current price control period, we are aware of other companies that have taken a different approach and have not sought to change their price limits. These companies have clearly stated that there have been cost pressures – for example, as a result of changes to legislation, most notably the transfer of private sewers – and have also acknowledged that other aspects of the price limits, such as the cost of debt, have been far more beneficial than was envisaged. Other companies have publicly explained how they are sharing 'gains' with customers in the form of incremental investment programmes.

We have considered a broad range of factors that could be argued to be circumstances whereby Thames Water may have benefited from circumstances beyond its prudent management control, and whether these are likely to be relevant to the high materiality threshold of 20% as set out in the licence. In some areas, such as taxation, we have concluded that there is no case for our intervention. But there are two areas where we consider that Thames Water may have materially benefited from circumstances that are beyond prudent management control. Our work to date suggests these two areas are in combination material and we discuss these areas below.

4.1 Reduced representativeness of RPI during recession, due to formula effects

In 2010, the Office for National Statistics (ONS) set out a revised interpretation of how the Retail Price Index (RPI), with the composition relevant for the price control period, was understood to reflect wider prices in the economy[3]. Given its composition and basis of compilation, RPI is now understood to be less representative of general price movements in the economy than, for example, the Consumer Prices Index (CPI), particularly in recessionary periods such as that covered by existing price limits. The impact of the way in which the ONS changed the way it compiled RPI indices, which was largely related to how clothing prices are calculated, has little impact on water company costs, so its impact is constrained to where RPI is used directly for indexing revenues, index-linked debt and regulatory capital value (RCV).

This change occurred after we had set price limits at the 2009 price review and was unanticipated at that time. It may have resulted in significant net financial benefit (higher revenues, without offsetting changes in costs in the wider economy or faced by Thames Water) as a result of the price determination that has not arisen as a result of management action.

Although the water company licences include provisions for us to reflect material changes to the basis of compiling RPI in setting price limits, the change to the representativeness of RPI is not sufficiently material for us to trigger a re-opening of all companies' price limits by itself. But we reserve our position in exercising our powers more generally in respect of the use of RPI in setting future price limits, as set out in our methodology statement for the next price review[4].

We remain committed to using RPI to index wholesale allowed revenues and RCVs (although not retail service costs), as confirmed in our methodology statement. This should help secure the continuation of low-cost finance for investment in the water sector, aligning the indexation of allowed regulatory returns to the basis on which most index-linked debt continues to be priced.

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[3] http://www.ons.gov.uk/ons/guide-method/user-guidance/prices/cpi-and-rpi/cpi-and-rpi--increased-impact-of-the-formula-effect-in-2010.pdf

[4] 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans', Ofwat, July 2013.

Even so, in recent years some commentators have said that RPI is becoming a less reliable indicator of general price inflation in the wider economy, including that it over-estimates inflation. In January 2013, the ONS concluded that RPI did not meet international standards and recommended a new index – RPIJ be published[5] – and RPI is no longer used for setting and monitoring UK monetary policy targets. Also, Ofcom, for example, has proposed using CPI as the relevant index for setting price controls in telecommunications markets[6]. During the recent recession, RPI may therefore have been a source of particular gains for water companies, which was not anticipated in setting price limits in 2009.

4.2 Impact of monetary interventions on market costs of capital

Water companies have also benefited from the sustained and unprecedented monetary policies that have been pursued in response to the recent economic downturn. The Bank of England has confirmed its intention to continue policies that will have the effect of helping to keep market costs of finance low until unemployment has fallen further.

These interventions appear to have achieved one of their key purposes, to suppress the market costs of debt and equity to help nurture recovery from the recession. As a result, market costs of capital since 2010 have been below those we assumed in 2009, when we estimated the financing costs of efficiently financed companies in setting price limits for 2010-15.

In assessing such effects, we need to compare the impact of actual market costs with those we assumed in setting the allowed cost of capital in existing price limits. In 2009, using assumed market costs of finance, we derived assumptions for the allowed cost of capital for efficiently-financed companies using notional capital structures – and adopted a common industry structure for this purpose for all companies, including Thames Water. In our methodology statement, we confirmed that we would be continuing this basic notional capital structure approach to setting allowed regulated returns in the sector.

[5] http://www.ons.gov.uk/ons/dcp29904_295002.pdf

[6] See, for example, http://stakeholders.ofcom.org.uk/binaries/consultations/llu-wlr-cc-13/summary/LLU_WLR_CC_2014.pdf and http://stakeholders.ofcom.org.uk/binaries/consultations/review-wba-markets/summary/WBA_July_2013.pdf

Consistent with this, and with the basis of Thames Water's cost of capital assumption in its own IDoK application, we would expect to retain the notional capital structure assumptions used for setting existing price limits when examining the effects of changes to the market costs of finance.

The effect of lower market costs of finance in the current control period on allowed returns can be estimated, to identify the extent to which an efficiently financed and operated company has benefited – or ought to have benefited – as a result of prudent management action from these lower market costs over the control period as a whole.

It is our view that the actual capital structure that each company adopts is a matter for each individual company and its investors. But companies are incentivised to raise efficient financing and this includes the ability of prudent management to take advantage of low financing costs[7].

[7] Even so, in our methodology statement we have set out our intention to implement a new monitoring regime to help provide us with sufficient information on the potential impact of companies' actual capital structure decisions to safeguard consumers from any associated risks. See http://www.ofwat.gov.uk/pricereview/pr14/pap_pos201307finalapproach.pdf

5. Other potentially relevant changes and effects considered to date

As with the lower 10% materiality threshold used for defined RCCs for standard IDoK reviews, the higher 20% substantial effects clause requires us to consider the **net** financial changes arising from relevant circumstances.

So, we have considered additional potentially relevant changes, and other effects from those discussed earlier.

In principle, such effects can be both positive and negative for the company, and these would need to be offset in identifying net effects. But based on our consideration to date, our initial view is that other potentially relevant changes and significant effects may have been, in general, reinforcing instead. Below, we set out the main effects we have considered.

5.1 RCV gains from RPI

Each company's RCV is indexed to RPI. So, any gains arising from a divergence between RPI and general price levels would be included in the RCV, which is used to set allowed returns in future price limits. This would further increase the overall value of the regulated company to equity investors and increase the value of equity in market based valuations in the way that companies are valued in this sector. While these gains that are held in the RCV are not realised immediately, they can be realised on exit or as a result of higher dividends to the extent these are financed by increased borrowings.

We have reiterated our commitment to the RCV as a mechanism to provide stability to investors in water sector businesses subject to price limits (in both our future price limits statement of principles and our methodology statement). This is because we recognise the importance that investors attach to the RCV mechanism, in securing efficient low-cost finance for the sector. This is particularly important in the water sector, given the nature of the long-term investments required for companies' networks. Consumers benefit from lower finance costs in the longer term, and the regulatory commitment to the stability of the RCV is an important ingredient for that.

So, we do not propose to adjust the RCV for any shorter term gains from RPI indexation for the purposes of any further determination of 2014-15 price limits.

5.2 Net effects of recession on operating costs

Beyond the impacts of monetary and government policies to address the recession on both pre- and post-tax costs of finance, the effects of macroeconomic policies in recent years are also likely to have benefited regulated water companies more widely through the price limits framework.

This is because their RPI-linked regulated revenues have risen faster than the market prices of other relevant costs such as salaries and wages, as indices of retail prices rose faster than most relevant indices of relevant market input costs in this period.

Some other water company costs can rise faster than RPI, as they have different drivers. In the current control period these have potentially included the bad debt and Environment Agency costs included in Thames Water's IDoK application (and hence excluded from our separate consideration of substantial favourable effects), and energy and business rates costs. But having excluding costs covered in the Thames IDoK application, such costs are not in general dominant within water companies' expenditures.

But regardless of the general real-terms falls in input costs experienced in recent years, many of these costs are to some degree controllable by water companies' management. Allowing companies to bear the risks – upside and downside – of managing these costs, and thereby out-performing the rise in RPI, is an important core component of the sector's regulatory framework, agreed when price limits are set. It is only when the RPI index itself no longer reflects the anticipated scope of price variations in the economy in the same way that genuinely unanticipated and uncontrollable gains and losses may have been judged to have occurred as a result of the regulatory framework, as discussed above.

For these reasons, while we consider there may have been significantly greater net beneficial effects to companies in the sector arising from RPI rising faster in the recession than other key input costs (such as wages and salaries), we currently do not consider these to be appropriate to use as the basis for any review of 2014-15 price limits, although we would welcome views on this.

5.3 Adverse volume effects arising from the recession

In its IDoK application, Thames Water noted that, as well as increased bad debt costs, its net revenues had also fallen below assumptions made in setting current price limits because of lower sales volumes due to the recession. Because regulated prices are set to recover average costs, these volume reductions could affect revenues more than avoided costs in the period.

But Thames Water also noted that such estimated shorter-term revenue reductions did not take account of the revenue correction mechanism (RCM). This is a specific part of the existing regulatory framework relevant to current price limits, aimed at largely insulating investors from such volume effects in the longer term, as future price limits will be adjusted in the upcoming price review to compensate for changes in volumes against forecasts.

For this reason, we do not consider there to have been significant adverse impacts on such revenues from any unanticipated falls in volumes in the current control period. So, we currently do not propose to include such falls in our consideration of the basis for any further review of Thames Water's 2014-15 price limits.

In summary, while the unanticipated impacts of the recession, and wider policy responses to it, may have had other net additional favourable effects on Thames Water, we think the most important gains to consider in any re-determination of 2014-15 price limits in a substantial favourable effects case are the additional revenues arising from the basis of RPI and lower market costs of finance (for a company with a notional capital structure) because of sustained monetary interventions in the period.

6. Consultation questions

As well as responses to these specific questions, we welcome views from stakeholders on any of the issues we raise in this document.

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?

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?

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

7. Next steps

We will continue to carry out our analysis of the circumstances outlined above on Thames Water, drawing on the advice of our consultants, PwC. In order to issue a notice under the substantial favourable effect provision of Thames Water's licence, we need to assess whether the effects have been 'substantial' for the purposes of the materiality threshold in the licence. We have not reached a view on this issue at this stage.

Once we have considered the responses to this consultation and considered the advice we receive from PwC, we will reach a decision on whether the effects were likely to have been substantial, for purposes of a notice to determine the effects on the price limits for Thames Water that will apply in 2014-15.

We will also consider the impacts of carrying out such a further determination, in line with our duties. Once we have gathered and assessed relevant information, we will decide whether to give notice to Thames Water of our intention to make a determination of the effects on 2014-15 price limits.

Under Thames Water's licence, we normally have three months in which to reach a final decision, once the IDoK or substantial effect mechanism is triggered. But, as we discussed earlier, it would be our intention to make a decision on the substantial favourable effect by early 2014 in order for any adjustments to be included in bills for 2014-15. In the event that we issue a notice, we will publish a short consultation on our draft proposals to adjust the price limits concerned, to make possible a timely decision.

We expect any such consultation would start after we have made our final determination on Thames Water's existing IDoK application and our counter-notice.

8. Hearing your views and consultation periods

We are interested in initial views on our consideration of a substantial effects notice, and would welcome these as soon as possible, and in any event by close of business on **7 November 2013**. If we then decide to issue a notice to Thames Water and a draft determination in relation to substantial effects, we would expect to run a further short consultation of about two weeks on our proposed bill adjustments for 2014-15. We would consider consultation responses carefully before announcing our determination.

We think these consultation periods are appropriate because it will allow us to provide early clarity for all stakeholders at an important time in the business planning process affecting both the 2014-15 bills for Thames Water customers and our setting of price limits after 2015. It will also allow customers to better understand the overall impact of our decisions both on the existing interim determination application and our counter-notice, and any substantial effect determination.

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