Water 2020 – Consultation Response

Dear Sir or Madam,

We welcome Ofwat’s consultative approach to date as it develops its approach to the next price review under “Water 2020”. It is apparent from reading the December consultation that Ofwat has considered the responses to its July consultation, including from investors, and taken some of those into account in reaching its current position.

The purpose of this response is to highlight the key aspects of the 10 December consultation that affect investors. We understand Yorkshire Water will be making a more detailed submission.
Markets

Ofwat has now clarified the issues it seeks to address by introducing markets, the specific opportunities identified in water resources and sludge and the approach laid out in the consultation. In general, we agree that the introduction of market-based models may offer the potential to improve resilience and reduce costs for customers in the long term.

We believe that Ofwat has steered the right course by drawing a clear distinction between past and future investment. We do however encourage Ofwat to continue to work with companies to find the simplest and most efficient way of implementing markets in each of sludge and water resources. We are aware that the implementation of non-household retail has incurred significant financial cost and management attention. We suspect that water resources and sludge could be even more complex, depending on the model adopted. We therefore believe that the net benefit to customers is likely to be maximised under the simplest model that enables markets. We agree with Yorkshire Water that Ofwat’s objectives, including with respect to transparency and ensuring a level playing field, could be achieved without separate price controls or allocation of RCV.

In relation to Ofwat’s proposals for an enhanced competitive procurement regime, we anticipate that some infrastructure investors may be interested in such projects provided the investment opportunity is large enough to warrant the effort. We suggest that the procurement process should be as streamlined as possible to minimise bid costs.

Indexation

We acknowledge there is a rationale for a transition away from RPI. We welcome Ofwat’s recognition that the transition should be NPV neutral and also that companies should have the tools to make it revenue neutral, thereby avoiding the short term step-up in bills that would otherwise occur by transition to a lower index. Given the significance of this point, we encourage Ofwat to be as transparent as possible, including showing the mechanics and demonstrating the application of the principle over the long term (including the wedge protection mechanism).

We agree with Ofwat that a staged transition is important, considering both the significant level of embedded debt indexed to RPI and the nascent nature of the CPI-linked debt market. To ensure a successful introduction we believe that final decisions on the nature of the transition should be deferred to allow more time to assess the development of the CPI-linked debt market. In particular, it would be helpful if Government’s Debt Management Office were to indicate if and when it intended to issue CPI-linked benchmark Gilts. We are mindful of the implications for the UK water sector but also the broader implications for UK infrastructure investment.

We understand that the Office of National Statistics has also indicated interest in CPIH. If there is a risk that Government might adopt CPIH instead of CPI then that should be clarified before any transition is made. For the transition to achieve the goal of improving legitimacy, we believe it is important that the sector adopt the same index as Government. We also believe that the index-linked debt market will most likely align with the index adopted by Government over time. It would be undesirable to make a transition to one index but then have to reverse it and make a further transition to a different index.
We note that the 10 December 2015 consultation suggests that the proposed transition mechanism could be revised in future price determinations. We believe it is crucial that any transition be effected as a single change and that the transition mechanism should provide clarity on future AMPs, e.g. it might specify that existing RCV linked to RPI would amortise naturally over the run-off period. Otherwise the prospect of further changes to indexation will increase investor uncertainty, leading to an increase in the cost of capital as well as making this initial transition more difficult to manage.

The licence modifications required for the switch to CPI will need to include prescriptive detail on the mechanisms for transition and ensuring NPV neutrality in order to maintain investor confidence through the change.

We look forward to continuing collaboration with Ofwat on Water 2020 to ensure that there is no impact on existing investment and the sector remains attractive to capital providers in the future, such that the net benefits to customers can be maximised.

Yours faithfully,

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