

31 October 2013

Dear Chairman,

As I come to the end of my first year as Chairman of Ofwat I wanted to give you a heads up on some of the coming challenges, outside PR14, over coming months. I do this in the spirit that it is better to encourage companies to face issues before they reach the very public difficulties that, for instance, we see at the moment in other utility sectors.

CEO Induction

Very importantly, we have in the last week welcomed our new Chief Executive, Cathryn Ross. I know Cathryn is getting around the water sector and meeting CEOs in small groups, rather like the meetings I had with Chairmen on my arrival in this role. I'm sure in due course she will get out to visit companies, but you will appreciate the pressures of PR14.

Prices

You will have noted that the social and political concerns about utility prices have increased significantly in recent weeks. The level of public concern and the many representations made to us raise questions of how an independent regulator should react. Our role is to protect the interests of customers and ensure that efficient firms are able to finance their functions. We do so independently, and this will continue, with wide support. But independence also relies on accountability and ensuring that we do listen to social concerns - be they about growth, sustainability or as now, affordability.

As you know, having compared the harsh pressure on customers and the generous returns to water company shareholders from macro-economic factors over recent years, I and my colleagues have been banging the drum about customers and water bills for most of the last year. I am pleased to see the growing acceptance by some companies that prices can come down in real terms over 2015 – 2019. Sonia Brown has made clear that it will be for companies to explain why they can't reduce prices for AMP6 if they choose not to submit a plan with falling prices. We will ensure that the current pressure on prices does not interfere with a vigorous, robust and independent process for PR14.

Your PR09 settlement allows for price increases – nominal or real - in January for the 2015 year. However, it is the choice of each company whether or not to implement these increases. The context for increases is going to be difficult. In addition to the general concern about utility prices, we have to contend with an application for an additional 8% real increase - largely to fund the cost of bad debt and private sewers - from the largest player in the sector. This does not help favourable sentiment towards the whole sector. In January we may be publishing the results of a Substantial Favourable Effects claim undertaken in line with the regulatory principles of proportionality and targeting. Whether or not the result crosses the 20% threshold, even our consideration of an SFE claim would highlight again the very beneficial environment of AMP5 for shareholders. A continuation of dividends and

Jonson Cox, Chairman

Direct line: 0121 644 7550 Fax: 0121 644 7548 Ofwat, Eland House, Bressenden Place, London, SW1E 5DU

Email: jonson.cox@ofwat.gsi.gov.uk Website: www.ofwat.gov.uk

growth in RCV values at current generous levels - and on which we report - would have a similar effect.

In an environment where utilities are under public scrutiny, those with long memories in this sector will recall the water summit of 1997. None of us would want to get into that situation again by a failure to acknowledge social concerns. We are accountable to parliament and have been urgently considering our response to the recent debates across the political parties on affordability.

Our response is (i) we have clearly set out that maintaining customer legitimacy in the sector is critical. (ii) There is an opportunity for bills to fall in real terms between 2015-20 and if they cannot companies must explain to their customer why not and (iii) the question of what to do about 2014 - 15 prices sits with the Boards of companies. We understand that some Boards are already considering an abatement of k factors, or reducing prices, in the light of the continuing beneficial macro-environment through AMP 5 for water companies.

A responsive and responsible approach by companies may add significantly to the legitimacy of the industry with customers at a time when bills are under such focus. But the choice whether to respond to current concerns is for you, not us. It is for us to focus on strategic long-term industry sustainability and the independent determination of prices for 2015 - 2020.

When it comes to announcing price increases, unlike in previous years, Ofwat's CEO will not be giving the interviews on the Today programme and elsewhere to defend price increases. We have decided that it is for companies to present their price increases (or decreases) to customers and we will expect companies to stand up and explain their decision to their customers.

Board Leadership and Governance

I wrote to you all a month ago and we are looking forward to answers by close of play today. At the time of writing this, most companies have signalled their intention to accept our Principles and devise a Board code of governance for their company which will meet or exceed our standards. It has been pointed out to us that some companies, particularly unlisted companies, will struggle to meet the governance conditions in the PR14 methodology, which pre-dated my September letter. We will take Board leadership into account in our assessment of the quality of board assurance, which is a critical element of our risk based review. To help, Ofwat has issued a clarification note. This allows companies unlikely to meet the existing conditions an option to comply with our conditions by giving an unequivocal and binding commitment to meet our Principles.

Ofwat Funding

I wrote to all the Chairmen about the issue of funding Ofwat which came to light in the review that Sonia Brown undertook on becoming Chief Regulation Officer. I am grateful for the supportive responses and the time of writing this, all companies have indicated their broad agreement of the licence changes.

PR14

I need hardly comment on the intensive engagement both in Ofwat and in companies on PR14. I know Sonia and her team have met with every company over the last month. From my observation point, this feels like significantly better engagement than we showed in PR09 at the comparable stage. I hope that is your perspective too. Time is tight, and a new

methodology brings additional changes, but we look forward to working through the next few months as smoothly as we can. My Board colleagues and I look forward to seeing many of you at companies' presentations to Ofwat in December.

On the question of my comments on 2014- 15 prices, please do feel free to give me a call to discuss. Cathryn Ross will also be open to discussion on this in her meetings with CEOs

Yours Sincerely

A handwritten signature in black ink, appearing to read 'J Cox', written in a cursive style.

Jonson Cox
Chairman