



## **Transcript of investor conference call on the risk and reward guidance Monday 27 January 2014**

**Sonia Brown, Graham Taylor, Keith Mason**

### **Introduction from Sonia Brown**

Good morning. Thank you very much for joining us. My name is Sonia Brown, and I am joined on the call this morning by Keith Mason, our Senior Director of Finance and Networks, and Graham Taylor, our City Adviser.

Today, as many of you will know, we have published our [guidance on risk and reward](#) for PR14. It is crucial for there to be the right balance of risk and reward between companies and customers. You will hear from me that our guidance will allow good management teams that are outperforming for their customers to outperform the basic regulatory returns. This is designed to help ensure that companies and investors are focused on delivering customer priorities through ensuring that water and wastewater companies are as efficient as possible, and are delivering the outcomes that customers themselves consider to be important. I will explain the headline information that we published today, and then we'll later move to a discussion with your questions.

As the independent regulator, we have two important roles to play within the water and wastewater sectors. We protect customers' interests. This means that we are very mindful of the squeeze on household incomes, and we also make sure that water services are delivered to respond to the long-term challenges that are facing customers, including the environment. We also ensure that an efficient firm is able to finance its functions.

Over £116 billion of capital has been invested in this sector over the last 25 years. Efficient investment to meet customers' needs will continue to be a key responsibility for water companies. Getting an appropriate balance between risk and reward is therefore central to our role. At the simplest level, 10 basis points is roughly £2 per year on household bills.

Most of what I'm going to talk to you about today isn't new. We've been saying for some time that there needs to be a shift away from the reliance on financial outperformance and for excellent companies to gain in other areas, such as by delivering good outcomes for their customers.

I know that many of you have heard the message that we delivered last year, that there was an opportunity for the cost of capital to start with the number 3. Today, we explain in more detail how companies can take up this opportunity and secure the best possible outcomes for their customers.

This is not a negotiation. We are not today going out with the lowest possible numbers that we could. This guidance represents our best view as to the appropriate balance between risk and reward between companies and customers. The guidance that we've issued today is relevant to all companies.

In the headlines, it sets out that the PR09 equivalent vanilla WACC is 3.85%, and there will be scope for excellent management teams to outperform this. In addition, a well-managed company can earn higher returns from the competitive non-household retail market. Retail margins will be 1% for households and 2.5% for non-households, and the wholesale cost of capital will be 3.7%.

We are continuing to test the companies' business plans that we received on 2 December, and I will not be able to provide you today with any detailed feedback on these plans. Overall, it is clear that companies have worked hard to engage with their customers. And you can see, some companies have been guided in their plans through understanding their customers' requirements and needs.

On 10 March, we will announce whether any companies have prequalified for enhanced status. These companies will need to decide whether to accept this guidance, and in doing so will be eligible to be fast-tracked through the rest of the regulatory review. We will carry out further limited testing on the plans, and on 4 April, as previously announced, we will set out the full results of the risk-based review: whether companies are enhanced, standard, or in resubmission.

I will now go on to explain in a little more detail the key parameters of the risk and reward guidance. In past reviews, we've been able to focus on one single number. This time, we are moving away from a single price control to four for our water and wastewater companies. It may be helpful to refer to the table in the overview section of the guidance document that we published today, labelled [Table 2](#). But don't worry if you

don't have this to hand, as I will walk you through the key numbers and our high-level rationale for these.

The first and most important figure is what we are calling the appointee-level vanilla WACC. This compares most directly to the WACCs that Ofwat has set historically, and was 5.1% in PR09. Our estimate of this WACC is 3.85% vanilla; that's pre-tax cost of debt, post-tax cost of equity. This figure is the starting point for calculations for the returns for the wholesale and retail price controls. Importantly, there will be the scope for excellent management teams to significantly outperform this level, a point that I will return to later. Very briefly, let me explain why 3.85%.

The notional gearing assumption that we have determined to be appropriate is 62.5%. On the cost of equity, as you know, there has been much debate in recent months about the relative merits of short- against long-term estimates of equity market returns, and how to incorporate the ONS changes to the calculation of RPI. We developed the total equity range of 6.25% to 6.75%, and ultimately we settled at the top of this range. Our view of the asset beta at 0.3 was modestly below companies' views but in line with market evidence. Together, these support a post-tax cost of equity of 5.7%.

On the cost of debt, our view of 2.75% is based on a 75% weighting of embedded debt, and a cost of new debt that allows for the expected rises in interest rates over the period. This is consistent with the range proposed by some of the companies.

I want to be very clear with you. This is a genuine, forward-looking cost of capital, and as such we would not anticipate our view changing ahead of the final determination unless there were a substantial shift in capital markets or unexpected events that meant it was reasonable for us to revisit this.

Before I leave the appointee WACC, I should briefly mention how we plan to deal with the adjustments that all of the water-only companies have requested in their business plans. In the past, these have been called small-company premiums. In putting forward requests for adjustments, we expect these companies to demonstrate both that they efficiently face a higher cost to raise finance and provide an offsetting benefit to customers. Companies proposing these firm-specific uplifts have advanced arguments as to why the finance is more costly, but we haven't seen any evidence on the benefits to date. Companies must demonstrate that it is cost-beneficial to customers for any adjustments to be made.

I will now walk you through and explain the returns within each of the separate price controls. I will start with the retail price control for household customers. As you know, in water, household customers are not able to choose their supplier. Therefore there are no costs or risks associated with competition in this price control. However, given that the historical RCV has been allocated to the wholesale business, we need to make sure that retailers have access to sufficient capital, both to be able to invest and reward existing capital and to manage operational risk. Our guidance explains why we think a 1% margin is appropriate for this price limit, and how this is supported by independent evidence. This is around the midpoint of the range that the companies have proposed.

Moving on to the non-household controls, the UK government's water bill will allow competition to be introduced for all non-household customers in England, with a target date of April 2017. To both compensate for the risks and to allow efficient entry, we have determined that the appropriate margin should be 2.5%, of which a 1.5% is a premium above household retail. The premium is separate from, and in addition to, the return captured in the appointee WACC, and as I'm sure that you will appreciate, a competitive market will also deliver opportunities for well-managed companies to gain higher overall returns in time.

For the companies that operate wholly or mainly in Wales, there is a different non-household margin, which reflects the policy of the Welsh government not to introduce competition for business customers. The non-household margin here would therefore be 1%.

Turning to the wholesale WACC – there will be no difference in the wholesale WACC between water and wastewater. The wholesale WACC of 3.7% is calculated by adjusting the appointee WACC for the retail margins, excluding the premium for non-household competition.

I mentioned earlier outperformance. Our methodology has made clear that there should be scope for a good management team to outperform the regulatory settlement. This form of outperformance can benefit both customers and investors. These include the areas of cost, outcome delivery, the SIM, and financial outperformance. Companies need to reconsider the calibration of their incentives to the single WACC that we've outlined in our guidance.

We've offered guidance on the RORE range of 3.5% to 4.5% around the cost of equity. As we have seen from [RIIO](#), the move to totex targets has revealed significant

opportunities for efficiencies, with the result that companies, notably National Grid, have delivered significant outperformance.

Finally, you will also see in the guidance that we have explained the principles which we consider should underpin any uncertainty mechanisms between companies and customers. You will also see that we are calling for greater transparency in customer engagement in this important area.

I appreciate that you've heard a lot of numbers for a Monday morning. To recap, and this time I will give the numbers bottom up:

The wholesale WACC is 3.7%.

The retail margin, excluding the premium for competition, adds an average 15 basis points to the allowed returns, which gets us to 3.85% appointee allowed returns. And this is the number that compares to PR09.

The extra 1.5% margin for competition in non-household retail equates to a further 6 basis points of return at the start of the control, with the obvious scope for that to change over time.

Finally, our guidance on incentives means that cost outperformance, ODIs, and SIM should be able to add between 1.3% and 1.7% to the return.

The boards of the water companies should all now carefully consider this guidance. Look again at the evidence for their customers about the outcomes that matter to them, and if they consider appropriate, discuss this directly with customers and their customer challenge groups and consider how to get the best possible outcome for their customers.

I will now open the floor for any questions that you have, and Keith and Graham will join me in responding to your points.

## Questions and answers

Certainly. If you would like to ask a question at this time, please press \*1 on your telephone keypad. Please ensure that the mute function on your telephone is switched off to allow your signal to reach our equipment. If you find that your question has already been answered, you may remove yourself from the queue by pressing \*2. Again, that is \*1 to ask a question.

### Question 1

We'll now take our first question from John Musk from RBC. Please go ahead, your line is open.

**John Musk:** Good morning everyone. Just a quick process question, really. How are the companies now meant to be considering this new guidance, and therefore – are they resubmitting full business plans, or are you just asking them to consider this in their approach?

**Sonia Brown:** Okay, thanks so much John. There's an annex in the guidance that deals exactly with what the companies need to do. What we've explained in the first instance is what needs to happen for any companies that prequalify, and in particular, we've been clear on what parts of the business plan can be unlocked and what needs to remain locked. At the highest level, it's important that wholesale costs and retail costs remain locked within the business plan. Any prequalifying companies will be able to vary a number of elements within their plans and give us that information back on 17 March. As I explained, we will undertake limited testing to see whether we are sure that the guidance has been fully incorporated and there aren't any new problems within the plan, and then we will announce the outcome of the risk-based review on 4 April.

**John Musk:** Okay, thank you.

### Question 2

We will now take our next question from James Brand from Deutsche Bank. Please go ahead.

**James Brand:** Hello, two questions. Thank you for that, by the way, the comm call. Just to be very clear, in terms of the return guidance, where you say that the guidance is as you've outlined unless there was a significant change in the market conditions.

Does that mean, I mean formal guidance is 'not higher than 3.85%.' I guess my question is, if you're saying the number will be 3.85% unless markets shift, but in which case if they shift it will only go lower, and it couldn't go higher than 3.85%? That is the first question. And secondly, on some of the financeability mechanisms that you've talked about in the past in terms of capitalization rates particularly being an opportunity for companies, if they need it, to have more fast money – you don't comment much on that in the document as far as I've seen. I was just wondering if you could give an up-to-date view on how you saw the flexibility there for companies and whether that will be still a lever that companies can pull in order to address financeability metrics?

**Sonia Brown:** Okay. Well, I will start on the base rate questions, but I will ask Keith to add any points on financeability that he wants at the end of what I'm going to say.

So, on the first one – no, our guidance isn't saying that it's only a one-way bet associated with these things. But what we are saying is that for enhanced companies, there is a "do no harm" rule. And so, if you like, the 3.85% can be seen as the floor for enhanced companies.

With regards to your second question and the levers that we've given people in PR14 – that's why we're putting those levers back in the companies' control, because we recognise that with a new financial package, they may want to use those levers differently than how they've put them forward in their original business plans.

Keith, is there anything that you want to add on that?

**Keith Mason:** Well, only to emphasise that point that, yeah, it's completely now for companies to look at our guidance and then to have a look again as to whether those levers, i.e. at pay as you go rates, or the RCV runoff rate, whether they would need to change them from their original submission. So yeah, all those levers are still open to companies.

**James Brand:** Okay. Thank you.

### Question 3

We'll take the next question from Dominic Nash from Macquarie. Please go ahead.

**Dominic Nash:** Good morning. Two questions, please. The first one is on order, again, which is you've come up with quite an aggressive return on equity first, but we're

basically going to be getting the Ofgem consultation on cost of equity in February, and that's based on their interpretation of the Competition Commission, which I think comes out in March. Is there not a risk that by going first and early, that you could get your cost of equity wrong if the CC or Ofgem were to say that these returns should be higher? Secondly, on the wholesale WACC, you've essentially come up with a cost of capital on an appointee basis, which includes retail, and then deducted the retail margin from the return you get on the regulated WACC. Does that not mean that essentially, that your cost of equity that you've given for the wholesale isn't 5.65%, it's actually 5.2%, which is a, very low, but also – does it not also go against the Ofwat's original 'we won't change the WACC process', because you've kept the WACC the same, but essentially, you're now deducting a return that you achieve from that WACC, all things being equal, on the way that you've calculated it?

**Sonia Brown:** Okay, I'll start with the first question, and then I'm going to ask Graham to pick up your second question, Dominic.

I think the first thing to say is that we have formed our view on the cost of equity on the basis of both empirical evidence and regulatory precedent. The announcements from the Competition Commission on their draft determination were helpful because it helped confirm a direction of travel that we were already thinking about. And so I think we are in this place on our own, albeit that we think that it is very helpful that those regulatory precedents have confirmed our position.

**Dominic Nash:** They're not confirmed yet, are they? The Competition Commission are still coming back with the final in March?

**Sonia Brown:** That's absolutely right. But I think that we can see that there's a clear direction of travel in thinking from the Competition Commission. But I'd go back to the point that we actually set our indicative range associated with this prior to that decision. And what we're saying to you this morning is in alignment with that indicative range.

Graham, do you want to pick up the second point?

**Graham Taylor:** Yes. Dominic, I understand how you're getting to that lower number on the allowed equity returns, but I think it's the wrong approach to take.

So long as there are significant retail assets sitting in the wholesale control, the wholesale WACC will need to be adjusted downwards to make sure that we're not remunerating those assets twice, both in retail and in wholesale. So I don't think it's

productive to look at the wholesale allowed return in isolation. The right way to look at it is at the appointee level, the 5.85% WACC, the 5.65% cost of equity.

**Dominic Nash:** But the 5.2% on the wholesale will be how the Competition Commission will look at it if there were to be an appeal, because that's it – the retail is split from other regulated assets. So isn't there a risk here that you're setting a cost of equity so low that there could be a CC referral that overrules you?

**Graham Taylor:** I don't think that is how the CC would look at it, and I think that when you've had time to look through the document in more detail, you'll see how the bridge from appointee to wholesale works. There is a quite robust calculation going on there.

**Sonia Brown:** I think the thing that I would just add is to say that it can't be – there is fundamentally no additional incremental risk associated with the household retail business. They will continue to do what they're doing today. So to do something that would effectively remunerate incrementally above that level seems to be completely inappropriate to do from a customer perspective.

**Dominic Nash:** Okay. Thank you.

## Question 4

We'll now take the next question from Edmund Reid from JPMorgan. Please go ahead.

**Edmund Reid:** Good morning guys. I have two questions. The first one was on financeability again. So the companies obviously have some levers that they can pull. Most of those would then lead to bills being higher in the next period. I was just wondering what the balance is between higher bills to the companies and maybe the companies accepting maybe a lower credit rating, and whether that was something which was on the table for them in terms of an option. And then the second question is in terms of the 1.5% premium on non-household retail, how does that translate into a WACC additional return on the regulated asset base?

**Sonia Brown:** Okay. I will answer your second question first, Ed, and then I will pass over to Keith to address your points around the balancing act associated with financeability, rate levers, and credit ratings.

I think that the 1.5% premium is basically 6 basis points. Keith, do you want to pick up the point on financeability?

**Keith Mason:** Well, Ed, only to say that this is exactly what companies have got to balance off, and that's why we are saying look at our guidance and use the levers, and come back overall and see where a balanced plan comes out. It's completely for companies to decide where they want to pitch their financeability metrics and credit ratings, and look at the overall outcome for customers.

**Sonia Brown:** I think that the thing that I would add, Ed, is to say that obviously the whole point of all of these levers that we are giving the companies is that they're not just considering prices in one five-year period in isolation. They're looking at things into the future. So they will be balancing how they are utilising these levers not just for the next five years, but also the impact into the longer term, and it's very much with a mind to these types of balances that we will be assessing when get back from the companies.

**Edmund Reid:** Okay, that's very helpful. Can I just clarify one thing? Did you say 6 basis points for the 1.5%?

**Sonia Brown:** Yes.

**Edmund Reid:** Okay. All right. Thank you.

## Question 5

Next question is from Guy MacKenzie from Credit Suisse. Please go ahead.

**Guy MacKenzie:** Good morning. Two questions. The first one, coming back to financeability. You obviously talk about companies demonstrating financeability in their revised business plans with RCV runoff rates and the pay as you go ratios. But as far as I can see, you don't really discuss the results of the Ofwat analysis other than the conclusion of the 62.5% notional gearing estimate. You mentioned in the release in December that companies could assume lower levels for certain financial ratios than those assumed at PR09 or defined by the credit rating agencies for a particular rating. Are you able to say what assumptions you used on credit ratings or on the thresholds of financial ratios when you're doing your financeability assessment? And then the second question, just on dividends – in 2009, I guess the assumption was a 7% cost of equity and an underlying 5% payout and a 2% real equity RAV growth. With the cost of equity falling to 5.65%, do you have an updated split of what your underlying assumption would be from 2015 to 2020?

**Sonia Brown:** I'm going to ask Graham to pick up your first point on financeability.

**Graham Taylor:** Guy, your first question was about how we landed on the 62.5%. PwC's range, which we talked about at the time of the methodology in the summer, was 60% to 70%, and it became clear that a number in the lower part of that range was sensible from a financeability standpoint. There was some discussion in the document of how we got to 62.5%, which was in a significantly narrowed range of 60% to 62.5%.

Your second point was on credit ratings. I think we made clear in that Q&A that you were quoting from that we aren't defining financeability in terms of credit ratings as such. We're trying to avoid defining it even in terms of specific ratios.

We've always talked about two parts to the financeability duty: to ensure that companies get a fair return, and then, second, that they have cash flows sufficient to raise capital. In my view, the first part of that is the critical one. If a fair return in the short term produces insufficient cash flows – because, in this instance, equity is getting a lot of the return through the indexation of the RCV – we think the solution is to let them monetize some of the asset growth via the methods we talked about earlier, the pay as you go ratios, the RCV runoff, rather than to give returns in excess of what is fair.

This is something that Ofgem and Ofwat have talked about quite a lot in the past. Ofgem provided NCV-neutral financeability adjustments some time ago. We talked explicitly about doing that in PR09. I would think of these new levers as effectively NPV-neutral financeability mechanisms put in the companies' hands for them to control.

**Sonia Brown:** Okay, and then I think on your second point about what it means for dividends, et cetera. I think that will wait and answer that question once we see the proposals back from any of the companies. So another six weeks or so before we'll be able to answer that one, Guy.

**Guy MacKenzie:** Okay, thanks.

## Question 6

We'll take the next question from Lakis Athanasiou from Agency Partners. Please go ahead.

**Lakis Athanasiou:** Hi, guys. Two minor questions, and one major one. First minor one – just to clarify on enhanced status, you seem to be suggesting that the 3.85% will be the absolute minimum that an enhanced status company would get, so that if you were for some reason to flex down the allowed return later, they would still get the 3.85%. If

you could confirm that that's what you said. Second minor question is, could you just give a couple of parameters that went into your thinking on cost of capital? I'm thinking inflation and if you've made any assumption on the proportion of index-linked debt in the mix. The main question on financeability is in two parts: one is are you going to be doing your financeability tests with individual companies with actual debt, or are you going to be looking at your parameters that you've put out, so 62.5% geared company with a 2.75% real cost of debt you said. And the second one is, if you are going that route, then what you've done here is plainly not financeable when you use pay as you go instead of opex. And one of the ratings companies has certainly said, we will look at any changes in capitalisation and pay as you go and depreciation. And you're saying, 'No, we disagree, you shouldn't; you should use the opex capitalisation mechanism to get the financeability.' And yet, they're saying, 'No, we're not going to look at it that way.' How do you square that circle?

**Sonia Brown:** Okay, so I'm going to start off and then I'm going to hand over to Graham on this. I think the first thing to say is that on enhanced status, just to be very, very clear, what we're presenting here today is our genuine forward look associated with the cost of capital, so that if we were having to make final determinations today, these would be the numbers that we would be utilising. But what we're trying to do is to give those numbers much earlier in the process to give everybody as much time as possible to think about what it means for them and their own plans.

As far as enhanced companies are concerned, the 'do no harm' rule is asymmetric, by which I mean that if it became the case that we needed to lower that estimate, then we would do no harm and hold still the overall package that enhanced companies got to in April. But if, conversely, rates were to aggressively rise because of shocks to the capital markets, for example, then we would increase the package of the enhanced company in those circumstances.

I'm going to hand over the Graham on the other points.

**Graham Taylor:** Lakis, the inflation assumption we used was 2.8%. On the index-linked debt, I don't think we set that out in the documents. We did, of course, have to make an assumption for that in our modelling, and we used a number materially below the actual industry average. But I don't think we went further than that in the document.

And on your rating agencies point, we certainly take the view of the agencies very seriously. We maintain a very regular dialog with them. While we're saying that the rating agency credit rating is not the be all and end all in terms of the definition of

financeability, it has a very significant impact on the borrowing costs of the industry, and so we're very conscious of that. Beyond that, though, it really is a matter for the agencies, and for the companies, as it would be in any other industry.

**Lakis Athanasiou:** And the question on where you do your financeability tests? Will you be using the actual cost of debt and actual gearing of the companies, or will you be using your parameters for the cost of debt and gearing?

**Sonia Brown:** Lakis, all of the work that we do is around the notional structure. It's not around the actual positions of any individual companies because as some of you have written, if we were to do that, it would introduce an element of moral hazard within these arrangements. And there is a real risk that transfer of decisions that companies might have taken in the past that have been inefficient would transfer across to customers in those circumstances.

**Lakis Athanasiou:** Okay, thank you.

## Question 7

Next question is from Harold Hutchinson from Investec. Please go ahead.

**Harold Hutchinson:** Good morning, everyone. Forgive my Monday morning grogginess, but could you just repeat to me exactly what you said on the small company premium? And specifically, I'd like to understand whether Ofwat does or does not believe there is persuasive evidence that a small company premium exists in markets? And then finally, if it does believe that such a premium exists, is the implication that you have to justify in operating terms the benefits of being small per se rather than, say, merging in order to get any uplift? Thanks.

**Sonia Brown:** Thank you ever so much for the question. I think what we're saying on small company premiums is that the door is open for companies to make the case, but the bar in terms of the evidence that is needed is high. And so what they will need to do is to explain, on the one hand, why any incremental cost of finance is as efficient as it possibly can be. And that's the first challenge.

And then the second challenge is that they need to construct an argument as to the benefits that they bring, either as a small company to their own customers, or alternatively, to customers overall. And so it needs to be that this is cost-beneficial to

customers in order for us to actually allow these premiums or these adjustments to occur. The door is open for evidence, but the bar associated with it is high.

**Harold Hutchinson:** Okay, thanks.

## Question 8

Next question is from Harry Wyburd from Barclays. Please go ahead.

**Harry Wyburd:** Morning guys. Just one very simple question. On your 3.5% to 4.5% RORE range, outperformance range, do you happen to know what the range was for the current regulatory period, just so we can compare?

**Sonia Brown:** I think that we'll have to get back to you, Harry, on that.

**Harry Wyburd:** Okay. Thanks very much. That's just one question, thanks.

**Graham Taylor:** Harry, if you look at figure 10 in the document, that gives you a good sense of history.

**Harry Wyburd:** Okay, thank you.

## Question 9

Next question is from Dominic Nash from Macquarie. Please go ahead.

**Dominic Nash:** Hi guys. Perhaps following on from Harry's question, regarding potential outperformance – could you just, I probably should know this one, but do you have an IQI or CIS score table process in this review? I guess any company that gets fast-tracked will by default end up with a score or 100 or whatever score you get. When you put your outperformance numbers of 3.5% to 4.5% around the RORE, and I think you quoted that a 1.3% to 1.7% is cost outperformance, would it be expected that a fast-tracked company would almost certainly be at the higher end of the outperformance range, or am I sort of missing the point there?

**Sonia Brown:** Thank you so much, Dominic. It's not you, it's us in a sense that because we haven't had draft business plans this time, we haven't been able to construct any of the draft menus for wholesale costs. And our testing in that area is actually still ongoing. So it won't be some time until you see the overall menus from us.

I think it's really fair to say that you would expect an enhanced company to outperform at a higher rate compared to others, not least because of the whole benefit of fast-tracking means that they get an opportunity to have an early start with regards to the AMP compared to everybody else. And what we've obviously also said is that those companies will receive a financial uplift through the way in which the menus operate, which is one of the financial benefits of being enhanced.

**Dominic Nash:** Okay, thank you.

## Question 10

Next question is from Robert Anson from Newton. Please go ahead.

**Robert Anson:** Hello there. A new, more basic question on the RORE calculation, just to make sure I'm not making a mistake here. The 3.5% to 4.5% – that is the range around the 5.65%. So we're talking bottom, the lowest a company can earn is 2.15% return; where equity is the highest, it's 10.15%. I guess one reason why that jumps out is that the bottom of the range is below the cost of debt assumption, which looks pretty punitive. And secondly, on that RORE question – how far away is the average business plan from actually being in a decent shape to set up a full range of these RORE options? Is the average company going to struggle to resubmit the plans in time? Thanks.

**Sonia Brown:** Okay, Robert. Just to say on RORE, your analysis is correct, and we've set out more information on that in the outperformance chapter within the guidance. Within the guidance itself, you can actually see in figure 9 and 8 the overall RORE ranges that the companies have proposed.

I think my overall view is that there is huge variation at the moment, and therefore I think that there would be more for some companies to do than others. That's not surprising, really, because at the end of the day, we didn't expect it to be the case that all companies were likely to be in a position to be able to pre-qualify.

**Robert Anson:** Okay. Thank you.

## Question 11

The next question is from Andrew Moulder from CreditSights. Please go ahead.

**Andrew Moulder:** Hi. I think I've understood most of what you're saying. But I just wanted to be clear on the credit rating implications here. You said that the credit rating not the be all and end all. You said that it's up to companies to decide where they want to pitch their credit ratings. It is a bit different from what you said before in terms of – before, you said companies should have a comfortable investment-grade rating. It doesn't sound like that's what you're saying anymore. I just wanted to be clear on that, that you're now saying, if a company wants to be BBB-, that's fine, or even if they want to be sub-investment grade, that's fine, as long as they can finance themselves. I just want to know how that also fits into your thinking on the cost of debt assumption. Obviously, if you're not now at a comfortable investment-grade rating, a much lower rating could lead to a much higher cost of debt, particularly on the cost of new debt. Could you just talk me through all of that, please? Thank you.

**Sonia Brown:** I'm going to pass over to Keith to pick up the first half of that as it regards to the rating implications.

**Keith Mason:** Yes, I think the key thing to say is that although we're not going to be specifying the particular credit rating range, most of the companies – and we would like all of the companies to – have a licence condition about maintaining an investment-grade credit rating. So when you talked, Andrew, about whether they could target sub-investment grade, I think the answer to that is probably not.

But in the investment-grade rating element, yes it is for companies to make their own decisions.

**Andrew Moulder:** I'm sorry, Keith, can I just come back a little bit on that one? I thought the licence condition about investment-grade rating was a best-endearments basis. I mean, could they not argue that with the price control you're setting, it's not within their power to maintain an investment-grade rating, and therefore this licence condition is meaningless?

**Keith Mason:** I wouldn't say that. The best endeavours clause is put in because it's clearly a legal document, and there may be very specific circumstances why that's not the case. But in the general, overall, day-to-day running of the business, including dealing with price reviews, having the investment-grade rating is part and parcel of having the licence.

**Andrew Moulder:** Okay.

**Sonia Brown:** And on your second point, around the cost of debt, we've obviously modelled it across a range of different ratings around what we think the notional company is likely to be able to sustain within this period and satisfy ourselves associated with this.

Just more widely on financeability – I think it's really important to remember that the majority of levers – and I'm not just talking about PAYG and RCV runoff rates – sit with companies, they don't sit with regulator. And so we will be looking to the companies to manage all of these issues, and to ensure that they are as efficient as possible in actually balancing the overall blend here.

**Andrew Moulder:** Okay. Thank you.

## Question 12

We'll take our next question from Robert Anson from Newton. Please go ahead.

**Robert Anson:** Hi, just one more from me. Your embedded debt cost assumption. There's no premium for embedded debt versus new debt in the cost of capital assumption. I just wondered how confident you are that that will bear any challenge to the Competition Commission, because as I read the recent document, it seems to be much more generous on the embedded debt assumptions in the Northern Ireland case.

**Sonia Brown:** I'm going to pass that one across to Graham.

**Graham Taylor:** Hi, Robert. So you're right. We arrived at the cost of new debt and the cost of embedded debt on an entirely separate basis. We looked at those independently. At the end of the day, we came to numbers that were very similar for the two. Clearly, borrowing costs right now are very, very considerably below where embedded debt is. But we made assumptions about how credit markets will evolve over the next number of years – we have to do that – with the end result that the numbers aren't far off. I think the critical observation is that if the companies were able to do all their borrowing today, it be very much below that.

**Robert Anson:** Okay. Thank you.

## Question 13

Next follow-up question is from Edmund Reid from JPMorgan. Go ahead.

**Edmund Reid:** Hi, guys. This is quite a general question, and I know you're not going to talk about your decision making around whether the companies' business plans or enhanced or not. But there seems to be quite a big difference between how you're looking at this review and how a lot of the companies have been looking at it in terms of you seem to have set a lower return but with more symmetrical incentives, whereas the companies obviously have asked for higher returns with more downside. I'm just wondering how you then judge the companies' business plans, given the very fundamental difference in ethos?

**Sonia Brown:** Thanks ever so much, Ed. I think that you're right as a generality, but obviously across the number of companies that we're regulating, there some quite divergent view even within the companies.

I think that the concern that we had with higher returns and downside is that there is a real risk that the companies strive to a model of financial outperformance – which there's nothing wrong with, that they keep the focus on trying to make sure that treasury functions outperform – and that they're not actually stretching themselves to outperform what their customers actually want.

I think that if you go back to our methodology document, we are really clear that there were circumstances in which it was really important for companies to potentially stretch their customers, and if they did stretch, then there was the opportunity for them to earn higher returns associated with this. So I'm not sure that this is a new policy.

I think the other thing that I would observe as well is that times have been very tight for all of us in this review process, and I think that some of these questions around the structure of incentives and the overall rewards package would have merited another go-round within the companies, with the opportunity to talk further with customer challenge groups and customers about what the overall package and balance between risk and reward really meant for them.

**Edmund Reid:** Okay. Thank you.

## Question 14

Next question is from Iain Turner from Exane.

**Iain Turner:** Morning everybody. If I could just ask a couple of questions. Firstly, if you're prequalified but you don't fancy these costs of capital, what do you actually have

to talk about with Ofwat over the remaining period of the actual price control process? How does that actually work? And then, secondly, when do the companies get sight of the enhanced menus to work out whether it's worth accepting or not?

**Sonia Brown:** On the first question, it's really important for us to be very clear on this. This is guidance. It's for companies to take this decision as to whether they want to adopt this guidance. It might be that a company thinks that they need to do a more fundamental change to their business plans to accommodate this form of risk and reward package than the time would allow right now. If that is the case, they should get all of the reputational upside associated with prequalifying because they really have tried their best to develop a really excellent business plan for their customers. But what happens is that they will drop into a standard process, because they will need more time themselves to work through how to make the overall package balance for them. So that's what happens in response to your first question.

On the second question, with regards to enhanced status and the size and scale of the prize – assuming that we have any prequalifying companies, that would be part of the information that we give on 10 March.

**Iain Turner:** Thank you very much.

## Question 15

We'll now take our next follow-up question from Lakis Athanasiou from Agency Partners. Please go ahead.

**Lakis Athanasiou:** Actually my question has now been answered, thank you.

## Question 16

Our next question is from James Brand from Deutsche Bank.

**James Brand:** Hi, just a follow-up, couple of follow-ups. I just had some questions on incentives. First question is, and apologies if you've put something in the document that I've missed at this point, is there, when you talk about incentives, should an average-performing company have scope to outperform? Is there anything that you've said in that area to give us a bit more granularity on that? And secondly, from a procedural process, do companies have to go back to consumer challenge groups to get their

revised business plans approved with Ofwat's incentive programmes? Could that create an issue if customers don't agree with the scope of the incentive programmes?

**Sonia Brown:** Thank you so much, James. I think on the first area, it's important to say that what we are doing at this point is effectively saying to people that we think that there is the scope for them to consider differently their overall incentive packages, and that we think that there should be the scope for outperformance in the areas that we've already outlined. As to what that means for the average company, I'm not sure that we can say at this stage because it's premature to do so.

I think on the second point on procedure, what we said in the document is that it's up to the board of the company to determine whether they want or need or feel that they should do any incremental customer engagement. And I come back to the point that I think that there are some plans where some of these types of incentive reward balances would be easier to move to than others. I guess it's a question of the scale of the changes, and those are the type of things that the boards of those companies need to be considering.

**James Brand:** Thank you.

## Question 17

We'll now take a follow-up question from Lakis Athanasiou from Agency Partners. Please go ahead.

**Lakis Athanasiou:** Hi, a question on timing on the incentives. Now that you're proposing that the incentives should be more two-way, there's going to be thinking on what the timing of when you actually get the reward should be. RIIO, you've generally got a two-year time lag between performance and getting the reward, or are you still thinking next year will be true-ups at the end of the regulatory period?

**Sonia Brown:** Thank you so much, Lakis. Overall, I think that this is one of those elements that we are expecting the companies to come up with their own proposals on. So we'll see what they develop over the coming weeks.

**Graham Taylor:** Operator, we'll take one last question.

## Question 18

We'll now take our last question from Jamie Tunncliffe from Redburn. Please go ahead.

**Jamie Tunncliffe:** Yes, good morning. I just wanted to ask whether it's all up to the companies to decide on the issue of intergenerational equity. You mentioned, basically, that financeability tools are very much in their hands, and I just wanted to check if that's in their hands as well, and it's not something that you have a clear view on, or something that you're going to impose? Thanks.

**Sonia Brown:** Thanks very much, Jamie. I think that our statutory responsibility is to protect the interest of customers today and tomorrow. So this is something that we have to have a view on in the way in which we look at the plans from the companies. But like everything else, if they come forward with something that's really well-evidenced, backed by customers, and really clear as to their rationale, then I think that they'll be in a much stronger position to have their plans accepted than if it didn't have any of that evidence associated with it. So that's what we would be looking for.

Okay, well thank you ever so much for joining us this morning, and we look forward to reading your write-ups of the overall package. Thank you.

That will conclude today's conference call. Thank you for your participation. You may now disconnect.