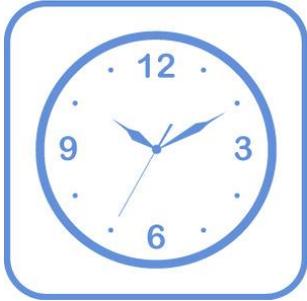




City Briefing

Cathryn Ross, Chief Executive

4 April 2014



Ofwat strategy – What matters to us, what it means for you
Cathryn Ross, Chief Executive

Q&A

PR14 – The journey to draft determinations
Sonia Brown, Chief Regulation Officer

Taking forward risk-based regulation
Keith Mason, Senior Director of Finance and Networks

Q&A

Ofwat city briefing

[Cathryn Ross] Welcome to the latest in Ofwat's City Briefings. Thank you very much for joining us today.

We've got three sessions for you today. Firstly we're going to talk about Ofwat's strategy: what matters to us and also what it means for you. And then we'll have a moment for some questions and answers.

Second we'll talk about PR14, which as you know has completed a major landmark this morning. We'll talk about the key points from that.

And then thirdly we'll talk about how we're going to regulate in the next control period.

Before we get into that, let me start with some introductions. As many of you will know, I'm Cathryn Ross, I'm Ofwat's new Chief Executive. I've been in post now for 6 months. Prior to being at Ofwat, I was at the office for Rail Regulation where I led their price review. And previously to that some of you will remember I was at Ofwat as the Director of Markets and Economics. Prior to that I worked at the Competition Commission and various other regulators. So I guess if you're looking to characterise me you can say that I am a professional regulator.

Looking to my left we have Sonia Brown, who is our Chief Regulation Officer, familiar to many of you, and leading our periodic review. And Keith Mason, who is our Senior Director of Finance and Networks, I'm sure most of you know.

Strategy – evolution



Before we get into the meat of the session, I thought it was worth spending a little of time covering one of the key questions that I'm often asked at the moment. And that is: what are your top priorities for Ofwat at the moment?

Well, firstly, delivering a successful PR14. What does that look like? Well it looks like a good outcome for customers, but also one that maintains the trust and confidence that stakeholders have in the water sector and its regulator.

Secondly, delivering a new strategy for Ofwat. That needs to encompass a vision for the sector because we need that in order to guide our work. But we recognise that that vision will not be the unique property of Ofwat, it must be something that resonates across the sector and its stakeholders. And crucially also it means a vision for Ofwat itself, something that spells out what sort of regulator we want to be.

And then thirdly, we need to deliver an Ofwat that is absolutely at the top of its game, with the capability and confidence to match its ambitions. And I'm really pleased to say that the substance of our conversations today will certainly cover the first two of those priorities.

So let me talk a little bit about Ofwat's strategy. We're in the process of developing a new strategy, but that strategy will build on the themes you're familiar with in our existing sustainable water strategy. And it will also take forward many of the themes that you will have seen develop through our periodic review.

In developing our strategy, we're very deliberately following an open and consultative process. And in our forward programme consultation, and in the final document published this week, we spelled out some of the things that feel really important to us at the moment.

First, and this won't surprise you given PR14, an open and constructive dialogue between companies and their customers that really drives what companies deliver.

Second, that means that our role needs to be focussed on facilitating and incentivising that dialogue.

We also need to acknowledge that water and wastewater services are essential public services, and we need to think about what that means. Part of what that means is the need for a safety net in relation to the provision of those services. Most obviously, perhaps, through things like drinking water standards and environmental protection. But perhaps also in terms of certain minimum standards for customer service.

And then the last thing that we said was important to us – and I really do think this is very important – is the need for us to work in an open and collaborative way as the regulator. I've spent a lot of time over the past few months talking to stakeholders about those themes, and

they really do seem to resonate, and we'll keep that conversation going over the coming months.

One size does not fit all



Water today, water tomorrow

In June we'll hold an event where we'll share our emerging thinking, and we will land on new strategy by the autumn, allowing us to take it forward on our next business plan, and crucially allowing it to form the first evolution of the regulatory model towards PR19. That said, although we're in the middle of the process, there are two key things that I'd like to share with you today.

The first is we are retaining a focus on outcomes. Outcomes are the things that matter to customers and society. If a sector, and I mean any sector but especially one that provides essential public services, delivers outcomes that are out of line with customer expectations, that sector loses public trust and confidence. And it loses legitimacy. And that sector becomes exposed to the risk of – how shall I put it – knee-jerk interventions.

Companies' managements need to focus on really understanding the outcomes that their customers want and are willing to pay for, now and in the long term. And there's been a step change on this in PR14, which I really welcome, particularly in the way the companies engage with their customers and other stakeholders. The challenge now is to maintain that through delivery in the coming control period.

The second key point, and the one illustrated by the slide, is that one size doesn't fit all in terms of the delivery of those outcomes. Companies manage the risk around delivery of outcomes: that's what they do. Investors earn returns that reflect how well companies' managements manage those risks. We have set up a framework through PR14 that allows more clarity than ever before on the nature of the risks that exist in different parts of the value chain and in relation of the provision of different services. And you can see that by the fact that we now have four separate price controls, and you can also see it through other elements of the package, like the ODIs [outcome delivery incentives].

The change that we've made to our approach has also resulted in a massive increase in the volume and quality of information for company managements and for investors. We're also giving companies much more flexibility than ever before through the price control to manage risk effectively. And again you can see that for example through our approach on totex and through the ODIs, through menu choices and the additional levers on financeability.

The Water Bill gives companies further flexibility, especially now that the government's agreed to amend the bill by including provision for voluntary retail exit, which we really welcome as providing benefits both for customers and for investors.

We also recognise that changes to industry structure may be appropriate. I don't have an industry blueprint that I'm working to, but I would be surprised if 18 vertically integrated water companies were the most appropriate structure. And I want to say clearly that we are open to conversations about changes to that structure. Now I don't have a cookbook I could give you for exactly how those conversations would go, but I can tell you that we would be interested to know what benefits would flow through to customers from any changes, and

how those benefits would flow. That will depend on the facts of the case. But what I can say is we are open to those conversations.

So, the message I want you to take away from today, and as we develop our new strategy this is only going to get more important, firstly: focus on the delivery of outcomes. Secondly: look really carefully at the information that is now available more than ever before for decision-making. And thirdly: really understand the flexibility that companies' managements now have to deliver those outcomes and encourage them to use it.

So in conclusion: in this way, because we've aligned the incentives between companies and customers through PR14, we will get the best outcome for customers and for investors. And that's what we want.

Questions



So I'd like to open the floor now for some questions on that session. There'll be further opportunities to ask questions on other issues later on. We've got some roving microphones that will move around to you, so please do wait until the microphones arrive before launching into your question. And if you can be clear about your name and your affiliation, that would really help us.

[Peter Atherton, Liberum Capital] So Cathryn, you're sort of opening up the door for mergers I guess between the water companies. Can you give us a view on how you would look at the public interest on that?

[Cathryn Ross] Well it's very much as I said really. I mean, I don't have a cook book, I don't have a recipe to give you that will sort of guarantee that we would be happy with a particular merger or acquisition. But what I can say is we'll be very interested in having the conversation about what benefits would flow through to customers. And we recognise also that there's an issue in terms of the profile of those benefits, which we would be open to talk about. So really all we're saying is that investors and company management need to look at the information that is now available to them, think carefully about that... if part of that thought process involves changes in structure, come and talk to us.

[Robert Miller-Bakewell] Could I ask you about your comment about investors earning returns reflecting how companies manage risk... How does that tie into Ofwat's stated view that companies have perhaps been paying out too great dividends in the past?

[Cathryn Ross] Well I think, I mean looking forward obviously what we're trying to do is make sure that, firstly, through the price review we allow companies to earn a level of return and investors to earn a level of return which is genuinely commensurate with the risks of providing the particular services in that part of the value chain for which we're setting the price control. And then of course we're also saying – and Sonia will say more about this later – that there are opportunities on top of that standard package through things like the outcome delivery incentives, to earn additional returns if companies are going over and above that to provide what their customers want. And I think that's really the key to it.

Any more? You all want to talk about PR14, don't you?!

[Verity Mitchell, HSBC] Clearly there's a lot on your plate with PR14 and retail competition. So what's your timing about structural thinking; is it going to evolve, or do you have a timetable for coming to some conclusions about any further changes?

[Cathryn Ross] You mean changes to the industry structure? Well, as I said, I don't have a blueprint. I don't have a particular optimal industry structure that is the right answer that we're all working to. I think we're just all going to have to accept that there's going to be an

evolution over time, there'll have to be a learning process that will evolve over time and we'll need to keep the dialogue going and keep the conversation going through that. I don't have a particular timescale that sort of leaves me to think we need to reach that industry structure by then, it's just not going to work like that.

Anymore? Okay, well there will be a further opportunity for questions and answers at the end and obviously you can pick up on anything that occurs to you at that point. Right now I would like to hand over to Sonia Brown who is our Chief Regulation Officer, who's going to talk a little bit about PR14 and the landmark we've achieved today.



The journey to draft determinations

Sonia Brown, Chief Regulation Officer

4 April 2014

The journey to draft determinations

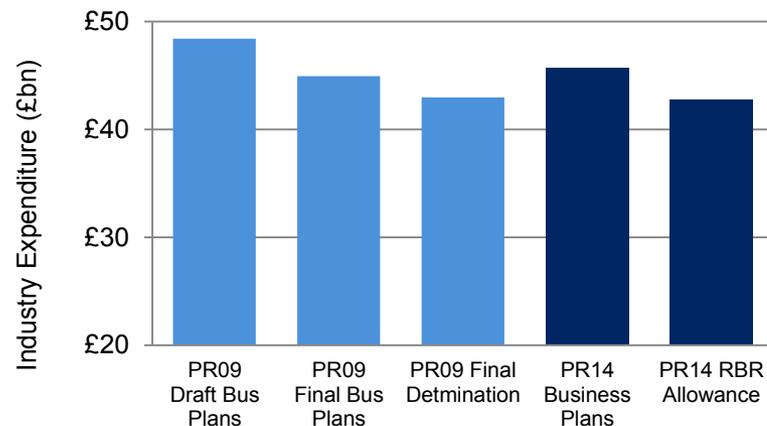
[Sonia Brown] Thank you very much, Cathryn.

Well – it's over. 18 business plans covering 64 price limits in 18 weeks: the PR14 risk based review is complete.

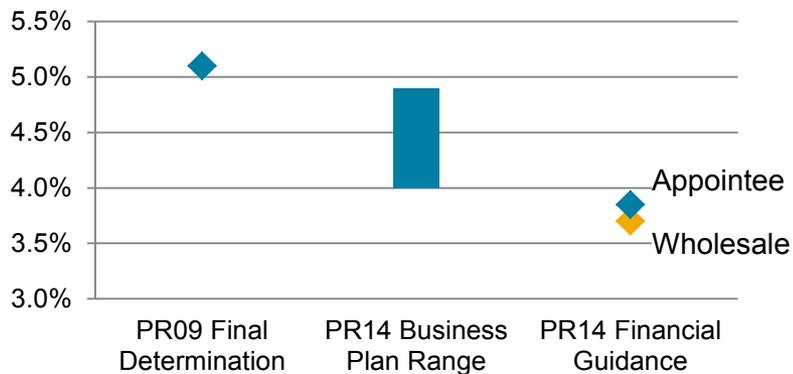
As many of you know, it hasn't been a straightforward race to the finish line. We've needed to change our course in response to the plans particularly regarding the cost of capital and risk and reward, but we've made it on time. And today I am absolutely delighted to have two enhanced business plans, being South West Water and Affinity Water – which can be fast tracked through our process.

Today we also published the full results of our risk-based review for all companies. Consistent with our overall strategy which Cathryn has explained, our aim is to be open and transparent throughout, which we hope will help all stakeholders understand the areas where discussions are ongoing in PR14. I will return to this point to later.

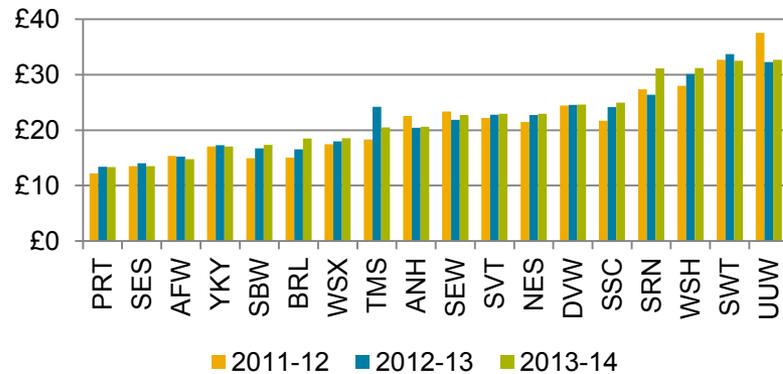
Better incentives driving better plans



Allowed Return



Unmetered Cost to Serve



Before getting on to the future of PR14, I want to very briefly reflect back to August, when I last stood in front of you. I said then that companies in the water sector would, for the first time, be competing for enhanced status – this would bring reputational, procedural and financial benefits. South West Water and Affinity Water are the very deserving winners of this prize.

We are also confident that business plans overall are of a higher quality, as a result of the incentives we have put in place, the hard work of the companies, and the scrutiny and challenge from the customer and challenge groups, which have really added value into the process. We don't believe that the plans will require anywhere near the level of regulatory intervention that has been the case in the past.

In PR09, for example, we saw a reduction of over 10% in the level of capital and operating expenditure between draft business plans and final determinations. You can see from the information that we have already published that our current expectation is that final levels of totex will be much more consistent, in aggregate, with companies' plans.

We also said that separate price limits for different areas of the value chain would reveal information for you as investors for the potential efficiencies to chase and opportunities to secure more value. This would obviously benefit both investors and customers. The move from one price control to many has already revealed much more about companies' performance, with predictable effects. For example, in exposing the cost to serve in household retail control, we've already seen improvements in companies' costs levels.

We said that customers should benefit from a significant reduction in the cost of capital that we've seen over the past five years. In January we set out our guidance for an allowed return, somewhat below companies' proposals but in line with market evidence.

We said that you would be able to tell who the really excellent management teams are from an objective assessment. This morning we have published detailed scorecards that set out where we think management teams have delivered excellent business plan proposals.

We made the promise that if companies listened to their customers, and developed a high quality plan, we would get out of their way. It's not easy for regulators to do this given our statutory responsibilities, but this is what we will do and very intentionally done with the plans of South West Water and Affinity Water.

On that note I would like to welcome Chris Loughlin, from South West Water, who will be followed by Richard Beinfait from Affinity Water – the front runners – who will present on how their proposals deliver for customers.



Getting to an enhanced plan

Chris Loughlin, South West Water
Richard Bienfait, Affinity Water

4 April 2014

WaterFuture

SUMMARY OF OUR PLANS

→ Balanced, well evidenced and well supported plan

84%
CUSTOMER
ACCEPTANCE

→ Most thorough customer & stakeholder engagement ever

- ✓ Challenged by WaterFuture Customer Challenge Panel including quality regulators



→ Capital investment programme increased by 19% to £868m

- ✓ Supporting 6,000 jobs for the regional economy
- ✓ Legislative driven requirements
- ✓ Measured pace
- ✓ Innovative approaches

£868
MILLION

→ Current performance

- ✓ Good operational and financial performance
- ✓ Recognise there are areas for improvement



→ Future performance - glidepath of improvements developed from 25-year plan

- ✓ Further efficiencies planned: 5.5% capex and 2.5% opex per annum



→ Balancing affordability & financeability is key (now and in the future)

- ✓ Recognised and responded to customer affordability

– Average bills held below inflation to 2019/20

- ✓ Careful consideration of required returns outlined in the risk and reward guidance

UP TO 13%
REAL
REDUCTION
IN BILLS

**EQUITY
RETURNS
UP TO 10%**

→ Continue track record of sharing outperformance

- ✓ Transparent pain/gain share mechanism proposed:

WaterShare

WaterShare	2019/20	2020/21	2021/22	2022/23	2023/24
WaterShare	10%	10%	10%	10%	10%
WaterShare	10%	10%	10%	10%	10%
WaterShare	10%	10%	10%	10%	10%
WaterShare	10%	10%	10%	10%	10%
WaterShare	10%	10%	10%	10%	10%
WaterShare	10%	10%	10%	10%	10%
WaterShare	10%	10%	10%	10%	10%
WaterShare	10%	10%	10%	10%	10%
WaterShare	10%	10%	10%	10%	10%
WaterShare	10%	10%	10%	10%	10%

Getting to an enhanced plan

South West Water

[Chris Loughlin, South West Water] Thank you. I don't know where to start, but I guess the best place to start is... I'm delighted to be here with you today. I'm delighted to be here presenting our business plan and having the pleasure of saying that we're one of the enhanced companies. So, delighted to be here. We think we've put together a very good quality plan, but now we're looking forward to moving towards the draft determination which will come in a few weeks' time, and then really focusing on delivering what we think is a good plan but a challenging plan as well. So we hope to take one of the advantages of going forward with an enhanced plan: that we can get on with delivering the outputs that we've promised in the plan as soon as we can. So, looking forward to that and we're looking forward to being able to prepare ourselves for the changes that are happening in the industry over the next few years as well. So, we're looking forward to starting our delivery as soon as possible.

Now it would not be appropriate for me to go through the details of our plan in any detail, it will take more time than we have available today. Most of you will have seen this document, which is our sort of investor summary of our business plan. This is still available; it's still on our website. By definition the details of our plan are in here, and I think most of you have had the chance to look at that and we took you through that in December when we published our plan. We would obviously be intending to update that when we get the draft determination in a couple of weeks, so have a look at the details of our plan in that document if you'd like to see it.

But I will just give you some highlights of our plan. Our plan, we believe, is a balanced, well evidenced plan and a well-supported plan. And as you can see on the chart there, we've managed to get 84% of our customers supporting our plan, and that's a very significant achievement for us this time because if you go back to PR09 – the last time this process went forward – we had about half that level of customer support, and... that's a very significant achievement for us. We've had the most thorough and the most extensive customer engagement in our history, and I'll talk a little bit more about that in a moment.

But we have produced what we call a balanced plan, so we've obviously been able to offer price reductions to our customers, and as you see on the chart there, up to the level of maybe 13% real reduction in prices. But also, if we do deliver on our promises to our customers, our promises that are in our plan, there is potential for an equity return up to 10%. So, a balanced plan in our mind.

We haven't ignored our capital investment requirements to meet the challenges of the future. So even though we have constrained our plan, it's still a 19% real increase in capital investment in our plan. £868million, as you can see, in 2012-13 prices.

We've also set ourselves significant challenges in terms of operating efficiency and capital efficiency; and you can see the numbers there, 2.5% per annum opex efficiency and 5.5% capex efficiency challenge for us.

And one thing about our plan which we were quite pleased about, and I'll say a few words about, is that we've built on what we regard as an enviable track record of delivering responsibly for our customers and sharing that outperformance with our customers and also our shareholders. And we've proposed a scheme called WaterShare. I'll talk about that in a moment.

How we engaged

- ➔ Most thorough customer & stakeholder engagement ever
- ➔ Iterative process run from 2011 with customers involved every step of the way
- ➔ Tested priorities, risk and reward packages and willingness to pay
- ➔ Extensively reviewed and challenged by the WaterFuture Customer Challenge Panel

What our customers & stakeholders told us

- ➔ Affordability and value for money must underpin the plan
- ➔ Essential work should be undertaken but the costs spread so that no generation is unfairly burdened
- ➔ Support the use of incentives
- ➔ Investors should receive a fair return
- ➔ Our regional supply chain should support economic growth

How we have responded

- ➔ Recognised and responded to customer affordability
 - ✓ Average bills held below inflation to 2019/20
 - ✓ Social tariff already in place with further initiatives rolled out
 - ✓ Lower bills not at the expense of service
- ➔ Investment programme focused on customer priorities and balanced over longer term with flagship North Plymouth water treatment works, Upstream Thinking and Downstream Thinking projects
- ➔ Re-balanced risk and reward package with wider range of incentives for the best outcomes for customers
- ➔ Wholesale returns 3.7%, retail returns 0.2%, RoRE range 2 - 10%
- ➔ Supporting 6,000 jobs for the regional economy



So, just to go into two elements of our plan then. The first one is about our customer and stakeholder engagement. And from our point of view, it is the most thorough and the most extensive customer engagement we've ever done. And it has been an iterative process. So we started way back in... I think it was autumn 2011 when we went out with our 25 year strategic plan, and that was a process of consultation – the first wave of consultation, if you like. And we didn't just go out with a strategic plan which is talking about climate change, population growth, ever-increasing demands on our services and so forth. It was very, very specific; it had investment profiles in it, it had investment options in it, and it had some price indications in it. So, we started from the theme, which has run through all of our customer engagement, of really, really understanding what our customers' priorities and preferences are, presenting them with options and allowing them to exercise choice about the way forward. And that's been underpinning the whole of our engagement, and we've done that not only through direct consultation and direct engagement – and you can see on the graphic on the left some of the ways we've been doing that – but also using our customer challenge panel to challenge us every step of the way, whether what we're doing is appropriate and whether they think, as a more educated challenge panel, whether we're engaging in an appropriate way.

The first wave was in 2011. Our second significant wave was in 2013. In the early summer of 2013 we again went out with a plan which had real investment proposals in it, real price proposals in it, and got some significant feedback from our customers at that time. And then went out again in 2013 in September with a revised and modified plan, which is very similar to the plan that we submitted in December. It's been an iterative process on individual components of the plan all the way through.

One thing I'd also like to highlight is the fact that we tested risk reward packages throughout that process – the things that Sonia and Cathryn have been mentioning about ODIs, that if we focus on delivering what customers want we will get some extra return. Even though it was complicated, we looked at that and we did manage to get good positive customer support for the idea that, if you deliver what the customers require, there is a benefit to share not only with customers but also with shareholders.

As I say, it was a long journey for us, but what came out of that was some very specific feedback which was saying that customers were very focussed on affordability issues. Affordability issues today were very important to them, certainly, but a very interesting conclusion from that 25-year investment proposal was that people didn't support intergenerational cross-subsidy. The idea of putting off investment today for people tomorrow to pay for, or indeed bringing investment forward so that we're in a better place for the future, weren't supported.

So we were very focussed on affordability, and of course our customer prices were a very significant issue. One of the things they told us was that, with the lower cost of capital coming and with the business plan that you could foresee, we were predicting lower prices in

2015 onwards. But customers were saying that we really needed to understand the cost pressures and the price pressures on household budgets this year, and that led us down the path of looking at not a 5 year window for our prices, but a 6 year window. That enabled us to offer a price freeze in this financial year, so the one that's just started on the 1 April, in addition to the 7.2% that we reduced our prices by last financial year because of the government's contribution. So, effectively, having price freezes for three years. That was very well supported by customers, and probably one of the reasons why it came up with that positive customer support.

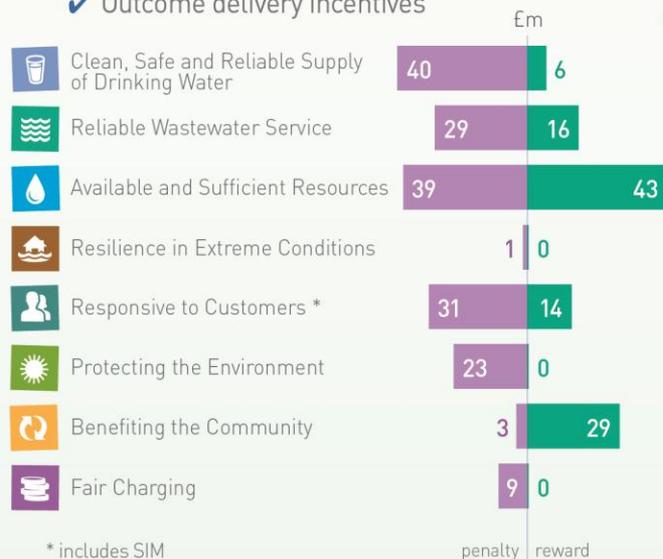
I could talk about it more but generally speaking it's been the most expensive – sorry, extensive! – research that we've ever done. So a good exercise.

What our customers & stakeholders told us

- ➔ Measurement of performance
- ➔ Targeted incentivisation
- ➔ Customers can rightly expect to benefit from outperformance - this needs to be done in an open and transparent way
- ➔ The benefits of outperformance need to be shared between customers and shareholders fairly, in a way that reflects the level of risk
- ➔ Pain/gain should be shared appropriately

How we have responded

- ➔ New WaterShare framework
- ➔ Tracks regulatory performance
 - ✓ Cost base
 - ✓ Outcome delivery incentives



- ➔ Assessment of other areas of risk and opportunity

Support for the approach

- ➔ Endorsement from the WaterFuture Customer Challenge Panel
- ➔ Willingness to pay results
- ➔ Positive feedback from customer & stakeholder groups



I wanted to say a little bit more about WaterShare as well. This is, we think, a good result for customers and for shareholders as well. It's a perception we have – which may or may not be shared with people around me and in the audience – that we have an enviable track record of acting responsibly, looking at our outperformance and sharing that in a responsible way with our customers. And I can site examples going way back to 2006 when we did a capital restructure. Obviously that led to a dividend return to our shareholders, but we also gave a price reduction to our customers at the same time. And those of you who've had the pleasure or privilege or something else of listening to me in every results presentation, will remember the purple histograms I used to put up on the chart looking at outperformance, and saying every single time we are looking to reinvest some of that outperformance for our customers' benefit. Even going back to our results at the end of the last financial year, we said we put forward a £60 million package of reinvestment of our outperformance. We announced that we wouldn't be taking the option of presenting an IDoK for the private sewers work, and that was another example of reinvesting our outperformance in shareholders' and customers' interests.

So we've got an enviable track record, but we've tended to look at those things internally, within ourselves, and then make a proposal to share that outperformance. And, of course, the external perception might be... we know RPI has gone up, so you should be sharing that, but we were saying, well, COPI has come this way and maybe the private sewers have gone that way. So what we thought about, from that germ of an idea, is this: let's have a transparent mechanism, a very open mechanism, and we'll have an annual account and a transparent mechanism which will be independently validated each year, to look at the over- and underperformance. The pain/gain share mechanism. And then we won't have these perceptions about whether they think we've gone one way or another way. We'll do that in an open way, and we think that's a fair and transparent way, and it was one of the board pledges that we made in the submission of our business plan.

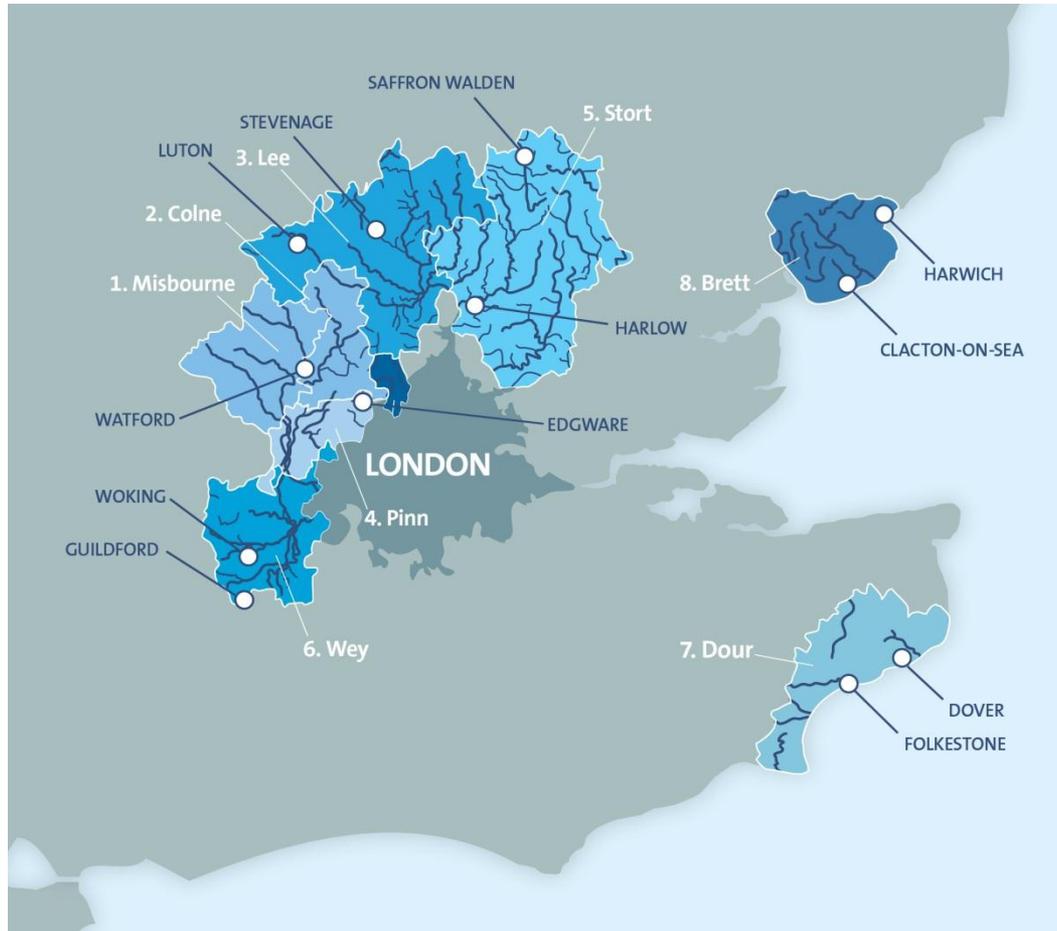
That pain/gain share mechanism will have three distinctive elements. One is looking at the cost space, one is looking at the ODIs and the ODI pluses and minuses – and we were able to get customer support and water future panel support for having both positives and negatives in that regard. And also just other factors. So, for example, if another private sewers comes along, or taxation rates change, business rates change, that would be put into the mechanism as well in a transparent and auditable way.

We think this is a great result, it's supported by our customers, and it's also supported by our customer challenge panels. So we think this is a great result for both customers and shareholders.

As I say, I don't want to go into too much detail about our plan, this is just a flavour of our plan and some of the highlights of our plan. We think it's a good plan, a well-evidenced plan, a well-supported plan and we're looking forward to getting onto delivering what we think is also a challenging plan.

So I'll hand over to Richard.

Affinity Water – our eight communities



Affinity Water

[Richard Beinfait, Affinity Water] Thank you, Chris. Good afternoon everyone, I'm Richard Beinfait, I'm the Chief Executive of Affinity Water. And I too am delighted to be here today, having heard that Ofwat have made our plan enhanced and that we'll be receiving a fast track draft determination at the end of this month.

In case you're unfamiliar with our business, because we're a new name in the market place. As shown on this slide, at Affinity Water we supply 3.5 million people water in the south east of England. We're the largest water only company and we supply to those customers in the blue shaded areas. At Affinity Water we have a vision: to be the UK leading community focused water company.

Now, since most of our customers aren't able to choose who their water company is, I recognise it's essential that we are community focussed, so that we can maintain the legitimacy of being the soul supplier.

Why do I think that our business plan is enhanced? Well firstly, our business plan represents a best and final offer. It's a stretch and it's ambitious. We believe that our plan will address the really strategic challenges our business faces, particularly in terms of water resources.

Our plan was grounded on customer research and evidence. Over 12,500 customers provided their views of our draft plans, and we were able to demonstrate to Ofwat that those views really did influence our final business plan.

Our board have been involved in our plan every step of the way. They've provided leadership and also they've sought third party assurance to satisfy themselves, not believing it from management, but satisfying themselves that the accuracy of key aspects of our plan, particularly in terms of proposed totex and efficiencies.

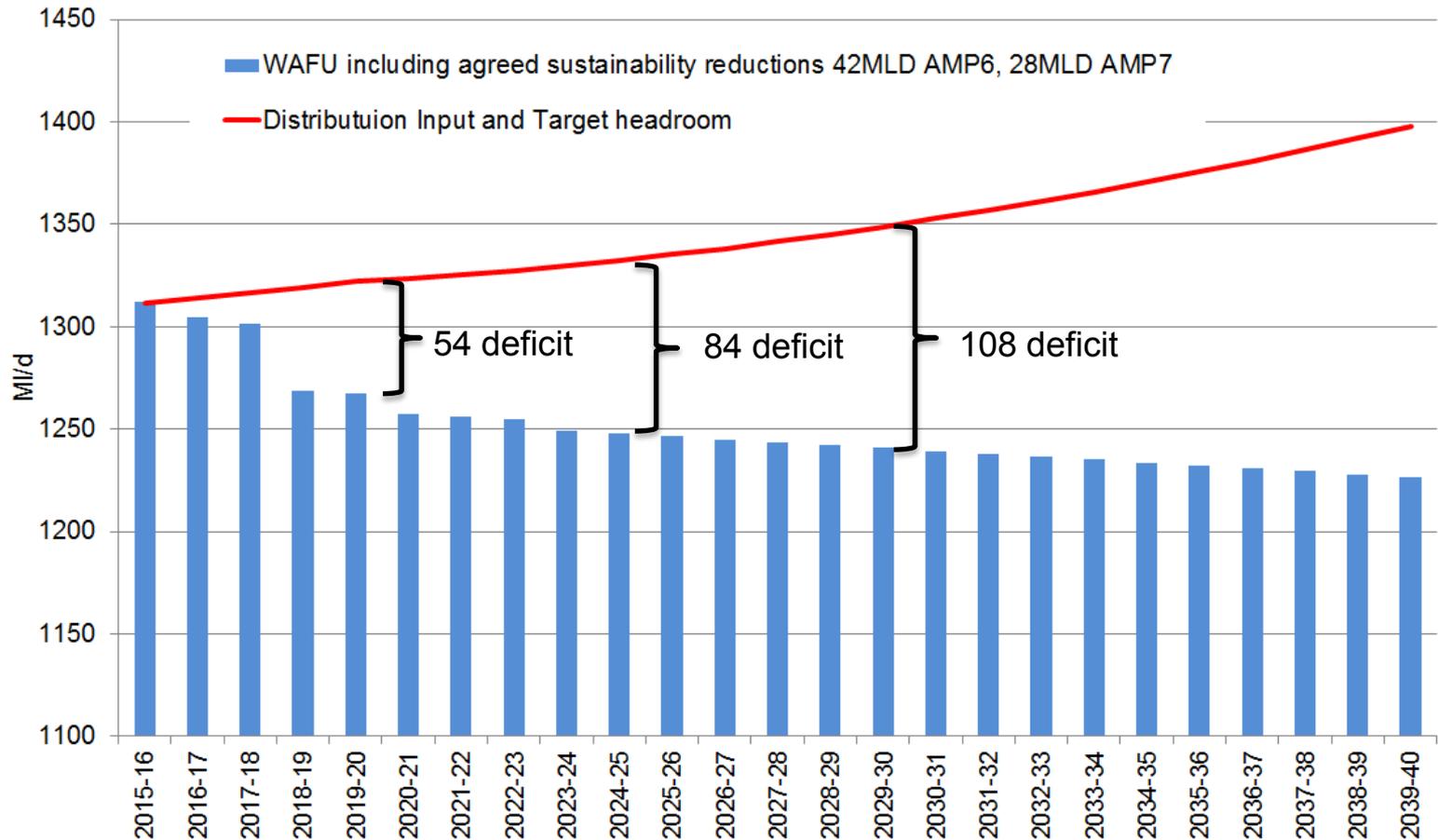
In developing our plan, we benefited hugely from an independently-led CCG [customer challenge group]. They objectively challenged us and reviewed the way in which we interpreted the evidence from customers. So, despite the stretch, our board are confident that we can deliver our plan. To be enhanced I believe we needed to convince Ofwat too. And I believe that we've been able to demonstrate to Ofwat that our business plan is a culmination of continuous improvement in our company's performance over AMP5 [2010-15].

Over the last four years we've driven various improvements in our business performance. In customer performance we have now the second lowest customer written complaints record in the industry. In operational performance the number of bursts on our water network is down by about 40% over these last four years. And in financial performance, we've cut

operating costs by 20% over these last four years, and our business plans proposes to go further.

So this track record in terms of AMP5 delivery provides me with real confidence that we at Affinity Water will be able to deliver our AMP6 business plan. I believe that this track record gave Ofwat confidence that Affinity Water is able to deliver the stretching commitment to address the challenges over the next five years.

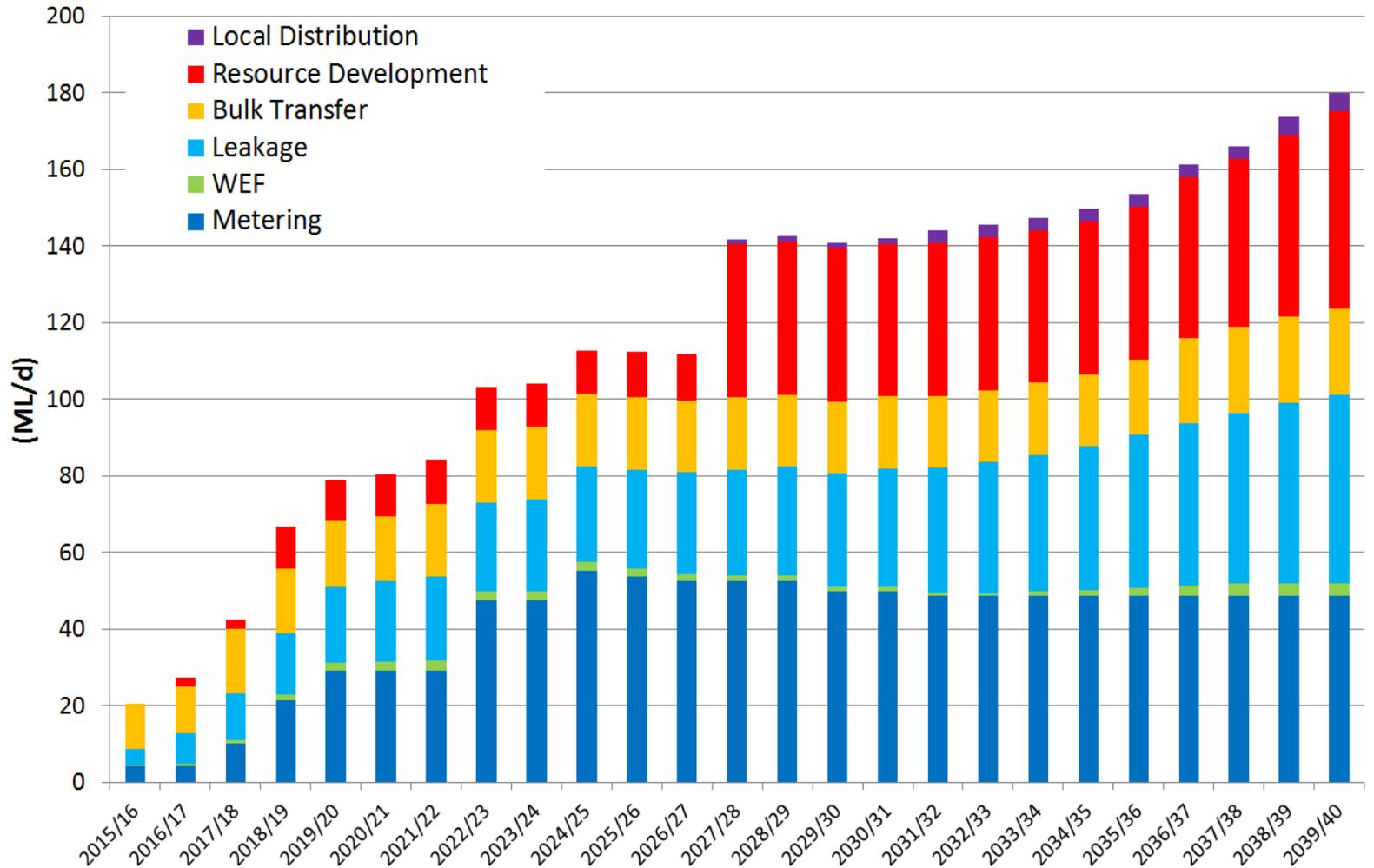
Our supply and demand challenge



Extract from Affinity Water's Statement of Response – Nov 2013 at dry year critical peak

So what are these key challenges? Well, of significant challenge to our business is our water resources situation. We operate in an economically active south east of England. And we know that our population will grow over the next five years, over the next 25 years. However, at the same time our business is under pressure to reduce our abstraction from the environment to help protect local rivers. So on this slide... this slide illustrates our supply/demand balance over the next 25 years, with the demand line (which is the red line) steadily increasing whilst our supplies (the blue bars) decreasing not just over the next 5 years, but beyond. The decreases in supply reflect the reductions we will make in our abstraction that we've agreed with the government as part of the water framework directive. Over the next five years we're committed to reduce our abstraction, the amount of water that we take from the environment, by 42 million litres of water per day. This represents about 4% of our normal take. So, if we don't do anything to resolve this deficit, we will be in a supply demand deficit in two years' time, and it will grow from there on.

Our 25 year supply demand strategy



Mainly demand management with some new supplies

Mainly supply management



Extract from Affinity Water's Statement of Response – Nov 2013 at dry year critical peak

This slide shows you how we're going to solve that problem, how we're going to solve the supply demand challenge over the next 25 years. And in our business plan over the next 5 years, we are committed to a combination of measures. The red and the orange are the additional supplies, and largely we're going to bring in new supplies from Thames Water, one of our neighbours. But you'll see that over the next 5 years our measures are skewed towards the blues, and that is demand management. We're going to reduce leakage by 27 million litres of water a day – that's a 14% reduction in leakage. It's the highest percentage reduction in the industry of any business plan. And also we're going to promote water efficiency with our customers, along with a universal metering programme will encourage our customers to value water and be more efficient with the use of drinking water. This will save 29 million litres of water per day by 2020. And again this is the most ambitious water efficiency programme in the sector.

So we've ensured our business plan delivers for customers today. We're committed to reducing our average bill in real terms over the next five years by 14%. For customers in the future we'll ensure that we have enough water to supply high quality drinking water for future generations. And for the environment we'll reduce our abstraction and leave more water in the environment. Close to chalk streams and close to chalk rivers where we know our abstraction has the most material effect.

I hope you can appreciate our plan is ambitious, and I'm delighted that we're an enhanced company and so that we can get on with delivering our plan for the benefit of all our stakeholders.



The journey to draft determinations

Sonia Brown, Chief Regulation Officer

4 April 2014

The journey to draft determinations

[Sonia Brown] Thank you very much, Chris and Richard.

So, big challenges ahead but a real prize in reaching enhanced status – not just in terms of the additional financial reward – and Chris I hope that outweighs some of the expense of the expensive customer engagement process! – but also in getting that all-important head start that you've both talked about.

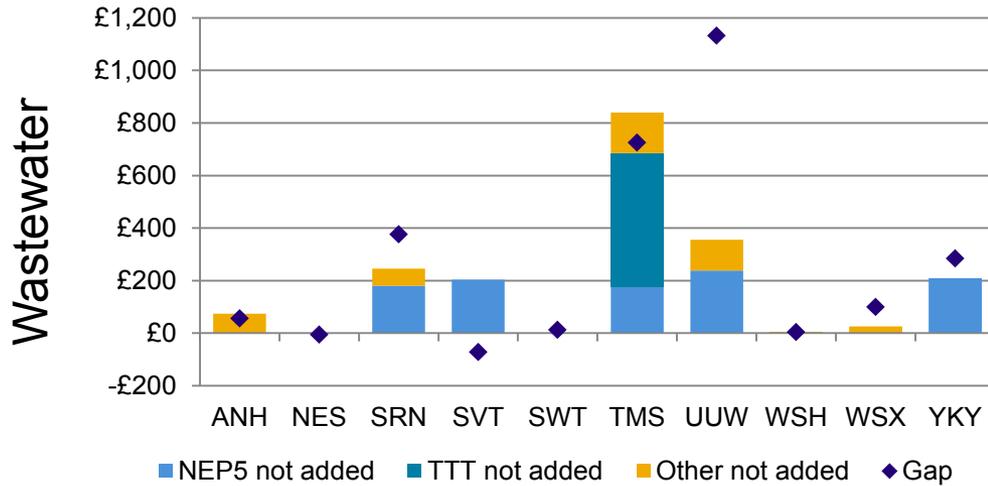
For Chris and Richard the draft determinations will be at the end of April – and they know that their plans will be the basis for those draft determinations.

For other companies the risk base review has shone a light on the areas for future dialogue.

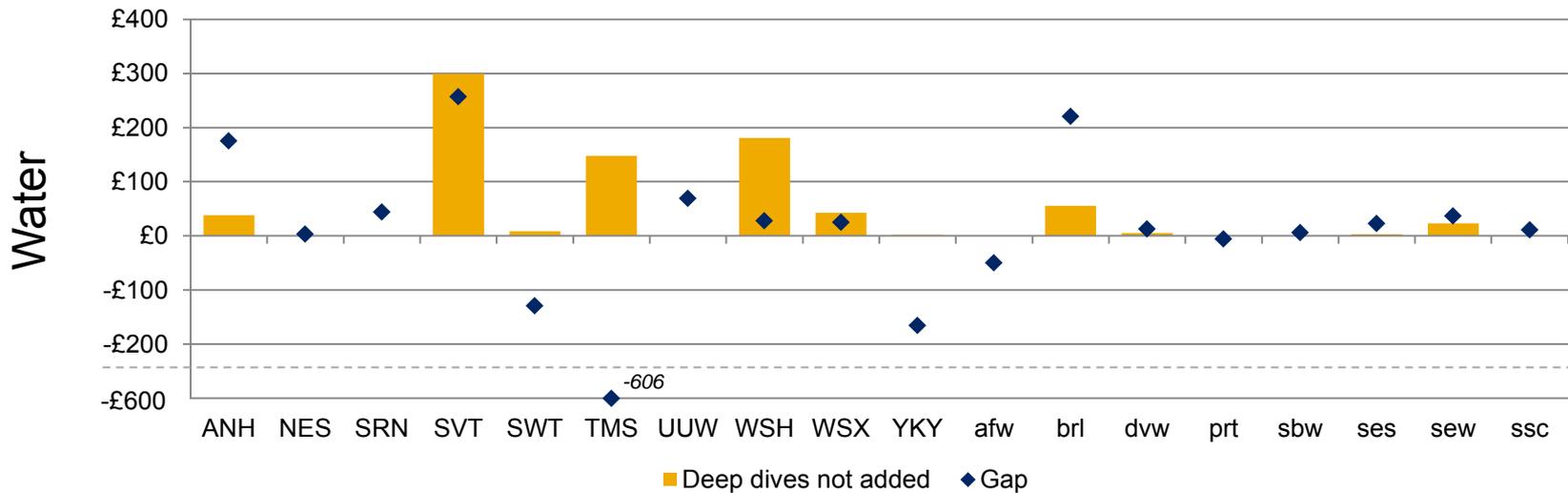
Companies may provide us with further evidence to support their existing plan, or choose to change their plans.

The dialogue needs to happen to help our understanding, so that we can either be sure that there is no need for us to intervene in any way in a company's plan – or if uncertainties remain, we will be left with no choice but to make a draft determination that we consider protects customers interests and could be different in some areas to the plan that the company put forward.

Understanding the plan vs. threshold gap – Wholesale



These graphs show the gap between Ofwat’s RBR thresholds and companies’ plans (◆), and specific expenditure items which were included in company plans but excluded from the threshold



One area where we know that there will be focused discussion relates to wholesale costs. Wholesale costs are obviously very material to customers' bills. As part of the risk based review we have published initial cost thresholds and compared these to companies' plans.

It is important for me to be very clear that there is a real difference between these cost thresholds and what will come later in the process as baselines for setting prices. Nevertheless the thresholds do show areas where we want to have dialogue with particular companies.

This morning, we published information which will help you to understand the gap, especially around items of expenditure where companies need to have further conversations with us. As of today, the difference between our cost thresholds and companies plans is around £2.6 billion in wastewater. In water, our cost thresholds are actually slightly above companies' plans, by about £40 million.

On wastewater, much of the £2.6 billion gap can be explained by specific large cost items where we have not yet made any allowances within the thresholds. £500 million is around enabling expenditure for Thames in relation to the Thames Tideway Tunnel, where we accepted the company's evidence of need and that the correct option was chosen, but we want further evidence in support of cost estimates and requests for totex menu exclusions.

Of the remaining £2.1 billion, £1 billion of this is associated with phase 5 of the National Environment Programme, where five of the companies we require more evidence on options and costs. Around £440 million is associated with other programmes which were identified for specific scrutiny but, for a variety of reasons, not added.

This leaves a gap of around £650 million, just 3%, which isn't explained by specific, significant cost items. As you can see from the graphic, this is driven principally by United Utilities, where we currently do not understand the proposed level of either base or enhancement expenditure.

In water, the differences between our plans and company thresholds are generally smaller. Where a particular company's plan is above our threshold, it can generally be explained in two areas:

Firstly, large infrastructure projects for which we require further evidence or justification.

And second, "special" factors where the company is making arguments for adjustments to our models, such as for population growth.

Around £800 million of spending proposed by the companies was not added to our water thresholds. The most significant was Severn Trent's Birmingham resilience scheme, at £255 million, where the size of the project was not sufficiently justified in light of forecast demand,

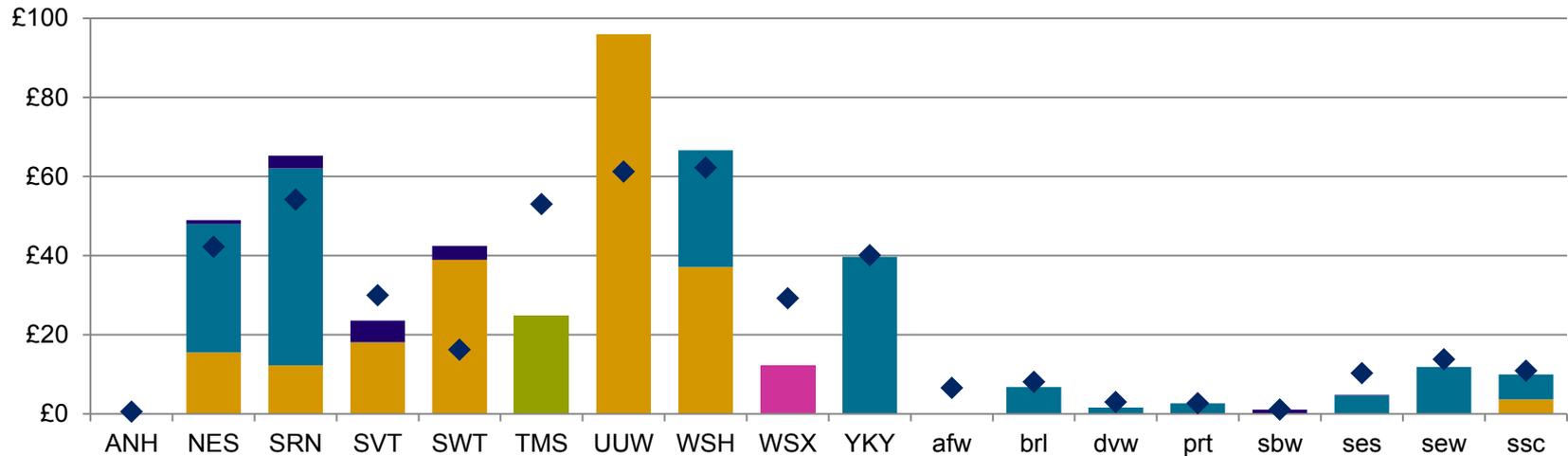
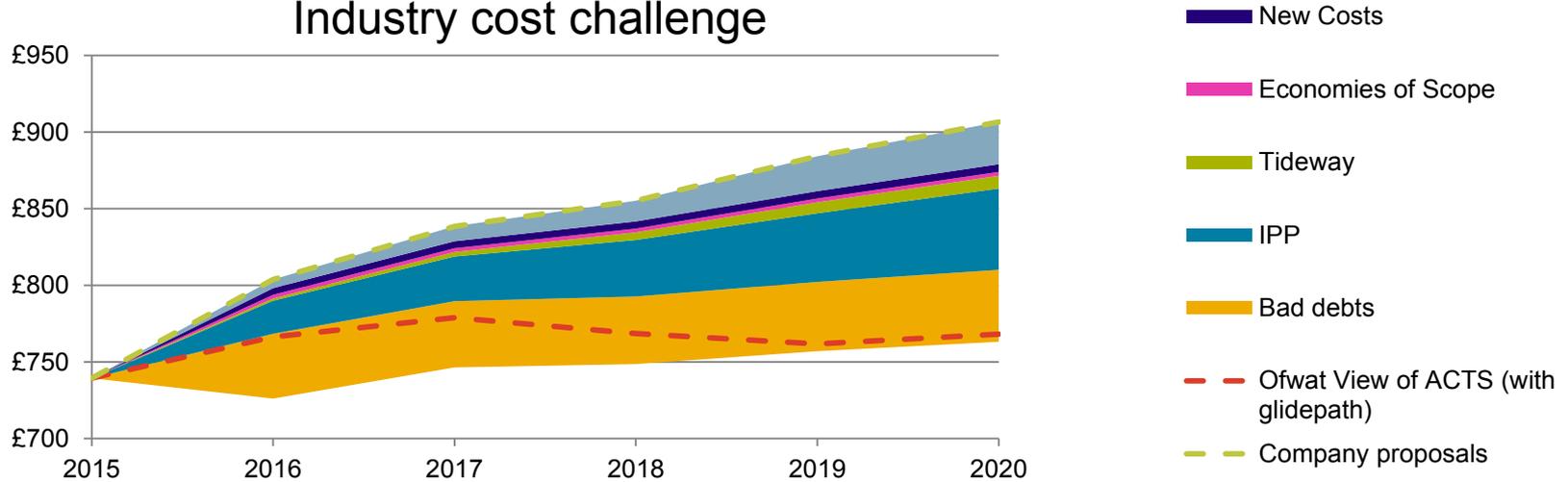
and there was insufficient evidence that other options to secure resilience were not preferable. Bristol's Cheddar 2 reservoir, at £45 million, was also excluded on similar grounds.

In order for projects to be included in the baselines, we expect companies to explain why the expenditure is necessary – statutory obligations, for example, or compelling evidence of need alongside evidence of customer support.

We also expect to see evidence that options were considered and that the most cost beneficial option was chosen, and that the costs of the chosen programme were well-justified – by which we mean upper quartile of historical efficiency.

Understanding the plan vs. ACTS gap – Household Retail

Industry cost challenge



As well as setting price limits for the wholesale business, we are also setting price limits for retail activities for the first time.

Retail costs are obviously relatively small compared to those in wholesale. An important reason for separating the price controls was to focus attention on a part of the industry that had been easy to overlook.

By breaking the mechanistic link between RPI and retail revenues, insisting that any growth in costs is justified against efficient retailers in competitive markets, and challenging companies with above-average costs to serve, we expect the industry to significantly improve its efficiency.

To this point, as part of the RBR [risk-based review] tests, no company provided us with convincing evidence to allow any adjustment to the average cost to serve, including cost input pressures.

We have, however, indicated today that South West Water has completed its pre-qualification action in this area and there will be an adjustment for bad debt for South West Water. Neither South West Water nor Affinity Water applied for an adjustment for input price pressure.

The red and green lines on the top graph show the difference between our current view of allowed costs and the business plans submitted by companies. The red line is above the bottom of the stack largely because companies with costs to serve above the average benefit from the three-year glide-path.

You will see that applications for bad debts adjustments, the orange area, are the largest parts of the wedge, worth £220 million over the five years.

Input price pressure, inflation, accounts for just under £200 million, rising over the AMP. The other categories of adjustment that were applied for are relatively small.

If no adjustments were allowed, the savings to customers in this AMP would be over £400 million, 10% of retail costs, compared to the companies' proposals. This compares to an efficiency factor of perhaps 1.5% that would have been applied in previous methodologies.

The bottom graph shows the gap, and the applications for different costs by companies.

Bad debt adjustments are concentrated at a few of the WaSCs [water and sewerage companies], while most water-only companies and some of the WaSCs have also asked to pass through input price pressure.

Aligning customer and investor interests

Driver	Examples	Return guidance	
		On Regulated Equity	On RCV
Base return		5.65%	3.85% (3.7% wholesale)
Cost performance	Where companies find new or more cost-efficient ways of delivering services to customers they will be allowed to share this outperformance with their customers	+/- 2.0%	+/- 0.75%
Performance commitments and ODI targets	Where companies deliver an outcome, supported by customer engagement, to a higher level of satisfaction for customers it should be possible for them to earn additional returns	+/- 1.0% to 2.0%	+/- 0.4 to 0.75%
Service Incentive Mechanism	A relative measure of performance to assign rankings and rewards	-0.5% to +0.25%	-0.2% to +0.1%

As Cathryn has already said, we absolutely intend for PR14 to bring about a step change in how reward can be generated by water companies.

The guidance that we issued is a package and is designed to ensure that there is a good alignment of risk and reward between customers and investors.

Both of the enhanced companies have adopted our risk and reward guidance and you have heard some of what this might mean in practice. You will see from the information that we have published that the base wholesale return do no harm rule applies to 3.7% for the wholesale business for both companies. And both companies will manage risks within this return with very narrow uncertainty mechanisms which is consistent with our guidance.

But PR14 will deliver the scope for financial outperformance where companies are outperforming for their customers.

You have heard me before say that the move from capex plus opex to totex should deliver a real opportunity for cost outperformance in this price review period.

We have today explained that our cost assessment is based on the upper quartile of historical efficiency, which will be used to set baselines for draft determinations.

This does not, however, imply that only 25% of companies can be expected to outperform on costs and it is my expectation that we will see significant cost outperformance over the next five years.

For standard companies around 50% of this outperformance will automatically be shared with customers from 2020, and over time through encouraging greater efficiency within the sector we can also expect to see benefits.

The new Outcome Delivery Incentives, ODIs, which companies can propose as part of their risk and reward package, will also deliver further scope for outperformance.

It's really important for us to be clear what ODIs are – and what they are not. Since the publication of our risk and reward guidance some companies have really understood that ODIs need to be about challenging and stretching performance targets and the associated rewards and incentives – because the base return already compensates them for the delivery of a standard service to customers.

Where ODIs are suitably challenging, in the short term, their customers will benefit from better outcomes that they've indicated a willingness to pay for. And investors will benefit too from material additional returns – up to 2% on regulated equity. In the longer term, customers everywhere will benefit from raised expectations.

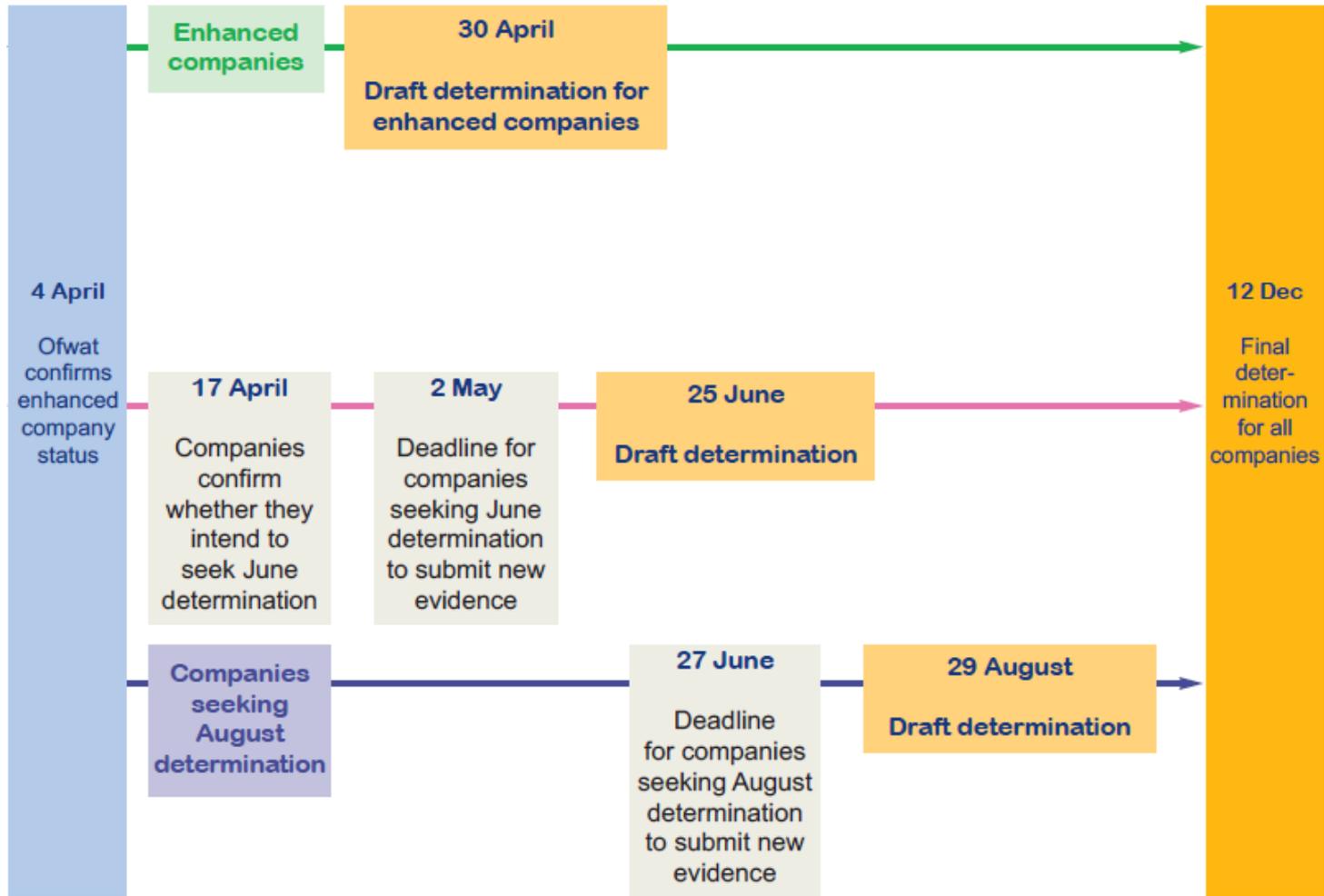
What ODIs are not is an opportunity to re-distribute revenue from base returns – and an opportunity to expect customers to pay either for catch up to an efficient service standard, or alternatively to pay for extra services that a company may find easier to deliver but that they have expressed no willingness to actually pay for.

As Cathryn's already mentioned, we are giving companies lots of flexibility around the proposals around timing and nature of these rewards. And again we will only intervene if we consider that customers' interests are not being well served by the company's proposals.

The opportunities for cost and outcome delivery outperformance are additional to the proposals on SIM and financial outperformance which are pretty much the same as in the current AMP. There will also be real opportunities for companies to benefit from the newly open market for business customers.

Overall, like with the risk based review, the next 5 years should allow management teams to distinguish themselves and to really out perform for their customers and for you as investors.

The process from here



So, with the risk-based review complete there are some small final stages in this journey to complete.

On 17 April we expect to see some companies come forward and indicate that they are seeking a June draft determination. Other companies, who want for example to engage more with customers or to make more substantial revisions to their plans, will be resubmit theirs in June for an August draft determination.

We've also published more information today on our expectations for the remainder of the process, including the equivalence rule between the June and August draft determinations.

PR14 has been characterised so far with excellent engagement between companies and their customers, and with us as the regulator. We are very much looking forward to continuing these constructive conversations and achieving the best possible outcome for customers – and in doing so help to preserve the legitimacy of the sector that Cathryn's already spoken about.

Our pledge to you is to continue to engage, to be transparent and to deliver on our pledge for no surprises as we complete PR14.

Thank you very much.

[Cathryn Ross] Thank you very much, Sonia, and also to Chris and to Richard for giving us their views of their plans and where we are in the process.

I'm now going to hand on to Keith Mason, our Senior Director of Finance Networks, who's going to say a few words about how we plan to regulate in the next control period. Keith.



Taking forward risk-based regulation

Keith Mason,
Senior Director of Finance and Networks

4 April 2014

Taking forward risk-based regulation

[Keith Mason] Great. Thanks, Cathryn.

I want to talk for a few minutes about risk based regulation, looking beyond this current price review. Cathryn talked earlier about our developing strategy and about the way we regulate and how that fits into that – and she also talked about building on the good things that we have already.

I think one of these is risk based regulation, which we began to introduce after the last price review in 2009. This is a deliberate and evolutionary change in policy and aligned with the themes of the Gray review that came out later in 2011.

We did this primarily to refocus companies on their relationship with customers and to decouple to some extent the dependency of companies on the regulator that we thought had had built up and was not probably a healthy way forward.

We started in 2011 with abolishing the annual return – the June Return – that I know some of you love and we didn't love quite so much. But we did place the onus back on companies to produce quality assured data and quality assured KPIs for things that they needed for their customers – to explain their performance to customers, rather than things they needed to explain to us.

This worked pretty well, and we followed this risk-based approach through to the price review where we expected companies to take ownership of their business plans. And we in return would look at their business plans in a risk-based way. As Sonia has outlined, the companies have responded to this and good progress has been made so far, and we're quite happy with the way the risk based review was carried out.

So, continuing this approach through 2015 to 2020, I'm going to talk to you about two areas – ongoing performance, financial monitoring, and then secondly about corporate governance.

Taking Forward Risk Based Regulation

SIM

**Performance
Commitments**

Totex

**Financial
structures**

So, firstly, ongoing performance. Better regulation can be achieved by having engaged investors, who are empowered with good information, and so that they can drive management and prudently control risk. And it's for this reason that for this price review we have put a particular premium on increased transparency rather than direct regulatory intervention wherever possible, and we do want to carry this through 2015-20 and beyond, and so it's been the same as we have in getting through to the price determinations.

We recognise that this means that people need easy access to high-quality data, high-quality KPIs that will be important to you as analysts, investors and lenders, so that you can understand how companies are performing against what has been set in the price review.

For example, we will continue to publish scores under the service incentive mechanism (the SIM) and this will remain an important relative measure of customer service, and we've seen that this has already driven improvements in customer service, and this is genuine improvements in customer service that customers want, as opposed to being simply done to meet regulatory targets.

Performance commitments on outcomes is a very important area, as I think Cathryn mentioned right at the beginning which talked about the strategy. And we will require companies to consistently measure and record their performance, and have appropriate governance and quality assurance processes in place – including an independent challenge – to make sure that this data is robust. Companies proposed processes for performance commitments – we carefully looked at these as part of the risk based review, and it probably has to be said that this is an area where many companies will need to improve.

Once this performance data is captured and assured, we will expect companies to make it easily accessible for both customers and investors and lenders. The bespoke nature of these measures means that you will probably be more interested in how companies performed against the companies' own performance commitments rather than in a relative way against what other companies have done. And we'd be happy to have a discussion about how we might facilitate this work going forward, perhaps by us gathering data together in one place – but please don't read this as the son of the June return.

You will also be very interested in companies' performance on totex, as Sonia had outlined. And this is a key area for incentive performance and, as one of Sonia's slides showed, companies' business plans on totex showed a very wide variation. So, here too we want to ensure that you have access to good quality data in a timely fashion. Exactly how we do this we haven't quite decided yet and we'd be very interested in your views as to how you might like to receive data on performance.

In terms of monitoring financial structures, this is an area where we want to share better information around emerging risks from financial structures. We committed last summer in our final methodology document to look at the risks to customers that could arise in future

from companies' financing arrangements. We did this because we said we were going to carry on with the same way we've approached financing structures and the cost of capital as we have done in previous reviews, but recognise that we perhaps needed to publish more on an ongoing basis as to what our views were on those particular structures.

The intention is that we would flag emerging areas of concern so that you, as investors and lenders, can take appropriate action long before we, as a regulator, needed to take any intervention ourselves. And I'm talking primarily here about systemic risks, not necessarily about company specific risks. Now, again, the details of this monitoring regime will start to develop over the course of 2014 and early 2015, and again we'd welcome views as to how you might like to see it and what sort of information you'd like to see in such a financial framework. I do want to be clear today that this isn't motivated by any specific concerns about any specific financial structures, but rather by a desire to ensure that companies, investors and lenders can respond quickly to new risks as they emerge.

Principles and self-regulation

Board leadership

My second topic is corporate governance. To have confidence in what companies tell us, we and customers need to know that they are operating to high governance standards and are taking full accountability for their performance and for meeting their customers' needs.

Over the past year we have set out what we think are the high expectations that are needed from companies – in terms of leadership, transparency and governance arrangements.

And we've talked with all the boards, we've talked with a number of independent NEDs [non-executive directors] and quite a few investors as well. I think it's fair to say that not all companies could be described as shining beacons of corporate governance, but we've certainly welcomed the positive spirit in which companies have responded to it – an example of that is the way they have taken ownership and accountability for the assurance of business plans for the price review.

Generally, corporate governance you probably think is a board/management issue, it's not really a regulatory one but it isn't quite so clear cut in public service sectors such as water and sewerage. Most companies also in their licence have a requirement to comply with their UK Corporate Governance Code. But, again that code was probably more oriented towards the protection of minority shareholders and is not directly applicable necessarily to water and sewerage companies. And now that given the overwhelming majority of companies are in private ownership, protecting a minority interest through the code is perhaps not necessarily so direct.

So we thought we needed to develop a set of principles for the water and sewerage sector. We wanted this to be a self-regulatory approach, we didn't want to impose a uniform set of standards on companies and we didn't want to go to a licence modifications route that was a regulatory intervention and imposition.

The principles we put out focussed on a unitary board structure at the regulated company level rather than focussing on a two (or more) tier structure. And we thought the board of the regulated company should have a balanced composition, with a significant proportion of independent non execs and it should take all the key decisions that affect the regulated company itself.

We also thought there needed to be greater transparency around how governance works, what the group structure looks like, not just simply the regulated level... more information about dividends and more information about pay and rewards for directors.

We published these draft principles in September last year and the final ones were published in January, and as I say, we genuinely welcome the positive statements that companies made in respect of those principles and their willingness to take a self-regulatory approach to develop individual codes.

We asked companies to do these codes in draft by 1st April, so just this week, and we've had all those in. We've given companies another year to comply fully with the principles, because we recognise that during the price review that might be quite a difficult thing to do.

What we've seen so far is that a number of companies are adopting practices that have gone even beyond our principles, which is really great. Some are probably not quite there yet, it's fair to say, and some have got some tricky decisions to take and tricky discussions to have with shareholders, particularly over board composition. And I think what we're looking to do is to see how far that goes, see how far companies are looking to comply with the spirit of those principles before we have to take any decision, which we're loathe to do, about whether licence modifications are needed.

We focused primarily on the regulated companies, as you might think, but we did also consult on a set of principles for the holding companies, as clearly they're very important in relation to how the regulated business is run. These don't cut across the idea of a unitary board structure and are completely complementary to the principles we put out for regulated businesses. And they are also pretty short and pretty simple. And we consulted on these back in January. You can see on the slides the three principles we put out, and the actual principles underlying them are actually probably not much longer than what you see on the slide.

We've already had some very positive responses from holding companies – these were directed at holding companies, rather than the regulated business, and we've had some very positive responses to these so far.

So we're looking to see more coming forward in this year's sets of accounts when these come out in June and July, but I do want to emphasise that this isn't a 'one-off' exercise; we're looking to have this on a routine basis, and we're looking to see continual improvements in the way that companies are governed.

Taking Forward Risk Based Regulation

Transparency

Managing risks

**Supporting long-term
decision making**

So in summary, our continued drive for risk based regulation, together with improved corporate governance and transparency, ought to allow companies the space to perform and to innovate and to provide better quality assessments of that performance. This could mean outperformance, this could mean underperformance as the case may be, but it should be clearly linked to what customers want and what customers are paying for, and should be more clearly visible to you analysts, investors and lenders.

As I said we certainly welcome your input and thoughts on the design and development of these performance and financial frameworks over the course of the next year, so that we can use them in anger from April next year.

And that is where I finish. So, Cathryn...



Final words

Cathryn Ross, Chief Executive

4 April 2014

Final words

[Cathryn Ross] Right, thank you very much, Keith. So, you heard something from me at the start about the strategy, you've heard something from Sonia about where we are in this periodic review having just completed the landmark of the risk based review. And you've heard something from the companies about their plans and how they fed into that risk based review. And then about next steps in PR14, and some really important words from Keith about some of the things that we think will be key features about how we regulate through the next control period.

Questions



Questions and answers

So I'm now going to throw it open to the floor for any questions. I think we still have our roving microphone, so if you will just put your hand up and wait for the roving mic to get to you, and don't forget to give me your name and affiliation, please. Nobody wants to go first!

[Guy MacKenzie, Credit Suisse] Just a question on your cost assessment versus company proposals. Obviously you highlighted that United Utilities proposed just over a billion more on its wastewater capex than your initial assessment suggested. And you mentioned in the report that they lacked evidence that the schemes were cost beneficial or efficient. I was just wondering if you've engaged with them already, and if they're clear on specifically what evidence they need to provide.

[Cathryn Ross] Thank you for that question, that's really timely, and I'm happy to answer that, and I'll ask Sonia to come in and say a little bit more in a second. I suppose the first point I'd like to make really clearly is: we are engaging on a grand scale with companies. And we have, as you know, 18 companies to engage with, so that is no mean feat, and we do have to make sure that companies who really need our focus get it when they need it. But we are absolutely engaging with companies and United Utilities is no exception to that. So we very much do want them to be completely clear about what evidence it is we are currently lacking and what they need to provide. But... Sonia.

[Sonia Brown] Thanks every so much, Guy. I think that for UU, the challenge sits in a couple of different buckets. They've got their NEP and they know that they have their NEP, and they need to get back to us. So that's not a question of need, it's a question of demonstrating to us that they've considered all of the options associated with meeting the need, that they're choosing the most cost beneficial one and that they're benchmarking those costs to the upper quartile for efficiency. So it's quite straightforward with the NEP, and that's around 200-odd million of that difference. They've then put forward other forms of quality schemes as well. And again you go through the same levels of test, but some of those schemes tripped at the need element. And so it will be really important for them to set that out to us. And then finally, as I said in my presentation, there's quite a significant gap remaining, and really it's for the company to come back to us on that very significant gap because we just don't understand, really, what's driving a large proportion of it. They asked for an amount to be excluded from our totex models, we've looked at that carefully and we didn't think that there was the need for the exclusion for all of it from our models. And so that's where that dialogue is really going to focus and centre. I don't have the answer today but there's a complete open door for UU with us.

[Cathryn Ross] Thanks very much. Robert?

[Robert Miller Bakewell, White Rigg] Staying with the theme of UU's and also perhaps adding Severn Trent. Given the timeline chart which Sonia spoke to and the issue of resubmissions, would it be fair to assume from your comments, Sonia, that you're expecting both UUs and Severn Trent, given the Birmingham scheme that you referred to, to be companies who you would expect to resubmit and go for a later draft determination?

[Cathryn Ross] Well I think, Robert, that's very much a matter for the companies to decide. I mean, I think we've been very clear what the gap is in terms of evidence. And, as you've heard from Sonia, we're engaging in further conversations about that. But that's really going to be a choice for them as to when they want to go for a draft determination, but, Sonia, do you want to come in on that?

[Sonia Brown] I'm not sure I have a great deal to add. I think that we'll know for sure on the 17th April the position of the companies, all of the companies. And it's absolutely an issue for them. I think what we are being clear about, though, is that draft determinations are just that, and if we aren't satisfied with any companies' proposals, then that is the point that we will have to intervene and change the company's plans. And so all companies have got to really consider the trade-off associated with perhaps putting in something earlier with more risks versus later with less risk. And it's for them to take that view.

[Cathryn Ross] Okay, we had a question down here.

[Jamie Tunnicliffe, Redburn] Staying in exactly the same area again, just looking at AMP5 and using that – and I'm interested to know if it's inappropriate – but if I stay on wastewater cost and look at your threshold, the numbers for Severn Trent and South West Water are sort of 10-11% above the AMP5 level that your threshold comes out with. But for UU it comes out like a third lower. Do you expect, in the end, the sort of agreement and package that you come up with will be really, really different from AMP5 levels across the different companies – is that the sort of direction that we may be going in? And sorry to push it again, but just a minor point, but have you actually had a one-on-one with UU on this issue, because I'm pretty sure they want to understand this £1.1 billion gap.

[Cathryn Ross] Okay, well I'll ask Sonia to say something both specifically about engagement with UU and also about where we might end up in a second. But I think the really important point about where we might end up is, and Sonia said it in her presentation, the results of the risk based reviews are not the baselines that will appear in draft determinations, so there is a further set of stages to be gone through in the process.

[Sonia Brown] I think, Jamie, I'd go back to particularly the NEP that's been excluded, and put that number back in in some way. There is to be a conversation about the relative efficiency option

selected, but there will be an allowance for that, it's a discussion about what level of that allowance. And equally, you know, it's not inconceivable that some of those quality schemes that I talked about equally could go back into those thresholds. Where that takes you versus AMP5 I think that that's, as Cathryn said, a discussion that you'll see for the baselines. I mean, I'm actually joined today by Georgina who's in the audience who actually manages the UU relationship and was on the phone this morning for over an hour with UU on these very issues. So, UU are being engaged with constantly on these issues.

[Lakis Athanasiou, Agency Partners] Hi, sorry to be a pain and keep focussing on UU...

[Cathryn Ross] Sorry, Lakis, just for the benefit of those...

[Lakis Athanasiou] Oh sorry, Lakis Athanasiou, Agency Partners. Sorry to be a pain and keep focussing on UU, but I'm really struggling to understand what you're telling us today. I mean, I know you can't resolve it, but going on the sewerage side, there's a £1.1 billion gap between your assessment and theirs. You've shown about £0.3 billion is to do with scope differences if I've read what you said correctly, leaving about nearly £0.8 billion as something else. And it seems to me that that £0.8 billion can only be errors on your part, errors on UU's part, unit costing efficiencies, or inefficiencies in the type of things they've done. Is there any other category that I've missed out on that, or has it got to be one of those things and we don't know which yet?

And, on a separate topic, on Keith asking about financial monitoring, could I suggest regulatory accounts aligned to the regulatory process reconciled to statutory accounts which are IFRS. Because it won't just be investors who won't know what's going on, it will be you guys. And you'll end up, if you don't get this information, asking for other information under the table, as you did when you got rid of the June Returns.

[Cathryn Ross] Okay, so, thank you for your thoughts – we did ask for thoughts from the audience about how we might take forward the reporting the KPIs, so thanks and I'll ask Keith to come in on that in a second. I mean, on the UU point, you know there's a multiplicity of factors behind that difference. As Sonia said before, we don't know exactly how that unpacks, and that's exactly the conversation we need to have with them. I don't know if we have anything to add on UU, really, at the moment.

[Sonia Brown] I think that the categories of conversation are exactly as you spelt out, Lakis. And I think that, you know, it really is a question of trying to just unpack some of these differences, understand, you know, the profile of some of the expenditure that was in previous AMPs and what the impact of that is going into the next AMP and might be that we've got some different assumptions around the delivery of those projects. It might be that there are issues within either

one of our modelling approaches. We're at an early stage within this process – it could be. But I guess that what I'm reassured by is that for other companies these models are producing numbers that look like they're in the right ballpark, and we have got an outlier here with UU, and I guess that we're up for the conversation to try and find out what is at the root cause of that outlier.

[Cathryn Ross] Keith, you've got one of our early suggestions from Lakis on what we might wish to do in terms of information gathering and how we might approach that in the next period.

[Keith Mason] Yes, I wasn't sure it was a question, Lakis...

[Lakis Athanasiou] No, it wasn't a question, it was a suggestion saying if you don't go for regulatory accounts, you'll end up clueless as well and asking for information under the table.

[Keith Mason] No, you're right. And the implications of IFRS and people moving to that is also something that we need to pick up from next financial year. So yes, that's a helpful suggestion.

[Cathryn Ross] Okay. Ah, we've got a question from the other side. We've had a lot from this side, we've got one on that side.

[James Brand, Deutsche Bank] Question for Cathryn. Under your predecessor there was a big drive towards trying to produce more competition in the sector, and obviously that got caught up in the licence changes and the debate around that. And in the end it ended up, certainly from my perspective, getting pushed back, or certainly there was a comment that it might get opened up again as we go into the next regulatory period. And I was just wondering where Ofwat stands now on competition; is that less of a priority? Obviously at the moment we're going through the review – but as we go into the next regulatory period, is that something that's going to be opened up again and that's going to be another big push towards competition, or is it less of an important item on the agenda now?

[Cathryn Ross] Okay, well that's actually a really helpful question and particularly at this point as we develop our strategy as we're thinking about our priorities going forward, it's very timely. Where are we on competition? Well, it's happening. It's in the Water Bill; the market will open in 2017 for business customers, so that's kind of a fact. Is it going to be a priority for Ofwat to think about how we best prepare the ground for that, working with the industry, working with OpenWater, working with government? Absolutely it is. You can see things moving on that already now with the OpenWater markets limited entity being set up. So there is some progress there. We have to make that work. I think what you'll see us doing very much is focussing on how to make that work in the best interests of customers, because I think frankly that's in everybody's interest because it maintains the legitimacy around that. So is competition a priority for Ofwat? Yes it is, we have to make it work for customers and it's happening and we need to engage with it.

In terms of what that means for the next control period, partly it's going to be about making sure that the market architecture is set up to give everybody the best chance to succeed, making sure that stakeholders are bought in and engaged on that. And also – and this goes back, I think, to the point that Keith was talking about in terms of the information that we collect through the control period – making sure that as the regulator we are informed as to whether the market is genuinely working well and delivering outcomes for customers. And all those things are important for us.

Does that answer your question?

[James Brand] It does in part. I mean I guess that with... one of the things that Regina was pushing for was to open up competition across a much wider part of the value chain, other than just having retail competition for industrial and commercial customers. And obviously when the licence changes were proposed, there was flexibility in the original proposal to regulate a much more significant part of the value chain in a way other than having a RAB with an allowed rate of return.

So is that still a priority, above and beyond preparing for an industrial and commercial competition in terms of retail? Is there still a real desire there to bring in competitive forces across a much wider part of the value chain, or... or maybe you haven't decided yet? But just wondering where you stand on that.

[Cathryn Ross] Well obviously, I mean for retail competition for business customers is happening pretty soon. I mean, 2017 is just around the corner, frankly, in industry terms. So that has to be a priority because we've got to make sure that that is up and running and delivering for customers in 2017. So that's front and centre.

In terms of the remainder of the value chain, I think what we need to do is look at the information that's been revealed through the business planning process this time, look at the information that's revealed as we progress through the next control period, and we need to learn from that, and we need to take appropriate regulatory responses to that. Now, I don't know exactly what that looks like right now. What I can tell you is that one of the core functions I think we have as a regulator is to make sure that markets – wherever they exist, and whether they are competitive or not – work well. And for me that's about making sure that there is good information for decision making, it's about making sure that people in the market have the ability to respond to that decision making, and it's about making sure that the incentive structures are right. And that applies, frankly, whether the market's competitive or not.

[James Brown] Thank you.

[Iain Turner, Exane] As you look back now on this process – the process has had a few tweaks as it's gone through. Do you think that if you'd been able to give a bit more guidance at the beginning of the process, you might have had a few more companies on enhanced status?

[Cathryn Ross] Gosh, that's a good question. I'll ask Sonia for her perspective! I think what I'd say at the beginning, though, is we always said, point 1: isn't hindsight a wonderful thing! Point 2: I think we always said, and I remember this from when I was at Ofwat previously, we always said that the 2014 period review would be a learning process. We were doing things very differently. And the important thing for us was to reveal information through that process and to learn from it. And you have seen us adapt our process as we've gone through – absolutely we have. I think that was absolutely the right thing to do as well, because it's much better for a regulator to look at the facts before it and make sensible responses on the basis of those facts than to plough on with a process regardless. And I think that's what we've done: we have adapted along the way. You know, when we get to the end of it we will do a review, we will think about what lessons we've learned and we'll take those into the next periodic review in 2019. Frankly I still feel a bit too much in the middle of it all to do that stepping back at the moment. But does anybody want to add anything to that, Sonia or Keith?

[Sonia Brown] I definitely still feel very much in the middle of it all

[Cathryn Ross] Yeah, there's a reason for that!

[Sonia Brown] I think that there are some areas where that were particularly new and novel – so a really good example of that is default tariffs for the retail business where, in hindsight, I think if we'd have had more time... actually, it's not necessarily guidance, it's more conversations. I think it would have put the plans in a better place. But we de-scoped that from the risk based review. I guess what's really important to me is that the number of enhanced companies isn't the success or failure of the risk based review, it's about making the right decisions. And I think that we feel very much that we made the right decision with the two companies that have gone through for enhanced, and that we made the right decision in setting up the framework for a conversation with the other companies where we needed to have it.

But I think that if we're in a world where we're really asking, as a strategy, for companies to take the ownership of the relationship with their customer, it would be quite strange to have a regulator intervening with lots of guidance in the middle of all of that.

[Keith Mason] That point that Sonia made was the point that I was going to make, because it is for companies putting in their plans. I'm not quite sure how earlier guidance, even if you had that hindsight, would necessarily have changed what happened.

[Cathryn Ross] Yeah, fair point, thanks. Any more questions? We'll take the one at the back and then the one at the front there.

[Nick Walker, Lloyds Bank] We're a corporate lender to the sector, and a lot of the questions have been about the publicly quoted companies, but are you prepared to give us any crumbs of comfort regarding your relationship with the leveraged sector? We not only have exposure directly ourselves, but facilitate exposure through the bond market, so I know you're putting wind up our credit committees as well as the ratings agencies. So it will be interesting to see if you've got a comment.

[Cathryn Ross] Okay, well again I'll ask others if they want to come in in a second. I'm not sure I feel like I'm really in the business of dispensing crumbs of comfort at the moment. But I guess what I would say is I hope that you have felt the benefit of the way that we've conducted engagements through this price review. Because one of the things we've been really conscious of this time, as I said before, is that we really have fundamentally changed some of the features of this price review compared to previous price reviews. One of the things we've tried to work very hard at is making sure that all our stakeholders, including bond holders, have good information about what we're doing and why we're doing it, and how the levers that we're changing in the review give companies more flexibility in what that means. So I hope that your comments aren't from a position of feeling somehow uninformed, because I think we've really tried and worked very hard at that through this review. Do you want to add anything?

[Sonia Brown] I would just come back to the fact that it's really important that capital structures are an issue for companies. You could be in a very different world, which it does exist internationally, where you have regulators that are very prescriptive over the nature of what the capital structure should be. We're definitely not there. We are basically just giving a very simple message, which is this. move away from our notional structure if you like – it's completely up to you as to whether you want to do that – but understand the risks and equity within that structure, and understand that it's for you, not for customers, if you need to rebalance that overall structure. And I think that that's fair, and it's part of the deal of allowing people the flexibility and freedom to move away from the notional structure.

[Cathryn Ross] Yeah, that's a really important point. Keith?

[Keith Mason] And that's not a new policy. We've had that policy for probably a dozen years now. Just as Cathryn's not offering crumbs, neither are we in the business of trying to put the wind up people. But that is certainly not a new policy, it's been there for a very long time, and it is clearly a question for management and investors to own their own structure, rather than for the regulator to do it for them.

[Cathryn Ross] Yep. Ah yes, we had a question down there.

[Dania Seiglie, Société Générale] Perhaps an easy question, specifically perhaps for Keith. As you mentioned, Keith, you will be looking at financial structures and determining to what degree there are risks inherent in those structures. Can you give us a little bit more colour on that?

And I absolutely welcome the engagement that you're requesting and of course we'd like to talk, certainly understand how would we engage in terms of financial structure that we put in place and discuss with our clients if I may.

[Cathryn Ross] That is, as Keith said, it's very much an ongoing conversation. So, glad that you'd be willing to be part of that, but Keith...

[Keith Mason] I think it's not so much things that aren't available to people, but trying to pull them all together and to look at that on a more regular basis, because perhaps in the past we have tended to do this as part of the price review. I think it is more trying to do that, so there are not any surprises as you come up to a price review. Exactly what that looks like, really, is to be discussed, to see what people would find useful to them. But that's the rationale behind it.

[Cathryn Ross] Just building on what Keith said, it isn't just for us to collect and pull together information that is useful to us: we're trying to inform a debate in the sector and inform a debate between companies and their managements as well. So it's really critically important that we get your input in that, otherwise the thing won't work. So, thanks. Okay, one or two more. Got one at the back there.

[Chris Gallagher, JP Morgan] Sonia, you mentioned about the upper quartile for cost alliances, and I'm wondering if you've taken in account of the totex effect and how you've judged that upper quartile? And the second question, on totex as well: you've mentioned that you expect more than 25% of the companies to outperform on totex. So what sort of numbers should we be thinking about in terms of distribution?

[Cathryn Ross] Okay, I think that second question comes under the heading of "nice try!" And I don't blame you! I guess one of the things we're acutely aware of here is the difference in the approach that we're following in this review, and totex is a huge part of that; we do think it opens up massive new possibilities. But of course exactly how companies are going to respond to that is a bit of an unknown quantity, so it is genuinely difficult to say anything definitive on that. Sonia, do you want to come in on either or both of those points?

[Sonia Brown] I think that, for me, the totex benefit comes when the companies start to really change the structure of their businesses. I've been talking recently with National Grid, and you can really see with Grid how the totex incentives are running through all of the elements of their business. And I think that it's only when you get to that point that you could ever

really see the full effect of what totex might do to the cost level. I think that we're putting really strong incentives there for companies to really think about this during the next AMP. What we're almost doing is saying "go after these efficiencies, there's a real benefit here for everybody if you do it." But I have got no idea how many people will be outperforming, I just want to be really clear that I think there is the scope for all of the companies to do really well in that area.

[Cathryn Ross] Okay. I think I'm going to take one more if that's all right. Okay, I've got two hands so why don't we just take those two there.

[David Rees, AMP Capital] Just picking up on the point the gentleman from Lloyds made and also Keith's point about not changing the policy on capital structures. Could you say a little bit about your attitude towards financeability for debt, credit ratings and confirm that your policy on those issues – in particular, what you look at and how you approach what the credit rating agencies are doing – has not changed.

[Cathryn Ross] Okay. Well, I'm going to ask Keith and Sonia in a second to come in. I guess the key point on financeability is that we still have our primary statutory duty to ensure that efficient companies can finance their functions, that's not changed. And our interpretation of that, which is that it is a statutory duty to ensure that *efficient* companies can finance their functions, hasn't changed either. So the overarching framework with which we're thinking about this stuff really hasn't changed. But on the specifics...

[Sonia Brown] What PR14 has done is to give even more levers to companies to manage financeability. And so we are looking very hard to the companies to give us reassurance associated with financeability. Both Affinity and South West Water have been through that process over the last two weeks. And today we've published information with regards to that assurance process and where they have ended up with regards to the key credit metrics and financial metrics associated with their plans. So I hope that that additional information which is generated through having two enhanced companies will be helpful to everybody. The onus is upon the company to demonstrate its financeability. We look at that with the notional structure, we look at it with the actual structure, and that process has been pretty onerous over the last couple of weeks.

[Keith Mason] More generally, what companies have been asked to do is to test themselves against financeability metrics of their own, ones that the ratings agencies will probably recognise, as opposed to us specifying them and then companies meeting them or not meeting them as they are. It's really for companies to demonstrate this. But the way they demonstrate it ought not to be very different to what's happened in the past.

[Cathryn Ross] There's one more question next door.

[Peter Atherton] It's actually a question for the companies. I know you guys are like the good boys, the winners, but if you can sort of put that to one side for a second, and try and think objectively... Looking at this process, and also looking at the outcome of this process and how you're going to run your businesses over the next five years or so, do you think regulatory risk has increased or decreased with these changes?

[Cathryn Ross] Okay, I'm going to ask Chris to go first and then Richard.

[Chris Loughlin] I've got to say, Peter, I don't really see it in those terms. The underlying comments and the underlying theme for all of the answers here, I've got to say, I completely and utterly agree with. I think Keith said it, it's back to the Gray Review: the relationship had gone very strongly to the point that the companies were looking at Ofwat, and the companies defaulting to Ofwat's approval or otherwise. However it happened, it's nobody's fault – it happened on both sides, probably.

The philosophical shift is to look at the company's relationship with its customers as the primary relationship. So all of that underpins every single question, and every single answer as far as I've heard, as a witness to it.

Going back to Iain's question about whether, with the wisdom of hindsight, we would have got more enhanced companies if there'd been more guidance. It seems to me that if you were to simply to ask the question, "well, what are the rules of engagement?" you've missed the point – the whole point is that we should have ownership of our own plans, our own financing structures, our own debt portfolios and respond to what our customers want. And that's the underlying principle for the whole of this review.

Now, has it been more risk or less risk? I find that hard to quantify in my mind. Obviously, we are in a position where we've got towards the end, or are getting towards the end of the process; we've got some certainty which the other companies haven't yet, but they will get that certainty in a matter of weeks or months, it won't be that long before they will be able to assess it. But, you know, we've got more levers to pull now, we've got more degrees of freedom. We aren't looking at the regulator all the time, asking the regulator's permission to do this or that. We've got more degrees of freedom, and we've got more choices and we've got to act like more 'normal' companies, in inverted commas. I believe the degrees of freedom we've been given through this process is actually going to help us.

[Cathryn Ross] Richard?

[Richard Bienfait] Can I say that there are certain aspects of the process which have worked well for us, particularly with respect to the fact that we want to be the UK's leading community focused water company. So, naturally, we actually want to ask our customers what they want from a water business. And they've engaged very nicely with us on our water

resources situation. And the timing of this process and the water resources management plan – I thought it was not going to work, but it has worked so far. When we went to consultation on the water resource management plan, that fitted really nicely with respect to our consultations on our business plans which we then undertook during the summer last year, where we then provided bill profiles and also the various solutions that we were proposing. But there was a combination of solutions and we were trying to find out what was the best solution for customers. So that's been a really good aspect to this process.

Also the CCG concept has been really good. And hats off to Ofwat for promoting that. Our independently-led CCG had, of course, all the statutory stakeholders on board. And it's very important to receive the feedback as we're going along, and so that's been helpful as we've been developing our plans.

Of course, there's been learning as we've gone along. We've been able to be flexible in understanding if there has been a change in the rules that Ofwat have put down. And I'd just like to re-iterate it's nice to be here as an enhanced company!

[Cathryn Ross] So there you go, that's the objective view. I just want to say a few words to close. Before I do, I want to thank our speakers: thank you to Sonia and thank you to Keith. Thanks particularly to Chris and to Richard for joining us.

So those final words that I want to leave you with... I think it is clear now what companies need to do: they need to deliver outcomes that their customers want. It's clear that company management have more flexibility now than they ever had before in how they do that. It's clear that companies and investors have more information than ever before. And it's now up to you, as investors, to drive your companies to deliver and to use that information and that flexibility to really innovate. If you do this, you will make a return, and you may even outperform. And if you do, because of the changes that we have made to the way that we regulate, in order to align the incentives of companies with the interests of customers, we will be very happy.

Thank you very much.