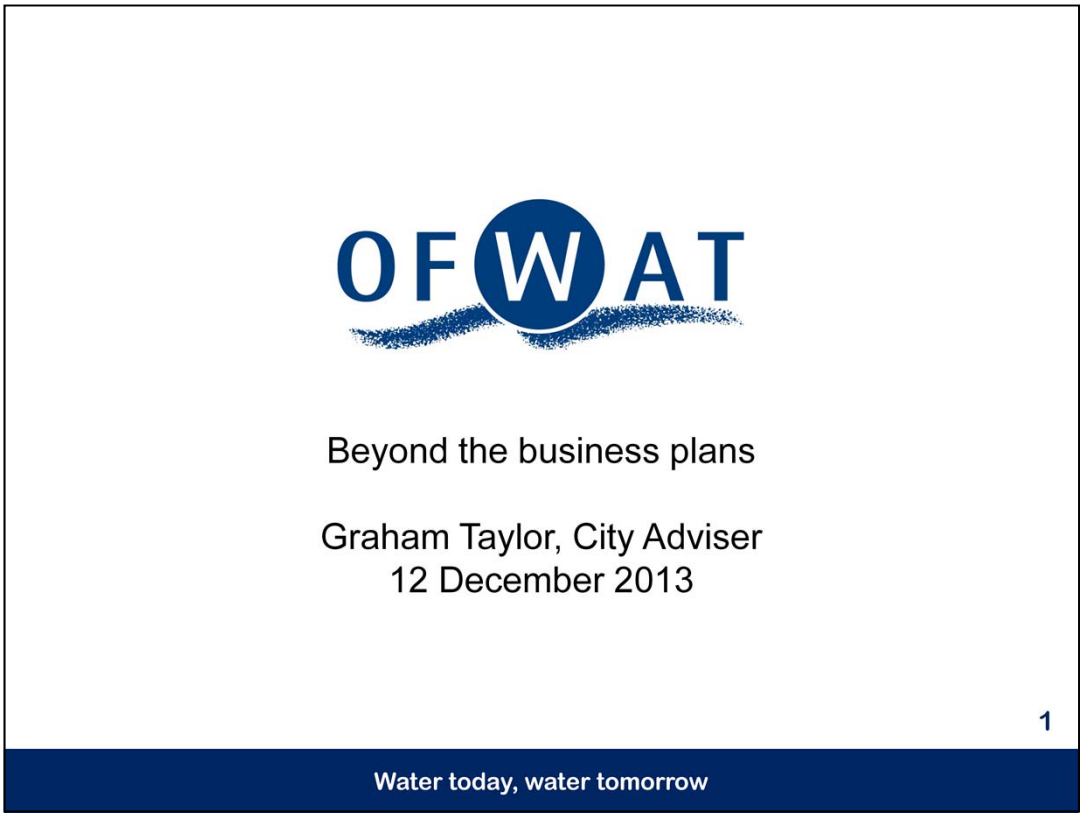


- As those of you who follow the sector will be aware, this isn't an easy time for a presentation.
- Business plans were submitted just ten days ago. We are still in the process of uploading data and reading hundreds of pages of submissions from each of eighteen companies. We're meeting three or four companies a day, and will be for the next week.
- That said, I have spent enough time on your side of the table to know you will appreciate some initial observations on the business plans and where we go from here, and will tolerate my longer-than-usual list of disclaimers.
- First, the data I've had to work with is incomplete. The validation of data tables alone will likely take until next week.
- Second, what I have got is subject to change. The error rate on the last round of tables the industry submitted to us, in August, ranged from 2% to 40%, and that's unlikely to have fallen to zero.
- Finally, absolutely nothing I say today should be interpreted as pre-judging anyone's business plans. It is much too early for any of us to have formed views on individual companies' plans. Please don't try to read between the lines.

Overview of the sectors in England and Wales

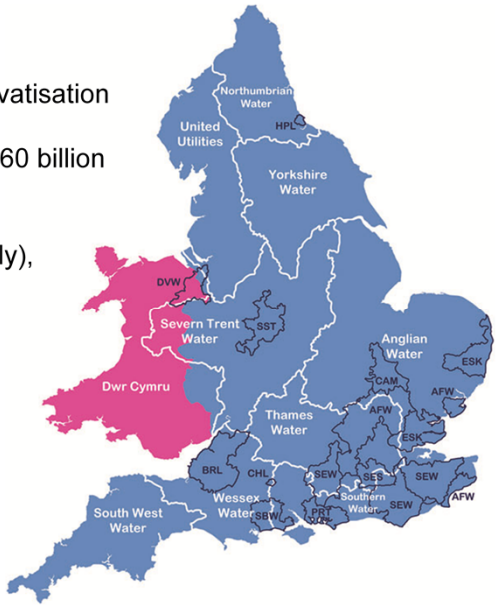
Water companies privatised in 1989

About £116 billion invested since privatisation

Regulated capital value more than £60 billion

19 regional monopoly companies
(10 water and sewerage, 9 water only),
5 newly appointed companies and
8 water supply licensees

Stable, predictable and transparent
regulatory framework



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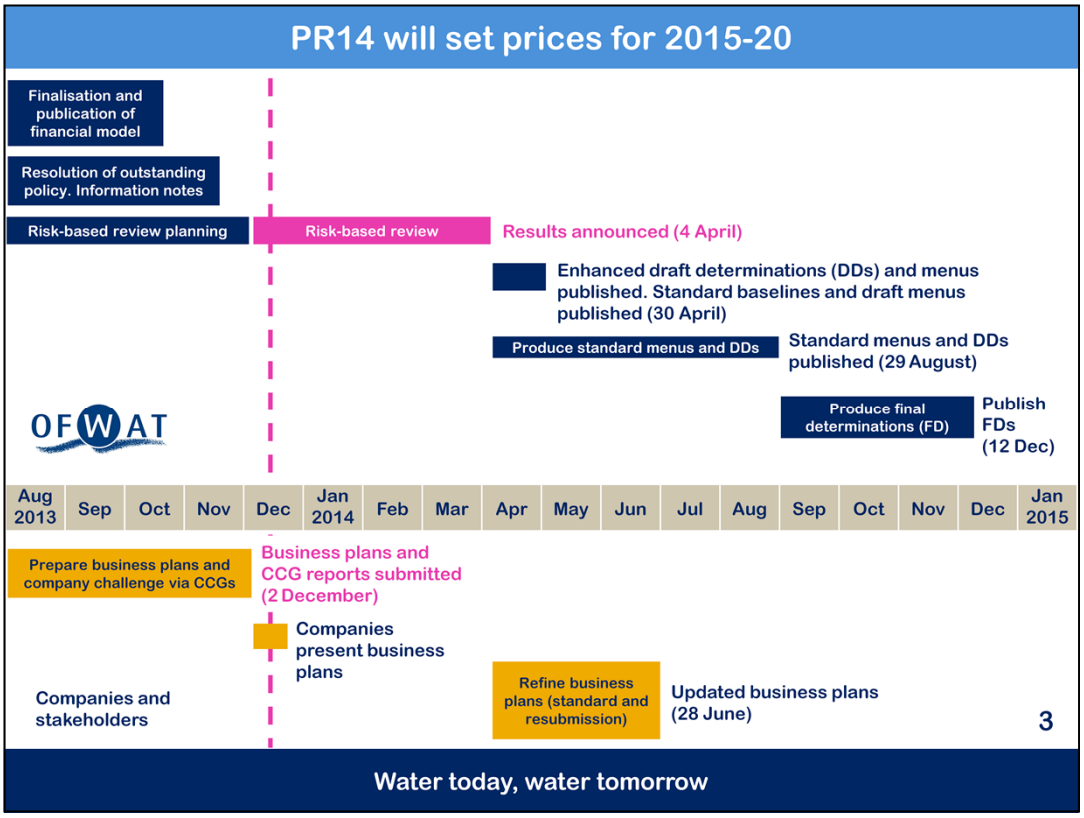
Water today, water tomorrow

- The industry was privatised 25 years ago. Four and a half Asset Management Plans later, the industry has invested around £116bn, leading to marked improvement in every measure of water quality.
- The industry has accumulated a regulatory capital value (RCV) of around £60bn, significantly larger than gas and electricity combined. But because our commodity falls from the sky, average bills are a quarter of those in energy.
- The original ten water and sewerage companies (WaSCs) still exist. There are also nine remaining water only companies (WoCs).
- We recognise that the sector's success in attracting investment is a function of stable, predictable, transparent and independent regulation -- something that we take very seriously, as have successive governments including the current one.



- PR14 will set prices for the five-year period starting April 2015.
- This review is different in that the onus is on companies to engage with customers and to present them and us with a consistently strong business plan.
- There are no draft and final business plans. Companies have been asked to submit their best and final offers.
- We are calling the current stage of the process, which began last Monday, our “risk-based review”. The focus is on identifying business plans and elements of business plans that require particular scrutiny and focusing our resources there, while getting out of the way of companies with consistently strong and well-justified plans.
- That process is scheduled to end on 4 April, with any “enhanced” companies receiving their draft determinations at the end of the month. Others will have to wait until the end of August, with final determinations for both following in December.

Early observations on the business plans

On average, companies are proposing real price decreases

Companies have proposed a range of innovative solutions

All are putting forward measures to address affordability, in most cases through social tariffs

All have proposed a number of outcome incentives against which they can be judged

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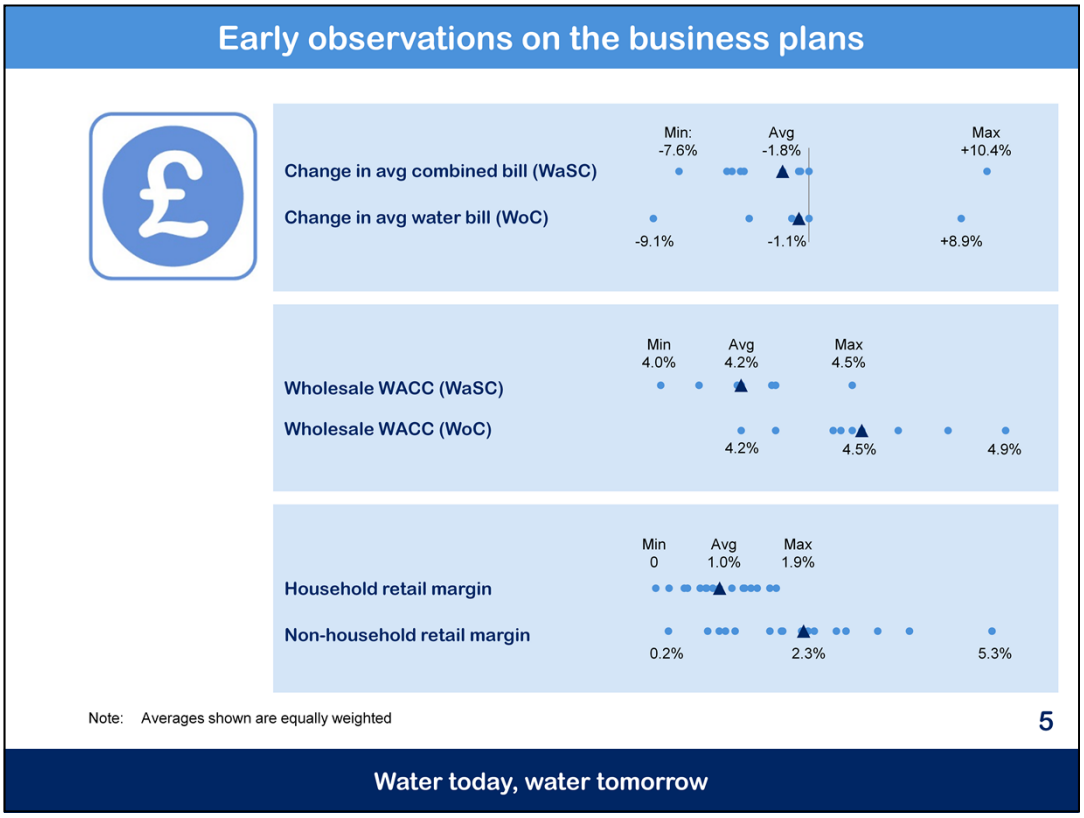
Water today, water tomorrow

- With only two exceptions, companies are proposing flat or declining real bills for their household customers, responding to a consistent message from customers that finding savings is important to them in the current economic environment.
- While it is too early to express a view on them, companies seem to be looking at innovative solutions, as we had hoped.
- 13 companies have proposed social tariffs, with most of the others suggesting other targeted measures to address affordability.
- In total, companies have proposed around 580 outcome measures against which they would be judged and incentivised.



- This chart shows the spread of company proposals on average household bills in 2015-20 compared to 2010-15.
- 11 companies have proposed real reductions for their household customers, six companies flat bills and two increases.
- The 10% increase from Thames Water is associated entirely with the Tideway project; excluding this they would be proposing a small decrease. The other increase is from Dee Valley Water, a small WoC which is proposing three substantial investment projects in this period.
- Wholesale weighted average cost of capital (WACC) proposals range from 4 to 4.5% for the WaSCs and 4.2 to 4.9% for the WoCs. All of the WoCs have made arguments for a premium to reflect their smaller scale or other factors. You will recall that in 2009 they received an uplift of 20 or 40 basis points. We haven't taken a position on a smaller company premium in this review, and will be looking closely at their arguments.
- It is important to note that the WACCs here should not be compared directly with the PR09 figures, which were at the level of the whole appointee.
- One important difference is the introduction of a retail margin, which I will talk about later. Here you can see that companies have proposed household margins ranging from 0 from Bournemouth Water to 1.9%, and business margins from 0.2% to 5.3%.

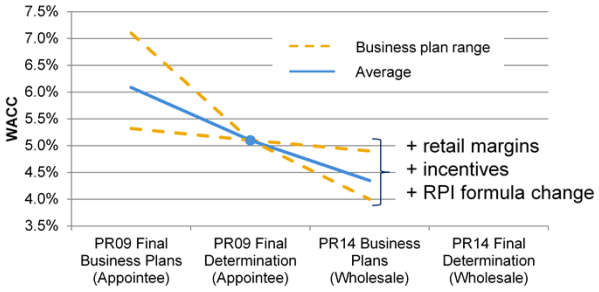
We will now test and analyse plans

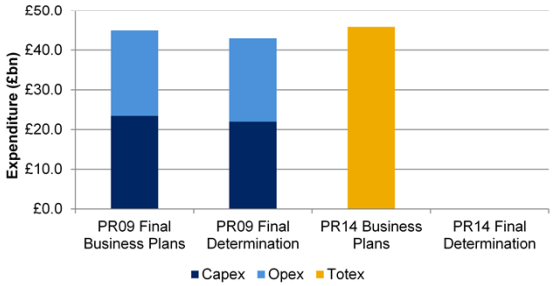
Ofwat's challenge to companies' business plans saved household customers 10% in PR09

PR14 emphasises the relationship between company and customer

We have committed to passing any "enhanced" business plans with minimal intervention

We will continue to challenge plans that fall short of this high bar





Note: All figures in 2012/13 prices
Source: Preliminary analysis of business plans.

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Water today, water tomorrow

- In PR09, Ofwat's challenges to companies on the cost of capital and spending plans saved customers 10% on their bills.
- You can see in these graphs the large dispersion in proposed WACCs five years ago, compared to where we settled, and the 4% reduction in proposed capex and opex between final business plans and the final determination. Draft business plans aren't shown here but were considerably higher.
- Our hope is that the incentives in PR14 will reduce the temptation for companies to bid high and the size of the changes necessary later in the process.
- Certainly the range of proposed WACCs is narrower than in PR09. It is also significantly lower, although any comparison with the 5.1% WACC in PR09 needs to take into the additional retail margin and the greater scope for incentives in this review. It should also consider the fact that, for a given level of return and underlying inflation, the RCV will grow significantly faster than we assumed in 2009 because of the important formula changes to the calculation of RPI.

Features of PR14: outcomes and incentives

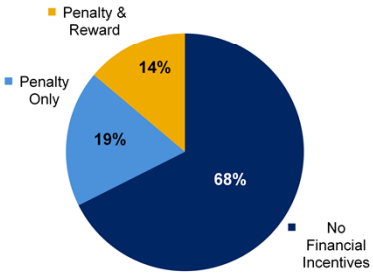
PR14 focuses on **outcomes** valued by customers rather than outputs specified by the regulator

Companies were asked to propose these outcomes and associated commitments, supported by evidence from their **engagement with customers**

They were asked to propose associated **financial incentives** where appropriate, with **both penalties and rewards** where there was evidence of a benefit from increased performance

We note that many business plans have focused on non-financial and penalty-only incentives, citing customer preferences. We will look closely at this

Proposed outcomes



Source: Preliminary analysis of business plans

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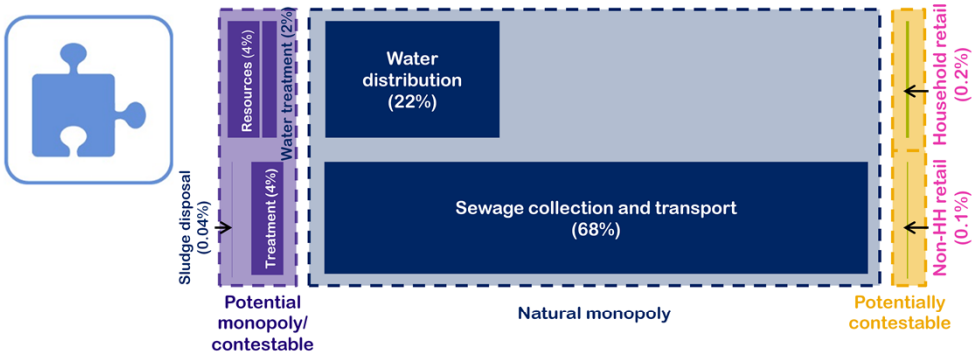
Water today, water tomorrow

- In PR14, companies have been invited to propose outcome commitments valued by their customers, and to propose associated financial incentives wherever appropriate.
- On average, 38 outcome delivery incentives (ODIs) have been proposed by each WaSC and 24 from each WoC – so administratively complicated for us, but consistent with our new approach that emphasises the responsibility of companies to engage meaningfully with their customers and to respond to local needs.
- In our July methodology document, we talked about the situations in which reputational benefits, penalty-only financial incentives, and balanced penalty and reward incentives might be appropriate. Our expectation was that there would be less of the former and more of the latter. The business plans have in fact had relatively few ODIs with balanced penalties and rewards, with some companies noting that their customer challenge groups didn't support them. This is something which we will need to look closely at.
- We have also noted that a high proportion of targets in some plans are based on no improvement in performance during the period. It's too early to say whether this simply relfects lack of ambition.

Features of PR14: retail price controls



For the first time, retail will be regulated on a margin rather than cost-of-capital basis – but stay within the existing regulated entity

From 2017, non-household retail will be opened to competition in England (not in Wales)

Source: Ofwat, Book value of assets based on companies accounting data 2011-12. Based on the net book value of assets as % water and sewerage total assets

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Water today, water tomorrow

- Another feature of PR14 is the creation of four separate price controls, of which two -- household and non-household retail – will be regulated on a margin rather than cost-of-capital basis.
- From 2017, the non-household portion of this – around 2% of revenues – will be opened to competition in England.
- As you can see from this chart, which might be familiar from the licence modification discussions last year, the assets associated with these businesses are very small, making the old RCV-and-WACC methodology inappropriate…

Features of PR14: retail price controls

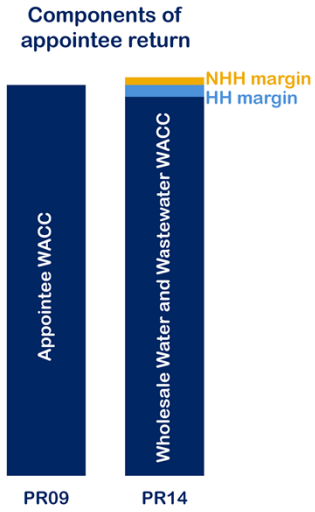
100% of the existing 2015 RCV will be allocated to the wholesale controls

As a result, retail profits will be **additional** to the WACC-based return, with limited incremental risk

(Non-household retail will face competition from 2017, so risks in this part of the business may have increased)

Under companies' proposals retail would on average **contribute 5% to appointee profits**

Companies and investors need to **consider this, as well as the impact of RPI and incentives, when comparing headline returns with PR09**



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Water today, water tomorrow

- … As a practical matter, we took the decision last year that 100% of the RCV at 2015 would be allocated to the wholesale control and none to retail.
- As a result, the profits earned through the retail margins will be additional to this WACC-based return. And on the basis of companies' business plans the increment is quite meaningful, representing between 1% and 9% of profits, with an average of around 5%.
- The associated new risks are very small in household retail, in our view, since this business will remain a monopoly for the foreseeable future.
- There may be new risks introduced by the opening of non-household retail to competition from 2017, and we will be interested in companies' views on this.
- But it seems clear that the bulk of the retail profitability is associated with a transfer of risk from the wholesale control, not the introduction of new risks, and the wholesale WACC ought to be proportionately lower.
- So the next time you hear a company or analyst compare their new wholesale WACC with PR09's appointee WACC, please set them straight.

Features of PR14: financial flexibility

PR14 introduces a number of changes which should improve companies' ability to manage risk

Totex places operating and capital expenditure on an equal footing, minimising incentives to favour one over the other. As part of totex, companies have been asked to propose **"pay-as-you-go" ratios and RCV run-off rates** in their business plans

These provide flexibility to balance **current against future bills** for their customers, and **cash flow against growth** for companies, and were welcomed by companies

Where companies financed in our notional range need additional cash flow to ensure financeability, we expect them to use these levers rather than propose a higher cost of capital. A preliminary review of the business plans suggests that some companies are taking advantage of them

Companies are responsible for ensuring that business plans are financeable, including decisions on the appropriate levels for financial ratios

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Water today, water tomorrow

- Totex has been introduced in PR14 to address a perceived bias toward capital over operating expenditure.
- Under the new framework, companies have the flexibility to choose a PAYG ratio that determines how much expenditure is recovered in-year -- what Ofgem would call fast money -- and how much is added to the RCV.
- This, and the related flexibility we have given companies to decide the run-off rates of new and existing RCV, gives helpful flexibility to balance current and future bills, as well as current period cash flow against RCV growth.
- If companies have liquidity challenges associated with the current macro environment of low interest rates and relatively high inflation, we would expect them to use these levers rather than demanding a higher cost of capital. In case you missed it, we issued an information notice to this effect in October.

Features of PR14: Categorisation of business plans

The risk-based review is testing four key areas:

- Outcomes
- Costs
- Risk and reward
- Affordability and financeability

Companies which submit high-quality business plans that meet these tests and do not seek to game the regulatory process will be "enhanced"

Company categorisation

- **Enhanced**
- **Standard**
- **Resubmission**

Our scrutiny will then be focused on others which do not meet this high bar

Benefits of enhancement include

- Acceptance of the business plan with **few adjustments**
- A **four-month head start**, with Draft Determinations in April instead of August 2014
- **Enhanced Totex menus** allowing a greater share of cost outperformance
- **Reputational benefits**

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Water today, water tomorrow

- Finally, I want to return to the immediate matter of the risk-based review.
- By 4 April we will have finished this assessment of business plans, testing them in the broad categories of outcomes, costs, risk and reward, and affordability and financeability.
- Only business plans which meet these high hurdles will be classed as enhanced.
- To be clear, there are no quotas or forced rankings. We will not burden customers with a poorly justified business plan for the sake of a press release.
- But any companies that do get enhanced will see meaningful benefits. We have committed to accepting their business plans without significant adjustments. They will get their draft determinations in late April rather than late August, giving them a significant head start. They will get explicit financial benefits through enhanced totex menus which give them a greater share of cost outperformance. And they'll get a pat on the back from us.

Government's Water Bill

The Water Bill is currently going through its Commons Committee stages

It represents the first major reform of the water and sewerage sector since 1989

Among other reforms the Bill will:

- Allow all non-household customers the choice of who supplies them with a water and sewerage service
- Open the upstream market to allow more water to be used in the public supply
- Create a new resilience duty on Ofwat

Competitive reforms affect the upstream resource and retail elements, with limited impact on the core network business

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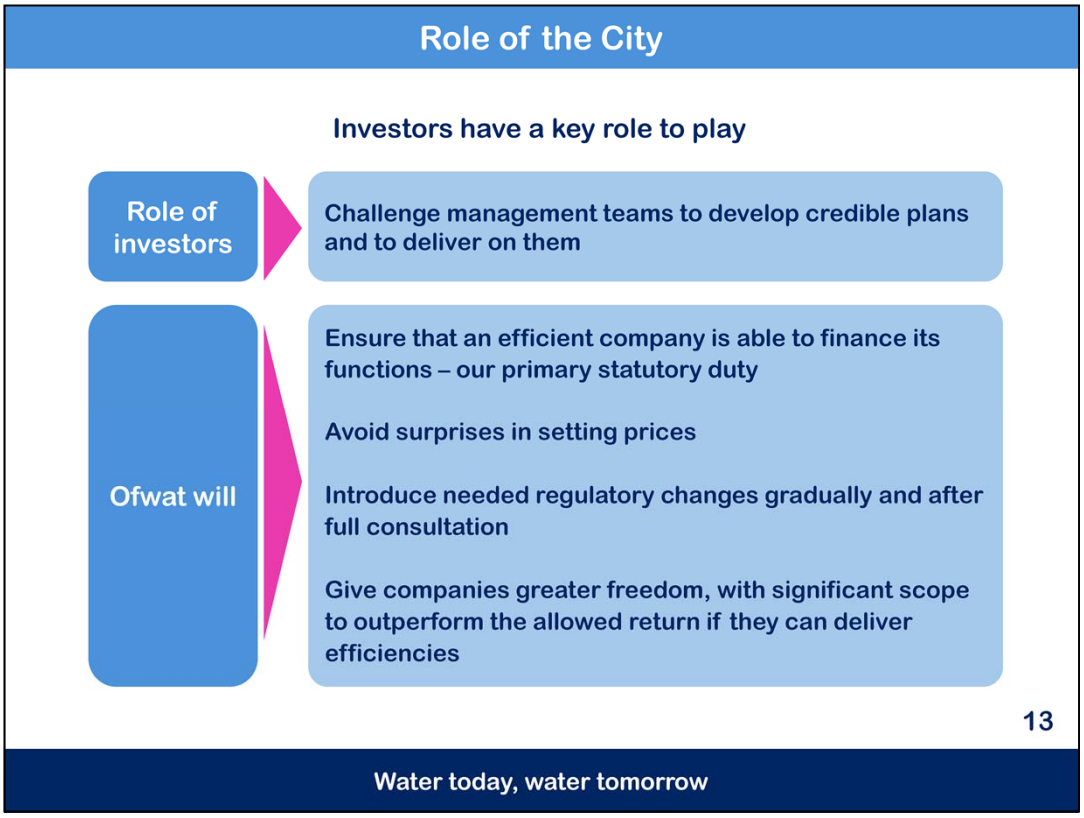
Water today, water tomorrow

- I should mention one other process running parallel to but very separate from our price review.
- The government's Water Bill had its second reading on 25 November and is now going through its Commons Committee stages.
- The Bill represents the first major piece of legislation in the sector since privatisation, and has significant intersections with our price review – particularly the provision that will allow non-household customers to change supplier.
- The impact on the core network business will be limited, apart from the possible adoption of private supply pipes.



- We are very conscious that private capital has made the industry's transformation possible, and that water will continue to require significant investment for the foreseeable future.
- We are also aware of how important an informed and engaged investor community is in focusing the attention of management teams, as I think we have seen on the question of retail costs to serve.
- Ofwat will continue to ensure that efficient companies have the ability to finance on reasonable terms.
- We will continue to speak directly to the City, to avoid surprises in price reviews and to include you in genuine consultations on future regulatory changes.
- And we will give the companies you own greater freedom to operate commercially, with the scope to generate meaningful outperformance as they deliver efficiencies and innovations that benefit their customers.

Questions

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Water today, water tomorrow