



Ofwat Board meeting held on Thursday 20 November 2014

Members in attendance

Chairman:

Jonson Cox

Chief Executive

Cathryn Ross

Non-Executive Directors:

Chris Burchell
Martin Lawrence
Christine Farnish
Catherine Waddams
Robin Paynter Bryant
Wendy Barnes (from item 4.4)

Executive Directors:

Sonia Brown
Richard Khaldi
Keith Mason

General Counsel

Elizabeth Hillman

In attendance:

Rachel Wright	(Board Secretary)
Claire Forbes	(Senior Director of Corporate Communications)
Shane Anderson	(Delivery Director)
Giles Stevens	(Delivery Director)
David Black	(Delivery Director)
Andrew Walker	(Delivery Director)
David Lancefield	(PwC)
Stuart Cook	(PwC)
Henrietta Farrell	(PwC)
Bill Easton	(Interim Delivery Director)
Mark Worsfold	(Delivery Director)
Peter Jordan	(Principal Analyst)
Andrew Chesworth	(Principal Analyst)

Steve St Pier	(Principal Analyst)
Graham Taylor	(City Advisor)
Claire Simpson	(Strategic Advisor)
Ben Woodside	(Strategic Advisor)

1 Declarations of interest

- 1.1 None

2 Opening items including minutes

- 2.1 With minor amendments the Board agreed the minutes and actions of the meeting held on 16 October. The minutes will be published on the website.
- 2.2 The Board agreed to delay review of the actions until the next Board meeting on 8 December recognizing that this is a particularly busy meeting.

3 PR14 – Overview

- 3.1 It was confirmed that for the purposes of all final determination discussions, Sonia Brown would not be regarded as a decision making Board member, given her involvement in the assessment of companies' business plans and making recommendations to the Board.
- 3.2 For the purpose of these minutes (and previous minutes) 'The Executive' refers to the PR14 Executive. All Executive Directors fully participated in the discussions and decision making, subject to point 3.1 above.
- 3.3 The Executive provided an update of the PR14 programme and the next steps, including future engagement with Board up to the publication of all company Final Determinations on 12 December 2014.
- 3.4 The invitation to the 4 December PR14 Programme Board was extended to all Board members.
- 3.5 The Executive gave an overview of the company representations to the Draft Determinations and discussed with the Board both the assessment framework applied to the representations. They also provided the Board with an update on the quality assurance processes that had and were being adopted.

4 PR14 – Wholesale Costs

- 4.1 The Executive provided an overview of wholesale costs. In particular the Executive highlighted that for many companies the changes in wholesale cost thresholds between DD and those proposed for FD were relatively modest and noted that on aggregate there is no significant wholesale cost gap for water and wastewater. The Executive pointed out that there were two companies with large differences at draft determination between cost thresholds and business plan forecasts of costs and that these would be subject to further discussion later in the meeting (see 4.4 to 4.12 below).
- 4.2 The Executive had provided the Programme Board with an update on its assessment of all companies wholesale costs except Batch 3 companies. The Board therefore discussed Draft Determination representations on wholesale costs made by Thames Water (excluding Tideway costs), United Utilities (water element) and Wessex Water (water and wastewater element). The Executive proposed a number of interventions in the companies plans but overall the remaining wholesale costs gaps for these companies were reducing.
- 4.3 The Board endorsed the Executive's recommendations for all the above Batch 3 companies' wholesale costs for the purpose of financial modelling and preparations of publication material.
- 4.4 The Executive reminded the Board that 3 large capital expenditure schemes in the sector had all been accommodated within the cost thresholds. These are Elan Valley (Severn Trent), Thirlmere project (United Utilities) and Counters Creek (Thames Water).
- 4.5 The Executive presented a representation that Ofwat had received from Thames Water on the 5% cap threshold for wholesale costs. The Board endorsed the Executive's recommendation to retain the 5% cap for PR14 but agreed that different options be explored in thinking about the next price control (PR19) for the purpose of financial modelling and preparations of publication material.
- 4.6 The Executive provided an update on the ongoing engagement with Bristol Water in relation to its wholesale costs. As previously discussed at an earlier Board meeting, the Board supported the decision to continue a dialogue with Bristol Water since Draft Determinations to help get the best outcome for customers of Bristol Water, for the purpose of financial modelling and preparations of publication material.

- 4.7 The Executive updated the Board that it had received new material from Bristol Water very late and close to finalising its recommendations. The Board noted that the cost claims submitted by Bristol Water had failed our assessments. There was however a need to consider the appropriate level of totex for customers.
- 4.8 The Board discussed proposals from the Executive around the enhancement total expenditure (totex). The Board endorsed the Executive's recommendation for the company's enhancement totex allowance and hence agreed the totex threshold for Bristol, for the purpose of financial modelling and preparations of publication material.
- 4.9 The Executive discussed options for base totex. The Executive provided further detail of the late representation made by Bristol on the 7th November. The Board noted that this evidence had been received only at a very late stage, and that it had therefore only been possible for it to be considered in a limited way in preparation for this meeting. The Board endorsed the Executives recommendation on the base programme totex scenario, for the purpose of financial modelling and preparations of publication material.
- 4.10 The Executive recommended that the Board consider whether to adopt a base programme totex glide path scenario for Bristol Water. The Board raised concerns over the proposal to have a glide path given a potential lack of consistency in approach with other companies and the potential to have long term adverse consequences for companies to deliver efficient business plans. The Board did not support a glide path scenario. The Board discussed the possibility of smoothing bills to avoid big changes in bills for customers, which customers find undesirable. The Board supported exploring this issue and would return to consider this at its next meeting.
- 4.11 The Board mandated that the Executive clearly communicate the decisions and background to the decisions on Bristol Water in the narrative to be used in Final Determination publications. This should include a clear explanation that a better outcome could have been reached if the company had followed the whole process better.
- 4.12 The Executive presented to the Board a material outstanding issue around United Utilities claim for incremental base costs for its waste water control. The Executive presented a number of scenarios for United Utilities base totex. The Board agreed with the Executives proposals for base costs for

the purpose of financial modelling but challenged the Executive's proposal relating to United Utilities error associated with its PR09 capitalization of pension deficit recovery costs.

- 4.13 The Board endorsed the Executive's recommendation on United Utilities costs, for the purpose of financial modelling, subject to allowing the company to recover from customers in AMP6 pension deficit costs to correct for an error in its AMP 5 PR09 plan. This recognized the cost that the company had borne 100% of the costs in AMP5 as a result of this error. The Board fully endorsed the principle that companies should bear the risk associated with errors in their business plans and asked for this to be communicated clearly in Final Determinations.
- 4.14 The Executive presented the recommended Thames Tideway Tunnel uncertainty mechanism to protect customers from paying any additional amounts arising from costs that are within Thames Water's control associated with the Thames Tideway.
- 4.15 The Board approved the recommendation for the Thames Tideway Tunnel uncertainty mechanism subject to any late changes to be raised and discussed at the December Programme Board.

5 PR14 – PR09 Legacy

- 5.1 The Executive gave the Board an update on PR09 including the proposed shortfalling for serviceability and the treatment of the issues identified by Severn Trent associated with the technical treatment of the PR09 legacy tools including the Capital expenditure Incentive Scheme (CIS).
- 5.2 The Executive noted that with hindsight there was possible ambiguity in the PR09 methodology for both serviceability and aspects which Severn Trent had identified including the operation of the CIS.
- 5.3 The Executive noted that whilst it would not have chosen to start PR14 from this position, given the starting point it was important that the best decision possible was made to protect the interests of customers today and tomorrow, and to maintain the predictability of the regulatory process.
- 5.4 The Executive presented proposals designed to ensure that the level of serviceability shortfalling is proportionate.

- 5.5 The Board agreed to the cap on the contribution to shortfalling arising from failings for any single indicator should be related to the volatility of the indicator and should not, in any case, exceed the fraction of sub-service expenditure assigned to that indicator.
- 5.6 After reviewing Severn Trent Water's submission in October and considering the results of an independent review by PwC on the issues raised, the Executive acknowledged that the established CIS methodology adopts a different approach to indexation for the RCV and financing cost adjustments.
- 5.7 The Executive explained the background to the issue including an information note in 2012, publication of a model in January 2013 which included the financing adjustment and the use of the established CIS methodology in the risk-based review and to derive companies' draft determinations. To change to the established methodology for the CIS would be inconsistent with the position adopted since 2012.
- 5.8 The Executive explained the rationale for not recommending a change to CIS methodology. A clear expectation has been set in recent years about how the CIS would operate. A change would be perceived as a retrospective adjustment. The Executive explained that this situation is qualitatively different from adjustments to PR14 models. If we were to make changes at this point to AMP6 mechanisms, companies have time to adapt their behaviours. This is not the case for AMP5 reconciliation.
- 5.9 The effectiveness of the incentives we have introduced for PR14 depend on companies and other stakeholders having confidence in how they will operate.
- 5.10 The Executive recommended to Board that no change is made to the Draft Determinations CIS methodology for the Final Determinations, recognising that companies have made decisions on financeability based on their Draft Determinations.
- 5.11 The Board endorsed this recommendation for the purpose of financial modelling and preparations of publication material.

6 PR14 – Outcomes

- 6.1 The Executive reminded Board of the outcomes methodology used at Draft Determinations including: the use of horizontal comparisons to

incentivise companies to achieve upper quartile efficiency performance; “bottom up” incentives to check willingness to pay for outcomes where there is no industry comparator; and, a cap on Outcome Delivery Incentives (ODIs) at 2% of RoRE.

- 6.2 The Executive recommended to the Board that it maintains the upper quartile performance level for horizontal comparisons, with some minor adjustments to improve consistency. The Board endorsed this recommendation.
- 6.3 The Executive recommended to the Board that some adjustments are made to the ODIs for some companies where industry comparisons cannot be made.
- 6.4 The Board endorsed this recommendation.

7 PR14 – Risk and Reward

- 7.1 The Executive gave an update on the development of the Cost of Capital since Ofwat’s Risk and Reward guidance was published in January 2014. The Executive noted that there has been a reduction in the cost of debt since January 2014, and that this market evidence is sufficient to move Ofwat’s Weight Average Cost of Capital (WACC). The PR14 Executive team also presented the evidence for a reduction in the equity return based on market evidence and decisions by other regulators.
- 7.2 The Executive recommended that Ofwat reduce the cost of new debt from 2.65% to 2%, resulting in reducing the appointee WACC to 3.74% and wholesale WACC to 3.6% (rounded) and considered the case in relation to a reduction in equity return.
- 7.3 The Board endorsed the recommendation in relation to reducing the cost of debt and concluded that the case for reducing the equity return might exist but was less strong. It was concluded therefore to use an appointee level WACC of 3.74% , for the purpose of financial modelling..
- 7.4 The Executive reminded Board of the PR14 approach to Pay As You Go (PAYG) ratios and RCV run off rates. The Board discussed the difference between ‘in period’ smoothing and allowing smoothing of revenues and run off rates across regulatory periods. The Board concluded that while there were instances where the latter might make sense in the view of

customers, there should be considerably more caution about smoothing across periods than within period.

- 7.5 The Executive provided an update on the initial results of the financial modelling used to analyse and calculate allowed company revenues and determine company financeability. The Executive updated the Board on the financial ratios for all of the companies, noting that final results will be presented to December board meeting.
- 7.6 The Executive recommended to the Board that the use of PAYG and RCV levers are allowed at Final Determination only where a company has demonstrated that it is in customers' interest, and has support from its customers through well evidenced customer engagement.
- 7.7 The Board endorsed this recommendation but requested a later discussion at the December PR14 Programme Board on the financeability and results of bill smoothing for some companies.
- 7.8 The Executive reminded the Board of the Draft Determination position on company specific uplifts on the cost of capital and the assessment framework for allowing a company specific uplift.
- 7.9 The Executive recommended that the Draft Determination position on company specific uplifts is retained. This would allow an uplift of 25 basis points to the cost of debt in the Final Determinations for Portsmouth Water and Sembcorp Bournemouth Water.
- 7.10 The Board discussed the importance of both comparative service quality and cost efficiency offered by smaller companies in relation to providing a small company premium. At the end of the discussion, the Chairman drew attention to the comparator value of a smaller Water Only Company (WOC) which goes beyond just efficiency measures, to include outstanding service comparisons. He recognised that SIM was the only available tool for this assessment at the current time, but an Upper Quartile assessment of SIM could be used as a method to recognise a service excellence comparator for any WOC.
- 7.11 The Board endorsed the recommendation, for the purpose of financial modelling.

8 PR14 – Company Recommendations

- 8.1 The Executive presented the recommendations for Anglian Water’s Final Determination. This included interventions based on the company’s Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.2 The Executive presented the recommendations for Dwr Cymru’s Final Determination. This included interventions based on the company’s Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.3 The Executive presented the recommendations for Northumbrian Water’s Final Determination. This included interventions based on the company’s Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.4 The Executive presented the recommendations for Severn Trent’s Final Determination. This included interventions based on the company’s Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.5 The Executive presented the recommendations for South West Water’s Final Determination. This included interventions based on the company’s Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.6 The Executive presented the recommendations for Southern Water’s Final Determination. This included interventions based on the company’s Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.7 The Executive presented the recommendations for Thames Water’s Final Determination. This included interventions based on the company’s Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.8 The Executive presented the recommendations for United Utilities Final Determination. This included interventions based on the company’s Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.

- 8.9 The Executive presented the recommendations for Wessex Water's Final Determination. This included interventions based on the company's Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.10 The Executive presented the recommendations for Yorkshire Water's Final Determination. This included interventions based on the company's Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.11 The Executive presented the recommendations for Affinity Water's Final Determination. This included interventions based on the company's Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.12 The Executive presented the recommendations for Bristol Water's Final Determination. This included interventions based on the company's Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.13 The Executive presented the recommendations for Dee Valley Water's Final Determination. This included interventions based on the company's Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.14 The Executive presented the recommendations for Portsmouth Water's Final Determination. This included interventions based on the company's Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.15 The Executive presented the recommendations for Sembcorp Bournemouth Water's Final Determination. This included interventions based on the company's Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.16 The Executive presented the recommendations for South East Water's Final Determination. This included interventions based on the company's Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.

- 8.17 The Executive presented the recommendations for South Staffordshire and Cambridge Water's Final Determination. This included interventions based on the company's Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.
- 8.18 The Executive presented the recommendations for Sutton and East Surrey Water's Final Determination. This included interventions based on the company's Draft Determination representation. The Board endorsed the recommendations for the purposes of running the financial modelling.

9 Any Other Business

- 9.1 The Executive gave an update on the Thames Tideway Tunnel programme.
- 9.2 Wendy Barnes confirmed that she would be taking up a role as NED and Chair of the Information Systems & Services (ISS) Governance and Risk Assurance Committee for the ISS department of the Ministry of Defence from 1 January 2015. The Secretary confirmed the Rules of Procedure would be updated.
- 9.3 Catherine Waddams, the Chair of the Casework Committee noted that the Committee met on 16 November 2014.
- 9.4 Martin Lawrence, the Chair of the Remuneration Committee noted that the Committee met on 19 November 2014.

Rachel Wright
20 November 2014