



## **Ofwat City briefing – speaker notes**

**31 January 2013**



City briefing

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## Slide 1 – Welcome

Good morning everybody. I am Jonson Cox and I have been the chairman of Ofwat since November 1st last year, and so it is the first time I have been to an Ofwat event such as this.

Today's programme is about the methodology consultation which we put out earlier this week. Regina and Keith are going to take you through that; Regina is going to introduce the conceptual part of it, and Keith is going to take you through the "hows" and the "whys" of the proposals. It is a consultation and we are very interested in your feedback and getting that as promptly as possible. I see there has been quite a lot of interest already and I have been pleased to read in some of the broker notes phrases, like; "as expected" and "no surprises". And I hear similar things from some of the companies too, so that feels to me like quite a good start.

There has been a very long and open process of dialogue with companies and with investors either directly or through boards where investors are represented, so I am pleased to find comments like "as expected" and "no surprises". But I am sure you are going to have plenty of questions as we go through.

I am going to hand over to Regina, who is going to take you through a couple of slides. Keith has some more detail. I would expect their presentations to take up to half an hour, then we will open up for questions. I am keen to marshal questions sensibly to make sure that we first of all take questions on the methodology. If there is anything wider anyone wants to ask, please do, but let us hold that until the second part of questions.

Over to Regina.

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# Challenges

## Growth and investment



**£310 billion investment needed for infrastructure to 2020 and beyond**

**Water and sewerage sectors invest £4 billion a year**

**New businesses with new needs**

## Customers and accountability

**5% reduction to household incomes since 2010 while bills have gone up 10%**



**Water bad debt £15 a year for every customer**

**A case study: A business customer that could save £80,000–£200,000 by receiving one bill instead of 4,000**

## Sustainable water for the future

**April 2012 drought as previous 18 months driest for more than 100 years – water restrictions**



**2012 second wettest year since UK records began – 8,000 properties flooded**

**Currently only 4–5% of water being traded**

## Slide 3 – Challenges

Now you are all very aware, I know, of the challenges that the sector is facing here. We have talked about them almost at every city briefing. Companies are really very conscious of this too, and government is very focussed on these challenges. So I am not going to repeat them, but I do want to just remind you since we last talked, just how much more acute perhaps some of those challenges have become.

We have challenges around growth and investment. The Treasury estimates investment in UK infrastructure in the next 20 years or more is very significant: £310 billion is a big number. The water sector with investment of £4 billion a year is a not insignificant part of that. So it is crucially important that we regulate to sustain the level of investment that is needed in the long term.

But we also need to be conscious that hard pressed customers, including business customers, are paying for the service that they get. It is an input cost into the economy, and we need to make sure that our regulation is targeted to encourage companies to innovate and focus on what those customers want and need. This will enable the overall economy to benefit and grow.

There are some pretty stark figures up there in terms of customers. The challenge of affordability is becoming ever greater, with customer incomes going down, and their bills going up. This is not going away any time soon and that really sharpens the challenge. We can see what the result of that is; bad debt is adding £15 to every bill. This cannot keep going in this direction. This is not sustainable for customers or for the sector.

And business customers too are finding times a bit tough. There is a 2011 Policy Exchange report that had a particular case study of one customer. The study noted that this customer was getting 4,000 paper bills from various companies. If that company could actually get one bill electronically from one supplier, it could save up to £200,000. Now, that is the kind of innovation and focus we want to incentivise in our regulation.

Finally, there is the issue of the sustainable use of water. We have all seen the odd behaviour of the weather over the last year. Those of us who were in London during the Olympics watched bus hoardings go by telling us to conserve water because we had a hose pipe ban. We were looking at them through torrential rain! This kind of weather volatility is something that we need to incentivise the companies to manage in a sustainable way, and we think there is more we can do with our price review to target that.

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So, what are we proposing? How are we proposing to target our regulation to encourage and enable companies to tackle those challenges? How can we give companies and their boards a clear signal that they are responsible and accountable for:

- the strategy of their business;
- delivery to their owners; and
- delivery to their customers over the long term?

That is a key idea we want to get running through all our incentives.

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# Targeted regulation

## Growth and investment



Stable tools –  
RCV and RPI

Risk mitigants  
eg, IDoKs

Greater scope for  
innovation

Separate price limits for  
retail and wholesale

## Customers and accountability

Greater accountability  
and customer  
engagement

Focus on  
longer-term outcomes

Company Boards taking  
ownership of business  
delivery for customers



## Sustainable water for the future

Totex to replace  
separate capex  
and opex

Water trading incentives

Abstraction incentive  
mechanism



## Slide 4 – Targeted regulation

In terms of growth and investment, as I mentioned at the beginning, there is a challenge here in terms of ensuring the sector can continue to attract the right type of investment. And investment at the right cost to customers. We are very conscious of that.

Our proposed methodology uses a lot of the things that we know work. We have committed very clearly to the use of the Regulatory Capital Value and indexation by the Retail Price Index for the wholesale controls. We have committed to a range of existing tools, like Interim Determinations of “K” and substantial adverse effects. These are risk mitigants. So first thing we are doing is to ensure that we underpin the stability of the sector, to enable it to raise that long term investment. Keith will talk about that in a little bit more detail.

But we also recognise the need to regulate for growth and to incentivise companies to focus very much on their customers and what they want. And that is why we are setting separate retail price controls, and indeed two retail price controls: one for household customers, and one for business customers. Once again these two types of customers are different. They will have different needs and demands so we are regulating them differently. Keith will talk you through some of the detail of how we are constructing the incentives in the retail businesses. We want to drive company ownership of their customer relationship, and innovation in service provision.

In terms of customers and accountability, we really do want to create and see change. Companies should be focussed on what their customers want. We want to do this through greater customer engagement and creating legitimacy with customers. When customers pay their bills, they should know what they are getting and that it is something that they are willing to pay for. This will help underpin the stability of the sector. So we have increased our focus on companies engaging with customers. We have confirmed our move to asking companies to set their own long term outcomes, and do that with customer support and engagement. Companies will need to demonstrate that to us.

We particularly want to see company boards take ownership of this process and this engagement and ownership of the decisions that the companies make. We have put a strong incentive in this process. We want companies to do this and to do it well and provide a well evidenced plan that is supported by a positive report from their Customer Challenge Group. Companies that really excel (and demonstrate that) will get a different treatment in how their business plan is assessed. We will accept more of their business plan and not challenge every part of it. Now that is a high bar for companies to reach. We do not expect everybody to get there because it will be a stretch. But we really want to see companies try to hit that bar, and we want to

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reward them when they do. If we feel that that bar has not been hit, we will engage in a more detailed scrutiny and challenge of their plan. This is consistent with our risk based review of those business plans. And if companies do not engage at all with their customers and do a very poor job, they will get very tough scrutiny. So we do want to see company boards responding to this incentive.

And finally, we have made a number of specific changes to ensure companies make the right choice to invest in the right things at the right time. Last time we talked we were still exploring the feasibility of treating capital expenditure and operating expenditure together as a total expenditure approach. I think there is a general view that, in principle, it sounded very sensible. We have done a lot of work underpinning that and we have published a lot of detail work alongside the proposed methodology. We are confident that this will work well. Indeed some of the econometric models we use for the efficiency challenge, work even better with the total expenditure approach.

We are also proposing to introduce water trading incentives to improve companies' choices about what they do. And that means incentives for both importers of water and exporters of water. That means financial incentives for companies. These incentives encourage them to trade water where it is the most sustainable and best choice for their customers and their business. And to protect any potential adverse effects on the environment, we have the Abstraction Incentive Mechanism. This is designed to stop any incentive for companies to take unsustainable amounts of water out of the environment. So there is a spread of incentives in the package. It is designed to address the three pillars of behaviour that we want to target our regulation on in the next price review period. As Jonson said, it is a consultation, you will find things in there that we are reasonably firm about, and things that we are still working on and consulting on quite broadly. So we are very keen to get views across the board on all of those issues.

I am going to pause here and ask Keith to go through some more of the detail on the incentives. In particular we have tried to pick out things we think you will be interested in. But so as not to be here talking for a very long time, we have had to be a little selective. But we will be very happy to take questions on the other parts, even if we have not emphasised them in this presentation.

So thank you for listening and, Keith, I will hand over to you.

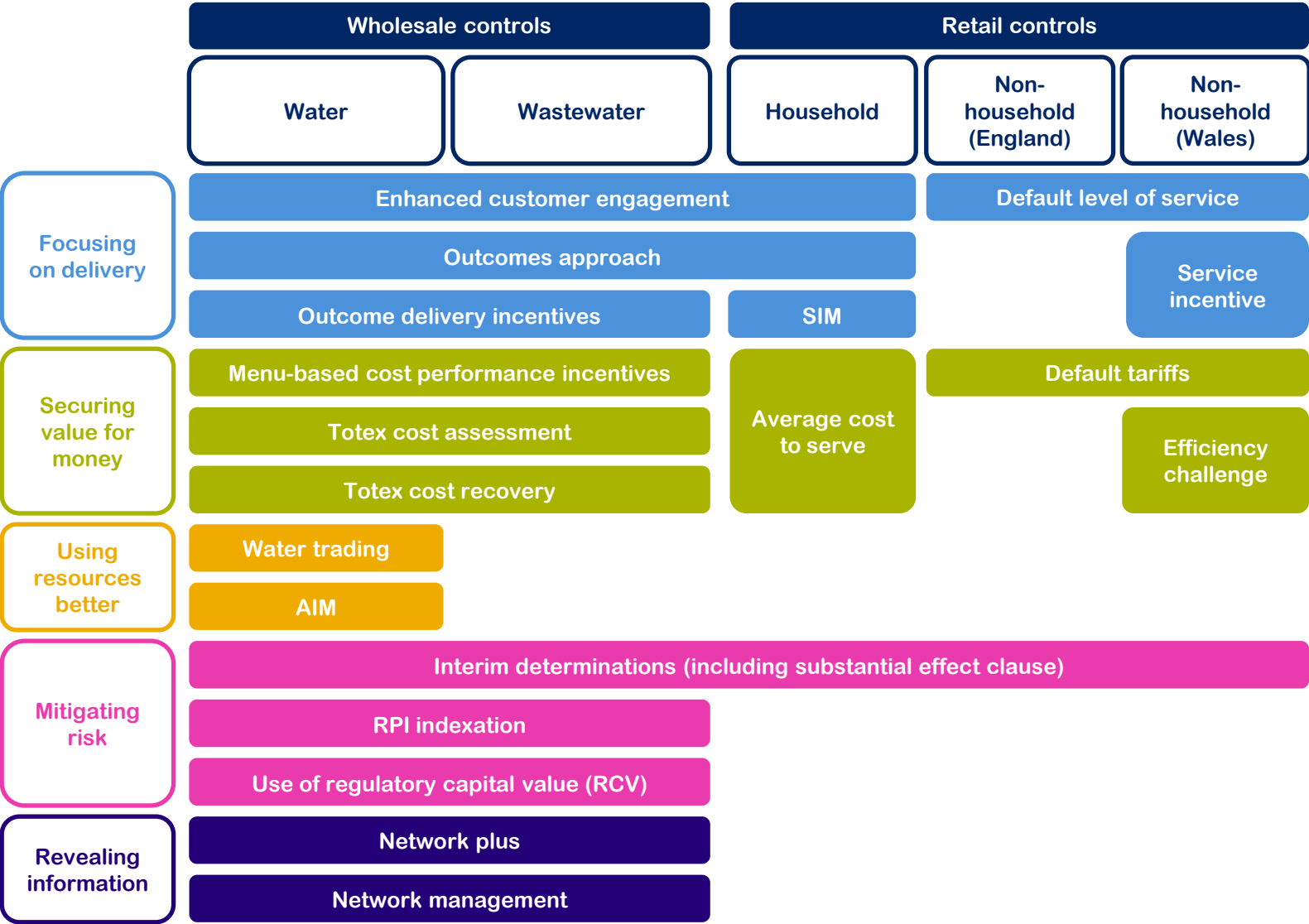
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Overall framework

Keith Mason, Senior Director of Finance and Networks

# Our overall framework



## Slide 6 – Our overall framework

Thank you, Regina. I just want to start, with this illustration which you will find in the executive summary of our methodology document that we published on Monday. It does provide a very useful overview of the overall framework, and also where the incentives sit within that framework. The left hand column sets out the objectives of what we want to get out of this review. I am not going to go through them all, because, as Jonson said, we do want to wrap this up within a reasonable time. So I am just going to highlight some of the more critical ones. But we can take questions after on the others.

# Regulating for growth and investment



## Wholesale controls

Familiar RPI+/-K

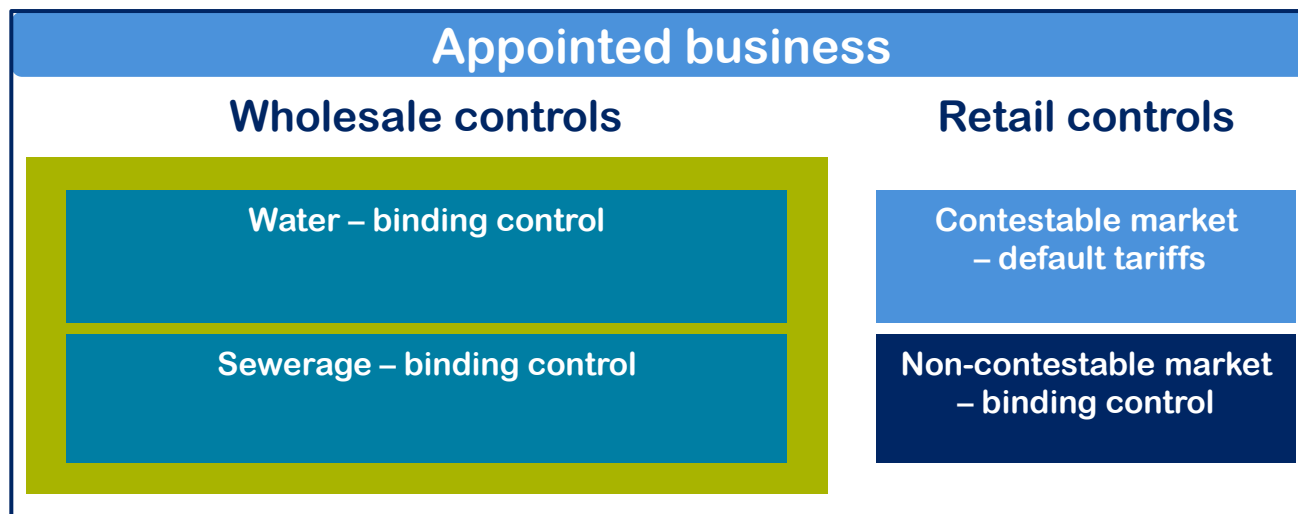
Continued use of the regulatory capital value

Continued protections – eg, interim determinations

## Retail controls

Greater choice for business customers

Default tariffs and default service



## Slide 7 – Regulating for growth and investment

Firstly, I will pick up the theme of regulating for growth and investment. This is very important to us. We want to maintain the confidence of investors in the overall regulatory framework. This is crucial to the financing of this particular sector.

As Regina said, for the wholesale controls, we have kept some of the key elements that are familiar and important to you. You will be familiar with; the RPI +/- “K” form of control and the continued use of the Regulatory Capital Value. We have said that 100% of the Regulatory Capital Value will remain in wholesale. And the normal protections that are there in the license in terms of interim determinations and substantial effect clauses will continue. What is new compared with perhaps the last review is we are going to have two binding wholesale controls; one for water, one for sewerage (though they will both be in the form of RPI +/- “K”). One of the main reasons for doing that is alignment with the total expenditure approach. I will say a little bit more about that in a few minutes.

For the water wholesale control, we are going to put in some elements of average revenue control into that part of the price cap. It will not be a pure price cap. We think that gives companies more control over their cash flows and will allow them to adjust prices year on year to accommodate the actual change in numbers of connections and numbers of meters. And so that gives very useful flexibility for companies as they go forward. We are not, at this stage, convinced that we can do it for sewerage. One of the consultation questions we have posed is whether it could be extended to sewerage.

Moving to retail. Again as Regina said, retail has got very different characteristics from wholesale. The whole idea of trying to target incentives is to target them to the particular characteristics of the activity. We are proposing two controls for the two separate segments within retail.

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# Focus on customers and greater accountability



## Wholesale controls

Outcomes approach

Cost assessment and menus  
– totex

Cost recovery

## Retail controls

Average cost to serve

Service incentive mechanism



## **Slide 8 – Focus on customers and greater accountability**

For household customers who will not in the foreseeable future have a choice, we are proposing an average cost to serve model. I am going to pick up more on average cost to serve as we go forward.

For business customers which will be a more contestable segment, we are proposing a default tariff. This will protect those customers who do not want to shop around. But certainly we are expecting companies to be offering business customers different types of tariffs and different offerings for service.

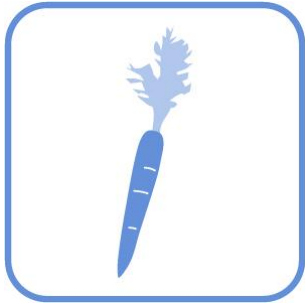
Moving on to customers and greater accountability. Again, a key theme of what we are trying to do with this price review is to give companies all the reasons to focus on their customers. And we want companies to take greater accountability for what they are doing. There are a number of incentives under this theme.

Before I get to them I will just explain that we are going to do a risk based price review. We started to use a risk based approach in terms of the way we carried out ongoing annual monitoring. Those of you that follow us will know that for the first time last year the June return data submissions were no longer required. We replaced the June return with a risk-based review of what companies were doing, focussing on where the areas of biggest risk were. We are carrying this approach through to the price review methodology. Our assessment of business plans will be very much a risk-based review. We will concentrate on the areas of most risk. To echo what Regina said, for companies that have a very good high quality business plan it will mean that we will not have to look as hard at that particular company's plan. That company will be able to move through the process, not necessarily quicker, but certainly with less scrutiny.

I will now come back to the particular incentives. The first one I am going to highlight is outcomes which can cover both the wholesale and the retail parts. They go across all the areas of the price review. I am also going to talk about cost assessment, cost performance and cost recovery – both for retail and for wholesale.

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## **Value based but incentives are not one size fits all:**

Financial and non-financial incentives

Incentive rewards as well as penalties for non-delivery

In certain circumstances, trade-offs between performance against different outcomes

## Slide 9 – Outcome delivery incentives

Firstly, outcomes. We have foreshadowed this concept for quite a while. We want to shift the balance to a higher level outcome approach, rather having to set lots and lots of detailed outputs that companies then have to meet. It was not necessarily us setting all of these outputs, but also the Environment Agency and the Drinking Water Inspectorate. What that tended to inculcate was a culture where, providing the regulator says it is acceptable, the company would follow that output irrespective of whether a better solution might provide a better result to customers overall.

So we want to shift this to higher level outcomes and longer term outcomes. Companies need to engage with their customers to determine precisely what the outcomes are, and that is one of the functions of the Customer Challenge Groups. Each of the companies has set up a Customer Challenge Group. They will work through companies' business plans and companies' views on what their outcomes might be. They go by different names depending on what companies you are talking to, but we think Customer Challenge Group is the right phrase because the emphasis is on challenge, the middle C.

So companies need to consider what incentives they should get for delivering these outcomes. And there was some concern I think, particularly in some of our early consultations about whether these outcomes would be all penalty based. We thought very hard about it and listened to those concerns. Our view is that it is not necessarily the right way to go. So you will see in the methodology document that there will be a range of potential incentives. Some may be non-financial for example where it is quite difficult to assess the value of an outcome or it may be you cannot have a financial incentive (whether reward or penalty) because it is just too difficult to measure. Although I do not think there will be too many of these.

Incentives can take the form of rewards as well as penalties. These may or may not be symmetrical. There could be a reward and a penalty associated with the out-performance or under-performance of a particular outcome. But there will still be outcomes where we do not think out-performance rewards are necessarily valid at all. These might be outcomes where there are mandatory standards put forward by the relevant environmental regulator i.e. the Environment Agency and the Drinking Water Inspectorate. It does not seem right to have rewards for outperformance in relation to mandatory standards.

We also think that in certain circumstances the performance against outcomes could perhaps be traded off against each other. So out-performance on one outcome, and under-performance on another, might be traded off. That might be quite limited in the way it can be used. The performance against outcomes that that might be traded off, would have to be linked. And customers need to understand the link before it is right

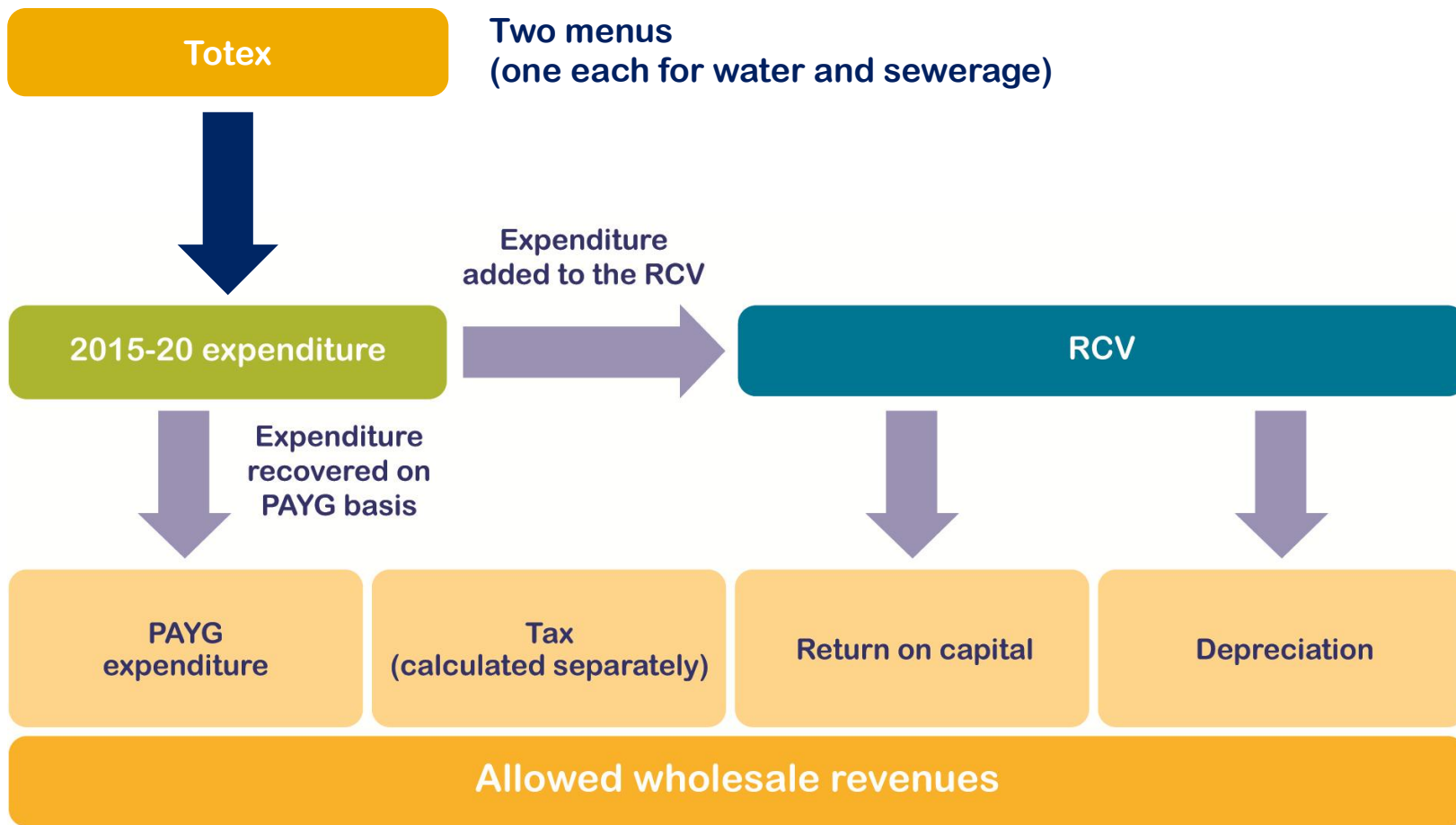
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to be able to make that trade off. We do not think it will be right to trade off outcomes that are completely unrelated.

My final comment here – and again I hope we spell it out reasonably clearly in the methodology document – is we are looking for the incentives to be related to the value to customers. It is not necessarily related to the costs that companies incur. This is because what matters is what is important to customers and how they value that performance.

My final comment in relation to outcomes is about duration. Outcomes are relatively long lived but thinking about how you can measure them over the long term looks more difficult. There are other incentives to make sure the outcomes look to the long term. Water resource management plans, for instance, cover 25 years. But in terms of the incentives for delivery, we think it is more difficult to try to establish those over the long term and to get commitment to them. So we propose to look at outcome delivery incentives only over the length of the price reviews. So that is five years for this particular review.

# Totex – cost assessment and cost recovery



## Slide 10 – Totex – cost assessment and cost recovery

Now I want talk about total expenditure. As Regina said, we have been thinking for quite a long time about how to do this i.e. whether we should be bringing operating expenditure and capital expenditure together. We think this approach will deal with a perception of capital expenditure bias. I know some argue that there might be a number of reasons why there might be a capital expenditure bias or that it might not exist at all. But I think most people agree that there is a bias towards capital expenditure. We want to target our incentives to make sure there is no bias coming from the regulatory framework. We think that a total expenditure approach is the right one. We will still be using quite a lot of the techniques that you are familiar with, in terms of the econometrics. As Regina said, we have some new and improved econometric models for total expenditure. Some of the detail of that has been put out. It is not in the methodology document directly. There is a companion volume that has been done for us by CEPA which is available on our website.

A total expenditure approach will encourage people to look at more whole life solutions. Take sustainable urban drainage for example. There has not been a great take up of this. I think one of the reasons is that it is an operating cost based solution, for which people have no certainty of recovery. So a company might prefer to have a more certain capital expenditure based solution because that expenditure gets into the Regulatory Capital Value and earns a return. With a total expenditure approach incentives will be equalised. So there should not be, from the regulatory framework perspective, any bias towards one solution or another.

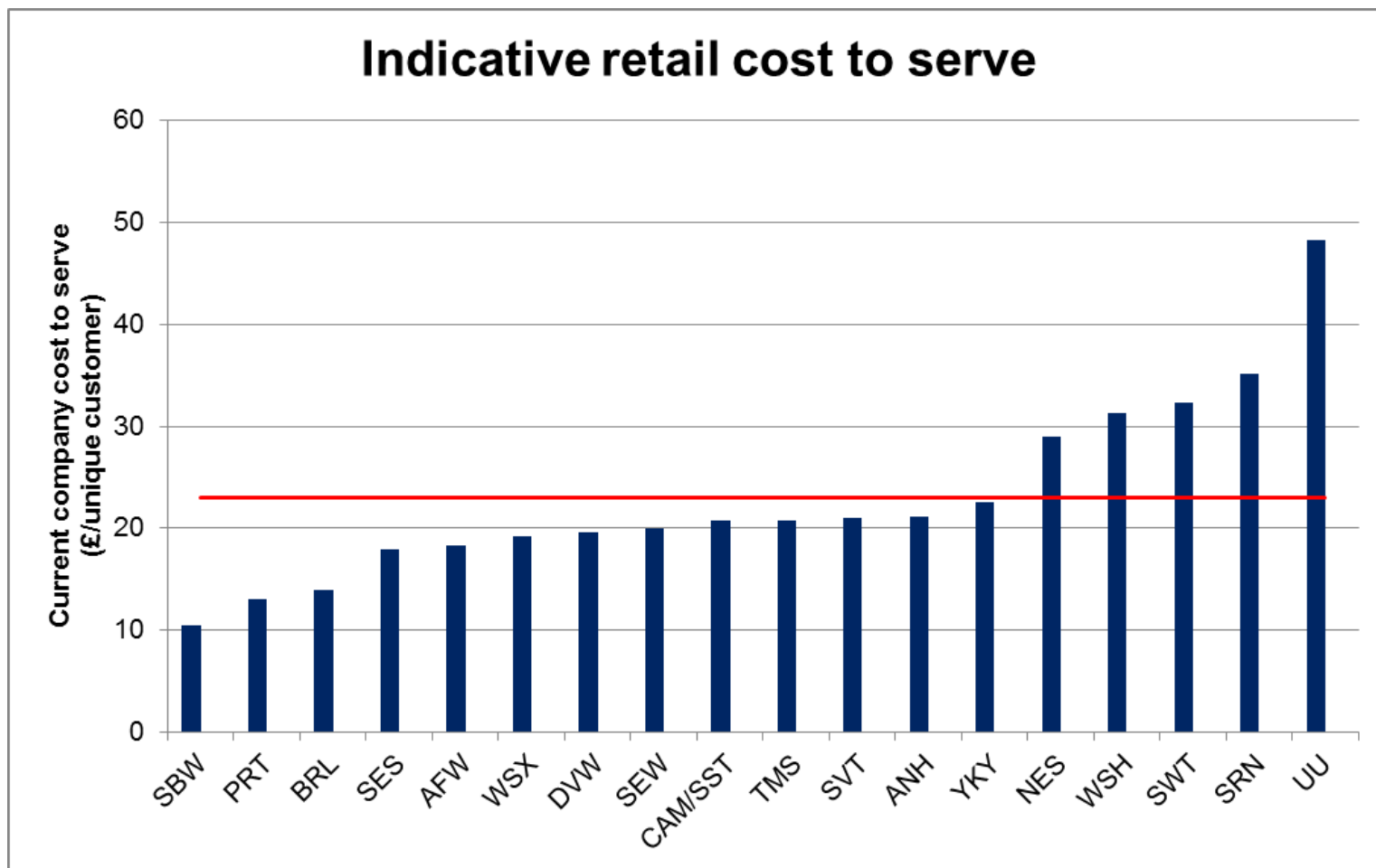
I would now like to reiterate a point about menus. We are proposing two menus. Again in our consultation document in the summer we looked at a variety of menus, and we have come back to what we consider to be the cleanest and the best. We will use one for water and one for wastewater, and that echoes the point I made about separate binding wholesale controls, one for water and one for wastewater.

Next I will move on to cost recovery. I know this is probably the most interesting part for this audience. Going to a total expenditure approach means there is some change to the way that we then remunerate expenditure going forward. The key one is that you have to split your total expenditure into what is pay as you go (or fast money) and what is slow money that will get added to the Regulatory Capital Value. We are suggesting that companies can choose their own split of that total expenditure. We think companies being able to do that will give them more flexibility and more control over their own cash flows. And this flexibility also links that to their ability to manage their overall financeability over both the short and long term. Companies will need to balance the short term needs for cash, the long term need to preserve their operational capability as they go forward, and the impacts of this on customers' bills.

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Average cost to serve is the preferred incentive for the household parts of the retail control. We think that it is a relatively simple but a relatively strong incentive. It incentivises companies to minimise costs and be more efficient in terms of their retail provision.

# Retail – average cost to serve



## Slide 11 – Retail – average cost to serve

The average cost to serve will be based on the number of unique customers. Again, in the retail consultation in the summer we posed a number of denominators that might be useful. What came out of the consultation was this idea of unique customers, so you only count the customers that get a bill, hence the term “unique”. This chart is an illustration of the average cost to serve based on this denominator. It is not a chart that we have got in the document itself. Please, as the title says, use it as indicative or illustrative of where things might be. It is certainly not where things will necessarily end up. One thing it does not adjust for is metering. We said in the consultation paper that we will be adjusting for the relative levels of metering of each individual company. We know it costs more to serve a metered customer.

We propose that, other than for metering, it is for companies to propose adjustments to the average cost to serve. And we set out three criteria that we think companies have got to meet for us to consider them.

Firstly: is it material? Secondly: is it controllable by management, or is it something beyond their control? And then thirdly: is the particular company particularly affected by this factor? There is no point having a factor that affects all the companies equally because by definition we should not be making an adjustment.

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## Wholesale controls

Totex addresses capex bias

Water trading and AIM

## Retail controls

Water efficiency measures

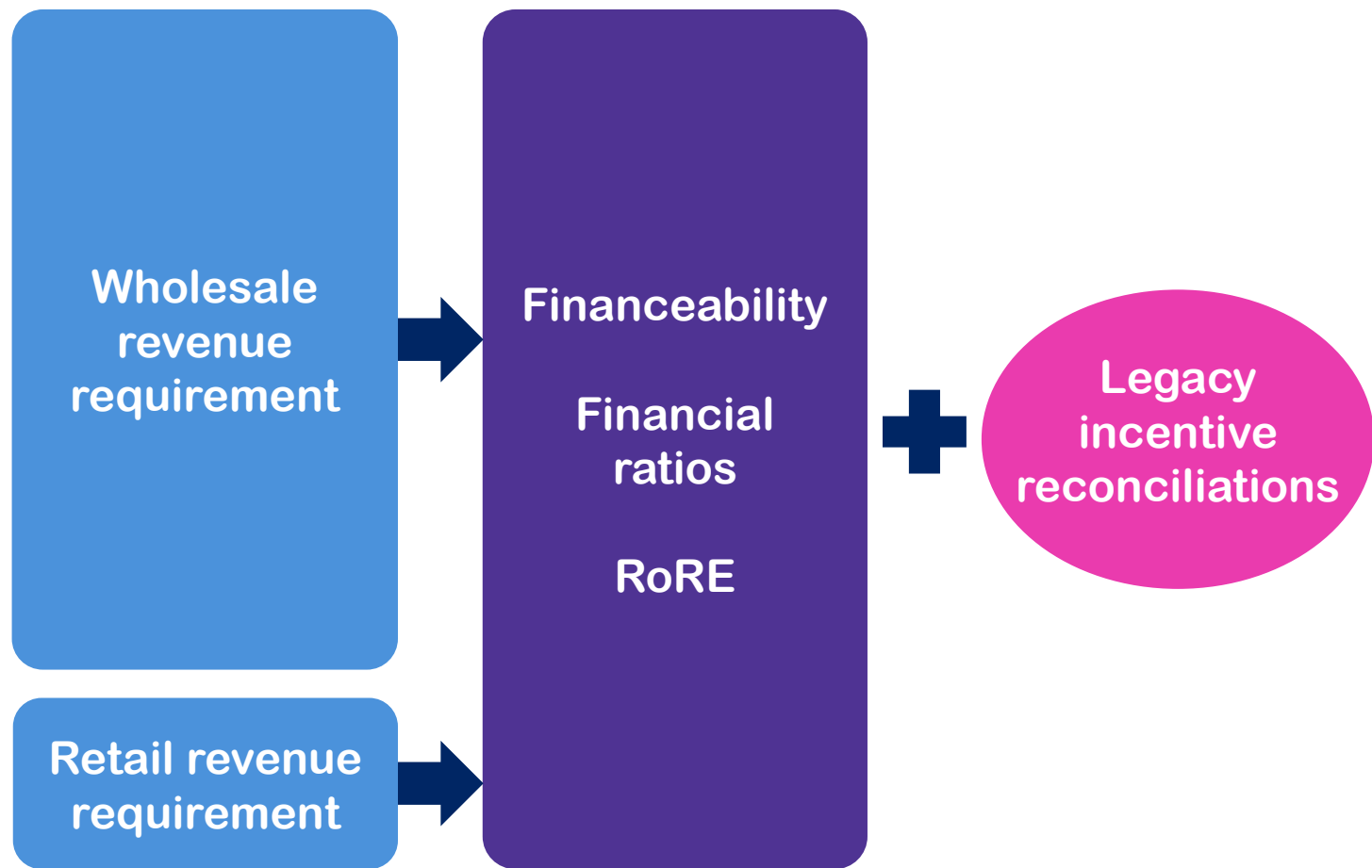
## Slide 12 – Ensuring sustainable water for the future

The next area I want to cover is sustainable water for the future. I will cover retail first. There is a strong incentive there for retail businesses to help customers deal with water efficiency and improve their overall level of water efficiency because that makes for a better business service and makes for lower bills. We think that is very important. We have seen this in the Scottish markets, which has been open for retail competition for nearly 5 years now. A report from Grant Thornton estimated that £110 million has been saved for business customers in Scotland through simple water efficiency measures. You can compound that up for the English market and you get relatively big figures.

On the wholesale side, we could have tried to ensure sustainable water going forward by just using the total expenditure approach and menu incentives. But we did think that it needed something slightly more because of its overall importance in terms of sustainability. So we are introducing specific incentives to trade water. We have always had an incentive for exporters, but we are extending that now to importers. There will be a financial incentive to importers. And we are increasing the value of the incentive to exporters. Very broadly, exporting companies would have kept about 30% of the lifetime profits of a trade under the way we have previously done price reviews. We are thinking of increasing that to around 50%. Again, use that figure with a few inverted commas, but that is the broad order of the incentive we are considering.

On the other side of that coin we are still looking to introduce the Abstraction Incentive Mechanism. What that does is to limit the amount of resources taken from unsustainable water resources going forward. So that is a cap. Again, in our consultation over the summer, we explained this incentive and a series of options around it. Some of the options could get quite complicated and could be incredibly data hungry. We have rowed a little bit back from those. We still want to introduce it but it is going to be a simpler mechanism, and it is also going to be more limited in scope. Only the worst of the abstraction sources are going to be affected or limited by the Abstraction Incentive Mechanism. I am not going to go into detail except to say that it is going to be linked to “Band 3” sources as defined by the Environment Agency. We will not have sufficient detail for the first year of the price review, so the Abstraction Incentive Mechanism will not be effective in financial terms for 2015/16. There will be a shadow Abstraction Incentive Mechanism for that year and it will be introduced in financial terms for the next year, 2016/17.

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## Slide 13 – Risk and financeability

So finally bringing it all together is risk and financeability. This is where we bring together all of the targeted incentives, all of the incentive package and look what that means in terms of overall risk for the business and what that means in terms of the overall cost of capital. Again, we set out in the methodology we are going to use the normal tools of a weighted average cost of capital for the wholesale part. We do not think the weighted average cost of capital approach is very relevant for an asset light business, such as retail. So we are going to use a margin approach for both the retail components.

This is not, as some people have said, a zero sum game in that whatever margin is allowed for retail gets automatically knocked out of wholesale. We are looking at the risks faced by each of those businesses. Of course we have our duty to enable the appointed business to finance its functions. But the appointed business will have individual price controls within it and we are going to look separately at each price control.

We are proposing to use the return on regulatory equity approach that Ofgem also uses. We are going to look at that in terms of the calibration of the incentives. We have already done some qualitative analysis. Over the course of the next six months we will undertake quantitative analysis of the impact of these incentives and what that means in terms of risks and rewards for equity finance.

Finally I will cover the legacy incentives from the last price review. Principally that is reconciling for:

- the Capital expenditure Incentive Scheme;
- the Revenue Correction Mechanism;
- the operating expenditure roller; and
- the Service Incentive Mechanism

So they are the principal incentive mechanisms from the last review where we need out-turn positions to determine the final outcomes. The effect of those reconciliations will get layered into the overall price controls. For simplicity they will all go into the wholesale revenue requirements.

So those are the main incentives that I wanted to cover. Those of you that do follow our publications pretty closely will have noticed that I have not talked about a couple of other incentives that we consulted on early last summer. We have listened to respondents and their concerns about the pace of change of regulation, so we have not proposed formal financial incentives on some of those issues.

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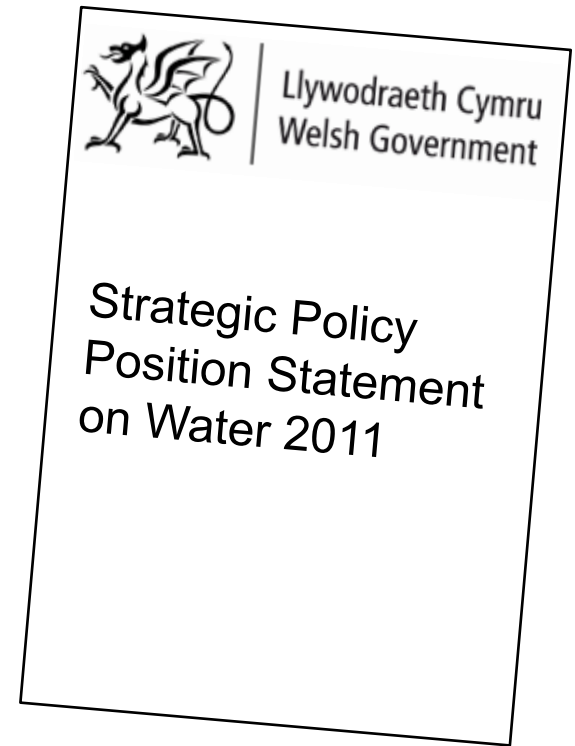
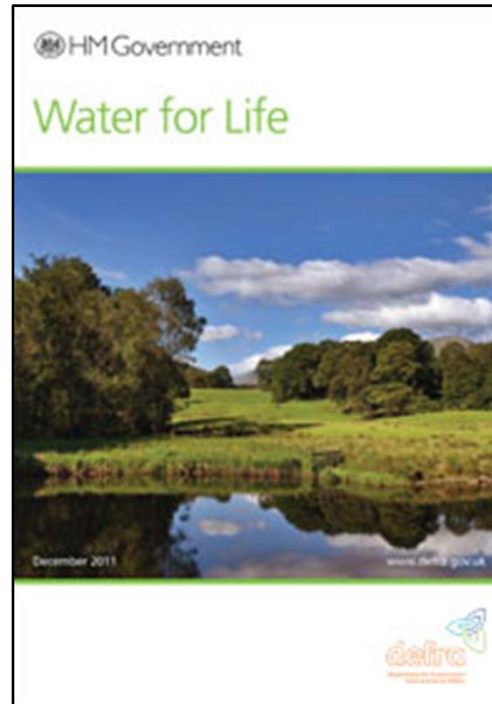
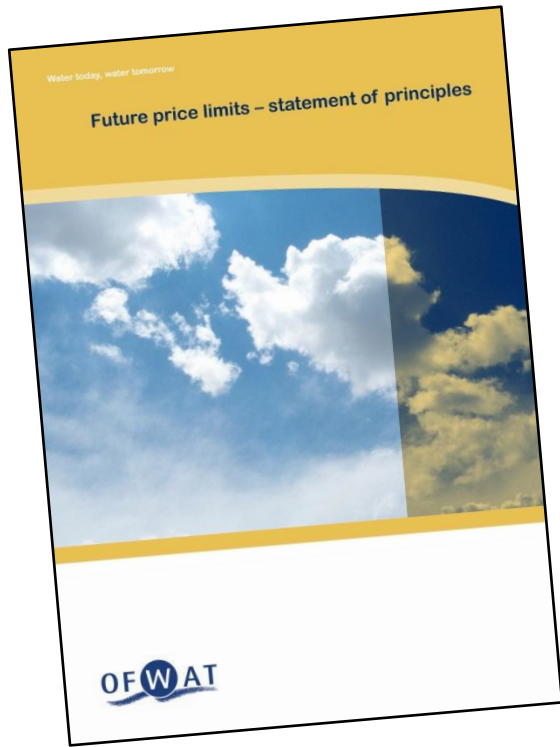
I am going to hand over to Regina now for the last few minutes just to take you through where we are going on those issues and building to the 2019 price review.



Building for the future

Regina Finn, Chief Executive

# Building for the future

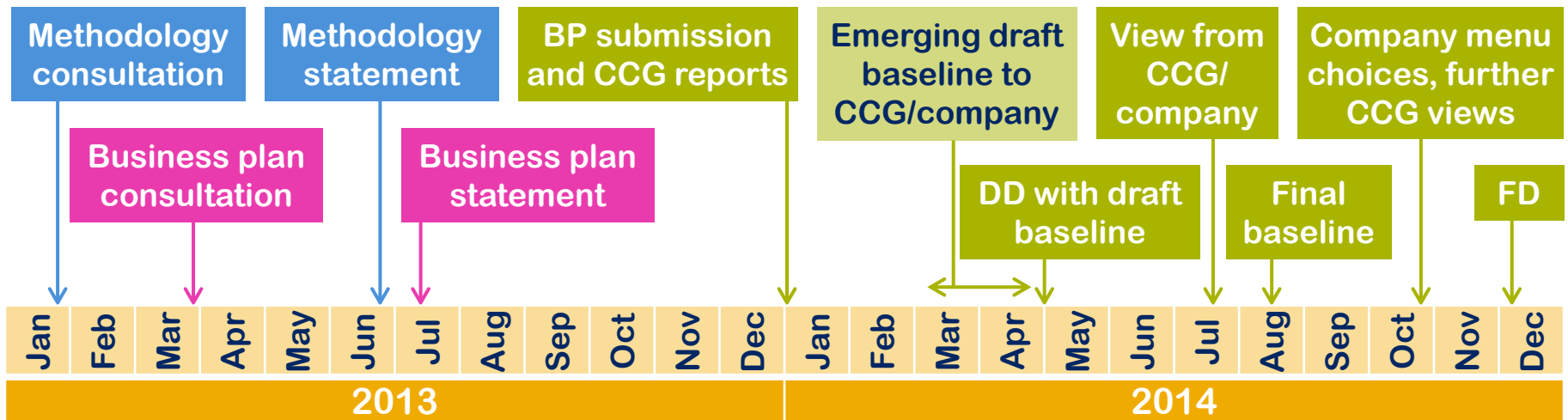


## **Slide 14 – Building for the future**

Thanks, Keith. Keith has given you a whistle stop tour of our vision for the next price review. But clearly while that is our end game and our vision for this price review, this is not a five year business. This section is a bit of a chance to look into our crystal ball of what the longer term end game might be. I will cover how we are preparing for that - how we can help inform how we shape targeted regulation, and so how we control prices in the longer term.



# Price controls timetable



## Slide 15 – Price controls timetable

We are very much aware that the broader policy ambitions of the UK government, the Welsh government and our own future price limits principles all recognised the need for us to regulate in a way that is sustainable in the long term. There is a need for regulation to be evidence based and evolutionary. So what we have done is included some incentives in this periodic review that are designed to help us gather that evidence. That evidence can help us decide on the best way to target our regulation in preparation for 2019. It is that sort of time horizon that we need to be looking at under this kind of broader policy framework.

So for example, we consulted in the early stages about how we should use our regulation to get the best incentives for companies to manage their networks. Now, we are firmly introducing water trading incentives in this price review. But what we are not doing, which we considered doing, is having a targeted price control for the networks business within the overall wholesale business. And one of the reasons for that is to ensure we get the pace of evolution right and we get the evidence to put the right incentives in place. So at this review, we want incentives for companies to reveal better information.

So to give you an example: we want to get better information about network management practices to find out what best practice is. This will do two things. First, it will hopefully shine a light on that activity and allow companies to improve relative to each other. And second, it will help us to know whether we should have more targeted incentives for the next time around. That may become more important over time because, as our overall policy framework envisages, what we want to see is water used most efficiently. That might mean water being traded. As we have already talked about, that might mean one company having to sell water into another company's network. That might mean that the company will need better information about that network plan compared to its own network plan so it can decide what the best choice is.

So that is the kind of additional incentive we have proposed. The incentive is purely information revealing and evidence gathering at this stage. But it will help inform our decisions on how we shape and target regulation after this price review. So we will keep in mind at all times that our framework is building a platform for a very very long term business.

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# Questions?



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## Slide 16

Before I hand over to Jonson to handle the questions I will quickly bring you back to the present. This is a timetable you all know well. It is simplified and shows just the key milestones. This allows for plenty of stakeholder engagement. As part of this, as we usually do, we will have further bi-laterals and smaller group discussions with you. I hope to see many of you at such meetings over the period of the consultation. We will hold another formal City briefing sometime in the summer.

So thank you for your attention and I will hand back to Jonson.

Thanks, Regina. You know the Water Services Regulation Authority has a board, and the board is very engaged with how we set the direction of change and pace of change. I am what some people seem to call a veteran, after three price reviews in this sector. This review is different. I am approaching it for the first time from this side of the table. I will just say a little bit about the spirit of what we are trying to do.

Previous price reviews have been very rules based. There have been companies at the progressive end who say “give us more choice” but I know that there are some who rather like the rules based approach. This is the spirit in which the board is approaching how we go through this consultation and how we will move to a final methodology. We believe good companies really want to own their plans. They want to reduce their dependence on the rules and they want to act in a way they would if they were in a commercial market with customers who had a choice. It is very important to us that that is straight forward. And Regina and Keith have both talked about how we are going to try and give a lighter scrutiny on plans that are well developed. Now we have to develop that approach. But the sort of things that are in the mind of our board are very good for customers.

You know the world in which customers have to operate. Incomes have ceased to go up with RPI a long time ago and we need to see that the customers get a good deal. One thing that is very much on our mind is the need to maintain the legitimacy of the sector. Huge investment has been made in this sector to make good the legacy of the past under investment and to meet challenges of the future. It is very important that prices are set in a way that maintains legitimacy for customers. We want to see sustainable progress. We want to see companies finance themselves efficiently. We all know the way that companies try to approach the cost of capital as a negotiation. And for anyone asking any questions on that, the choice is back to the company to propose a realistic approach. That will be an important outcome in our thinking as to how companies get lighter scrutiny. And of course we are very concerned to see how responsible companies want to share pain and gain of things we get wrong. All of that is in the context that the business world at the moment is absolutely brutal. There are brutal forces at work for anyone who works in the competitive business

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(and that is where I spent a large part of my life) towards innovation and towards improving the deal for customers. And I think part of our process is, with due emphasis on sustainability, that we make sure managements in companies take on those challenges.

So that is the spirit of what is going on here. And I want to emphasise something Regina said, which is we put huge emphasis in our thinking as it is emerging on the role the company board takes. Because the better the board challenges, the better the debates. We look particularly to the independent directors that are nominated to the board, but we also welcome the input made by investors and owners and others. The more the board makes those difficult trade offs and puts forward a proposition it can stand by the better that is for the company who might then get lighter or less intrusive regulation. So that is the spirit of what is going on here.

As Regina said we look forward to your comments and to working to take this forward.

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## **Ofwat City briefing – questions and answers**

**31 January 2013**

[Jonson] Happy to take questions

**Jonny Constable from Nomura. Just a couple of questions on financing. Firstly considering the financing out-performance that many of the companies have been able to lock in through the current regulatory period, can I confirm whether or not indexation on the cost of debt is off the agenda for the coming regulatory period? And secondly, can I get Ofwat's latest thinking on its attitude towards RPI indexed debt for both the coming review and beyond – is there an actual limit on how much companies should be issuing if some parts of the value chain might eventually be moved out of RPI indexed remuneration?**

Okay Jonny, thank you for those. Have we got any other questions on that subject of financing debt indexation because we might as well take them all at the same time. Yes, one over here.

**Jamie Tunnicliffe from Redburn. Just one in that area. I just wondered if you are willing to commit at this stage that the credit metric tests that are used in financeability will be consistent with the cost of debt assumption you make, because there has been recent departures there from some other regulators.**

Okay, and one more down here and then we will get some answers.

**James Brand from Deutsche Bank. There was a comment in the consultation in the financial section that where companies use innovative financial structures to deliver benefits for shareholders, that some of these benefits could be considered to be shared with customers. I was wondering if you could give more specifics on what might have been meant by that, whether that was a general comment around cheap financing being achieved by companies, or whether it was more a comment related to higher leverage financial structures?**

[Jonson] Not sure if it was designed for either of those. I would like to answer that question, but can we just take, Regina or Keith, the RPI indexation – whether we have a limit on it- and then the credit metrics. Keith, are you going to take those?

[Keith]First I will take Jonny’s questions about indexation of debt and are we going to adopt that going forward. At the moment we have no real plans to adopt that. Although we can see why perhaps Ofgem have done it. We do think it is a bit limiting in terms of the size of the water industry, whether you can get a proper index to benchmark that from. And it takes incentives away from the business. So at the moment no plans on introducing that, as set out in the methodology.

And the RPI and indexed linked debt. No, capital structures and the instruments within them are for management to decide. We have made assumptions in the past about a proportion of debt coming from index linked securities because we think that does match with the RPI controls, and we can see that going forward. But I do not think we are going to say there is going to be a particular limit. If you are thinking in terms of limits because of the split between wholesale and retail, by definition retail is asset light, so I am not quite sure why we would want to be setting limits, in terms of how much a company would want to use index linked debt.

And moving on to the credit metric tests, I may just have to pick this up with you outside the room Jamie, because I do not understand quite why we would want to set metrics that were inconsistent with debt costs, so it could be I have misunderstood the question, and so rather than labour it here I will pick it up outside, but I just can see no possible reason why we would want to have an inconsistent mix.

[Jonson] Shall I just take James’ question which was “what was the view on financial structures” as I understood it.

I think we have an issue to think about – and this is not the signal of anything other than that we are thinking about it. Is a perverse outcome of one notional cost of capital been an incentive to gear up, and what risk does that bring? Proponents of securitised structures will say those structures are as robust or better than the notionally financed ones we model, in which case clearly a corollary question is: do you need the same cost of capital then for them?

The other point you made about risk sharing is a slightly different point. The question here is where a regulator does not get it right, and statistically there must be quite a probability we do not because unexpected things happen, and when unexpected things happen that are outside the control of that company, what is the balance of where you expect the company and customers to pick up the costs? That is typically what notified items are about where customers take the risk. And conversely if you

do much better for some reason, also outside the control of management, so I am not talking about operating or capital expenditure anything, should the company give some of that back to customers? Now, we are putting those questions on the agenda. We actually think the right people to think about it are the boards of the companies. So we are not being prescriptive on it. Regina, do you want to add anything?

[Regina] I think what we are saying here, James, is that there are (and you know we have talked about this before) there are opportunities that come companies' way, there are sort of windfall opportunities, and the question is where is the split with customers and companies at that stage? And we have seen companies in the past actually return benefits to customers because they have thought that that is the right thing to do. So we saw one of them do it just before PR09 in terms of giving back some financeability money which they said they did not need. We saw Severn Trent plough some money into some assets because they felt that was a good thing to do. So we are looking at the way this is evolving and saying what does it mean? I think that is a good question to ask.

[Jonson] We can be prescriptive about that, or we can listen to companies tell us about their customer focus – in which case tell us what you think is a fair deal here. So I hope that answers it.

[Jonson] Any more questions then?

**Bobby Chada from Morgan Stanley. Just to follow up on that example, I am not sure I really follow it. Are you saying things have happened in the past that you viewed as being overly generous and because of financing opportunities? And therefore if those happened in the future it is the right question to ask whether you should share things as, if you like, the reverse of a notifiable item? So do you have specific instances in mind, or are you just flying a kite?**

[Jonson] I think we are doing more, Bobby, than flying a kite. I think it is a serious issue that I think responsible public service businesses would think about. What is the regulatory contract here? We have a very clear duty to make sure that efficient companies can finance themselves – absolutely one of our top two duties. But equally, what happens if events happen outside management control. You mentioned notified items as one protection – what happens if it happens the other way? What would be a fair way to treat customers? Do you expect all that benefit to go to shareholders? Or do you think actually there is some sharing with customers. And I think it is important we raise the issue as a regulator and we put it back with companies and owners of companies to think what they want to do about it.



[Regina] Just to build on that, I mean it is not flying a kite, it is not new. So if you just pause a minute and think about what Keith was talking about: outcome delivery incentives. Okay, so what we have said to companies is “you come to us and tell us the thing you are going to deliver” and we are asking companies then to say if they over deliver, what reward should they get? And if they under deliver, what should they give back to customers? Okay, so what would that look like? Let us take an example. Let us say we set a minimum standard for leakage, we still need a minimum standard for leakage. But a company engages with its customers and says “well actually our customers are really willing to go further and pay more and we are going to propose a better target on leakage. Customers are willing to pay for that and will be rewarded by that amount if we do that. But if we under-perform, we will give back money to customers.” So it is a similar principle, it is exactly the principle that Jonson was talking about. This is asking companies to take ownership of that balance and how it should best be managed. I gave you a couple of real examples where companies have done that. They have actually asked themselves that question. And we are asking companies for their views on this as an issue, that is all it is.

[Jonson] Bobby, you have been around this a long time, you know the old way this would work. The companies would come together through Water UK, and Water UK would tell us we need a set of rules for this. We actually do not think that is the modern world. And we think the way to do this (and this reflects what some companies have said to us) is to say to the company, “come on then, let us have some ideas come forward of how to do it” because all of us are absolutely determined to get the best, sustainable, most efficient industry here. That is why whether you sit in a regulatory office or whether you sit in a company, that is what you are about. And we want to have that debate with the companies.

**[Bobby] So you will ask them what is an acceptable level of debt outperformance?**

[Jonson] You could put it like that. I am going to cut you off there, and I will come to you in a minute, Lakis. There was someone over here before.

**Thanks, Iain Turner from BNP Paribas. Can I just ask, and make sure I have got this clear in my mind. Effectively when the companies produce their business plans, they will come up with their own cost of capital and their own fast money / slow money split. Is that not just a recipe for confusion? And companies that might be very similarly situated delivering very different outcomes for their customers.**

[Jonson] Okay, let us just see if there are any more questions on that theme which I would characterise as uncertainty deriving from giving companies more choice.

**Harry Wyburd from Barclays. Just on the total expenditure capitalisation rates, how do you judge whether a total expenditure capitalisation rate is fair?**

[Jonson] Okay, Regina is noting that one.

**[Harry] And how do you avoid a situation where you set a total expenditure capitalisation rate based on the amount of revenue you get up front or pay as you go money in your slides. How do you set that to be fair and avoid it just being credit metric goalseek?**

[Jonson] Okay, Lakis?

**Lakis Athanasiou, independent analyst. Just two things, one specific and one general. I would really like to nail down this point on debt. Are you now putting on the table as an issue to discuss companies whose existing debt has been, say, lower than your assumptions, you will make company specific adjustments to get back some of that benefit? I mean that is very clear for the listed companies - two of them have got good levels of debt. Are you now suggesting putting on the table this debate that you would claw back some of that benefit on existing debt of low interest rates, something you have never done before and have always said you would never do.**

**And, secondly, just going on this theme of company specific proposals coming through, and this is the theme that I think has cropped up in some of the questions. I mean you talk about that being about business ownership... but does it not really, when you come head to head with them, then allow you to make company specific adjustments opening up the issue of higher regulatory risk increasing the cost of capital, increasing risk in general?**

[Jonson] Now let us take those points, and I am going to turn to Regina after I have just said one thing. What we have put in the discussion, we have injected this “give the companies more opportunity to distinguish their plans and come up with their own proposals”. And as I have been around and talked to companies and boards, I have heard, and of course I recall having done this in my own past as a chief executive, companies saying that is exactly what we want. Companies want to give us proposals as to how they should finance, how they should share pain and gain etc. Now, the difficulty of this, because it all sounds great in principle does it not, is the moment we say okay, we are open to that, that is progressive, evolutionary regulation all within those statutory duties we have. The moment we put that forward, then look at the number of questions coming right at us such as “how are you going to adjust this, how are you going to adjust that one, could it create more uncertainty, could it create more regulatory risk?”. Yes, for companies who do not step up to the

mark it will. For companies who do step up to the mark it might reduce their regulatory risk. So I think, the reason why this is so important after what we have been through in the last few months since I joined this organisation, is we need to have that debate in a fairly mature fashion. One which recognises the regulator is both trying to set a lead in this, but also to work with the industry to find these solutions, and they are going to bring some uncertainties as we go through it.

Regina...

[Regina] Yes, so there is a collection of issues. I will ask Keith to support me on this to bottom anything out. So what I am hearing is, “won’t letting the companies decide their split of fast and slow money be a recipe for disaster? Who is going to decide what is fair when they choose what their fast and slow money is? And if it is just a way of getting loads of cash on the table, what are you going to do about it?” So, I mean it is a fair set of questions, and I need to take them together because it is building on what Jonson says.

What we are saying to companies is yes, we have gotten very rule based. Yes you had no discretion in the past, what went onto the Regulatory Capital Value and what went into operating expenditure was decided by whether it looked like an asset and did it walk like an asset? You know, then it was an asset. Now we are saying we want companies to take ownership, company boards to take ownership of thinking strategically about the balance between their financeability, which can be managed by deciding what you put in fast money and what you put in slow money and its impact on their customers’ bills. And that is all driven by your revenue and your cash flow, so you can make choices around that.

We are giving some space to companies to make that choice. And what we are saying very clearly is that companies now have to think about the balancing act that we have been thinking about for a long time. Now, we are not saying then that is a free for all and every company gets what they want. What we are saying is we want proposals within a banded kind of set of freedoms. So let me be really honest, any company comes to me and says “oh great actually I want to put 100% onto the RCV and get a return on it” I will say “no, that is not an appropriate balance.” Okay, so let us just be clear about that.

So what we want is companies to come up with a clear strategy that balances their financing and their customers, the impact on the customers and their bills and their cash flows, and we are giving them some space to do that.

At the same time, and Jonson said this very clearly, we have primary duties to enable efficient companies to be financeable and their customers are protected. So at the end of the day we will examine those proposals against the criteria, that is

what we will be looking at. But it is true – we are asking companies to take ownership on these decisions in the first instance with the sensible protection of the regulatory regime against those primary duties.

Keith, do you want to build on that?

[Keith] Yes, I have got two points to add to that. Firstly yes, it is going to be for companies to choose, but also they have got to look in terms of what is their overall investment programme? And what am I looking to do in a total expenditure world. What solutions am I looking to achieve over the period of five plus years? And then make that decision. So, as Regina said, the company at the moment is spending – I am going to pick a number in the air – you know, 40% is operating expenditure and 60% is capital expenditure of their total expenditure. If they suddenly turn around and say “that is now 100% on the Regulatory Capital Value” that is just not going to work. But it is going to be for companies to be able to decide exactly, given their future programme and what they have got to do, what that particular choice is.

And then my second point is partly relating to what Jonson said. There was a report very recently, that KPMG did, sponsored by Severn Trent, I think it was probably issued in the early part of this month that talked exactly about this. It suggested that the financing part of the business plan is just as important as the investment programme part, and companies have got to discuss both parts with customers. They asked whether Ofwat would recognise that those two things are linked and take a sensible look at it because they want to put together a plan that all hangs together, including the financing part of it, which may not necessarily fit with an imposed regulatory world? They asked whether we would look at that because that is a grown up way of doing business planning going forward? It was an interesting report. I recommend you have a look through it. It is part of those ideas I think Jonson is alluding to. We need to recognise that things are changing and we want to help companies do that.

[Jonson] So this is opening up, but it is not a free for all, not every company is going to be treated like that. What we are signalling is a willingness to put more back to the companies to propose, but because we want to evolve cautiously and prudently, there will be a high hurdle for companies that wish to get that lighter touch.

[Regina] Jonson, I just realised I did not answer one part of Lakis’ point. Are we suddenly going to tear up the past and claw it back? No, that is not what we are saying. We are talking about the future and how this regime evolves in the best interest of all the parties - so just to be clear about that.

**Edmund Reid from JP Morgan. On the retail side, the slide that you showed, and I understand that it is indicative but there was quite a wide range in terms**

of cost to serve across the companies. You are going down this average cost to serve route. If, for instance, one of the companies is not able to reduce its cost to serve by as much as you think it might do, how would you look at that with regard to financeability? It seems like certain companies could lose a lot of money in retail. And I guess associated with that -what do you think the government's thinking is at the moment on the ability for the companies to legally split the licence between retail and wholesale, which I guess would get rid of that risk?

[Jonson] Thanks for that, I would like to pick up part of that, and Regina will, but shall we just hold that and get the other questions on the table.

Jamie Tunnicliffe from Redburn. The total expenditure incentive rate... will Ofwat set that? I just want to be clear that that is something you set in terms of this great world of giving everything to the companies to suggest. And can you give some order of magnitude, whether you think it will go up against, say, the historic rate we have seen in the RIIO proposals, it was sort of double from what it used to be in previous controls. I am interested to hear about that.

[Jonson] Okay, thanks.

Nigel Hawkins from Libertas Capital. Two questions; one specific, one general. Could you explain how the additional private sewer operating costs and capital costs as noted recently by South West Water and North West Water will be treated by Ofwat? Do you expect any IDOKs for private sewers costs to impact before April 2015? And a general one Jonson, following Iain Turner's comments. I have to say, to me, this new regime's complexity has a whiff of a Department for Transport shambles over railways franchises and varying revenue growth assumptions. Recalling how a very simple RPI-X approach was introduced for political reasons in the lead up to BT's privatisation in 1984, how concerned are you that Ofwat is seriously over egging the regulatory pudding. And I have to say, given your own experience, it makes UK Coal's recent restructuring very straightforward.

[Jonson] And the last one over here and then we will take a break and see if we have got time for any more.

Michael Ridley from Mizuho. My question is that by moving from a rules-based approach, to an outcomes based approach and giving the companies more freedom, are you not raising business risk in the sector? And if you are doing that, would you not think it is appropriate to lower the appropriate

**gearing level for the sector so you can introduce business risk but take away financial risk?**

[Jonson] Right, we have got some interesting questions there. Can we just deal with total expenditure incentive rates, Keith? Or Regina?

[Regina] First thing is will we set the incentive rate, will we set the efficiency challenge? Yes we will. Will it be double? Well we do not know yet, that is obviously part of the core methodology and part of the core business plan analysis and the data analysis. That is quite a simple answer.

[Keith] Yes we will be setting it. It will not be set by the company. But with normal menus what we have tried to do is establish a base line as independently as we can, and then companies will choose, given our established menu glide path of incentives, where they want to be on that particular menu. But it will be us that sets the incentive rates.

[Jonson] I am going to turn next to Edmund Reid's question about cost to serve and companies who might have a higher cost to serve. We will of course listen to reasons for that. But we would expect to see anyone who had a claim that they were higher to have a very considerable burden of proof as to why that was the case. This could include considering why someone else couldn't do it. I am going to give this to Regina and I will come back on a legal split in a moment.

[Regina] The first thing is that you asked how we would look at financeability. Well remember that we always look at financeability and always have looked at it so that efficient companies can finance their functions. So if a company is very inefficient, the company had better get efficient. Having said that, we do recognise that the data (although it is indicative) are showing quite a wide range. So we have proposed a glide path to the average cost. So there is a mitigant there to make sure the companies can do it. Now, with the glide path and with the fact that it is an efficiency challenge, I'd be incredibly disappointed if a company could not achieve that.

I think the second part of your question is would this risk be mitigated away if the company could essentially sell an under-performing retail business to a better performing company? It would but at the moment the government proposals are to require the companies to have a vertically integrated licence, which means the company can never divest itself of those retail obligations; we recognise that is less than optimal. We'd prefer to see that freedom. However, we will work within the framework that government sets, and that's one of the reasons why we introduced the glide path approach. It's complementary to the government's policy. So we think it definitely hangs together, but there's something there that's just not in our gift, it's a matter of government policy.

[Jonson] Ed, just to build on that. It's been interesting in the short period I've been here and catching up on the industry, to discover first of all the very extensive lobbying that went on to prevent there being a split of retail and wholesale. And then I was very struck at a meeting with debt investors where we had the sort of questions that you raise. They said, if you treat a retail business more like a retail business, you're increasing risk. Yes, absolutely, because retail businesses have lower assets and might be exposed to risk. So why could you not separate them and why could a company that couldn't do its retail very well, or chose not to, separate it? Answer: because the sector for the large part – for a very long period – have been saying “don't give us legal separation”. So there are two sides to this which need a bit more debate possibly, because I can logically see why a company might want to separate its retail operations for the reasons you articulate. But the industry collectively has closed that down by asking not to have the legal separation. So beware what you wish for, I think.

Let me go to Nigel and private sewers. What do we want to say about private sewers, Keith?

[Keith] We said private sewers qualified as an RCC1 and so you could have it as a part of an IDOK, but subject to the normal rules of materiality and triviality in an IDOK. So yes, companies can come in as part of an IDOK for that. They do now have one last opportunity to do it, and only one. So they would have to come to us by the middle of September this year if they wanted to do it, and price changes would be effective from the following year. So, yes there is that possibility. I'm not going to say whether companies will or won't, because I really don't know. It's up to companies to make that decision, but they have a few months to do that.

[Jonson] Okay, and the last bit I haven't answered was the question Michael addressed to me about increasing risk in the sector supported by the business risk argument “what does it mean for gearing?” And I think the answer to that is we are kind of damned if we do and damned if we don't. From my position, coming newly into this and not with the expertise that Regina and Keith have, it will be wonderfully simple, wouldn't it, to go back to the old world of how we did regulation, the price review, five or ten years ago. And there might be some who would love just the straightforward rules that were set then. And it might be much simpler, and you refer to risks of things like that happening in other sectors, and we might avoid all of that.

And of course there is significant danger in evolution and change to the sector that we do get something wrong. But let's go back to two things... One is: what's, as I understand it, good regulatory practice? And that's to try and make things simpler and trying to step back from being so intrusive and be able to set things at a higher level, and to put risks with those who can manage them (which in many cases is the companies), and let us look at what the companies have said through a series of

reviews to Ofwat, which is “less intrusive regulation, more risks with the companies.” Well if you want to manage those risks and you want to take them on, absolutely fine. But don’t come and then make a complaint that actually the system has more risk, because it’s what you’ve been asking for for some years, and what the regulator (and I think Regina’s been working on this for about three years) has been trying to do with the sector – to try to find a way of moving it forward and be less intrusive. More opportunities for companies to make decisions. But yes, there is more risk in that and there is more variability. And that’s one of the reasons why we are also putting on the table “how do companies propose to deal with unintended consequences, either those that work against them or those that work for them?” And I think that’s one of the sort of mitigants of the risk that goes with this.

Now, on the gearing structure, I think we have to very firmly put that back with companies. We will come to a view on that, but we have to say to companies “it’s your job to devise a structure.” I think there were very simple and straightforward reasons why early in the days of regulation Sir Ian Byatt set out a standard notional cost of capital and it worked very simply and very straightforwardly. But it has created some very perverse outcomes. It has created a very strong incentive to gear up. And that clearly is coming under question for a host of different reasons. For example, equity is now 30% of the sector, it was 42.5% six years go. That is raising questions Ofwat’s got to think about, about sustainability of the sector, keeping open a number of sources of capital. So it’s right and proper we discuss those. But I’m not sure the answer is for Ofwat to say “this is what it needs to be.”

[Regina] I think that’s right, Jonson, I think it’s a particularly intelligent question, so I just want to thank you for it because it doesn’t say “by giving the companies ownership are you just increasing risk?” because you’re not; what you’re doing is you are putting the business risk with the business people who are skilled and now empowered to manage it, so that’s what you’re doing. But remember it’s a total package and those companies also have the ownership of their financing risks. So companies can decide exactly what that balance is. That’s exactly the point, and we are asking them to take more strategic ownership of managing that balance of risk in their business. And that’s why they have, in the first instance, the ability to propose their split, the ability to propose their outcomes, the ability to propose - as Jonson said- the upside and downside for themselves.

And the thing about it is you’ve got to remember that this is happening in a very controlled way, in that we’re giving them this ability with the clear signal that companies who grasp this nettle and do it well, boards who engage and redistribute that risk within their business in the best way that they can manage it, will be rewarded by having greater opportunity to outperform. They will have a lighter scrutiny of their plan, and they will be able to make those choices. It is clear this is a journey. Every company is probably not going to get there on the first round. This is



something that is going to have to develop over time, but it is putting the ownership with those who are best placed to decide the balance of those risks. Within the overall, and I come back to it again, within the overall assurance that Ofwat has a duty to enable efficient companies to finance their functions and their customers are protected. We always come back to that in the decisions that we make.

[Jonson] It's quite interesting, in my period of informal discussions with a whole range of stakeholders over the last few months, this issue has been put on the table in several different ways. And it's come both from well informed consumer advocates, but it also came from debt investors – that sounds like an unusual combination. And the question was: "Look, we've gone from very straightforward financial structures that applied to the majority of companies in 2006, to really quite complex structures that we don't understand" people were saying to us. And I was reminded by a very articulate group of customers how important legitimacy of structure, legitimacy of trust in how that works and the need for financial certainty are to customer confidence. And that's why at the very least I think we need to have a discussion about structures, and we need to have clarity of what risks go with those structures and what benefits and risks go with them. But again I think it's appropriate that Ofwat's role is to look at that, but it's not to dictate.

[Keith] Can I just go back on the point Nigel raised about complexity. What I want to say is that one of the themes of the way we're taking forward the price review is about targeted incentives, and if you're having targeted incentives, they clearly need to have a target. That's why you split things up and you have more price controls than you might have otherwise. Because if you don't do that then, you know, the incentives can get muddied, and there was a reasonable amount of criticism of the fact that, particularly at board level, they couldn't see the incentives at the 2009 price review, so they couldn't see what was in it for them or what risks they were taking. So it may be that on the surface it seems a little bit more complicated, but I think that's because we want to be more transparent about how the incentives operate, and what are the ups and downs and what are the risks. So, you do trade that off a little bit. But it is in answer to previous criticism that the incentives were very muddy and they didn't understand them at board level. So we have tried to address that in the price controls.

[Jonson] It's just coming up to 12, and I said we'd break for informal discussion. Are there two last questions from people who haven't asked a question who'd like to.

**Hugo Rogers, Thames River Capital . I wanted to know about the licence modifications. Obviously there was a sort of almost unanimous rejection of the initial licence modification proposals, and I wanted to understand whether you think that you still have enough flexibility to achieve your long**

**term goals, given the fact that the licence modifications haven't gone through as you initially planned?**

**Pinaki Das from Bank of America Merrill Lynch. This was mainly on the indexing of the debt cost. So what's your thought on that right now? And also on totex, it's probably for Keith, whether you've done some back testing over the last period 2010-2015 where you could get some sort of range.**

[Jonson] You may need to pick that up with Keith later, but it's a quick answer on that.

[Regina] Yes, can I answer on the flexibility point?

[Jonson] Oh no, sorry, I'm coming back to that – that was more of a conceptual level and I want to come back to that last.

[Keith] On the indexation of debt, as I said, we're not going to use it, or have no plans to. So it would need to have someone coming in saying "you really really should do this because of X". We have no plans at the moment to index debt so I hope that's reasonably clear. And I'll pick up the total expenditure stuff outside, if you don't mind.

[Jonson] Now, licence modifications. We have settled an issue with something that at least moves us forward a bit. Regina, do you want to answer the question?

[Regina] The answer is we have sufficient flexibility to do everything that's proposed in the methodology that you see. What is going to be necessary though (and this is unfortunate) is we will have to start a process to build in the new flexibility that we need to deliver further evolutionary changes, and we're going to have to do that reasonably soon. So we thought to do this in a way that gave a platform for the industry and the regulator to work together without constant recourse to licence modifications. Now, the preference for the industry is to have constant recourse to licence modifications – that process is not the best one in the world. So to give you an example why it's not the best one in the world: if you look at the energy sector, there is a collective licence modification process, whereas in the water sector every single individual company has to agree to every single individual licence change. So we'll be working with government to see if there's a way of improving the process so that it's not as onerous in future. So the short answer is yes, we do have the flexibility to do everything we need to do in the price control. But, you know, at the end I talked to you about building for the long term future; we will need to continually revisit this to make sure that we have the right regulation for the sector in the long term.

[Jonson] I think we brought a pragmatic close to a discussion that does need to carry on, but in a different manner. It was important to bring the lessons for everybody in the licence modification discussion. And it was important to bring a close to it so we can all move forward to exactly what we're discussing today. And I'd just highlight for you: firstly, it's brought that closure to it, and secondly the process by which we did that, which was carefully managed with us and a few companies involved, finding a way of doing it without going straight to the lowest common denominator of change – that is never going to be a model that worked, and you will have seen the government indicated to us it was minded to review this process. So that's good, the government made that indication, companies have accepted in their licence a reasonable endeavours clause to work on change. I think there's been lessons for all of us out of it. And we'll no doubt take the next raft of whatever is needed as it arrives in a more stepwise fashion.

I think on that we draw a close today. The team will remain around for a short while if anyone's got other questions, but thank you all very much for being here today.