



Investor Meetings

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29 January 2014

Where we are now

Price review final methodology – July 2013

Approach to assessing business plan quality, criteria used to assess plans and incentives for high quality plans (**risk-based review**)

Deadline for pre-qualified company to accept is 17 March

December announcement – 19 December 2013

Introduced pre-qualification stage to risk-based review. Excluded risk and reward criteria from risk-based review

Risk and reward guidance – 27 January 2014

Further guidance on the risk and reward package

Pre-qualification announcement – 10 March 2014

Use subset of original tests to assess business plans:

- Companies assessed as 'enhanced' **'pre-qualify'**
- Pre-qualifying companies decide whether to accept 27 January risk and reward guidance
- Companies **not pre-qualifying** categorised as standard or resubmission in April

Enhanced company draft determinations – 29 April

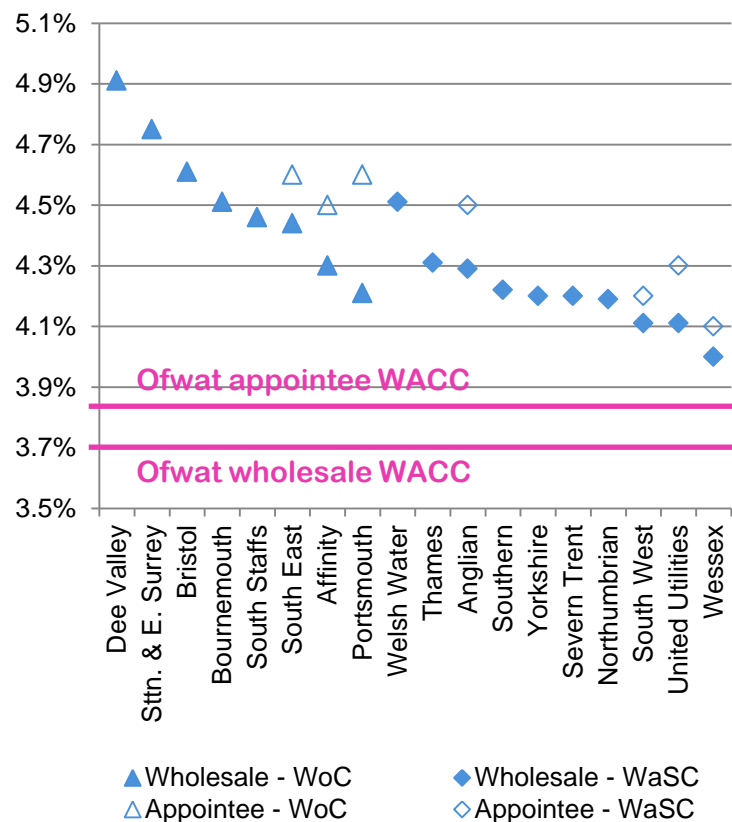
Standard and resubmission companies draft determination – 29 August

Risk-based review decision – April 2014

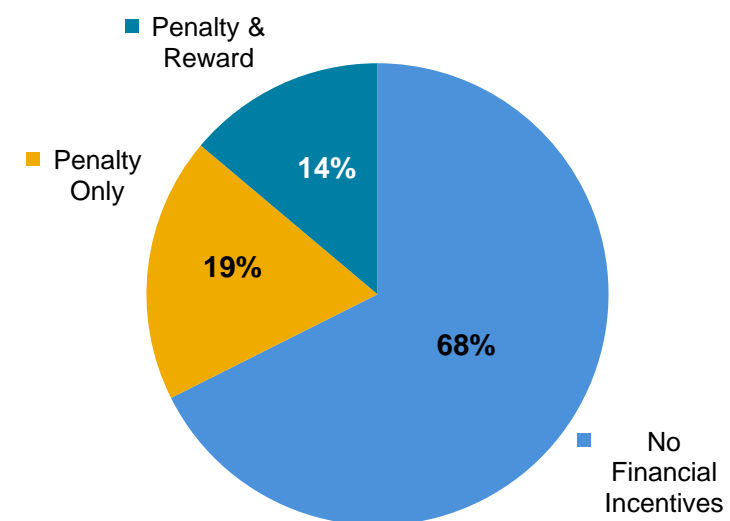
- **Enhanced** – pre-qualified companies adopting risk and reward package
- **Standard** – Includes pre-qualified not accepting risk and reward package
- **Resubmission**

Risk and reward in company business plans

Proposed Cost of Capital



Proposed Outcomes



Source: Company business plans and Ofwat guidance.

Source: Company business plans.

Our risk and reward guidance

Issue	Company proposals	Ofwat guidance
Appointee WACC	Exceed market evidence	3.85%
Retail margins: household/ non-household	Wide variation	Retail household margin – 1% Retail non-household margin (England) – 2.5%, including 1.5% premium
Wholesale WACC	Exceed market evidence	3.7% (appointee return less retail margins)
Outperformance	Level and balance of cost performance and outcome delivery incentives (ODIs) vary Upside lower than expected ODIs mostly reputational or penalty-only	Overall return on regulatory equity (RoRE) range of +/- 3.5% to 4.5% Resubmit ODIs with meaningful rewards and penalties as part of package
Uncertainty mechanisms	Wide variation in approach to uncertainty mechanisms Inconsistent with a single notional industry return	Notified items only appropriate where probability of event or its impact cannot be influenced by company Greater transparency on pain/gain, sharing between customers and other stakeholders

Composition of appointee WACC

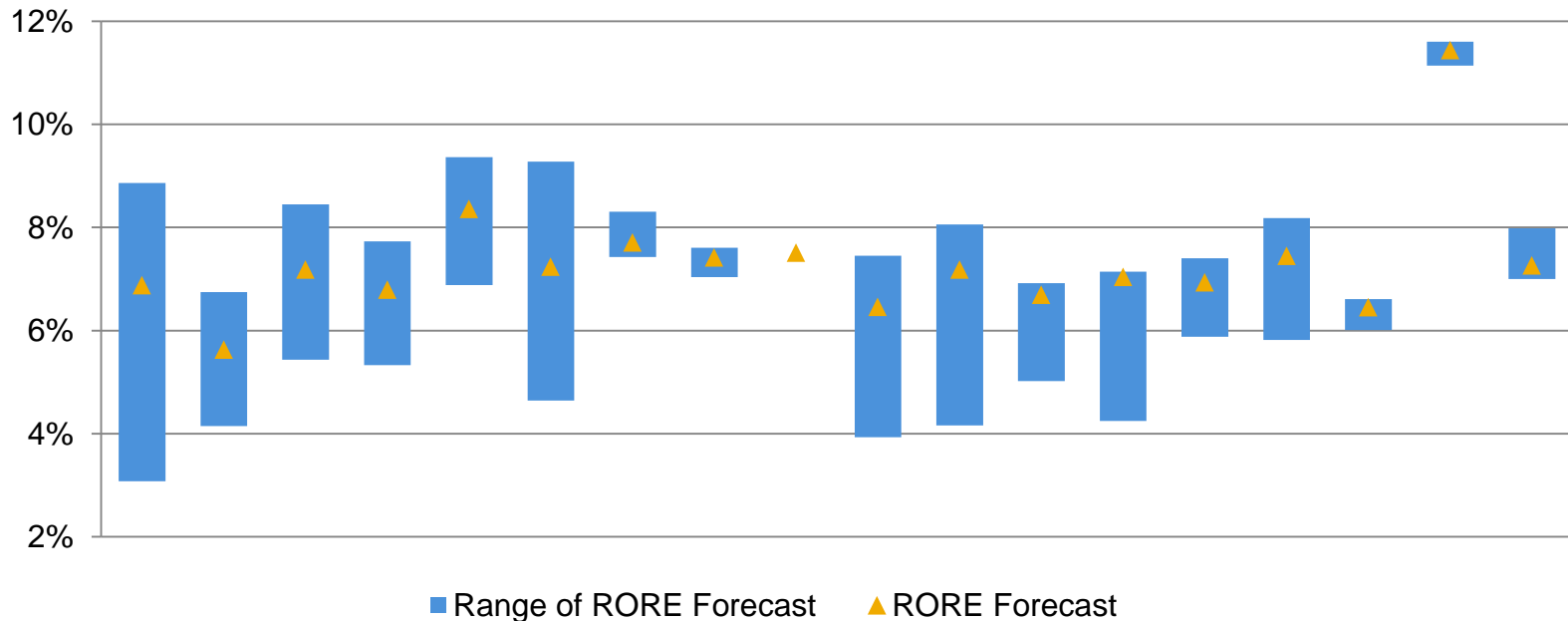
WACC inputs	Ofwat (point)	Ofwat range	Industry range
Total equity market return	6.75%	6.25% to 6.75%	6.50% to 7.25%
Real risk-free rate	1.25%	0.75% to 1.25%	1.25% to 2.1%
Equity market risk premium	5.5%	5.5%	5.0% to 5.75%
Gearing (Net Debt:RCV)	62.5%	60% to 62.5%	57% to 70%
Asset beta	0.3	0.3	0.33 to 0.40
Equity beta	0.8	0.75 to 0.80	0.84 to 1.07
Cost of equity (post-tax)	5.7%	4.9% to 5.7%	6.0% to 7.9%
Ratio of embedded to new debt	75%:25%	75%:25%	60%:40% to 94%:6%
Cost of new debt	2.65%	2.6% to 2.8%	0.6% to 3.5%
Cost of embedded debt	2.65%	2.6% to 2.8%	1.8% to 3.8%
Allowance for debt fees	0.1%	0.1%	n/a
Overall cost of debt	2.75%	2.7% to 2.9%	2.3% to 3.6%
Appointee (vanilla) WACC	3.85%	3.6% to 3.9%	4.1% to 4.9%

The importance of outperformance

The Gray review noted in regard to PR09,

“...there is also some evidence that the system of incentives applied by Ofwat may be too focussed on penalties and compliance as opposed to positive incentives for desired changes of behaviour.”

Business Plan Proposed RoRE Ranges



Note: Range represents 80% confidence interval
Source: Company business plans

Opportunities for outperformance

Driver	Examples	RoRE guidance
Costs	Where companies find new or more cost-efficient ways of delivering services to customers they will be allowed to share this outperformance with their customers	+/- 2.0%
Performance commitments and ODI targets	Where companies deliver an outcome, supported by customer engagement, to a higher level of satisfaction for customers it should be possible for them to earn additional returns	+/- 1.0% to 2.0%
Service Incentive Mechanism	A relative measure of performance to assign rankings and rewards	-0.5% to +0.25%
Financing	Outperformance or underperformance against the allowed cost of capital	+/- 0.1% to 0.5%
Total		+/- 3.5% to 4.5%

Categorisation of business plans

The risk-based review is continuing to test

- Costs
- Outcomes
- Affordability
- Board assurance

On 10 March, any companies that pre-qualify will be invited to adopt the risk and reward guidance.

Alternatively, they may choose to rework their business plans more significantly and follow the 'standard' price review process.

Companies classed as 'standard' or 'resubmission' will also need to modify their plans in line with this guidance.

Benefits of enhancement include

- Acceptance of the business plan with **few adjustments**
- A **four-month head start**, with Draft Determinations in April instead of August 2014
- **Explicit financial incentives**
- **Reputational benefits**

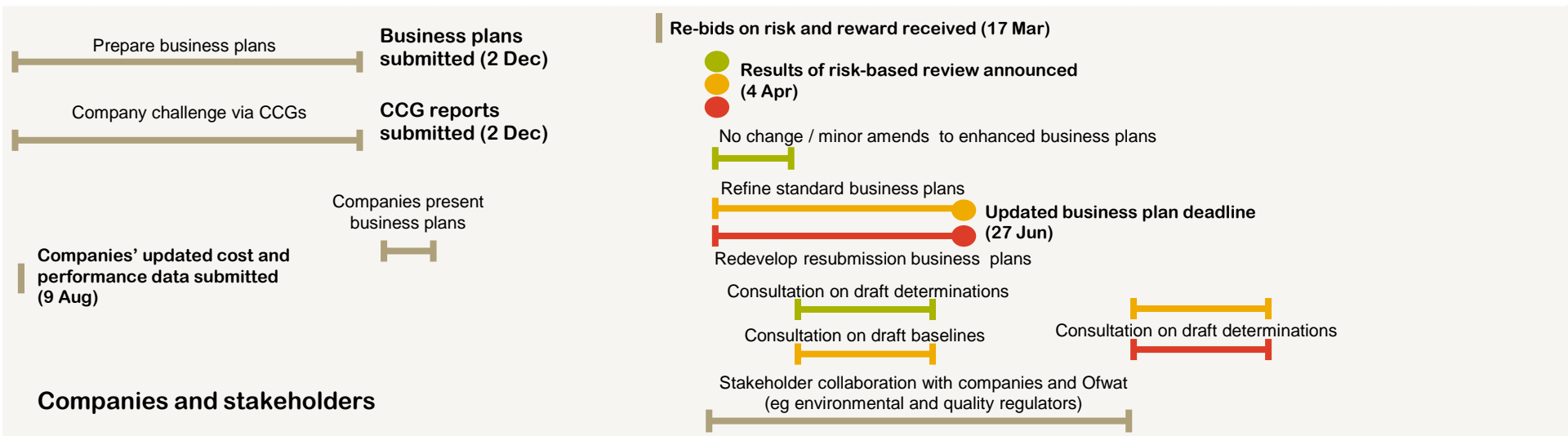
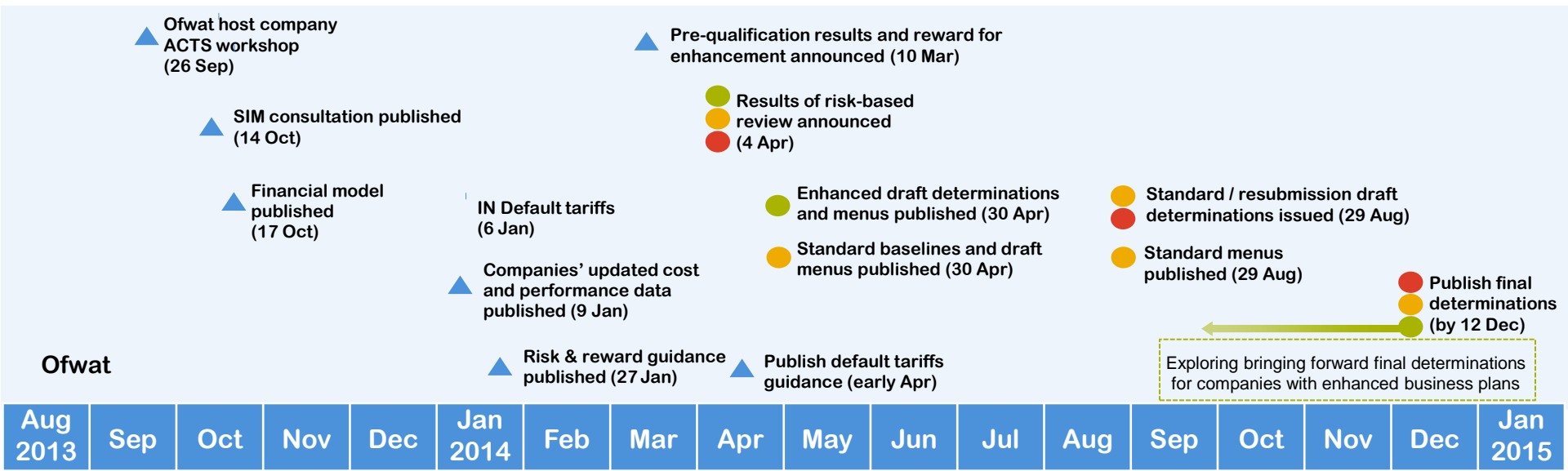
Company categorisation

Enhanced

Standard

Resubmission

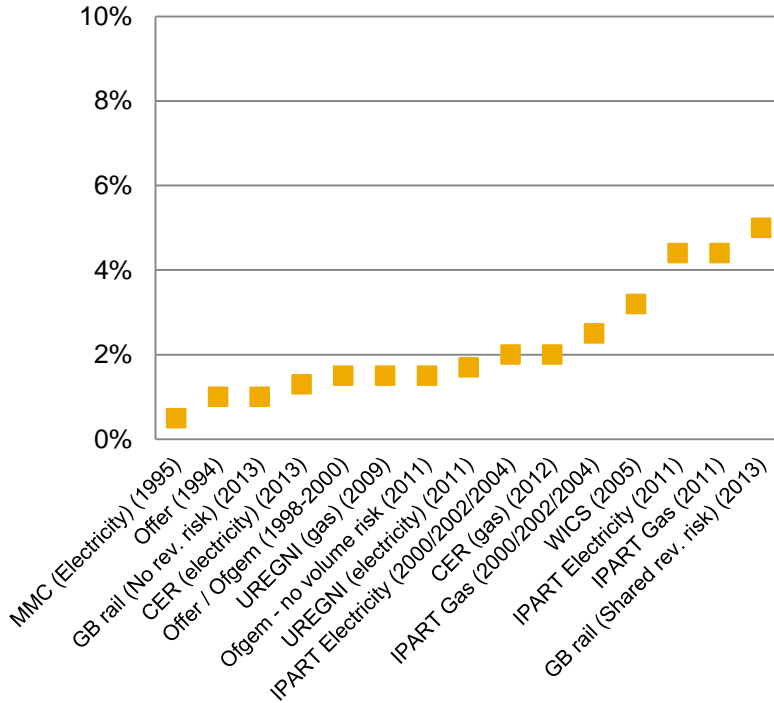
Appendix: PR14 Plan v2.3



Key: ● Enhanced business plans ● Standard business plans ● Resubmission business plans ▲ Guidance publication Plan elements are subject to change

Appendix: retail margins

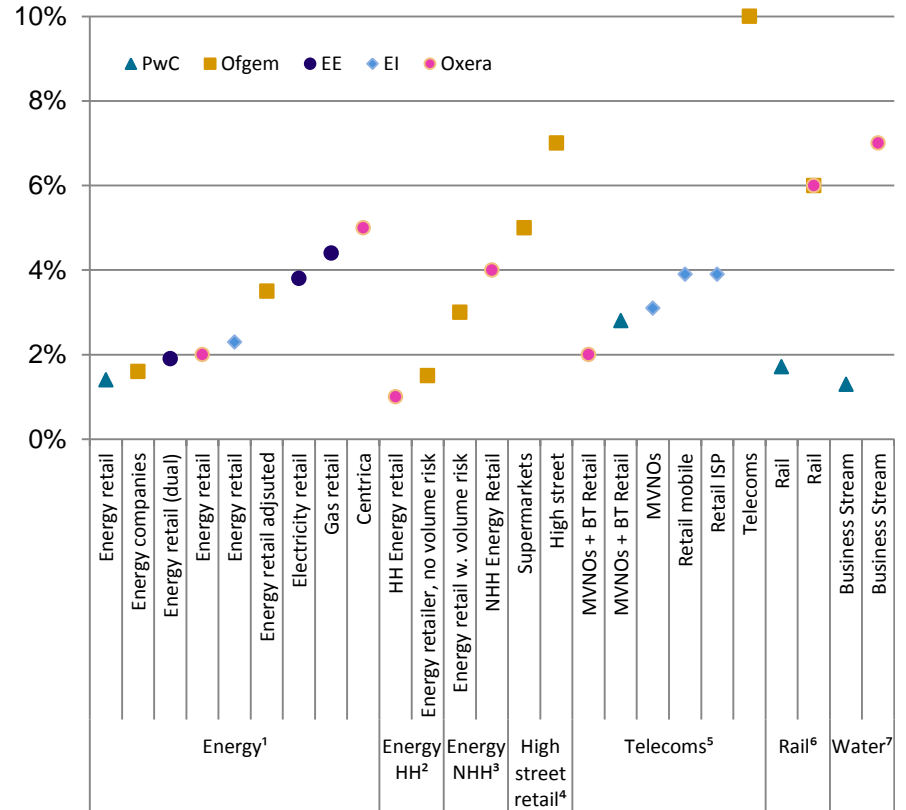
Household



Return on Capital Cross-Check: 0.5-0.9%

Ofwat guidance: 1.0%

Non-Household



Return on Capital Cross-Check: 0.6-1.1%

Ofwat guidance: 2.5%

Appendix: wholesale WACC

Component		Point Estimate
Total allowed return	A	3.85%
Retail net margin	B	1.00%
Revenue requirement (2015-20 year average)	C	£11,194 m
RCV (2015-20 year average)	D	£64,912 m
Retail return on RCV	$E = B * C / D$	0.17%
Adjustment from appointee to wholesale WACC ⁽¹⁾	F	0.15%
Wholesale WACC	$G = A - F$	3.70%

Source: Ofwat calculations and industry totals

(1) We do not deduct the full retail return on the RCV as the legacy retail assets in the wholesale WACC will depreciate away over the AMP.