



City Briefing

29 August 2014

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## **Q&A**

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## **Cathryn Ross**

Welcome to the Ofwat's latest City briefing. An important one for us – and I think for many of you – because it takes place on the day of publication of our draft determinations on PR14. As you can see we have got a pretty packed agenda for you. I am going to kick off with some introductions.

# Introductions and welcome



Image © Lisa Tancsics

**Water today, water tomorrow**

You can see we have got our chairman Jonson Cox with us today. He is going to start us off by offering some reflections on where Ofwat and the sector have come over the past two years and where things may go in future.

After the Jonson's session I will talk a little bit about our emerging strategy and how we are going to translate that into things which you will be able to see in reality, going forward.

At that point I'm going to pause for some questions from the floor.

After then I am going to hand over to Sonia Brown, who most of you I think will know, our Chief Regulation Officer. Sonia is going to talk you through some of the highlights of draft determinations published this morning.

And then after Sonia's session we got an opportunity for questions from the floor with the whole panel which of course includes, Keith Mason, our Senior Director of Finance and Networks.

So, without further ado I will now hand over to our chairman, Jonson Cox.

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Reflections on the sector

Jonson Cox, Chairman

## **Jonson Cox**

Thank you Cathryn, thanks again. My welcome, too, to everybody and thank you all for coming. It is good to see you here today and to brief you on what is really a very important milestone, not only in PR14 but also for Ofwat. Announcements today reflect a long, hard working summer for the team at Ofwat.

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# Reflections on the sector



Image © Mick Knapton

**Water today, water tomorrow**



There are two things today on the agenda on which we wish to update you. First, we think it's important to note that there is more to Ofwat than the five-year price review cycle, although I realise it is top of mind today.

At the beginning of June we held a successful event which commenced a discussion between companies, investors, customers and environmental groups. I know some of the people in the audience here today were with us. We set out at that meeting to open the discussion on our strategy for the water sector, looking forward for the next five years. Something we had promised to do more promptly this time and get underway in good time and I think we delivered on that. Our new vision centres on trust and confidence in this essential public service. Trust and confidence as in outcomes for customers and in the relationships with those we regulate. Our strategy will be the blueprint that guides the industry and also guides Ofwat to PR19 and beyond. In a moment Cathryn will update you more on those developments.

The second item for discussion today is of course PR14. This morning we published our draft determinations for the remaining fourteen companies. I know it was a long and at times bumpy road to get to this moment. You will recall that in summer 2013, just over a year ago, when we asked Sonia to take on running the review, companies gave us near-universal support to run this review differently from previous ones. Over the last eight to nine months Sonia and her team have worked solidly to assess company plans and to present proposals to our Board for decision. She will shortly be leading you through the key points to have come out from the determinations.

When I took on the role of Ofwat Chairman, which will be two years ago in November, my priorities included getting customers' interests back to the top of the agenda, maintaining trust and confidence in the sector in the eyes of our customers and stakeholders, the sharing of pain and gain more equitably between customers and investors, and reforming board leadership and governance. Over the past year and a half, Ofwat has delivered a real step change on all four of the above. Before we get into more detail I would like to say three things just about the PR14 process.

The first is that PR14 has delivered great success with regard to outcomes for customers. Determinations show that allowed revenues on the basis of these draft determinations would fall by 5% in real terms by 2020, and that's without any compromise on levels of investment and improvements in service.

The second thing I would like to highlight is that PR14 has given water companies the opportunity to own their own business plans through meaningful engagement with customers in a way that has not been done before. Many companies have taken this opportunity, and their plans demonstrate that they have listened to our calls to put customers at the centre of their business. Those companies with the best plans

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(that was South West Water and Affinity) were awarded with enhanced status when we published the first draft determinations in April.

The third point I want to make is that Ofwat has brought back companies' focus on to operational and service outperformance. We've set penalties and stretched targets to really push companies to reach the upper quartile standard of performance. The rewards that we offer for reaching upper quartile performance align the interests of investors and customers. That, of course, is our role: to set that. It's now over to the owners of companies to ensure that management teams deliver upper quartile performance in operating and service performance across all their services.

All of this and the review of the last 15 months has placed a reliance on strong performance by the boards of water companies. I don't need to remind you that public and customer trust in our utility sector remains vital, particularly with the level of expenditure and investment to correct failings of the past, provide today's service and to build resilience for the future. We were also concerned about risks to customer confidence due to the complex structures that emerged in the sector for some companies. Among the boulders that I threw into the pond in 2013 to start a debate, was working to shape a sector-specific set of principles for the board leadership of regulated companies. A number of investors in this room worked with us also in relation to holding companies. By the end of March 2014, all companies had agreed to meet our key principles and virtually all had confirmed to us their commitment to implement those key principles in their own specific governance code by the 1st April 2015. We have just one company yet to confirm shareholder approval. We are considering the regulatory action that we will take where a company does not voluntarily meet the 1st April 2015 timetable. I am pleased to say that we have seen from business plan submissions this year that there is a much greater Board assurance and that companies' Boards now have a much greater knowledge and ownership of their plans compared to the plans first submitted to us in December last year.

As Cathryn will explain in a moment, trust and confidence in the sector are the two characteristics which are driving our emerging strategy for the next five years and beyond. PR14 is an important part of this and we want a successful outcome to the price review which is good for customers, fair for investors and which simultaneously continues that feeling of legitimacy in the sector from all parties. At this stage in the PR14 process we feel like that goal is very much in sight. This price review has seen unprecedented level of engagement between Ofwat and companies and investors and indeed an unprecedented level of early warning signals from us, to help guide the process. We can see that you that have welcomed this. Our engagement in the City has been very different. In contrast to earlier reviews, our engagement with analysts and investors has continued throughout. I add up at least 350 meetings with investors and analysts, and at least 150 formal meetings with companies to date.

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So that's where we stand today and as I have said we are going to first talk about the strategy, how we move Ofwat forward and then turn to price review.

I'm now going to hand over to Cathryn to take us through the strategy. What I want to emphasize is that all the matters we talk about today are in our mind part of a coherent strategy. It is designed to make sure this sector maintains its legitimacy, delivers on the promises of privatization, appropriately rewards investors, requires outstanding performance from management and gives customers a good deal.

There will be plenty of time for questions, later. Thanks.

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Strategy into reality

Cathryn Ross, Chief Executive

## Cathryn Ross

Thanks Jonson. When I was here in April, at the City briefing we gave then, I remember talking to you about my priorities for Ofwat and saying that in line with what Jonson just said one of those priorities was to land a new strategy for the sector. I also outlined that one of those priorities was to land a new strategy that built on what we had already achieved through our 'sustainable water' strategy, but one that really does take regulation and the sector forward. And what I'm going to do now is take the opportunity to update you on where we got with that and also talk a little bit about what that is going to mean in reality.

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## Open and collaborative approach



Image © Todd Huffman

Water today, water tomorrow

One of the things I flagged to you when we spoke in April, was that as we develop our new strategy it was really important for us to follow an open and collaborative approach and this is what we have done. Since we last spoke, personally I had many conversations with: company management teams, chief executives, investors, customer representatives, some large customers individually and of course the regulators. Coming out of that process and indeed a wider process across the office and with our people, we shared our emerging thinking on our new strategy at an event in June which Jonson just referred to. The idea at that point was to share it, canvass views on it, refine it and to launch it towards the end of September/beginning of October this autumn. I am really pleased to say that the process has gone very well indeed and I am really grateful for the input that we had from a wide variety of stake holders including many of the people in this room.

So where does that leave us? Where do we stand now in the process of developing our new strategy?

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# Trust and confidence – hard won, easily lost



Image © Geoffrey Whiteway



As Jonson said any strategy starts with a vision. Our vision for the sector is really simple. It's trust and confidence. Trust and confidence in the quality of our drinking water. Trust and confidence in the reliability and the resilience of services that they will be value for money and they will be affordable. Trust and confidence in customer service and in fair dealing. Trust and confidence in the stewardship of the environment. More generally, trust and confidence that decisions taken today won't impoverish future generations. And of course trust and confidence on the part of investors in the sector and its regulator.

This theme of trust and confidence has come through really strongly from the conversations that I and others have had in the past few months. And we shared this vision as part of our emerging strategy for the sector back in June and it has really resonated. It has resonated with customers, with the companies we regulate, with other regulators, with wider stakeholders and – importantly – also with our own people within Ofwat. And so the strategy you will see us putting out in the autumn and that you will see us working to in years to come is going to be based on this sector vision of trust and confidence.

Of course 'trust and confidence' is all very well – but it bears a bit of unpacking. Where does trust and confidence come from? What determines whether a sector or a particular service provider has trust and confidence or does not?

When we shared our emerging thinking at the start of the summer we set out that there were two principal drivers of that trust and confidence. And again, these have really resonated with our stakeholders, so they will form part of the new strategy that we put out in the autumn.

So what are those two principal drivers?

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# Outcomes and relationships



Image © South West Water

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Well the first is outcomes. Crucially are people getting what they need and want from the sector at a price they can afford? And – equally crucially – recognizing what a lot of companies have found in their customer engagement on PR14, the recognition that customers are not one homogeneous lump, but have different needs and wants, and that those needs and wants also change over time. Which of course means that delivering the outcomes customers need, want and can afford, is not and cannot be a simple tick box exercise. It requires an ongoing dialogue – building understanding and responding to that.

Which of course brings me to the second driver of trust and confidence. Strong relationships. Relationships that are based on openness, honesty and fairness. That are based on understanding and respect. Talking and listening. The most obvious of these relationships is that between service providers and their customers. And that is something you have seen us put absolutely at the heart of PR14.

It's no surprise to PR14 watchers that when we talk about customers, it's using a broad definition of customers, so that includes bill payers now, bill payers in the future, but also includes the environment as a customer, and recognizing that society more widely benefits from the services that water and waste water companies provide. This broad aspect of customers has been a really important element in the PR14 customer engagement process. It is one of the reasons why the work done by the customer challenge groups has been both so valuable and frankly quite difficult.

It is also worth noting that we have a broad definition in mind to when we talk about 'service providers'. We are all used to talking about the 18 regional monopoly water and waste water companies. But let's not forget that we already have new appointees and water supply licensees in the sector. One of the things I am expecting to happen in the next few years is a much tighter focus on the services that people in the sector provide, right the way through the value chain. I am also expecting some real innovation in how those services and frankly by who those services are provided. On one level that flows naturally from the introduction of non-household customer competition which is coming in April 2017, but I think a shift towards a 'service provider culture' is going to be much more profound than that. I think a lot of the information that we have revealed and the conversations that we have had with companies through PR14 and the flexibility that we are giving people now in the regulatory regime to respond to that, is going to both prompt and provide the scope for some real innovation here.

While the relationship between service providers and customers needs to be strong for trust and confidence to be maintained, other relationships matter too. The outcomes that customers experience in the water and waste water sector reflect a wide variety of interactions, across what is a very complex system that includes customers and service providers, and the regulator, but obviously also includes

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government, other regulators, NGOs and investors. If the system is as a whole is going to work well, in the best interests of customers, we need strong relationships across all of these elements. I want to stress particularly that investors have a really important role to play here in driving the right behaviour on the part of companies. We think you will really want to do that because the way we've set up the incentive framework in the PR14, you and companies are going to make money by doing the things that customers really want you to do. We also think investors have a real interest in the continued legitimacy of the sector and in ensuring that the sector maintains that trust and confidence that we are looking for. Let's be under no illusion that if the sector loses that, if it fails to maintain and build that trust and confidence, there is a real risk that it will become subject to random interventions that would make it a lot less attractive as an investment proposition.

So that's our vision for the sector. Trust and confidence on the basis of outcomes and strong relationships.

It is important that we do have a vision for the sector. Even though we, as the regulator, don't ourselves provide water and waste water services. We need that vision to guide us in everything that we do. We also think it is important that we have a vision for the sector that really resonates with our wider stakeholders and that it's something that our wider stakeholders can really buy into because that is what will give the vision long term durability. That in term maintains the attractiveness of the sector to you as investors.

It is also important that we have a vision for Ofwat as well, for ourselves. What sort of regulator are we going to be? In particular how are we as regulator going to move the sector closer to that vision of trust and confidence?

I want to make three points on this.

First, it is entirely unsurprising from what I have said that we are going to focus on these two things. We are going to focus on outcomes and strong relationships. In everything we do we will try to add value in at least one of these areas and for preference in both. We are going to pay particular attention to those relationships that I was speaking about. Relationships within the sector itself but also our own relationships with different parties across the sector. That's because it's when those relationships are working really well, that the right behaviours become embedded, become self-sustaining and we can step back; it reduces the need for us to intervene as regulator.

The second thing I want to say, following on from this is that, this means that our vision implies that the sector itself needs to step up. We will be looking to those who provide water and waste water services to know what the right thing to do is and to

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do it, rather than waiting for the regulator to tell them what the right thing to do is and making them do it. They will need to provide us with assurance that they have done the right thing, and if that assurance is satisfactory, we don't need to intervene and that is a good thing. I'll make no bones about it – this is going to be a challenge for many in the sector. You can see how we have given companies more flexibility than ever before through PR14. Some of them, again you'll have seen this, have taken this flexibility and run with it, others haven't. For some that might be because they still aren't quite sure that we mean what we say. They'll get that message pretty soon, I hope. For others, frankly, there may be the capability issues and after all this is an approach to regulation that places much greater responsibility on company management than we've ever seen before

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Of course, if companies don't step up then we may need to step in to protect customers. The important thing here is to note that what I have said here is that we are going to step in to protect customers; we are not going to step in to protect companies. I recognise that we do have a statutory duty to promote the consumer interest but also a statutory duty in relation to financeability. But our financeability duty is to ensure that efficient companies have access to capital markets – it does not extend to insulating investors from the actions of company management.

I want to flag here the work that we are doing, at the moment, to develop our thinking on assurance and if you haven't got to it yet, there's a really important chapter in our draft determinations on assurance. We are not reinventing the June return here, and I apologise to some of you who I know would like that, but we do need to do a lot more thinking in terms of the information that we need, as the regulator, to know whether the sector is moving closer to our vision and crucially to know how we as regulator may intervene to help it to do that. This is a key enabler for the approach that you heard Keith Mason talk about at the last city briefing around a risk-based approach to regulation.

I also want to flag that when I talk about us stepping in, when I talk about us intervening you should expect to see us using the full range of tools in our regulatory tool kit. That extends from the more traditional tools that you are familiar with, of licence enforcement and price controls, through to the less conventional – but extremely powerful tools – of transparency and debate. We will continue to provoke, challenge and push things forward as you have seen us doing through PR 14, where we think we can add value by doing so.

Third and finally, as we do all this, you will see us continue to work in that open and collaborative way. As I said earlier this is the whole approach we followed in developing our strategy. I think it is been important and successful. We are going to need to follow it if we are to be successful in implementing that strategy.

## **Slide 11**

So we have a vision for the sector that's based around trust and confidence which hinges on outcomes and strong relationships. We have a vision for Ofwat that sees us focusing on those outcomes and strong relationships, that sees us encouraging service providers to step up and provide us with assurance. But also sees us ready, willing and able to step in where that insurance is not satisfactory to protect customers.

So what can you expect to see us doing over the next few years on the basis of this?

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There are three things where I want to draw your attention because there are three areas where you are going to see us putting a lot of effort into our work over the next few years.

The first one of these is in relationship to services. You have already heard me talk about service providers consistently in the past few minutes and that's for a reason. We need a much better understanding of the services that are provided in water and waste water, right the way through the value chain. We need a better understanding of the costs of providing those services. We need a better understanding of the extent to which they are, could or should be contestable. I separate those things out quite deliberately. We need an understanding of what all this means for the way that we regulate. This is clearly a particular issue in respect to the wholesale part of the value chain, where 90% of the cost sits. So we have a particular responsibility to ensure that our regulation is revealing information, and providing service providers and stakeholders more widely, with the ability and the incentive to respond to that really to shift the frontier on efficiency.

I am fully aware that as we progress our work on services, particularly in relation to the wholesale part of the value chain, this is going to get us into some complex and difficult territory. We are going to have to ask questions about cost allocation, and of course about the RCV [regulatory capital value]. But I can promise you two things. The first is that we will be asking those questions from a position of clarity about what we are trying to achieve and why it matters. The second, in line with everything I have just said, we will ask those questions openly and we will work towards the answers in dialogue, certainly with many of the service providers and also with many of you in this room.

The second area of focus is casework. This is a really critical area for us and one that is only going to become more important as we get to and beyond the opening of non-household customer competition in April 2017. After all this is an area that sees us make interventions that directly affect customers who sit at the very heart of our strategy. We need to ensure that we use our tools here to get the best deal for customers. This means working with the sector to get the basics right. And that's what we have been doing recently, for example working with the sector to get an alternative dispute resolution scheme in place and to make more effective use of arbitration. Now what that means is that we can focus our effort, our expertise on the really strategic cases – where we can and will have the biggest impact. Companies will need to pay much closer attention to our casework, especially as we get towards market opening, because we are going to be taking decisions there that will have a profound impact on the sector and its development going forward. We also need to use our relationships and dialogue across the sector to improve stakeholder's awareness of what we can do and what we are doing on casework and this, for example, is going to include working with the CMA [Competition and Markets

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Authority] to make sure that companies are aware of and really understand their responsibilities under competition law.

The third area of focus – and it is something that I think you are already seeing us make some progress on – is to ensure that we have as Ofwat have the right skills, experience, systems and processes to deliver our new strategy. There is no doubt in my mind that we have amazingly talented, and committed individuals in our organization and frankly we wouldn't have been able to deliver PR14 without that. I do recognise that our new strategy – and the role we see for as a regulator contains challenges for us, as well as for the sector.

To sum up then... the new Ofwat strategy is coming. Those of you who have been following PR14 closely, and that's probably most of you, may well have a sense of déjà vu as you see it emerge. That's no coincidence, many of the themes that new strategy builds on, are absolutely core to our work on PR14. The focus on outcomes, the onus on companies to own relationships with customers, the onus on companies to provide us with assurance, but a willingness on our part to intervene where we have to, to protect customers. That sense of déjà vu is no bad thing at all, because it is demonstrating to you our desire for continuity as we move forward and not cliff edge. The thing I want you to take away from this presentation is that we see PR14 not as an end point, but very much as the beginning of a further revolution in water regulation. One that will continue through the next control period and into the next price review.

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# Questions



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## Questions

### James Brand, Deutsche Bank

I was just wondering whether you could elaborate a bit more on some of the comments you made about looking at the cost structure of the wholesale components of the business. You mentioned potential implications on thinking around RAVs [regulatory asset values] and things like that. Could you just give some more context in terms of where – obviously it's a very early stage in the process – but where that might go and the kind of things you might be looking at.

### Cathryn Ross

Yes, I think it's really important that we are upfront about the fact that we are going to be looking at this and that we make that clear at an early stage. Because I think there are various different possible answers to the way in which cost should be allocated to services, and indeed what happens to the RCV [regulatory capital value]. There's no one unique solution and I think we will get to the best answer by a process of dialogue.

So I am not going to give you an answer on the substance but I am going to give you an answer on the process, which is that we are going to ask these questions openly and we are going to engage in dialogue with investors and with companies that sees us work towards the most appropriate answer. We are not the only ones thinking about these questions. If you talk to companies, they are thinking about this stuff as well. What we really need to do is to create the environment where we all bring our thinking together and come up with a solution that works for everybody. What that is I couldn't tell you at the moment, but that's the process we are going to follow.

### James Brand

Would this potentially re-open some of the questions that have been debated a couple of years ago, when Regina was CEO, about potentially changing the regulation of different parts of the value chain and moving towards more competitive forces? Is it more measured reopening of that kind of dialogue or should we view it as something else?

### Cathryn Ross

I think there are two really important distinctions here. One is the question about the extent to which different parts of the value chain should be opened up to competition. Then there is another question which is about the best way of regulating different parts of the value chain. There's clearly a link between the two, but the one that I am

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more interested at this stage is, how we regulate the different parts of the value chain. Now clearly you heard me say in the material that I spoke about just now, that the way in which we regulate will partly be a function of the extent to which we think different services could or should be contestable, but I think our focus, particularly at the moment, is on how we regulate, and that's going to be the focus of the dialogue that we have with you and with companies.

## **Dominic Nash, Macquarie Securities Group**

Following up from that, what is it that we actually expect be published in autumn. Will it be like a series of consultations that are going to take years to go through one by one, or have you thought of a solution that you are going to slam into the market in the September, with a view do we accept it or not?

## **Cathryn Ross**

I am sensing from your question that neither of those alternatives are particularly what you are looking for, Dominic?

## **Dominic Nash, Macquarie Securities Group**

Well, we're into year four of the Energy Market Reform and I think most people are probably fatigued of that, and to run out of that and into a water one for another four years would be quite depressing.

## **Cathryn Ross**

It is an entirely fair point. To be honest with you, one of the lessons we learned from the experience of the past five years is that, with the benefit of hindsight, we would have got much quicker to a point where we knew what we were doing, we knew what the approach to the next price control would be, we knew why, we knew what benefits it would be delivering and so we actually had a little bit longer to think about the methodology and to implement the methodology. And that's just a learning point. I think where we are is fine, but if we were doing it again we would be doing it differently. I think you can expect us to see that learning carried forward for the next five years and I think Jonson made this very clear in what he said as well. So what we are going to be publishing in the autumn is something that sets out the vision for the sector. As I said: trust and confidence, outcomes, strong relationships.

We will also be publishing our vision for Ofwat in terms of what type of regulator we want to be, and again no surprises there from what I've just said. We will also be setting out some of our strategic goals, so answering the question, really, if the sector had achieved our vision of trust and confidence, what might you expect to

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see? Because I think that's important in putting flesh on the bones. But then what you will also see is an ongoing conversation about what that means in practice and what is the best response from the sector and for us in order to move people along towards that vision. And that's the continuing conversation. Of course, all that process of continuing conversation is very much with the imperative of PR19 in mind, and the fact that we need a very clear idea about how we are going to approach that well in advance of starting to implement the methodology. I hope, Dominic, we are somewhere in the middle of your two unpalatable extremes.

### **Dominic Nash, Macquarie Securities Group**

Probably. Just following on from that, I guess the sort of time frame we should be looking at for this is 2022 or thereabouts, with water trading sort coming into law. You will be setting up your own license and regulatory models to allow retail trading and water trading to work in a different way.

### **Cathryn Ross**

Yeah, it's definitely with a view to that because you have already got there but you can already see that the 2019 price review is going to have to cope with and support reforms around water trading. And so the development of our methodology for the PR19 review needs to have that in mind, which means we need to start to think now about those services within the wholesale part of the value chain and what that means to the way that we regulate. So you are right.

### **Iain Turner, Exane BNP Paribas**

You talked about coherence of approach, and we have seen in the price control stuff this morning a real focus when you are looking at the companies' proposals on need, scope and cost. I wondered if you thought you are pursuing the same approach with the Thames Tideway: whether you think you were being coherent.

### **Cathryn Ross**

I think we are being coherent. Let me park that for a second, if you would, because I suspect we are going to come back and talk about Tideway in the context of PR14. Can I ask you to hold that question and come back to it later? Listen to what we have to say later and then test us on it.

### **David Pearson, KPMG**

Cathryn could you talk about what Ofwat's vision is for competition in the household market?

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## **Cathryn Ross**

Yes I am very happy to talk about that; Ofwat's vision in the household market is that that is a matter for government policy. So enough said. What else would you expect me to say on that?

I suppose the other thing I would see is that we are just about to see the roll out of competition in the non-household market, and what I would expect to see is a debate in the years to come about the potential of competition in the household market that very much bears in mind what we observe and what we learn from the non-household experience. But that is very much a decision for government policy. It's not one for us at Ofwat.

## **James Turner, USS**

You come across very reasonably saying we just want to warn you... evolution from Ofwat; we are having a new approach building on PR14. The trouble, as I see it, is that once you have said 'we are reviewing the RAV' there seems a great uncertainty to me already on what you might or might not do. The market has raised the cost of capital immediately and, as Dominic was pointing out, you need an answer or at least some more skin on the bones on what you might do to it. Otherwise, the market just hates the uncertainty because we don't know whether it's going to be potentially a very large change or very small change. It's just no good saying we are going to review our approach and then not tell us what that might involve.

## **Cathryn Ross**

I completely understand your point. What I said just now – about looking at services and the wholesale part of the value chain – really isn't news. And it isn't news because we know that further reforms are coming, for example in respect of water trading and abstraction. So simply by extrapolating from that you reach the conclusion that we are going to have to think, as regulator, for the PR19 price review, about what the services are in the wholesale part of the value chain and how we regulate them. It's not a great logical leap then to go from that to say, as we do that, we are going to have to think about cost allocation, and as we think about cost allocation we are going to have to think about the RCV.

So it's not a great announcement on that level, but what I am signalling is two things. One that we are completely aware of the need to be clear quickly about that point – and that was my point about needing to get to the PR19 methodology rather quicker than we got to the PR14 methodology. The second point I am making is that we are not going to produce a solution that emerges from the regulator through some black box process. We are going to involve everybody in a conversation about that and try

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to find something that works well for everyone. That is literally as much as I can say right now, but I think actually it's the most reassuring thing I can say, because anything else is just ducking an issue that everybody in this room can see is coming in any case.

## **Lakis Athanasiou, Agency Partners LLP**

Sorry to being boring, but I am going to follow on from what everybody has been talking about. I don't really see it as a logical conclusion on water trading that you need to break up the RAV, but what you seem to do today – correct me if I am wrong – is you are putting on the table the possibility that the RAV may be broken up into contestable and non-contestable segments, new or existing somehow, or whatever. But you are putting that on the table today. You seem to be doing that. Or am I wrong?

## **Cathryn Ross**

Firstly Lakis, that is a possibility. That's just a statement of the obvious. But what I am saying is that we are going to conclude, in good time for the next periodic review, what the right approach to dealing with the RCV is. Now one option is splitting it up, but that's not the only option; another other option is keeping it whole. There are different ends of the spectrum there. And I am also saying that we are going to follow a process whereby we get evidence from people, we engage in conversation with people, we get the best solution and we get to that point as quickly as we can for PR19. But what I am not doing – and this is really important – is signalling any particular direction of travel at this stage. I am just warning you that a conversation is coming.

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PR14 Draft Determinations

Sonia Brown, Chief Regulation Officer

## Sonia Brown

Thank you very much Cathryn. So apologies, the pretty pictures are going to go away and we are going to walk our way through a number of charts and tables to explain to you about the fourteen draft determinations that we issued this morning.

In July last year we said that there were positive signs that companies were taking ownership of the relationship with their customers. My perspective, just over a year later, is that the companies are now largely owning the responsibility that Cathryn and Jonson have talked about, in terms of gaining trust and confidence of their customers. That's been a really big shift over the past 12 months in the water sector, which I think is really important that we acknowledge.

Today I am going to take you through what's happening with regards to bills, companies' responses to the challenges that we set out in the risk-based review, and an overview of the key interventions. I will explain to you that we are going to continue to challenge hard for customers right through to the final determinations.

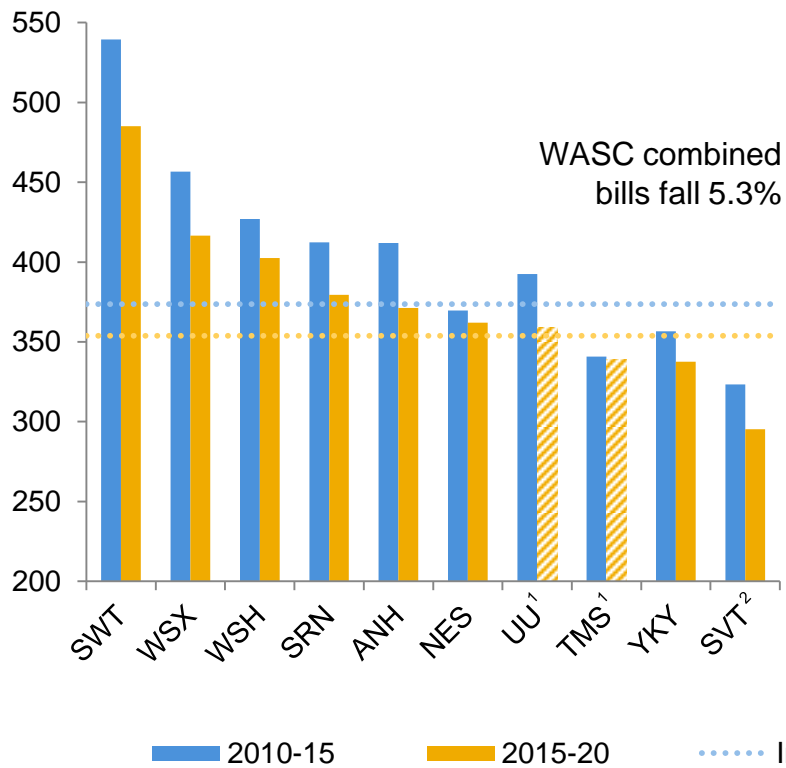
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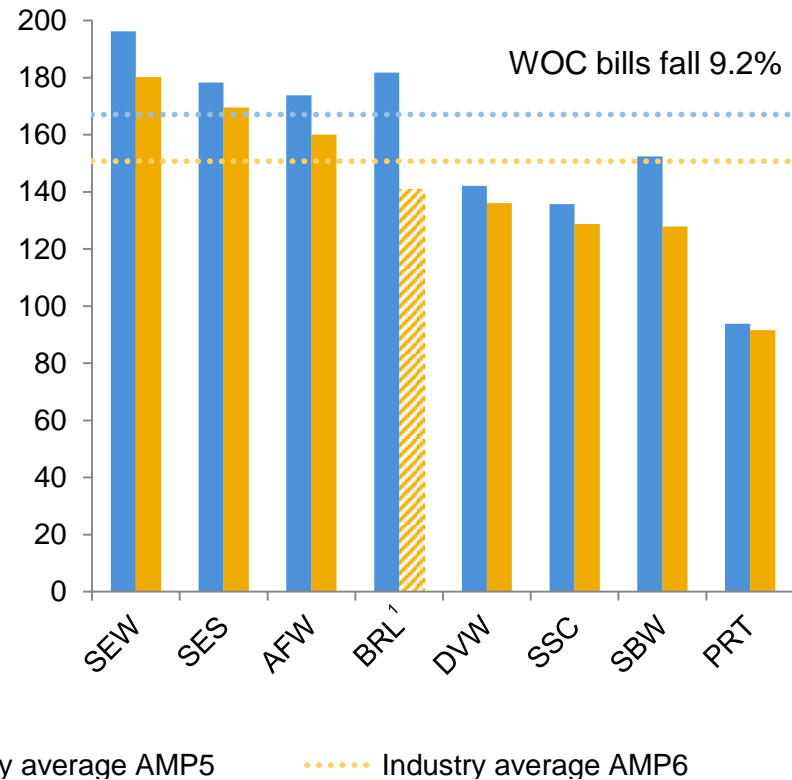
# Bills fall by more than 5% before inflation

## WASC Average Household Bill

Combined Water & Wastewater



## WOC Average Household Bill



(1) AMP6 bills for United Utilities, Thames Water and Bristol Water face greater uncertainty due to unresolved gaps in wholesale totex.

(2) AMP6 bills for Severn Trent are inclusive of the EVA "core resilience" scheme. Excluding this, bills would be £8 lower.

Note: Excludes indexation of wholesale revenues.

There is a very clear headline today about the reduction in bills that will be delivered to customers over the next five years. This obviously builds on the work that the companies did themselves: all but two companies put forward reductions in bill levels as part of their submissions into us last December.

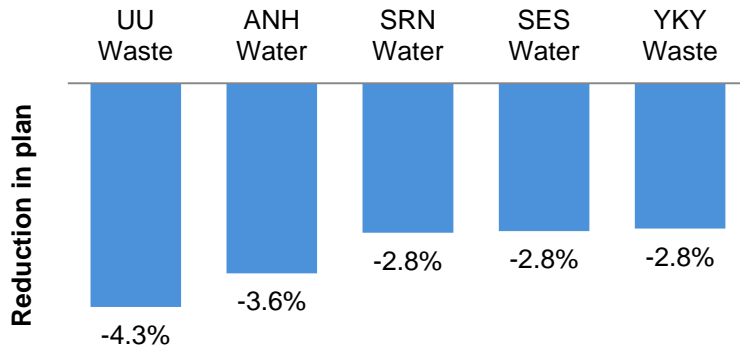
This focus on affordability is very welcome when many families have faced declines in real income; there is a lot of focus and attention in this area. We are also seeing companies not only worrying about the bill level but also thinking hard about how they reach into the communities that are struggling the most and putting in place arrangements, such as social tariffs, in order to make sure that they can really meet the needs of all of their customers.

As Jonson has already mentioned, what's really important is that the reduction in bills that we are seeing is not at the expense of investment, with over £43 billion worth of totex being invested into the sector over the next five years. The environment as a customer will also benefit. We will have cleaner beaches. You will hear today that all but one company has had its National Environmental Program accepted. Companies are also addressing issues such as resilience, and they are putting forward more sustainable solutions in areas like water treatment.

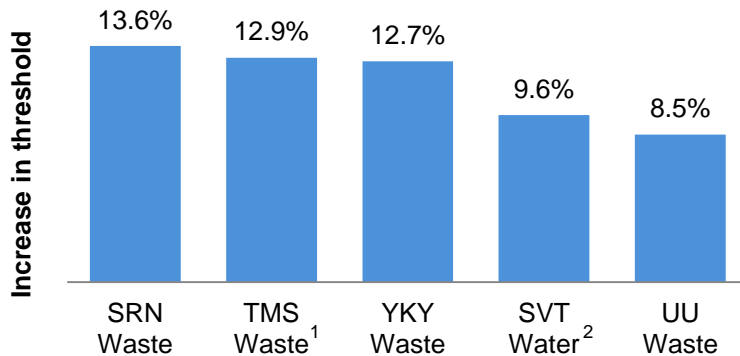
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# The sector responded to our challenges

Some have found ways to deliver their plans with lower cost



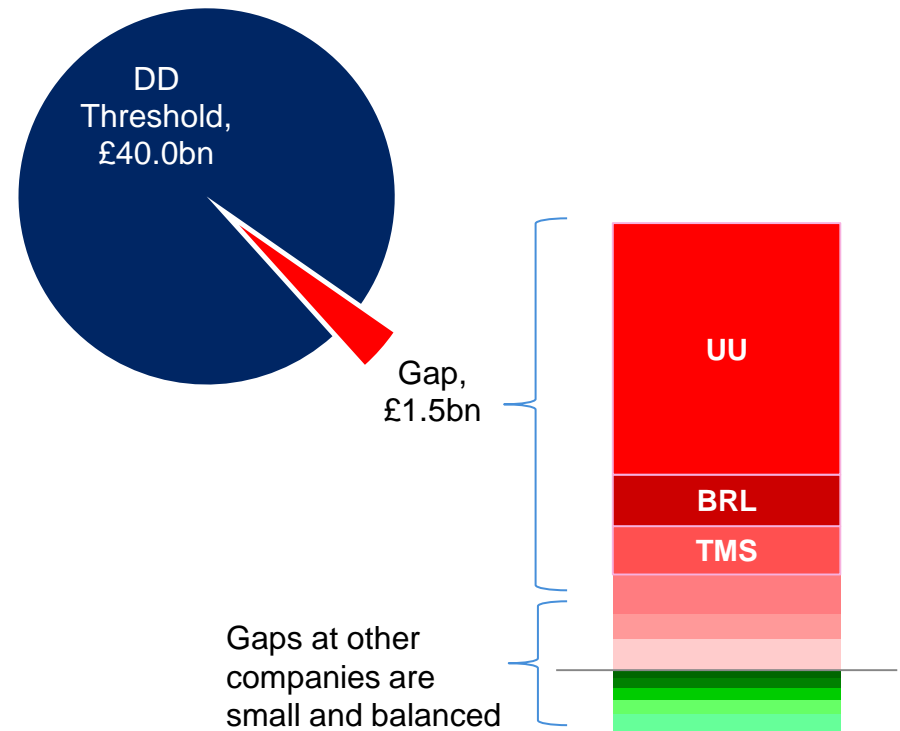
or supplied us with convincing new evidence...



(1) Including Thames Tideway.

(2) Assumes costs of EVA "core resilience" scheme are allowed.

Three companies account for the remaining unexplained totex gap



Naturally, as a regulator, when we talk about our draft determinations we tend to focus on areas of difference or the things that we think companies have yet to do. I think it's really very important, in terms of those relationships that Cathryn was talking about, that we acknowledge that overall this sector has really stepped up to the challenges that we set out in our methodology last July.

The fourteen companies that we have been looking since the 27 June had very different starting points as a consequence of their feedback from the risk-based review. You have companies like Portsmouth Water, who received very little challenge from us at the risk-based review. They have responded to those areas of challenge and what you will see in their draft determination today is that there's a pretty close match between the plan that the company put in and the draft determination that it's getting back.

Anglian, Yorkshire and Severn Trent all had challenges with regards to wholesale costs, and what you will see in those draft determinations today is that those companies have really sought to address those issues. Southern is one of the companies that has moved the most in terms of its position on wholesale costs. But you were aware already, before today, of some of the gaps that exist around the three companies that are outliers within the sector: the wastewater business of United Utilities, Bristol's water business and Thames Water, associated with the Tideway scheme.

So, what did we see when we looked at the plans when they came in June? The first thing that we saw was that some of the companies had themselves taken the decision to reduce the amount of expenditure that they were putting forward. You can see here a chart that gives you an idea of the scale of those reductions in percentage terms, and you can see that UU [United Utilities] for its waste business put forward the largest reduction in percentage terms associated with its plan.

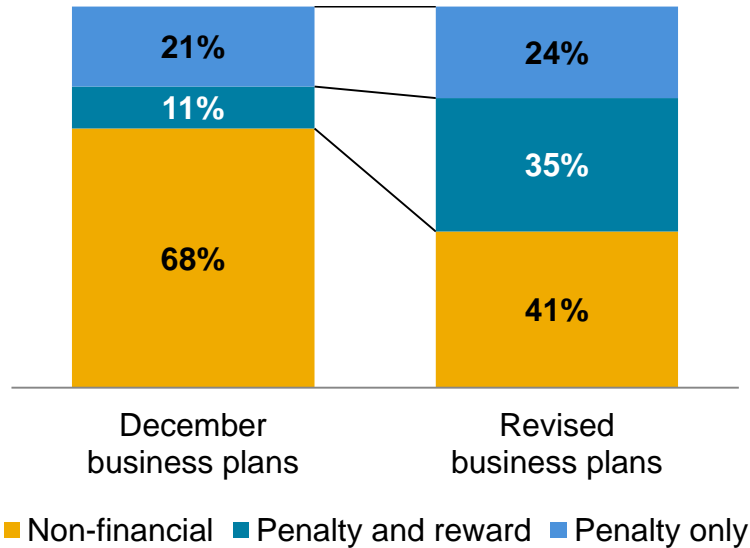
What we have also seen is real quality in the evidence that has come back to us from a number of the companies. We have set out very clearly the gates or how we test wholesale costs. Looking at the need, the options that the company has considered and then the cost effectiveness of the final solution that they choose. What you can see here is that companies like Southern, who is the largest mover with regards to their waste control, and they have really managed to convince us that we should move our position with regards to those cost thresholds.

Overall across the sector on wholesale costs we are in a close position and we are in a closer position than what we were at this point in PR09. I think the important thing to keep in mind is that it is these three companies that are explaining the vast majority of this difference.

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# The sector responded to our challenges

Revised ODIs provide a better balance of financial and non-financial incentives



Retail special factor claims

Company-specific uplifts to allowed return

Adjustments for 2010-15 performance

Uncertainty mechanisms

Financeability

Moving on away from wholesale costs, we put in place a challenge last January around outcomes and outcome delivery incentives. You will recall an unexpected bump in the process – as Jonson describes it – when we got the plans. We were concerned that there was too much continued reliance on financial outperformance. We saw that there were areas where companies could listen more to their customers and refocus their plans to be more aligned with what their customer really wanted them to deliver. What you can see is that the plans that we got back in June had a real rebalance towards more performance-related financial incentives. This really builds on the point that Jonson was making earlier about the importance of companies' focus over the next five years on operational and outcome delivery outperformance.

I could go on and talk to you about all of these different areas within the control and how the companies have responded. The important message is companies responded in all of these areas. To highlight one important one, all of the water and wastewater companies signed up to the lower cost of capital that we set out in the risk and reward guidance.

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# Wholesale costs: the gap has reduced since the RBR



(1) TMS Tideway and Lee Tunnel, UU Thirlmere link and SVT Birmingham Resilience.

(2) Assumes costs of EVA “core resilience” scheme are allowed.

I am going to move on and to talk you through some of the key challenges that remain within the plans. On the left-hand side of this waterfall you can see the totex gap at the risk-based review, and we are going to talk through to the right side which is the totex gap at the point of the draft determinations. I have already talked you through the reductions in the planned expenditure that the companies put forward themselves. But what also happened was that a number of companies looked at their plans and determined that they actually needed to increase their expenditure in some areas. Of note is Severn Trent with regards to Birmingham resilience where, although they put forward a lower total cost solution, more expenditure was required during the next five years. Also, Thames with regards to Tideway and United Utilities in dealing with an environmental issue within the Lake District.

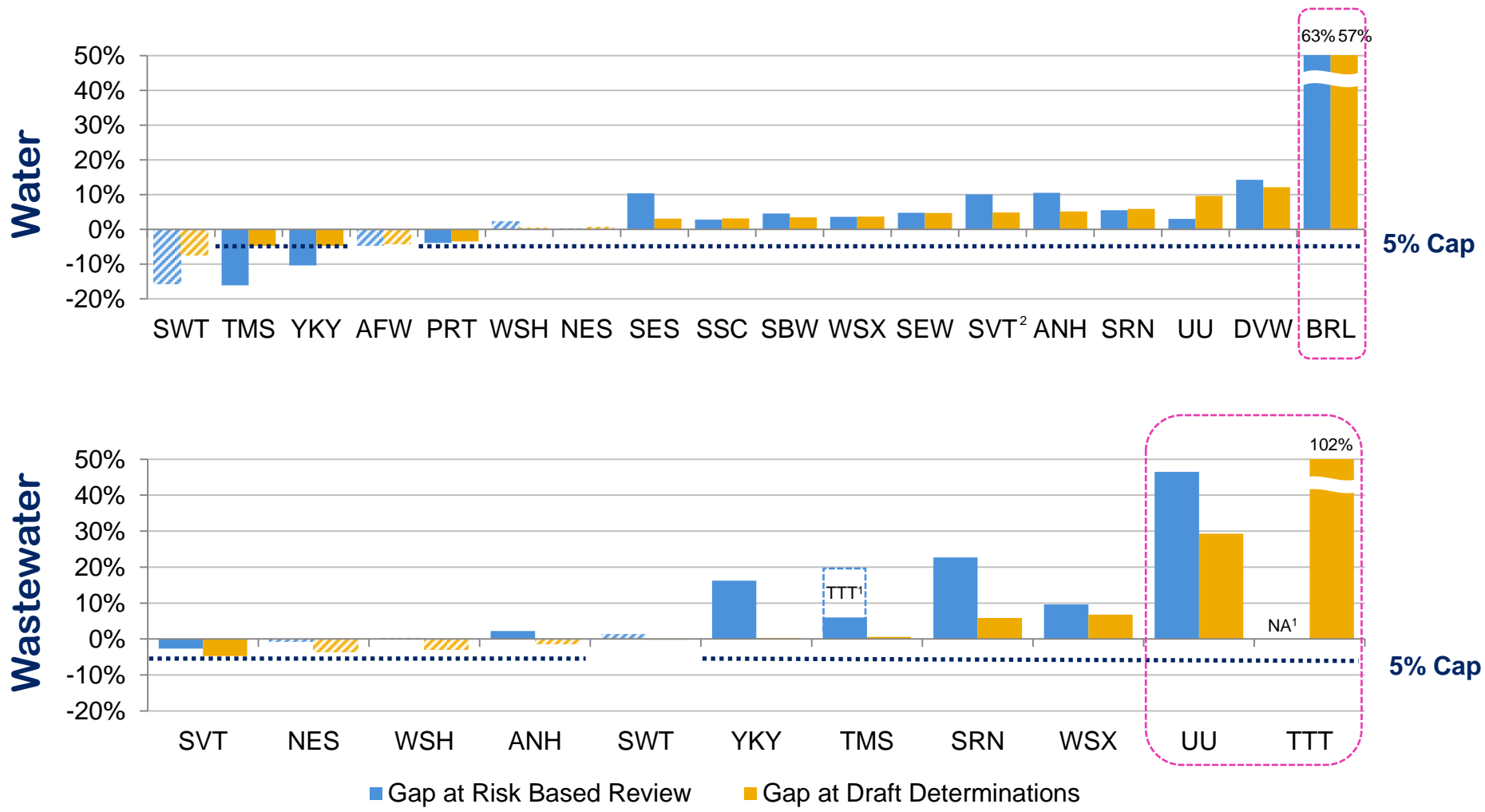
The next area that you can see, which is obviously is very significant, is the changes that we made to our thresholds. This is through the consistent application of our tests around need, cost benefit analysis and the cost effectiveness. What you will see when you look through the detail of the draft determinations is that we have challenged companies in a number of areas around UQ or upper quartile. The reason for this is that we thought long and hard about what was the right efficiency challenge within the sector and we concluded that between frontier efficiency or average, UQ was a fair balance between companies and customers. So where we found evidence that the companies are only challenging themselves to the average in their plans, we have stepped in and challenged them that little bit further with regards to cost efficiency.

The next area to talk you though is something we signaled in the risk-based review, although the implementation of it is new today, for companies which are significantly below our cost threshold. There is an obvious asymmetry here. If a company wants to persuade a regulator that they need more revenue, they provide us with lots of evidence and information to tell us why our models are wrong or why there are special factors that really influence their business. That doesn't happen so much in the reverse and so there's a real asymmetry here. In order to mitigate this, we have capped the difference between the cost thresholds and the companies' plans at 5%. This impacts upon Thames for its water business, Yorkshire for their water business and Severn Trent for their wastewater business. There is no impact on the enhanced companies due to the **do no harm** rule. Finally, we get to the right-hand side of the chart and to the fact that we have got a £1.5 billion pound gap between us and the companies, which I have explained earlier.

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# Wholesale costs: most companies are better positioned



(1) Thames Tideway Tunnel (a separate control within Thames Water) received no allowance at the RBR, against a plan of £508m.  
 (2) Assumes costs of EVA “core resilience” scheme are allowed.

This is a different way of looking at this information: moving from a sector way of looking at it to really understanding what's happening at all of the individual companies. The first thing that's worth mentioning on the water chart, which is on the top of the, Slide is Severn Trent. The key issue here was Birmingham resilience. The company has done an awful lot of work between the risk-based review and June and submitted really high-quality evidence around the Birmingham resilience scheme. We do, however, have some outstanding questions around how they are taking mitigating actions, so you will see that we present two scenarios for Severn Trent's draft determination. I want to be very clear with you that, on balance of probabilities, we think within Severn Trent's final determination there will be an allowance for addressing Birmingham resilience issues.

I have explained that United Utilities put forward additional cost claim which was for £215 million for the Thirlmere link, which was to deal with an environmental concern around an abstraction license.

We have looked at this really hard and we understand there's a real environmental need for the situation to be addressed. However, we are concerned that there is a level of expenditure – which is quite material – that is already included in our wholesale cost models to deal with this. We are also concerned with the scope of the scheme that United Utilities have put forward. We, therefore, at this point are making no allowance for this within United Utilities threshold. The final position to draw out is just the extent of blue water, for want of a better expression, between all of the other companies and Bristol Water. I haven't got any new information on this today, but we highlighted on the 6 August the difference between their wholesale costs and the level that we are modelling as being efficient at the moment.

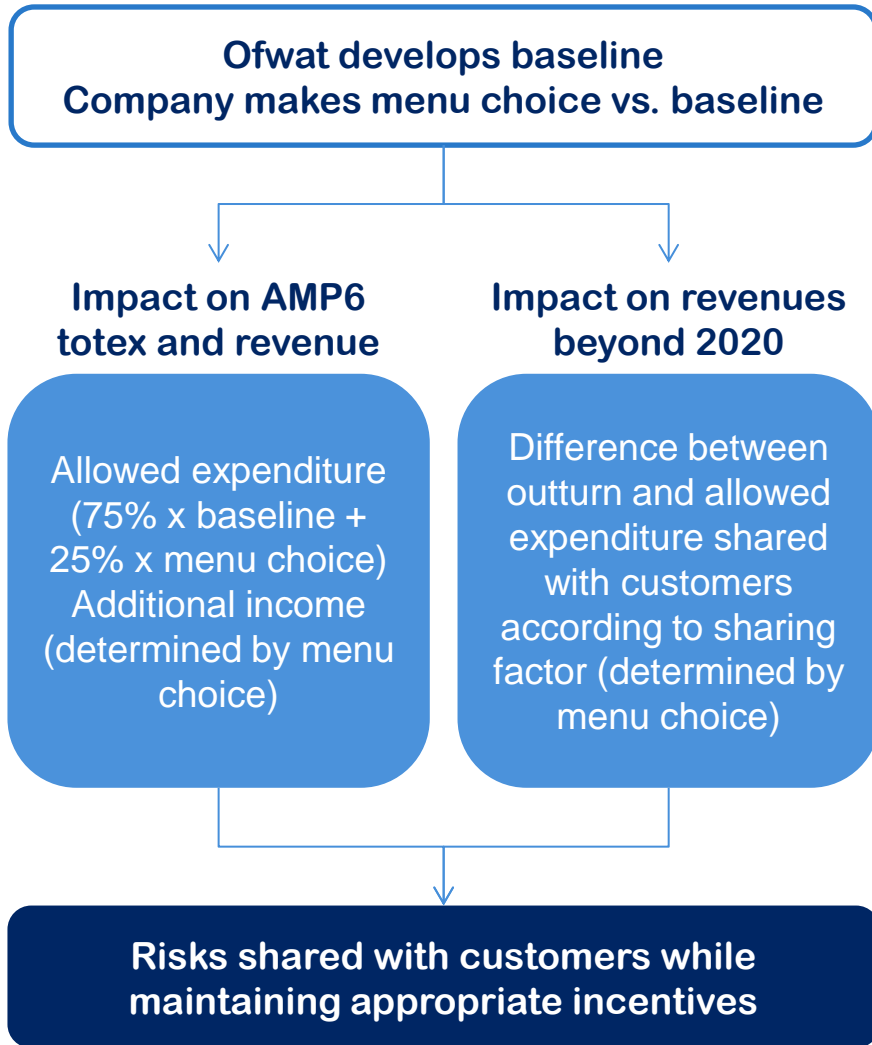
Moving on to the wastewater side, what you can see is that there has been some quite big movement here between the risk-based review and draft determinations. Of particular note is that Yorkshire, Southern, Thames and Severn Trent have all had their NEPs accepted within their cost thresholds. United Utilities is the outlier here and we have talked already about this on the 6 August, and again I don't have any new information today for you on that.

The final outlier Thames with regards to Tideway, where the issues are different because these relate to which costs are certain versus which are uncertain, and there is a conversation to be had with Thames now they can see the entirety of the price control that we are putting forward for the separate Tideway provisions.

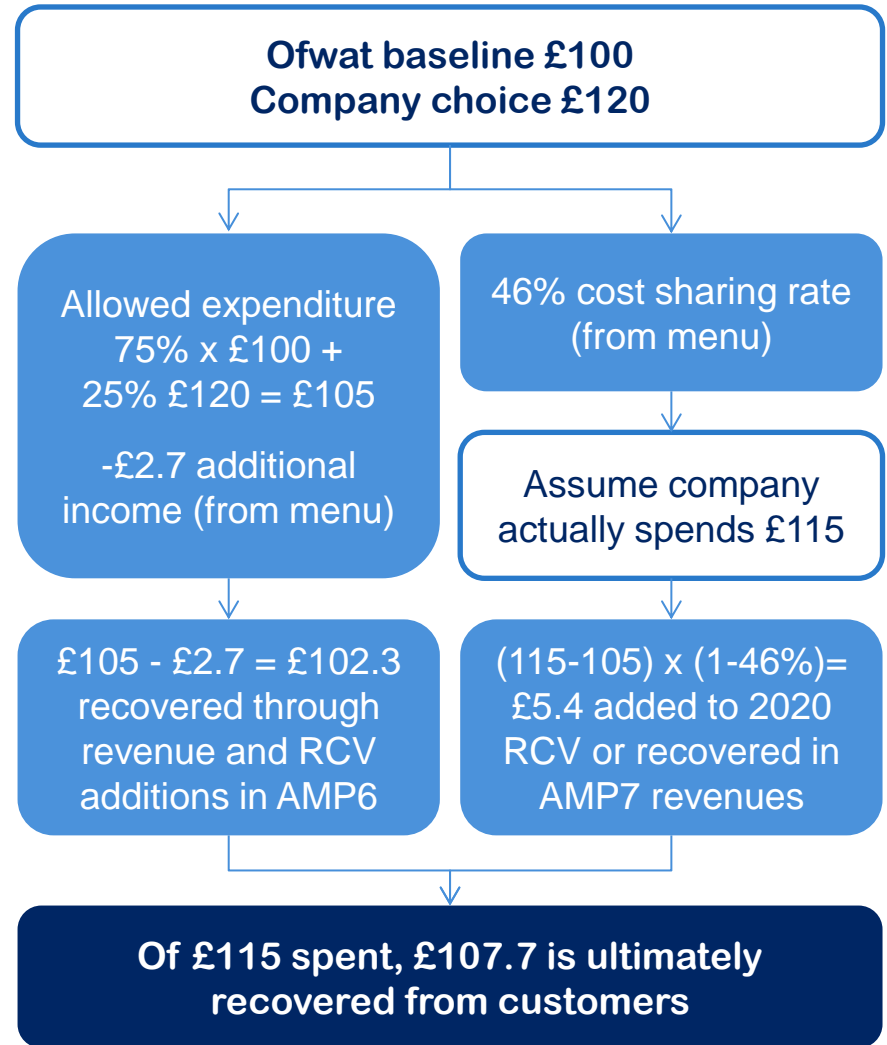
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# Menus mitigate risk

## Methodology



## Example

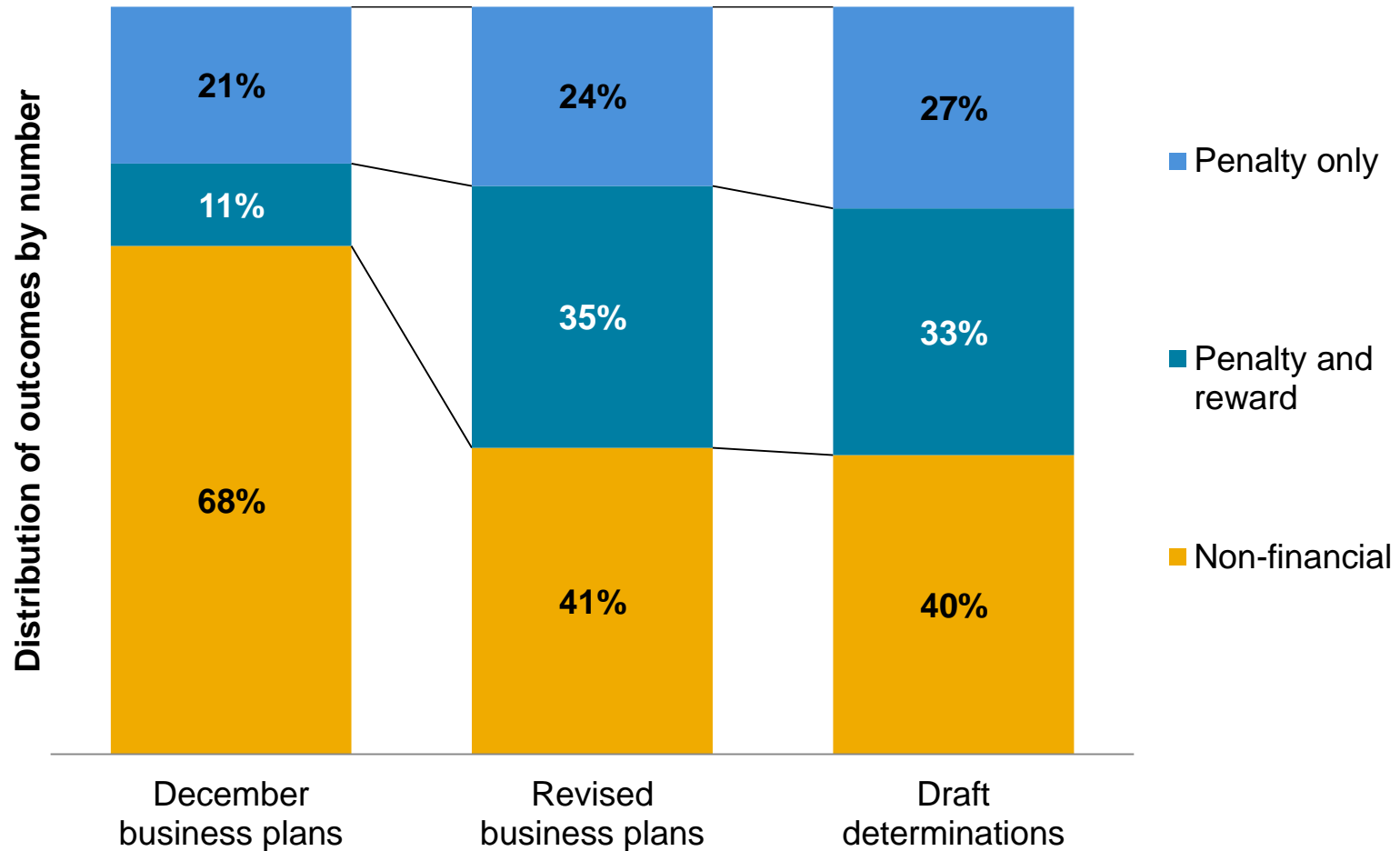


The fun on wholesale costs doesn't stop with our assessment of these thresholds. We are also for the first time introducing totex menus into the water and wastewater sectors. What this means is that the final amount of revenues that companies are allowed are based 75% on our base line and 25% on the company's actual menu choice. It's also really important to remember that there is under- or over-performance sharing with customers at the start of the next price control period, which is determined on the basis of that menu of choice. I know that a lot of you have been asking for a worked example of how this will feed through into practice, and so this will be available on our website later today for you to have a look at.

I spent a bit of time on wholesale because it is obviously the most material area of the value chain. I am going to move away now and talk about outcomes.

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# Delivering the outcomes customers want



I have already talked about the response that we have seen on outcomes from the companies. The final bar here is the distribution between non-financial, penalty-only and penalty and reward ODIs [outcome delivery incentives] at the point of our draft determinations. What you can see is that, if anything, our draft determinations have increased the scope for financial incentives – albeit relating to penalties.

What we have also been able to do for the first time is to step back and look at outcomes across the whole of the sector. In total, there were 399 outcomes that have been proposed through the engagement process between companies and their customers. We have seen some real successes, where companies are stepping up and listening to what local customers want and innovating on the outcomes that they are delivering in response to that feedback.

But for us as a regulator, and bearing in mind our job to protect customers' interest, we are very aware that there are some asymmetries in information. It is particularly difficult for us and for customers to compare companies where they have developed bespoke schemes. So I am going to talk you through a series of interventions that we have made in the outcomes area that are designed to mitigate this risk.

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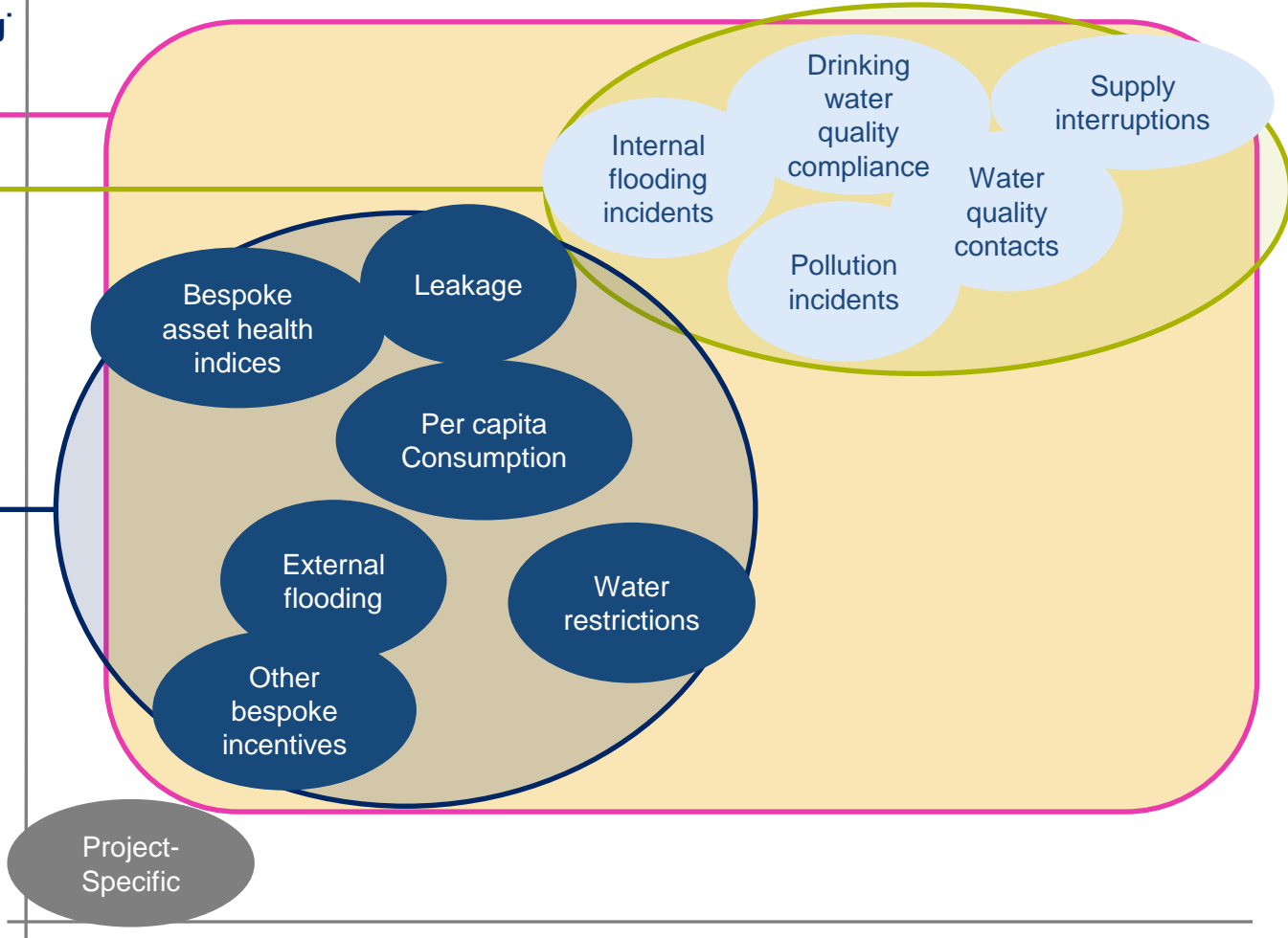
# Outcomes: we have made three global interventions

7cj YfU Y'  
UWcgg'  
Wta dUb]Yg'

Total ODIs capped at 2% of RoRE (both upside and downside)

High coverage/ comparability: base rewards on upper quartile

Bespoke incentives: global check and map to willingness to pay



Comparability of Outcomes

What this chart is showing you is the coverage of outcomes across companies and also the comparability of those outcomes. The first thing we have done is to introduce an overall, global cap and collar around the out- and under-performance associated with ODIs. It's a soft cap, and by that I mean that if within that period a company or a customer challenge group were to come to us and say, 'we think this cap is acting against customers interests,' then we would look at the evidence that they showed us at that time. It is really important that we are showing flexibility in recognition that this is a new and innovative area within the price control.

The second thing that we have done is that we have continued our bottom-up analysis, where we check back between what the customers are telling companies and the incentives that they are actually putting forward, and making sure that they are genuinely stretching themselves as far as is appropriate.

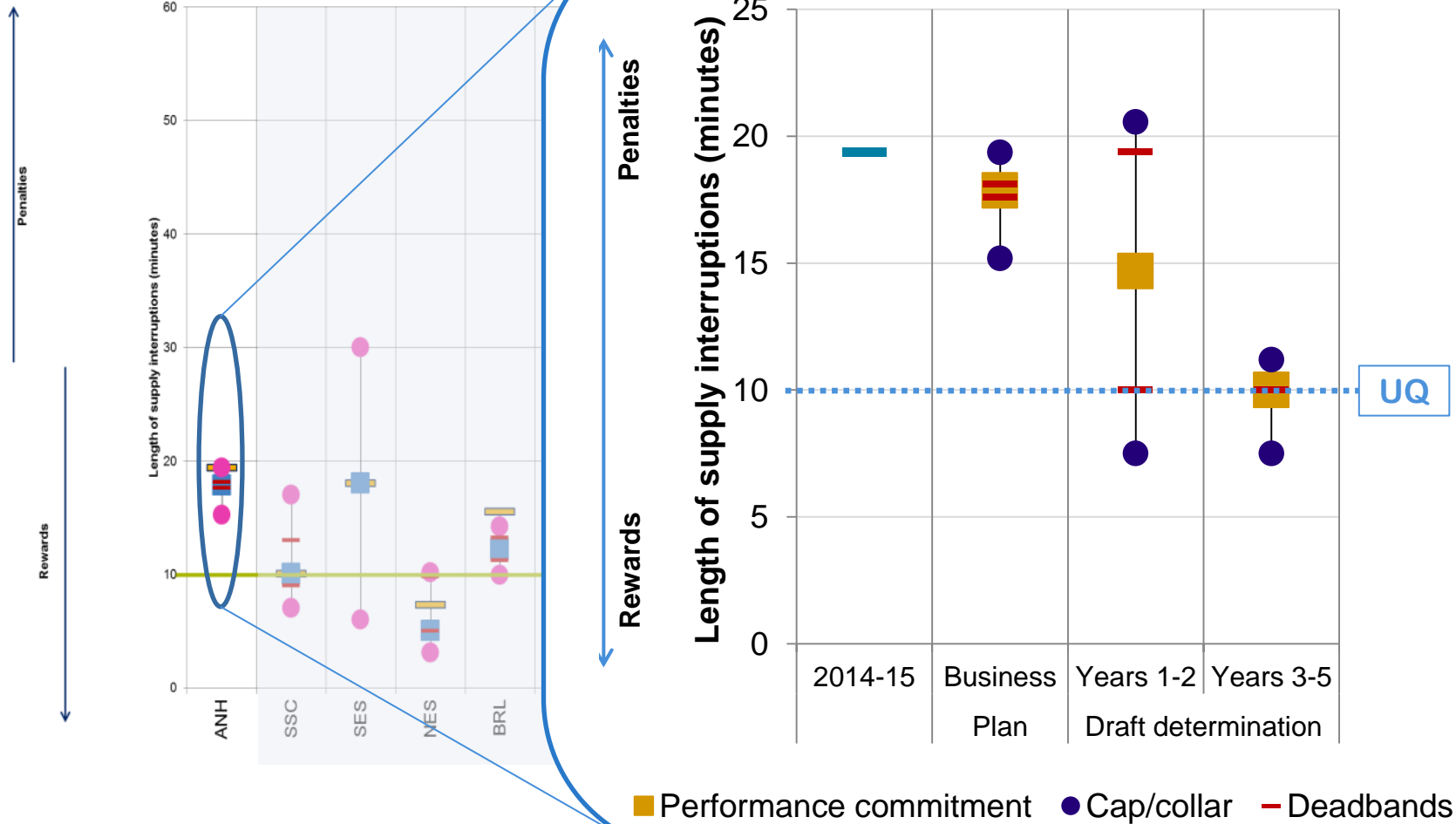
The third area is new. Where we have got outcomes that have high coverage and high comparability, what we are doing is introducing a common approach to our interventions. I'll talk you through that on the next slide, using an example.

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# Outcomes: supply interruptions example

Supply Interruptions Graph showing company 2014-15 forecast and 2019-20 targets with associated caps, collars and



What we are looking at here is supply interruptions, and apologies because I think this is probably going to test everybody's eyesight. What we are going to do is look in particular at Anglian Water – but I want to be really clear that I could have chosen any company and we've intervened across all of the business plans in this area. Anglian has been chosen because it's a nice example, it is not that they have done particularly badly in this area at all.

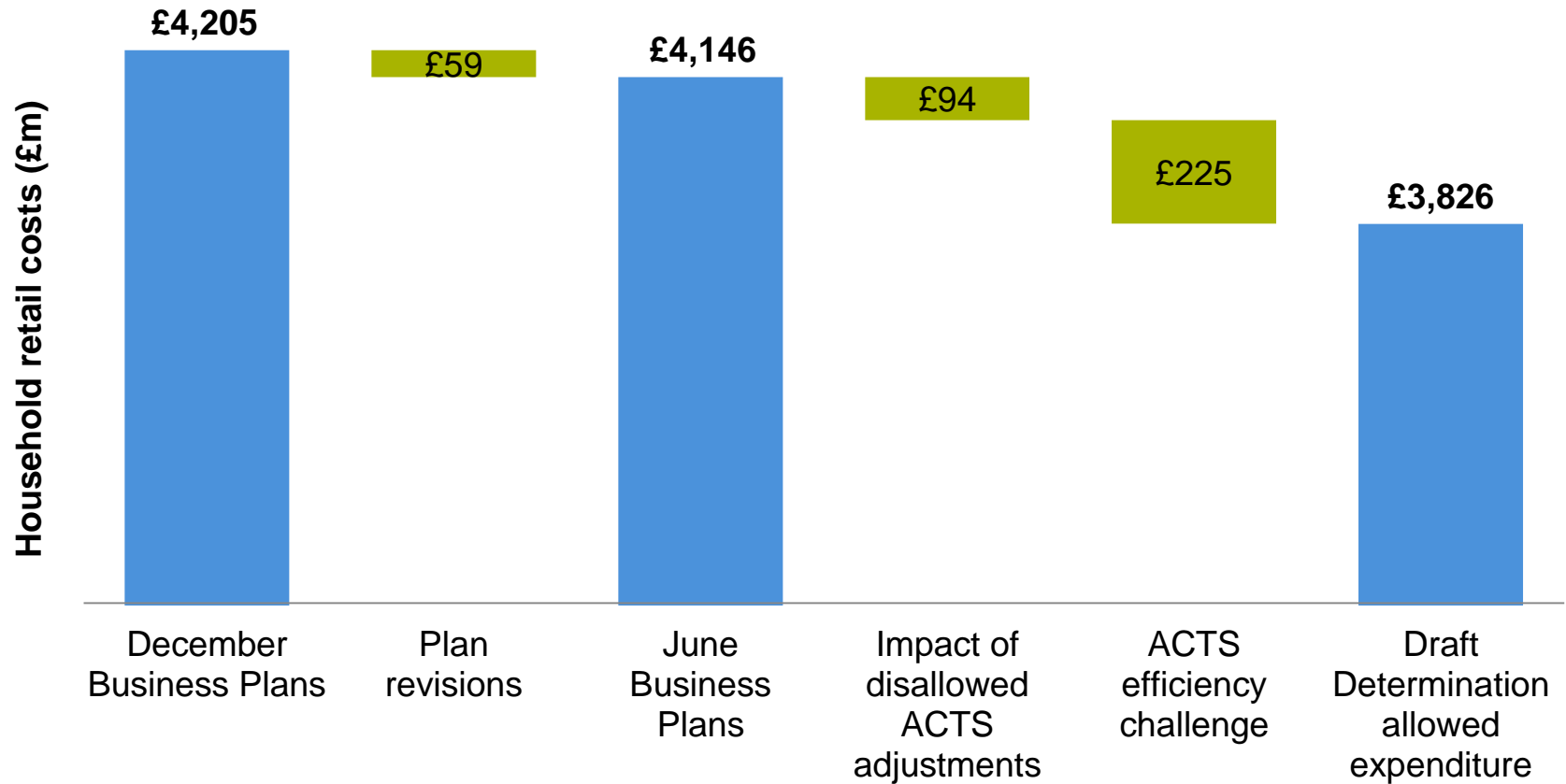
The first thing I'm showing you is Anglian's current performance level, which is around 19 minutes of supply interruptions to customers and which compares to the 10 minutes which is the normalized upper quartile level for supply interruptions across the whole of the sector.

The next thing that I'm showing you is the business plan that Anglian put forward – and you can see that they were really trying to do better for their customers. Their customers expressed that they were willing to pay for improvement. But the problem that their customers have is that they don't know whether 19 minutes is good or bad compared to other companies. And what you can see from this is that Anglian would have received rewards for catching up to upper quartile performance.

So our interventions are to do the following.

- In year one and two there will be a dead band in operation, and what that has impact of doing is making sure that as Anglian tries to catch up with that upper quartile it isn't exposed to any penalties. Of course, if Anglian beats that upper quartile and gets their faster, then it is able to enjoy rewards.
  - Then in years three to five, the dead band disappears and if the performance level is less than upper quartile then Anglian will experience penalties, subject to the maximum collar that's in place associated with that.
-

# Efficiency challenges in retail



**Further £704 million saved by removing automatic link to RPI**

So, moving away from outcomes and into retail, this is obviously the new area or the new price controls for PR14. I have explained before why we have done this but it's worth repeating again. Retail is a relatively small part of the value chain, but it's a part of the value chain that really matters for customer experience. And so we will continue to build on the success of the financial incentives that SIM [service incentive mechanism] has introduced over the next five years, and we also recognize that a number of companies have put forward other reputational outcomes designed to make sure that they are delivering the best retail services for their customers.

This is a different waterfall. It's taking you through, this time, from the December business plans through to the draft determinations and their allowed expenditure. Again, what you can see is that companies themselves looked again at their plans and made some modest reductions in the amounts that they were asking for with regards to the household retail business. That then gets you to the point of the June business plans.

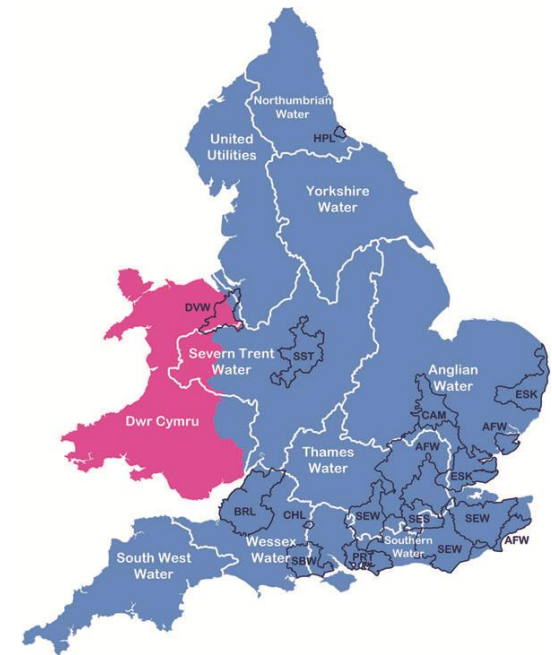
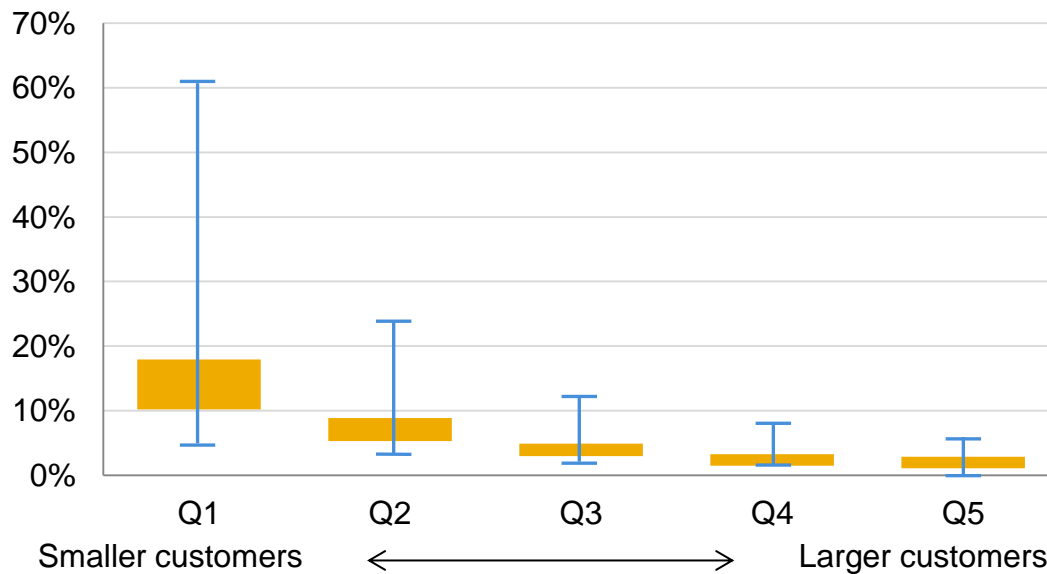
What you can see is that we've challenged hard some of the average cost serve adjustments that companies put forward. These were concentrated in two areas: bad debt and input price pressure. We have made an adjustment in these areas for United Utilities, where we have allowed their bad debt adjustment – albeit that we've modified it slightly, as the company put indexation into these costs. And Yorkshire was able to demonstrate that they were upper quartile and their management practice for controlling costs in the retail business benchmarked well to other retail businesses elsewhere in the economy, so as long as Yorkshire remains at upper quartile for final determination there will be an adjustment for the input price pressure.

The next thing that you can see on the waterfall is the consequence of our efficiency challenge on average cost to serve and then this takes you to the final position which is the draft determination allowed revenue for this area of the value chain.

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## Gross margin range by total revenue

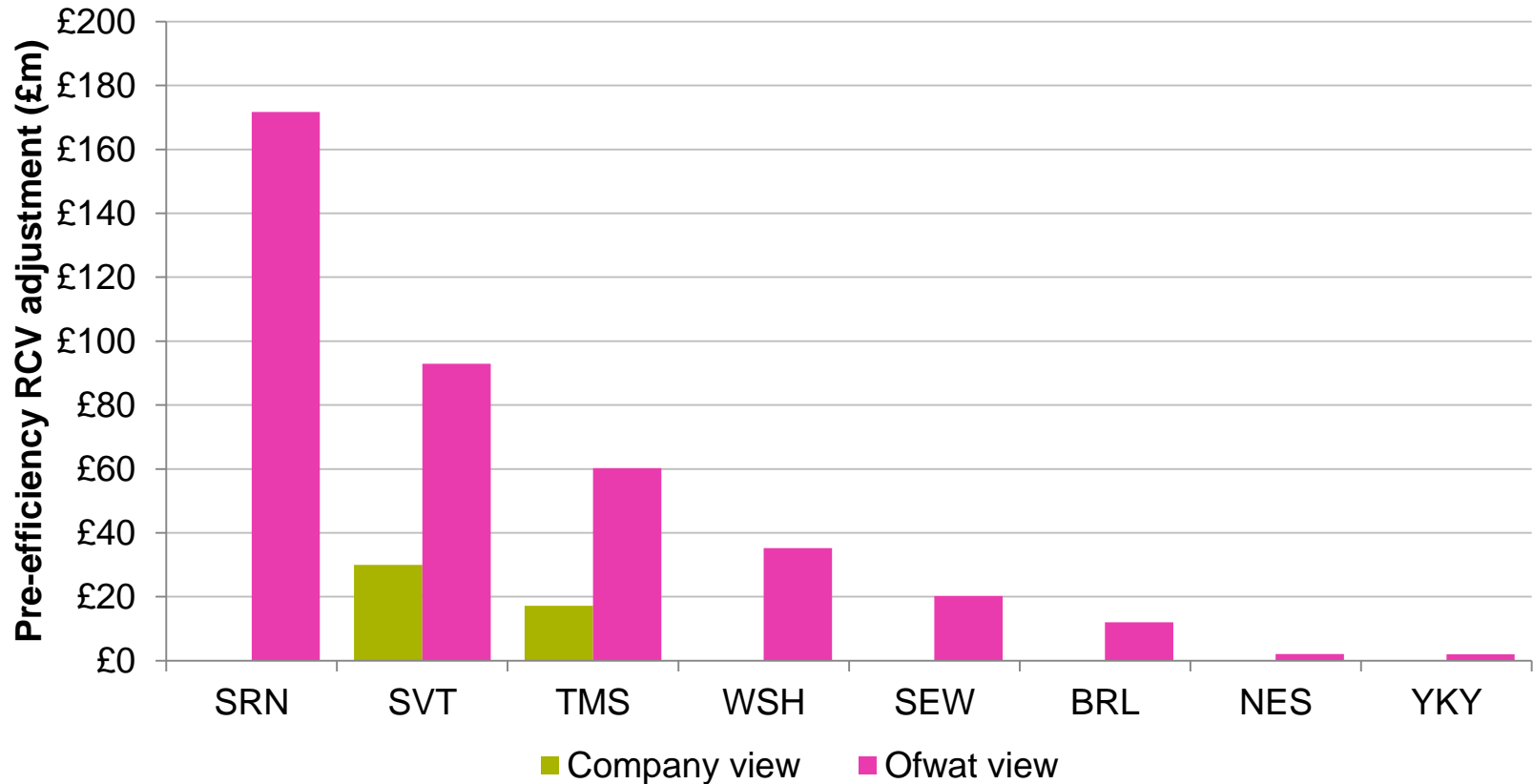


On non-household retail the position is obviously different between England and Wales. This reflects the difference in government's policy. In England, as Cathryn has already mentioned earlier this morning, the Open Water programme is working hard to deliver effective choice for all business customers for April 2017. Our approach to price controls has been light touch intentionally in this area to allow competition to really add value from 2017 onwards. We have, however, written to companies because we have noticed that there is a significant variation in their allocation of margin across different groups of customers. This is their risk, it's their problem, but what we are asking them to do is to consider carefully whether they want to reopen any of those default tariffs ahead of April 2017, because some of these variations may well attract attention from competitors and lead to casework for Ofwat.

In Wales, we are introducing an efficiency challenge and a business SIM; this is to reflect the fact that the Welsh government doesn't want to have competition. The other thing that we have needed to do is to intervene for Dee Valley Water – they're the only company that we've needed to intervene in these tariffs.

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# 2010-15 Performance: shortfalling



I've already talked this morning about that fact that PR14 is about creating accountability between the company and the customer. And this is a very important area where companies have the opportunity to check back on their own performance during PR09 and identify if there were any areas where they hadn't delivered everything that was within the price control settlement. What you can see here is that Severn Trent and Thames did identify important shortfalls for their customers. But when we have checked back, with our lens of protecting the interests of the customer, we think that there were larger shortfalls to their RCVs that was due to customers, and therefore we have intervened in their plans in order to deliver these changes. The most material intervention is with respect to Southern on their wastewater non-infrastructure side, because of a failure during PR09.

What's really important, as Cathryn has already said, is that going forward we will look to companies to own their own processes for delivery on their outcomes, except where we have doubts over the companies own ability to do this. And in those circumstances you will see us as the regulator stepping in.

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# Risk & reward

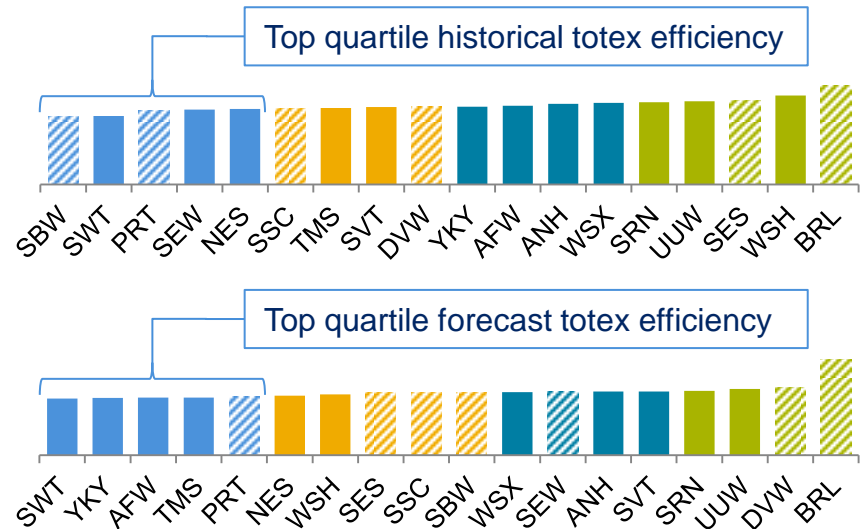
## Costs

Evidence that smaller WOCs face a **25bps higher notional cost of debt**  
Insufficient evidence of higher cost of debt for SEW

Insufficient evidence for an equity premium for any WOCs

**Incremental financing costs for small WOCs of 15bps on the WACC**

## Benefits



Source: Ofwat calculation of historical water efficiency scores based on 5 years of historical costs and on assessment of PR14 business plans.

Evidence that **SBW and PRT** provide valuable comparators for setting future wholesale price controls

**Bournemouth and Portsmouth have demonstrated both higher costs and offsetting benefits justifying an uplift of 15bps**

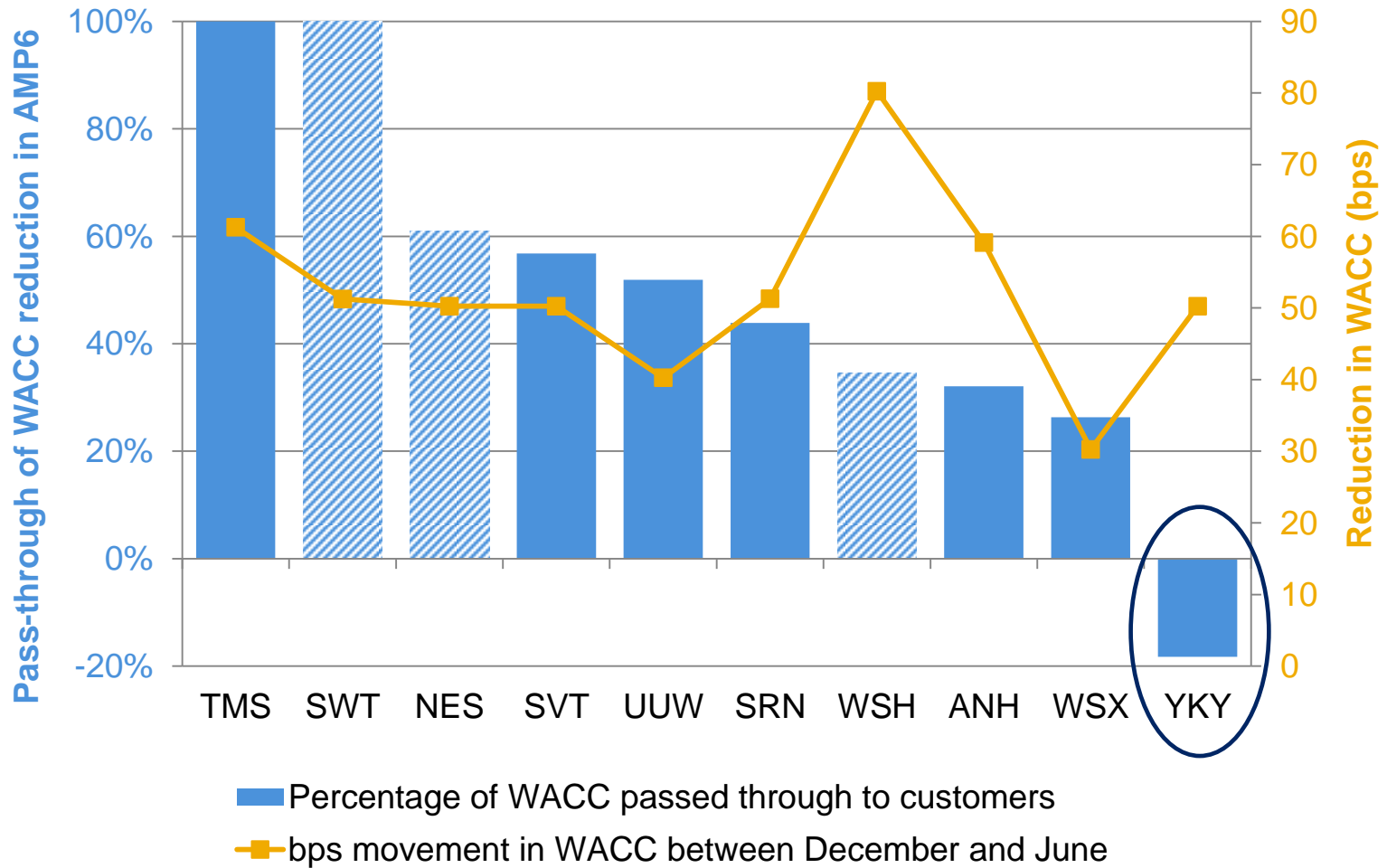
So moving on now to risk and reward. As I have already mentioned, all of the water and wastewater companies accepted the risk and reward guidance. One of the water only companies, Dee Valley, put forward alternative higher proposals for retail margins. We've intervened in Dee Valley's plan and made their retail margins consistent with the 17 other companies.

All of the water only companies asked for a company-specific uplift to the cost of capital – you may know this as the 'small company premium'. In our risk and reward guidance we said that we would only uplift the cost of capital if there was clear evidence that the benefits to customers were more than the costs, and so we have adopted the approach of looking hard at those costs and those benefits. On the cost side, we did find evidence that the smaller water only companies faced a higher notional cost of debt, but there was insufficient evidence of a higher cost of debt for South East Water. We found insufficient evidence for any equity premium for the water only companies.

On the benefit side of the equation, we looked hard at where we found comparators particularly valuable in the way we set wholesale prices. What we found here was that two companies, Bournemouth Water and Portsmouth Water, provided us with really valuable comparators for setting future wholesale price controls. When we have looked at this, the benefits that Portsmouth and Bournemouth are delivering to customers outweigh the costs – and so for these two companies we have made an uplift to their cost of capital by 15 basis points.

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# Passing through the WACC reduction in AMP6



PR14 has also given companies new levers, and in particular you heard me talk before about PAYG [Pay As You Go] and RCV run-off rates. What this chart is showing you is the percentage of the cost of capital reduction that has been passed through to customers in 2015-20. And the second thing it is showing you is the difference between the company's plans and what our cost of capital actually was. I should be clear that there is no assumption that if you pass through 100% of the reduction in this current period that's a good thing, and if you pass through 0% percent that's a bad thing. The thing that really matters to us, building on what Cathryn was saying earlier, is the conversation that has or hasn't taken place with customers to support that choice. We are intervening in Yorkshire Water's business plan in this area because we were concerned that the use of the levers was to support actual financeability concerns and that there was limited customer engagement.

---

# Financeability: interventions and additional assurance required

	ANH		SVT		SRN		TMS		UU		WSX		YKY	
	Plan	DD	Plan	DD	Plan	DD	Plan	DD	Plan	DD	Plan	DD	Plan	DD
Gearing	64.7%	62.2%	62.9%	63%	62.6%	61.9%	64.8%	64.4%	60.8%	59.9%	65.0%	63.5%	60.0%	60.8%
ACICR	1.41	1.46	1.60	1.60	1.46	1.49	1.31	1.40	1.63	1.61	1.74	1.76	1.71	1.64
FFO/debt	8.4%	8.7%	9.9%	9.9%	11.1%	11.3%	8%	8.6%	10.2%	10.2%	10.4%	10.5%	9.9%	8.7%

Require further assurance on financeability

Intervened to change PAYG ratio

	BRL		DVW		PRT		SBW		SEW		SSC		SES	
	Plan	DD	Plan	DD	Plan	DD	Plan	DD	Plan	DD	Plan	DD	Plan	DD
Gearing	64.3%	64.7%	67.9%	66.3%	62.9%	62.1%	59.5%	60.9%	63.5%	63.8%	66.7%	67%	64.4%	64.5%
ACICR	2.11	1.85	1.62	1.53	1.40	1.33	2.24	1.88	1.71	1.71	1.42	1.46	1.35	1.22
FFO/debt	14.6%	13.0%	11.9%	11.1%	8.6%	8.1%	13.1%	11.2%	9.0%	8.7%	12.4%	12.3%	12.3%	11.6%

Require assurance on data quality

What this is showing you is the key financial ratios for the notional structure, using our own calculations, before and after interventions. I have already talked about the intervention that we have made in regards to Yorkshire Water's business plan. We have also intervened in Bournemouth Water's business plan due to lack of customer engagement about the use of these levers and the balance between affordability and financeability.

What we are also doing is asking for greater assurance. There are a number of companies, Dee Valley, Portsmouth, South Staffs (and Cambridge), and Sutton & East Surrey where we found errors in their work and we want them to undertake some additional assurance on their data quality in time for the October resubmission date. We are also asking Portsmouth Water and Sutton & East Surrey to provide us with further reassurance, because you can see that the ratios around the notional structure for these two companies look lower compared to their peers and we want to make sure that their boards are really owning this issue.

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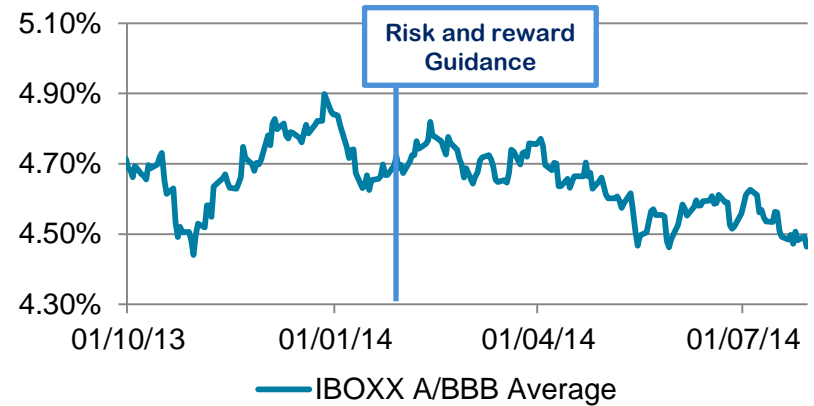
# From draft to final determinations

Draft determinations are open for consultation until **3 October**

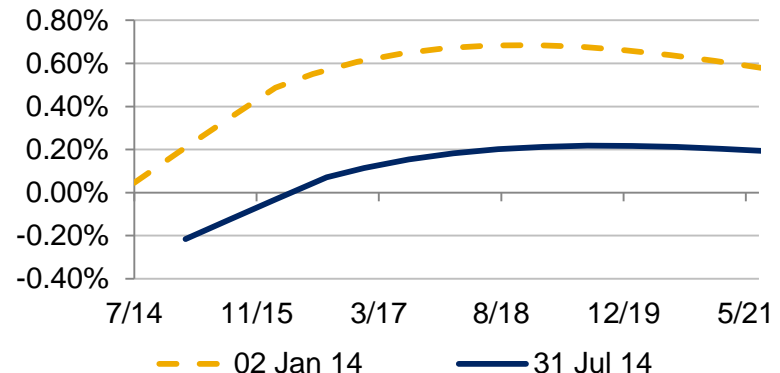
Final determinations on **12 December** will reflect company challenges, as well as our challenges on behalf of customers

The **final determination cost of capital** will reflect current market evidence and regulatory precedent (including the NIE and ED-1 determinations)

### iBoxx nominal cost of debt



### Market-implied real risk-free rate



10 year real forward rates implied by index-linked gilt yield curve.  
Ofwat calculation based on Bank of England data.

So, draft determinations are open for consultation from today until the 3 October. What we are clear about is that we will receive lots of representations from companies setting out the additional evidence that they think we should consider in advance of final determinations. But what we will also be doing is challenging hard on behalf of customers, right the way through until those final determinations. One of the areas that we will be looking at again – as we said that we would – is with regards to the cost of capital. And what we are highlighting today is that since we published our risk and reward guidance there has been a downward track with regards to the cost of debt. We are not saying today that we are going to change the cost of capital, but what we are saying is that we will challenge hard for customers in all aspects of these plans right through until that final determination.

Thank you very much.

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## Cathryn Ross

Thank you very much Sonia that was a complete tour de force, as I expected.

So today we have published draft determinations for fourteen companies and – I think we touched on it earlier – it's really important to remember that we already published draft determinations for our two enhanced companies, South West and the Affinity back in the April, and you heard Richard Bienfait and Chris Loughlin at our April strategy briefing. And of course two other companies, Welsh Water and Northumbrian, were able quickly to address the issues that we had in our risk-based review which also allowed them to get earlier certainty about their draft determinations. So let's not forget those.

## Questions

### Guy MacKenzie, Credit Suisse

Just two quick questions. Sonia, you touched on at the end that you are going to finalise the WACC allowance at final determinations in December, suggesting that there is some evidence you might even bring it down. If you do reduce the WACC [weighted average cost of capital] allowance would you potentially adjust RCV run-off rates or Pay As You Go ratios to alleviate the potential pressure on credit metrics and financeability? And secondly, just trying to understand the ODIs: you mentioned that companies will be rewarded if they are in the top quartile, does that suggest that if they are in the bottom three quartiles they will see penalties? In other words, from years 3 to 5, the average company would actually be penalized on those ODIs?

### Cathryn Ross

Sonia, do you want to pick those up first?

### Sonia Brown

Yes. I think the answer to the second question is straightforward yes: in years three to five, if a company has only average performance [compared to historical benchmarks] then that means that they would be subject to penalties under the measures [subject to the ODI collar]. This is because when we talk about upper quartile efficiency, this efficiency has two elements to it: cost and the service that is actually delivered. It's important that people are being remunerated through totex for really delivering on both. And so we are making sure that totex and these ODIs calibrate together to give the best possible deal for customers.

With regard to your question around Pay As You Go and RCV run-off rates, I would expect that companies will be thinking themselves about that question and are likely to put forward, within their own plans, scenarios associated with what they might do with those PAYG and RCV run-off rates in the event that there is a reduction in the cost of capital.

### Guy MacKenzie, Credit Suisse

So just to be clear then, if you do reduce the WACC companies will have another chance to resubmit proposals on...

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## **Sonia Brown**

No, 3 October is the final date for submissions, but companies would be well advised to be thinking through all of the aspects that we are talking about and think through what that means for Pay As You Go and RCV run-off rates. It's not just the WACC: there are other aspects as well that could influence a company's decision on how they are using those ratios, and it's important that they think about that as part of what they are submitting to us on 3 October.

## **Cathryn Ross**

Going to take the question from the third row – the gentleman in the third row?

## **Peter Dooley, Royal Bank of Scotland**

Just a very quick one, to go back to what Lakis was touching on. Cathryn, you were ruling nothing in and nothing out as regards the things you need to look at to get upstream abstraction and so on, which is obviously in the pipeline. Can I ask how that links in to the commitments given as part of the section 13 debate at the back end of 2012 that no RAV as at 2015 would be touched. Does that still stand or are indeed all bets off?

## **Cathryn Ross**

No – obviously you would expect me to say this – the commitments that we have given in the past will be honoured. OK, so I know there was a debate around the section 13 issues. There was a lot of concern, I understand that concern, and I think actually we have ended up in a sensible place. And part of the reason that we've ended up in a sensible place is because we have reached a position of mutual understanding and it's not in anybody's interest, I think, to go back and unpick that. But we will have to look at it and of course we will have to look at it.

I just want to give Sonia an opportunity to come in on this as well, because we are already beginning to think about how PR14 would move forward towards PR19. So Sonia, let me give you an opportunity...

## **Sonia Brown**

Okay, I am not sure that there is a great deal to add on this, other than to say that I recognize that uncertainties can sometimes be worrying, particularly to investors. But I think it is much better to have that engaged discussion and debate than it would be for Ofwat to go in to a room and come up with an answer and then impose it on the sector.

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I think there are various ways, as Cathryn has already outlined, as to how this might work in terms of potential contributions from resource businesses back to wholesale businesses, for example – for legacy RCV, for want of a better expression. And I think we are up for solutions, so if people sat in this room are thinking that they've got a solution to this problem, then please do tell us. Because we don't think that we have the monopoly on ideas on all of this, but we do think is that there is an issue here that needs to be addressed.

## **Dominic Nash, Macquarie Securities Group**

Back to the dreaded WACC question again, could you give us some colour on how you are going to re-examine it? Are you going to using the same methodology as you used before? Because obviously you Ofgem and the Competition Commission spent a lot of time on the cost of equity. Are you saying that we could sit here and say comfortably that that methodology is not going to be re-examined? And on the cost of debt; could you remind is it 75% historic, 25% forward looking? I think on the graph you showed us there was a 20bps reduction in debt. Would it be a fair assumption to say it would be like a 5bps drop?

## **Cathryn Ross**

Sonia, do you want to go first and then I'll ask Keith to come on the methodology point.

## **Sonia Brown**

We are showing you what market conditions are showing us, we are not showing you what we are doing, we are very much keeping our powder dry on this. I think this isn't new: we've said all the way through we would come back. Part of the deal in us giving the sector the certainty of knowing our thinking last January was that we would always be able to come back at the point of final determinations. What we have said is that we'd look hard at regulatory precedents, so obviously what's happened since last January is Ofgem has made its decisions regarding ED-1 [Electricity Distribution], and then we have obviously got the final determination from the NIE [Northern Ireland Electricity], and I think that overall what we are signalling here is that we are looking at the cost of debt side. But again, just to repeat, we are not saying that we are *doing* anything, we're saying we are looking at this hard.

## **Keith Mason**

Yes. And in terms of Methodology, I don't think at this stage we are going to reopen the methodology and the way we looked at it. But, as Sonia said, the RBR [risk-based review] was at the back end of January, we are now in August, and it'll be

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December by the time we come around to the FDs [final determinations]. That's eleven months. So it would be only right that we look at the evidence of things that have moved since that date and the precedents that have been set since that date.

### **Cathryn Ross**

Thanks Keith. Any more questions from the floor? Lakis, you've had one already so I'm just trying to get a couple in and then I'll come back to you. The gentleman in the fourth row and then we will come down to Lakis.

### **Andrew Moulder, CreditSights**

I just want to be clear how efficiency and your duty plays in to your duty of financeability. We have heard just in one of the earlier question that if the companies are not in the upper quartile there will be penalties, so if they don't reach upper quartile performance, does that mean that their financeability ratios may be at risk and that we could see rating downgrades?

### **Cathryn Ross**

Okay. It is a really good question, I'll ask Keith to come in on that in a second. Really important to understand what that financeability duty means, because it doesn't apply, as it were, at a specific individual company level. What the financeability duty means for us is that we have got a duty to ensure that an efficient company can access capital markets. So it is not the same as looking at actual companies and basically making sure they are okay on the basis of the decisions that they have actually taken. Keith, do you want to come in on this?

### **Keith Mason**

Yes. That is an important distinction: the statutory duty we have is about the financing of functions of efficient companies. And I think even in the way we resolve and reconcile incentives at the end, we look at financeability before those incentives come in and out, whether plus or minus. Because if you start to look at financeability and start to make adjustments after incentives, then the value of those incentives just completely disappears. So if companies don't perform and they don't meet upper quartile and that means penalties, those will be assessed irrespective of where they are in terms of financeability test because that's what an incentive regulatory framework is all about.

### **Cathryn Ross**

Does that answer your question?

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## **Andrew Moulder, CreditSights**

Well partly, but some of the ratios that you presented for the companies on the credit metrics looked fairly weak, and I can just see that if there are penalties imposed on those companies, again from a credit perspective, you could easily see downgrades across the sector if they don't reach top quartile performance. I mean, are you not worried about that at all?

## **Cathryn Ross**

Sonia mentioned in her presentation that there are some companies where some of those ratios have caused us to go back and asked the companies to give us further assurance. But Sonia, do you want to come in on that?

## **Sonia Brown**

I think this is really important, isn't it? It's about trust and confidence, and we can't be in a situation where a company's actual financial structure means that they are not delivering for their customers. I think that's really important and goes back to what Jonson was saying at the start around what the deal was when these sectors were privatized.

So I think that we are being really clear that for us efficient means upper quartile. We are being really clear that there's a service challenge as well as the cost challenge. And I think that what has always amazed me in regulated sectors is that, when you set those challenges out to companies, they can actually find really good ways of responding to them. So I would expect to see quite a lot of dynamic change over the next five years, as management teams really grab hold of this challenge because they don't want to be in that position of facing any form of downgrade. They want to make sure that they can be the best.

## **Cathryn Ross**

Jonson, I don't know if you want to come in on this as well, because it does link in to a point that you were raising at the beginning about focusing on operational performance and really exposing companies to the risk and the reward around that.

## **Jonson Cox**

Yes, I think it's very clear. We fund companies to operate at an efficient level, which we deem to be an upper quartile level. Those that achieve that will find that their ability to finance themselves is entirely in accordance with their plans. If you can't reach that level, well clearly there is a price to pay for not being able to reach it. But

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that is the expectation and it's the whole basis that's underpinned privatization: that efficient management would bring their skill to delivering for customers in these sectors. So that's what it's about.

While I've got the floor, I'll just come back on the point that was raised about ELM – I think Dominic or James raised it – because I had the privilege of settling that dispute which had arisen just before I arrived. What I want to add to what Cathryn said is that part of the settlement of that was a commitment by companies, an undertaking to engage in constructive discussion about regulatory reform going forward. And while I realize even the few words Cathryn has said on it has sent a sort of frisson of tension and apprehension, I want to reiterate that all Cathryn is saying is what was given in that undertaking, which is that as policy by government or by others required change in this sector we would engage constructively – we being industry and regulator – in taking it forward. That is really all that is being said here.

### **Cathryn Ross**

I am going to get to Lakis, because I just want to take another couple of questions just to line them up, because I'm conscious of time. There's a chap on the front row, we'll go to Lakis first. And one more? No?

### **Lakis Athanasiou, Agency Partners LLP**

On the prospect of possible changes in the cost of capital for the final determination, would notional gearing changes be on the agenda as well? Also, just to confirm, your financeability test are purely on the notional company? And one other thing on going forward in the future, you haven't really mentioned anything about commitment to maintaining RPI indexation of the RAV; could you comment on that as well?

### **Cathryn Ross**

Okay so there's a number of points on that. On your point about does financeability apply on the notional capital structure? Yes it does and I am happy to confirm that. Sonia, I will ask you to pick up the point about RPI; and Keith, maybe you could pick up Lakis' point about whether the notional gearing comes up as we refine our view on the cost of capital for the final determination.

Keith, do you want to go first?

### **Keith Mason**

We were looking at it again in the round, so that was part and parcel of where we got to as to what a notional capital structure was about. It may be difficult, just looking at

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the cost of debt change, to make a very big change, certainly. We will look in the round. I expect not, but don't want to be held to that by the time we come to December.

### **Sonia Brown**

I think that it's a really legitimate question that we as a regulator will have to ask at the end of PR14 moving towards PR19. I don't have any preconceived ideas about whether now is the right time to move away from RPI [to another index]. But I think it is a really important question to ask. We have seen other regulators consider this, we have seen some of them actually make the transition, and I think it will be part of the conversation for what we might be thinking of for PR19.

### **Cathryn Ross**

It does link in to the whole question around trust and confidence, to be honest. I think if you start to look at the sector through a lens of what is required in order to maintain and build trust and confidence, then we've got to look again at the RPI question.

### **James Brand, Deutsche Bank**

It's just a question on ODIs and this upper quartile issue. Is it the upper quartile as of today or as of last year or whenever you did your benchmarking – and therefore you expect all the companies to do better and get to that point – or is it a moving target? I presume it's the former rather than the latter.

Tied in to that, you mentioned the link between the ODIs and totex. I presume that most companies have budgeted in their totex plan to get themselves to that point. Just to confirm whether that's been funded within their plans?

### **Sonia Brown**

So the first thing, this is obviously in some sense generous to the companies, but the answer is it will be static. So that means that it's a benchmark set in 2013-14, looking at that to set the upper quartile level. That makes me think that there's lots of scope for people to dynamically outperform that.

And then on the calibration of the totex to ODIs and business plans, we have been signalling this from the final methodology, signalled it again when we did the risk and reward guidance, signalled it again in the RBR feedback. So I think my answer to that question is that for good companies I would expect so, yes.

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## Cathryn Ross

Thank you very much everybody who has asked a question. Thanks also to those who have listened intently to the answers. Just one or two closing remarks from me; thank you very much for your time today and I know that many of you have come here today primarily to hear about our PR14 draft determinations and I am really glad that you have, because they are an extremely important milestone for us, for companies, for investors and for customers going forward. But I hope that you have also taken away from what we have said today is an understanding that PR14 with the new methodology, the new processes and really fundamentally a new approach from Ofwat, signals a wider resetting of regulations in the sector and that it sits very firmly within the context of our new strategy. As an exemplar of its key themes. And also as a foundation which we very much intend to build across our tool kit over the coming years and yes if you have taken away the impression that we are already beginning to think about PR19, you are not wrong.

Thank you very much indeed.

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