# Meeting note

Thursday 16 February 2017
Crown Plaza hotel
Centre Square Holiday Street
Birmingham
B1 1HH

## Risk and Return Workshop

| Attendees[1] | |
|---|---|
| Tim Charlesworth | Affinity Water |
| Sharon Hammond | Affinity Water |
| Gagan Gulati | Anglian Water |
| Richard Allen | Anglian Water |
| Keith Hutton | Bristol Water |
| Aubrey Slade | Bristol Water |
| Karen Perrett | Bristol Water |
| Crawford Winton | Northumbrian Water |
| Neil Rutherford | Northumbrian Water |
| Helen Orton | Portsmouth Water |
| Steve Morley | Portsmouth Water |
| Jim McLaughlin | Severn Trent Water |
| Tony Balance | Severn Trent Water |
| Mark Dovey | Severn Trent Water |
| Oliver Martin | South East Water |
| James Grant | South East Water |

[1] Note some attendees were present for only part of the day

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| Trevor Ankers | South East Water |
| Phillip Saynor | South Staffordshire Water |
| Alan Wells | South Staffordshire Water |
| Judith Corbyn | South West Water |
| Craig Lonie | Southern Water |
| Martin Roughead | Southern Water |
| Joanna Campbell | Sutton & East Surrey Water |
| John Chadwick | Sutton & East Surrey Water |
| Colm Gibson | Thames Water Water Utilities Ltd |
| Andrew Cottrell | Thames Water Water Utilities Ltd |
| Mark Andersen | Thames Water Water Utilities Ltd |
| Frank Grimshaw | United Utilities |
| Rachael Wray | United Utilities |
| John Hardy | United Utilities |
| Phil Wickens | Wessex Water |
| Yme Potjewijd | Wessex Water |
| Simon Westbrook | Yorkshire Water |
| Adrian Walker | Yorkshire Water |
| Mike Davis | Welsh Water |
| Eleri Rees | Welsh Water |
| Deryck Hall | CC water |
| Amelia Daair | Ofwat |
| Andrew Chesworth | Ofwat |
| John Leedale | Ofwat |
| Elinor Matheson | Ofwat |
| Martin Andrew | Ofwat |
| Gordon Hutcheson | Ofwat |
| Rob Thorp | Ofwat |
| Dave Roberts | Ofwat |
| Keith Mason | Ofwat |
| Anthony Stobart | Deloitte |
| Mark Lowrey | Deloitte |

# Meeting purpose

This work shop was to discuss some of the key Risk and Return elements of the PR19 programme to inform thinking for our methodology consultation in summer 2017.

Areas discussed during the workshop will be considered by Ofwat as the draft methodology is developed.

During this meeting, the following topics were discussed:

- Programme update – Risk & return issues:
  - Balance of incentives
  - Risk
  - Uncertainty
  - RORE scenarios
- Financeability
- Tax

Material was presented on each of these topics and the slides related to this event have been published on the Ofwat website.

# Session 1 – Balance of incentives

Ofwat presented some initial work from PwC considering the overall balance of incentives and invited discussion around a number of key points. Feedback from workshop attendees is summarised below:

## Overall balance

- Some attendees pointed out that the first question to ask should be what an incentive is trying to achieve. Its objective is to change behaviours in companies. This does not necessarily mean setting financial incentives. The SIM, a which was both financial and a reputational incentive, has changed companies' behaviour.
- Questions were raised about the optimal number of incentives. Some currently thought that there are too many incentives; incentives should focus on what matters to customers. Incentives need to be appropriately targeted and easy to understand.
- Incentives should be kept simple so that they are easy to measure and compare across companies. Indeed, some of the current comparative incentives are not fully comparable across the board.
- Financial incentives are important to investors but reputational incentives can also be important in driving management behaviour. Companies did not challenge the current balance of financial and reputational incentives. There was a question about whether or not the magnitude of incentives should be identical for the upstream controls as there is potential for a different cost of capital. However, there is a need to make sure that on average the industry can earn an appropriate cost of capital.
- One attendee commented that WRFIM had limited value and wondered if it was required.

## Strength of ODIs

- There were mixed views around increasing symmetry of ODIs. With some highlighting that customer support may not exist for this and others pointing out that to encourage innovation, incentives need strong upside incentives, as it is the case in energy, which resulted in improvements for customers.
- Customer legitimacy and engagement was also discussed as attendees were keen to know when they will know enough to engage with customers to set incentives.

- Many companies expect to complete all fundamental blocks of engagement by December 2017. Therefore, it would be appreciated if Ofwat can publish as much information as possible in the July document.
- There was a discussion around the fact that customers might not understand outperformance and how they benefit from it.
- How to present rewards and penalties was discussed with attendees noting that ODIs are shown as one lump in Ofwat's chart. It could be possible to ring-fence rewards in certain areas if relevant. The comparative size of ODI is also important.
- Attendees also raised the point that the most critical part to get right on the balance of incentives is the balance between totex and ODIs. Also, pushing frontier on all ODIs might not drive the best outcomes and inflict unwanted indirect consequences. It was noted that an ODI glide path would have impacted the 2015/16 performances and this was also relevant for retail.
- Some companies felt that their customers were happy with the current relative size of ODIs, bills and customer service and were keen to understand how to sell benefits of pushing further in this area.
- It was also raised that the impact of financial incentives on customers need to be considered. Moreover, targets need to be set with the buy-in from customers to make sure that customers understand the benefits that they derive from outperformance.

## Totex

- The first point that was raised by attendees is that the robustness of the econometric model is important when considering the strength of the totex incentives. It could be envisaged that companies justify variations in their totex sharing rates based on the ambition of their business plan.
- It was also pointed out that asymmetric totex rewards and penalties could be an issue when companies are making investment decisions which have an impact over more than one price control, especially for water resources and network plus.

## SIM

- Attendees agreed that a customer satisfaction measure is important but also recognised that there are some issues with the SIM. It needs to be improved and recalibrated.
- Attendees considered the reputational power of the SIM to be more powerful than financial incentives.

## Ambition

- In order to create opportunities to demonstrate ambition, some attendees suggested that not all companies have the same set of incentives. There could be an innovative premium which could, for example, be based on a menu for what business want. This would be an extra return on equity for innovative solutions. This would reflect the fact that if companies put more money at risk, they should rewarded by extra returns. How much extra return is allowed would have to be discussed.
- There was a discussion around customer legitimacy on ambition, inclulding the justification of financial rewards for ambition or the extra financial penalties for the lack of ambition. Questions arose such as how customer views should be taken into account, whether it was fair for customers from one region to pay for their company to be ambitious and shift the frontier, and then having customer in other regions benefit from this shift in frontier without sharing the costs. Some felt that, before looking at frontier shift, it should be clearly established that customers are unhappy with the current level of service and that they are willing to pay for their company to be ambitious.
- Attendees also discussed how ambition and frontier shift would be defined. Some were also keen to understand how the WACC, CoE and financial incentives would be set up to strike a fair and effective balance. It was highlighted that if the incentives are not carefully set up, it could introduce short-term distortions which could not be aligned to long-term customers' interests.
- Finally, some raised that in the current business planning, there are no clear incentives for companies to shift the frontier. Incentives for ambition could help deliver this. But there needs to be clarity between what constitutes a good business plan and what constitutes an ambitious business plan.

## Ex-post assessment of ambition

- Ambition has to be clearly and sensibly defined so that objectives to measure it can also be clearly set up. If companies do not manage to deliver their ambition, would there be a true-up mechanism or would this be captured through the ODIs? Attendees agreed that there is a risk to penalise companies twice. Therefore, incentives must be clearly designed and an ex-ante assessment was agreed to be preferable

## RoRE scenario testing

- Attendees welcomed the discussion on RoRE scenario testing but pointed out that the approach should be proportionate or the exercise could become more distracting than informing. Some warned that the scenarios should only look at the RoRE and not the cash-flows. Otherwise, this could quickly become too complex to actually be useful. The scenarios need to account for growth (ie changes in population and volume of industry). There was also questions about whether or not financial outperformance and actual financial structures would be accounted for. Scenarios need to be clearly set so that message are clear and do not confuse stakeholders such as investors.

- An alternative approach, raised, would be to include risk assessment in the scenario testing. This could link to the long-term viability statement. Companies could identify key risk areas and set out reasons why they chose them. This would be more useful than the P10/P90 approach taken at PR14. This approach would be more relevant to the circumstances of each company but would make it less comparable. However, it was noted that the P10/P90 assessments prepared by companies at PR14 were not prepared consistently.
- Many agreed there needs to be clarity on guidance from Ofwat and the earlier the better. There should be guidance on RoRE ranges, either by the P10/P90 figures or another method. However, the RoRE is insufficient to assess companies' resilience and they should give statements on how they assessed their financial resilience. Attendees also asked how will the customer engagement currently carried out by companies impact Ofwat's December 2017 RoRE ranges.
- Low probability/high impact event, such as cyber-attack, could also be tested. However, these scenarios could also be mitigated using other risk mechanisms.

# Session 2 – Financeability – PAYG/RCV run off

Ofwat presented material outlining some thoughts around the approach to financeability and some of the key issues. There was then a discussion covering the following points:

## How to set PAYG

- Some attendees were looking for clarity to know clearly what checks Ofwat intend to run, what it wants to achieve and how important it is. There was a general agreement that PAYG should be driven by accounting but some attendees were wondering why IRE should be reflected in PAYG rates.
- It was generally agreed upon to consider the natural rate and, then, the adjustments. The sum of PAYG and RCV run-off rates should be compared to opex and capital maintenance. More focus could then be directed towards outliers compared to the rest of the industry.
- Some raised that if there are material changes in the business plan, the PAYG rates need to reflect it. For example, it there's a reduction in opex, financeability may be challenged. Ofwat might not allow what companies submitted in their business plan.
- From 2020, there will be no more additions to the RCV in the upstream markets. What does this mean for the PAYG rates?
- To set the PAYG rates, companies could look at past natural rates and compare them with past performances. Companies need to explain the rates chosen to Ofwat and their customers. It was suggested that Ofwat could calculate and publish the natural rates in advance. Then, companies would only need to explain their rate if it differ from the natural rates published by Ofwat.

## How to set run off

Attendees raised:

- To set the run-off rates, the assessment should begin with overall bills and affordability and, then, look at overall fast money against natural position and impact on RCV. Companies need to look at the long-term impact on bills and RCV.
- It may not always be possible to link RCV to tangible fixed assets if part of the opex goes in the RCV. But customers today should pay for costs today. Therefore, the RCV should be run-off over a fair period.
- Some attendees would prefer a more fixed approach similar to the one used by Ofgem but they accept that this did not happen at PR14. Others also asked how best to reconcile intergenerational fairness and financeability. They believed run-

off rates will need a different approach for upstream and bioresources depending on how the RCV is treated.

## Same run-off rates for RPI-linked RCV and CPI(H)-linked RCV

- There was a discussion about whether run-off rates should be different for the RPI-linked RCV and the CPI(H)-linked RCV. Attendees generally agreed that the natural rates will differ for the different controls and RPI/CPI(H) RCV. The natural rates could differ due to differences in profile of the investment. Therefore, it makes sense to have different run-off rates but companies should carefully explain the reasons for the differences in run-off rates.
- It was raised that not accounting for these differences might result in bill increases. Attendees also discussed a lot about how levers could be used to smooth bills and improve financeability in the short and long term. The horizon over which this metrics should be monitored was also discussed. Some also questioned whether it should it be over the next AMP or spread over several AMPs?

## How to assess use of levers

- Attendees agreed that the starting point should be the natural rates (opex + IRE) and the objective should be to achieve low and smooth bills while ensuring financeability. Adjustments to the PAYG and run-off rates should only be made if cash is insufficient to underpin the level of service. Companies should clearly explain the reasons for adjusting the levers. Where there is a conflict between economics and accounting, it is the economics and intergenerational transfers that should trump the accounting.

## Other issues

Other issues raised by attendees were that:

- The WACC needs to be correct at the control level as financeability is key at the appointee level against companies’ duties and there is no debt covenant ratio requirements at the control level. This view would change if a legal separation was required.
- The rationale behind post-financeability adjustments may need to be reconsidered as it has changed since PR09 (adjustments using financial levers are NPV neutral).
- Companies discussed the difficulty their Board had to provide assurance on a notional basis as it is an arbitrary construct. Guidance, such as target for ratios,

would be welcome. Ofwat doubted this is the way to go as it could get in the way of companies talking to their customers about level of bills.

It was also recognised that, although the PAYG and run-off rates can be used to impact financeability, these financial levers have their limits.

A view was expressed that customers could reasonably expect flat bills unless there is a good reason to increase them. But it was also recognised that it is difficult to engage customers on financeability.

The change to adjusted Interest Cover Ratio (ICR) proposed by Moody's where index-linked liabilities mismatch with RCV was also discussed.

## Session 3 – Tax

Deloitte attended the session and presented some work they have been carrying out for Ofwat.

Feedback from attendees was:

- Only one attendee agreed the simplified approach to capital allowances at PR14 had been beneficial.
- Attendees asked how far should companies go back when restating capital allowances and if all customers actually benefit when companies disclaimed capital allowances.
- An alternative approach to tax would be to calculate tax on a wholesale basis and then apportion to individual controls based on a measure such as profitability. However, it would be difficult to allocate historic capital allowance pools between controls. Whichever methods is selected, it needs to strike an appropriate balance between simplicity and accuracy.
- Some attendees also asked Ofwat to give appropriate guidance on the way in which pools should be allocated to ensure that companies make the allocation in a consistent way. Guidance should also be given on how to allocate other items between the controls. Attendees also asked Ofwat if it was considering making other changes to reflect other movements in the balance of tax burden such as lower Council tax but higher business rates.
- It was recognised that there should be a standard approach to split brought forward pools between controls whether it is based on RCV allocation or bottom-up. Whichever method is chosen, it needs to be simple and avoid cross-subsidy. There are aslo items such as impact of pensions, interest and fair-value adjustments which need to be allocated. Materiality should be kept in mind to avoid unnecessary regulatory burden.
- There also needs to be reasonable support for making changes to rates. There needs to be a discussion about how changes to other tax legislation and accounting standards are dealt with.
- Finally, there should be a pragmatic rule about the proposal regarding defferals prior to computation. It was also noted that true-ups should be transparent, simple to apply and symmetrical.

## BEPS

- Companies are still considering the impact of the legislation but there is a potential risk to the financing companies (FINCO). The option to assume companies could benefit from the available exemptions (PBIE) was favoured by the attendees as it is a simple and a good starting point. Companies could then put forward evidence if they think their position is going to be significantly different. Companies that do not pay tax asked if they could opt out of undertaking detailed calculations.