Transcript of the Ofwat city briefing, 12 July 2017

Jonson Cox:

Good afternoon everyone. I think we'll make a start if we may. It's good to see you all. Many of you were here many times before for Ofwat conferences. I think the room's been upgraded since we were last here. It looks more like business class seats and a bigger screen, so I hope you're comfortable.

Today for the first time we're also live streaming this event, so can I just welcome those who are listening in on the live stream? I'd also like to welcome in addition to many investors, several members of our Ofwat Board who are here and I welcome their attendance too.

I'd like to just get some housekeeping out of the way if I may. No planned fire alarms. If an alarm sounds, we will evacuate. Three clearly marked fire exits either side of the front and one at the rear where Stewart is standing at the back left.

Now we've published our consultation as you know on methodology for the 2019 Price Review. It sets out what we expect from company business plans and how we plan to assess them and how we will intervene if necessary. In just a moment, Cathryn Ross, our CEO, will reflect on the journey we've taken to get here and how PR19 will look and feel. Then Cathryn will hand over to David Black, our Senior Director of Water 2020, who will take us through the key points of our consultation.

We know that Q&A is very important to many of you here and we will get to questions of me, Cathryn, David and also our Senior Director of Finance and Governance, Aileen Armstrong on the panel and John Russell, our Senior Director of Strategy and Planning. We will collectively field questions and we'll get there for 3:45.

If you're listening on the live stream, there's a question box on your screen where you can submit any short questions.

We plan to finish no later than 4:30.

The methodology consultation document which we published yesterday builds on the proposals known as Water 2020 which we set out in May 2016, just over a year ago. PR19 will also build on the successes of the Price Review in 2014, PR14, using the same framework of company ownership, customer engagement and greater use of markets. Companies will really need to show ambition and innovation to deliver more of what matters for customers.

Many companies have largely embraced the proposals we put forward in May. Positive engagement, and collaborative working have resulted in much smoother navigating of the license changes needed for this periodic review. We've achieved those without any appeal and those of you with longer memories will say, looking back five years, who would have believed we'd be at this stage in this Price Review.

We're signalling our methodology at least six months ahead of where we were at this point in PR14 and in addition I think we're doing so in considerably more detail, and we set out clearly and early our vision for the really big issues. Indexation, both inflation indexation and debt indexation, and RCV allocation. We're in a good place, I believe.

We're shaping PR19 around four themes. These all hang together: great customer service, resilience, innovation, and affordable bills for all. These reflect what customers want, we believe, and they reflect the UK and the Welsh governments' priorities and objectives. And at the very least, upper quartile levels of efficiency on a forward looking basis is embedded in these themes. Cathryn and David will go into more detail on these and you'll see these aren't random themes. They hang together and are deeply connected.

Now, those of you who went through PR14 with us, you know that went a long way to balancing matters back in favour of customers and aligning the interests of customers, companies and investors. But in our view too little has changed. When I first joined Ofwat as Chairman just over four years ago, companies and their investors had benefited from three years of high inflation, a low cost of debt and generous dividend payments. At the same time customers were being squeezed.

Now I should think the macro-economic environment right now is again just as challenging for customers as it was then. So pretty clearly affordability is going to remain high on the agenda for the foreseeable future. We're also challenging companies not only about affordability in general but also about how they support customers in vulnerable circumstances.

The conditions for financing since the PR14 Review have become ever more benign which gives us, I believe, significant headroom. Markets show the scope for the cost of capital to be set at a materially lower level. Add to that our expectation of a step change in efficiency, better use of markets and innovation. It all adds up to the headroom for a material reduction in prices to customers together with other customer priorities there may be around resilience and service.

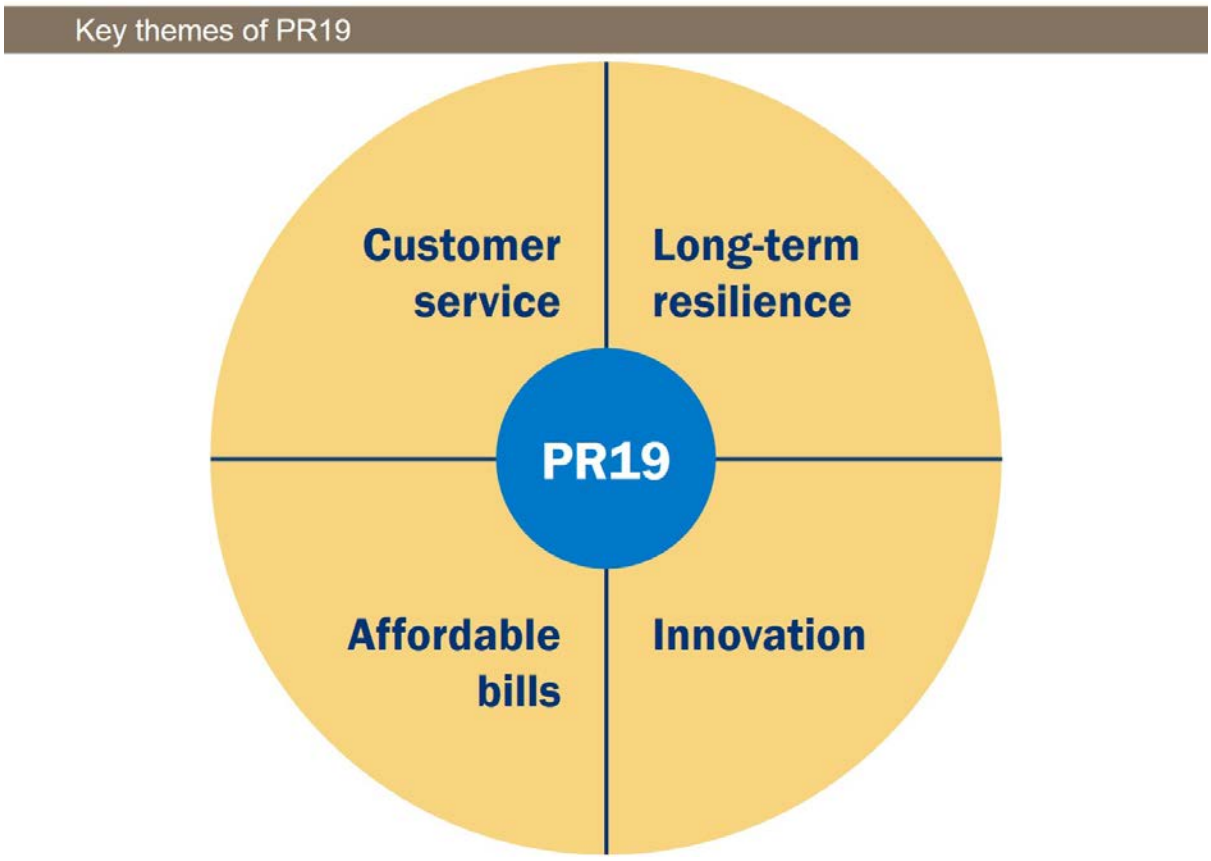
So, it's probably fair to conclude this is going to be quite a demanding review. Those companies at the bottom of the efficiency league in terms of whether it's operations, totex, asset health, or managing a balance sheet might find themselves struggling. Even well-performing companies will not be able to rest on their successes in the current price review period. They will need to go further because we're raising the bar.

You may remember 'enhanced' was the top category at the last Price Review. What was enhanced then I think will be the new normal in procedural and process terms in this review. Our new top category, exceptional, will be for the very, very best frontier shifting propositions only. It's about the quality of proposition that really moves the frontier forward. We'll drive innovation in the sector through payment by results. Those companies whose performance really stretches the frontier on efficiency and service will be rewarded.

So, that’s enough from me. I’m going to hand over to Cathryn. Thank you.

Cathryn Ross:

Thank you very much Jonson. I just want to add my own welcome to everybody here today. Thank you for joining us here at the Stock Exchange and thanks also to everybody that I know is listening in via the website; through the live stream.



I just want to build on, really, what Jonson has said, by spelling out a little bit more about the context for our 2019 price review. In particular, spelling out how that context tracks into our priorities for the review. I'm also going to put a little bit of flesh on the bones of some of those things that you've already heard. I will also talk a little bit about the process. Then I'll conclude and hand over to David, who's going to take you through some of the edited highlights of the methodology itself.

So let me start off by talking a bit about context. I think Jonson's already touched on the fact that we are in turbulent times right now, and I think that turbulence has been a salutary reminder for us, as I suspect it has been for you too, of the value that independent economic regulation brings in providing clarity and predictability to those sectors who benefit from it.

But of course economically-regulated sectors don't operate in a vacuum, and indeed it won't have escaped your notice that privatised utilities, public services provided by private companies, financed by private capital, are front and centre in a heated debate about the sort of economy and society we want in the UK.

And it's important that we reflect a little in this forum on what that's telling us. Not in order that we should engage in knee-jerk politicking, but rather because the long term sustainability of everyone's investment in this sector relies fundamentally on its continued legitimacy, and ultimately on the continued acceptance by society that this model, private companies using private finance to provide public services within a regulated framework, serves us all well.

Now water has been less front and centre than energy in the recent debate. And that's understandable. Water bills just aren't as high as energy bills, and water doesn't suffer from some of the issues inherent in that market, such as wholesale price volatility. I think we can all tell what is a genuinely impressive story about what the water and wastewater sectors have delivered in terms of improvements in drinking water quality, service, and environmental quality since privatisation.

But of course that is no reason that we ought to be complacent. And it's very much with an eye to this that we set out those four themes for our next price review.

The first theme is great customer service. Now there's no denying how much companies have achieved since privatisation on customer service. And you'll be familiar with the statistics in the same way that I am. People these days are eight times less likely to suffer from sewer flooding, five times less likely to experience supply interruption, 100 times less likely to experience low pressure. We have more Blue Flag beaches… you can trot out the stats in the same way that I can.

And similarly, for all its imperfections, we've seen companies responding really well to the service incentive mechanism that we've had in place in recent years, in particular by improving their handling of complaints and through first time resolution.

But customer service is an area where customer expectations quite rightly are rising rapidly, and where tolerance of perceived failures is also, quite rightly, a lot lower than it used to be. And the work we did looking at the cost and benefits of introducing retail competition to the residential sector really opened our eyes as to what a gap there is between the customer experience in water, and the best in other sectors.

So when we talk about great customer service in this price review, we don't just mean doing the things that water companies do and doing them a little bit better, though of course we do mean that. We mean thinking more holistically, thinking from the customer perspective, and not just thinking about those customers as water bill payers, but thinking about them as real people. People with busy lives, competing demands on their cash, with multiple affiliations to different communities. And by thinking about how what water and wastewater companies do touches those people. And how in everything they do that touches those people, they can make people's lives a little better or a little easier.

And of course, we also recognise that there are some customers, those in circumstances that make them vulnerable, who need extra help, and we're placing more emphasis than we have ever done in our assessment of plans in the coming price review, on company strategies for identifying and supporting these customers.

I should also say here that building on the step change that companies delivered on customer engagement in PR14, in PR19 we're challenging companies to go even further. Now this is in part about improving the quality of the evidence base, about the outcomes that matter to customers, moving beyond those stated preference willingness to pay surveys, and

making better use of all the evidence they have about customer priorities, including from their customer contacts, from social media, and more broadly.

But it's also about moving beyond engagements on outcomes, and into what we've been referring to as customer participation, which involves harnessing the willingness of some customers, and we accept it won't be all of them, to work with companies to co-create a vision of the future that then provides a basis for them to be involved in co-delivering that vision.

Now it won't be appropriate on everything or everywhere. But the closeness of water companies to the communities that they serve really does lend itself to the greater use of this approach, and there are already some developments taking place in the sector on this.

Our second theme is resilience. There are close links here to our first theme, customer service. Customers care deeply about not only the standards of the service they receive today, but about how reliable those services are, and how confident they can be that they will continue to receive them into the future and over the long term. And it's this customer perspective that drives us to think about resilience - as we put it – “in the round.” Challenging companies to identify and effectively manage all the many and various risks there are to the reliable provision of services to customers.

Now resilience in the round obviously includes operational resilience, and that's about making sure that resources and networks are managed to ensure that wholesome drinking water comes out of the tap, that wastewater is taken away, treated and returned safely to the environment. And this crucially includes the resilience of the assets that water companies own and control. And this is something we've taken a keen interest in for many years. First in respect to serviceability and more recently what we call asset health. And it remains something in which we will continue to take a very keen interest, and we've been reminded by some recent incidents, perhaps most notably the Thames water pollution fine, that we need to focus as much on how the assets are operated as we do on the health of those assets. And that's something that's reflected in our outcomes framework.

We've also learned from some recent incidents and from our targeted review of asset health, that we need to take an interest in the information systems and processes that companies are using for asset management planning, too. It's also important to note that operational resilience goes beyond maintaining and operating those assets that companies own and control, and into maintaining ecosystems too. Because we're as much dependent on ecosystems for our supply of clean water and the absorption of wastewater, as we are on more traditional assets.

And customers and communities matter for operational resilience, too. Customers themselves are part of the value chain. Their behaviour has a huge impact on how much water we need to supply, and how much wastewater needs to be collected and treated. We're going back here to the question of customer participation I talked about earlier. And incident response and recovery, which of course relies on excellent communications, are all critical to mitigating the impact of service disruption, which is another key part of operational resilience.

So operational resilience in itself is a broad context, but there's still more to this question of resilience in the round. There are other factors that contribute to the extent to which service providers are able to anticipate, prevent, withstand and recover from things that pose risks to the service that customers depend on.

Service providers need to be financially resilient. We've said consistently that the choice of capital structure and financing more broadly is a matter for companies and for their investors. But we've also consistently said that companies or investors are on risk for this choice. If those choices turn out to be the wrong ones, there is no recourse to customers.

We've also been raising questions for a good few years now on whether this risk has been properly understood, and about whether some companies' capital structures really enable them to manage and withstand risk in the most effective way. And I think that message is slowly beginning to get through, and we've certainly seen some companies making adjustments recently, which we welcome.

And finally on resilience, you would expect to see us emphasising corporate resilience. This is no surprise, it is quite obvious that a company's ability to identify and effectively manage risk is a function of the quality of its information, systems, processes, governance and decision making. And again, it's something we've challenged companies on a lot in recent years, and our company monitoring framework, which we publish every autumn, gives us a really good handle on how companies are doing on this, which is why we've said that we will pay serious attention to where companies are on our framework when we assess the quality of their business plans, and whether they will be seen as exceptional, be fast-tracked, slow-tracked, or alternatively seen as requiring significant scrutiny.

I should say one last thing before I leave this theme of resilience, and it's certainly true that resilience has been a very dominant term in the debate about water and wastewater services over the past few years. We've got a new statutory duty and resilience features really large in the UK government strategic policy statement that they gave to us and was out for consultation a few months ago. And all of this perhaps reflects that lower tolerance of failure that I was speaking about earlier.

But I just want to be really clear that sprinkling the word resilient through a business plan will not result in easy money for companies. We expect any company proposing significant spend on incremental improvements in resilience to be able to make a compelling case for this. And we expect that case to articulate the baseline levels of resilience that customers receive today, and why, if more of their money is needed in future - and I'm open to the fact that it may be - this comes on top of what companies and investors have done in fully discharging their obligations in the past.

All of which brings me neatly to the third theme for our review, which is affordability. If we go back to what the current debate about provision of essential public services is telling us, if one of those things is about rising expectations on customer service, another theme is about lower tolerance for perceived failures, then a third theme is most definitely about the importance of affordability. And it should be no surprise that this is a key theme for the review.

Our affordability and debt focus report back in 2015 highlighted the fact that 24 percent of water customers were spending more than three percent of their household income on their water bills. Since then, inflation figures have hit 2.7 percent, and that contrasts sharply with wage growth of 2.1 percent. And the UK's persistent productivity problem doesn't suggest this position is going to improve any time soon. So affordability is going to continue to be an issue.

Now the good news is that we do see scope for significant improvements in the affordability position for all customers, given the scope that we see for costs to come down in the next review. In part, this is likely to be because of a lower cost of capital. In part it's because of

the advantage that some companies have taken from the outcomes and totex framework, to really change the way they run their businesses, and deliver significant efficiency gains.

Companies will need to engage with their customers on how best to use the headroom created by this efficiency, and there will be differences between different companies. But overall, as I know Jonson said in his City conference speech back in March, we see the potential for improvement in service, greater resilience, and bill reductions.

As well as being concerned with affordability for all, we are also keen to see companies better identifying and supporting customers who are really struggling to pay their bills. In the face of affordability pressures overall, the current £24 of the average bill being made up of bad debt costs is simply unacceptable. But I do know that there is some great work already happening in the sector on this, that's already having an impact on those figures. For example, in particular where companies are doing more face-to-face visits and helping customers to navigate the complexities of the benefit system more effectively.

Bringing together the themes of great customer service, resilience, affordability and bad debt is our final theme of innovation. And this theme brings together all the others because it underpins them all. In order to square the circle of improved customer service, improved resilience and affordability over the long term, companies will need to find new and better ways of doing things.

And we aren't just talking about technological innovation here, although we do see scope for that, and I know some companies are looking at it. We're also talking about innovation in terms of new products and services, new ways of interacting and engaging with customers, taking advantage of the markets we're opening up, and embracing the innovation that comes not only from within the water companies themselves, but through the supply chain as well.

Now we are not creating an innovation fund, we're not creating an innovation prize, and we're not creating specific incentives for innovation as such. Rather, our expectation is that a combination of stretching outcomes and a tough cost efficiency challenge will mean that companies will have to challenge themselves to do things differently.

And of course for the very best plans, the genuinely exceptional one or two plans that display real ambition and innovation, those plans that really shift the frontier for the sector, there are substantial rewards available, including an upfront reward of 20 basis points uplift on the cost of equity, and the potential to benefit through the period from advantageous totex sharing factors, and more powerful ODIs. You'll hear more on this from David later.

Now before I close, I said I'd talk a little bit about process, and I'm going to keep this brief. There are just two things I want to touch on.

The first point I wanted to make is that what you're seeing here today is Ofwat doing what we said we would do. I remember standing up here, talking with you about the PR14 determinations, I think it was the draft determinations, and saying that we were going to be opening up some big questions as we developed our approach to PR19. I remember saying those questions included things like RCV allocation and indexation. But I also remember saying that we would close down those questions as soon as we could, to limit uncertainty. And I remember saying that we’d heard what people had said to us after PR14, that clarity earlier on in the process about our approach would be really helpful.

And so here we are, publishing a detailed methodology for PR19 for consultation a full six months earlier in the period than we did for PR14. And of course, we're doing that after

already having published our policy framework for the review in May last year. And on the basis of a process that's been characterised by transparency and co-creation. So even if you don't love everything in the methodology, and I'm sure you'll tell us about that later, I hope you do appreciate that we've made good on our promises, and in delivering that clarity and predictability that you look to us for.

The second thing I just wanted to touch on briefly is the process from here on in. This is a consultation. It closes on the 30th of August. And by the autumn, we will be very much in close down mode, as we finalise our methodology for publication in mid-December. We know that companies are working on business plans now, and most of them will be signing those off in summer next year. So it's important that we do deliver on that timing. But of course what that means is that it's really important that you say anything that you do want to say to us within that consultation period.

Between the publication of that final methodology statement and the business plans landing on the mat, you're going to see Ofwat really gearing up for the review proper, and indeed we've already started to do that. You can see on the podium here that David is joined by Aileen and John, and that's because the three of them together form our leadership team for the next price review. With David naturally focusing on policy and making sure that we conduct the review in line with our methodology and policy framework, Aileen focusing on engagement through the review, and John overseeing the delivery of the review, making sure that we have the right work planned at the right time, we have the right resources, and are managing our risks and opportunities.

We've also already started market testing for the procurement of our delivery partner for the review. We're getting really good levels of interest, and that's great to see. And in parallel with that we are continuing to recruit in and develop our existing people to ensure we have the right skills and experience in-house.

So in conclusion and before I hand over to David - who is going to take you through some of the highlights of the methodology - I want to say you'll have read through, I think, some of the commentary on our PR19 approach that says this is going to be a tough review, and I want to confirm now that it is going to be a tough review. And especially for the average company. We're going to be looking for more stretching outcomes, our totex efficiency challenge will be tougher, and a lower WACC will make it harder for companies to pull the usual out-performance-rabbit-from-the-financing-cost-hat. And we've set a higher bar on the quality of plans.

But - and this is important - for good companies, for efficient companies that do more to deliver what matters to their customers, and especially for those companies who have real ambition to push the frontier and innovate, there are powerful rewards available. Where companies deliver for customers and society, investors will do well, because our methodology better aligns their interests, just as we said it would.

David.

David Black:

Thank you, Cathryn. I'm now going to talk to you a little about the key elements of our methodology and methodological framework. Our methodology sets out how we'll aim to encourage companies to deliver more of what matters, and also sets out how we plan to

deliver PR19 in a way that's customer focused, long-term, and incentivises companies to innovate and be ambitious.

Firstly, our approach to the initial assessment of business plans, which is all about rewarding companies that deliver plans with more of what matters to their customers. We're very keen that business plans be right the first time. The great business plan should not require the regulator to step in and force companies to be efficient or to set themselves stretching performance commitments.

This challenge process should happen well before the business plan arrives at Ofwat. As part of developing our methodology, we've been considering how we incentivise companies to submit plans which are in customer interest and so do not require intervention by Ofwat.

The initial assessment of business plans is the successor to the PR14 risk-based review. We have renamed the process to better reflect its relationship with the overall price review and to reflect the changes we've made in our approach since 2014.

The initial assessment of business plans is our process for assessing the quality, ambition, and innovation inherent in company's business plans. We'll categorise each company plan as part of this assessment. The category each plan receives will determine whether it proceeds at a fast track, to an early draft determination, as well as the financial and reputational incentives.

We propose to categorise companies into four categories: exceptional, fast track, slow track and significant scrutiny. Exceptional plans are, as Jonson and Cathryn mentioned, the plans which are high quality, ambitious and innovative. These are plans that really shift the frontier

in terms of outcomes, in terms of cost, and in terms of customer engagement and driving wider benefits to the sector.

They're also plans where we consider that no material intervention is required in the customer interest. Companies who make this category will benefit from an up-front financial reward of 20 basis points on the return of regulatory equity, but perhaps more importantly, they'll also benefit from better totex cost sharing rates, which reward efficient business plans and ODI rewards for delivering stretching outcomes.

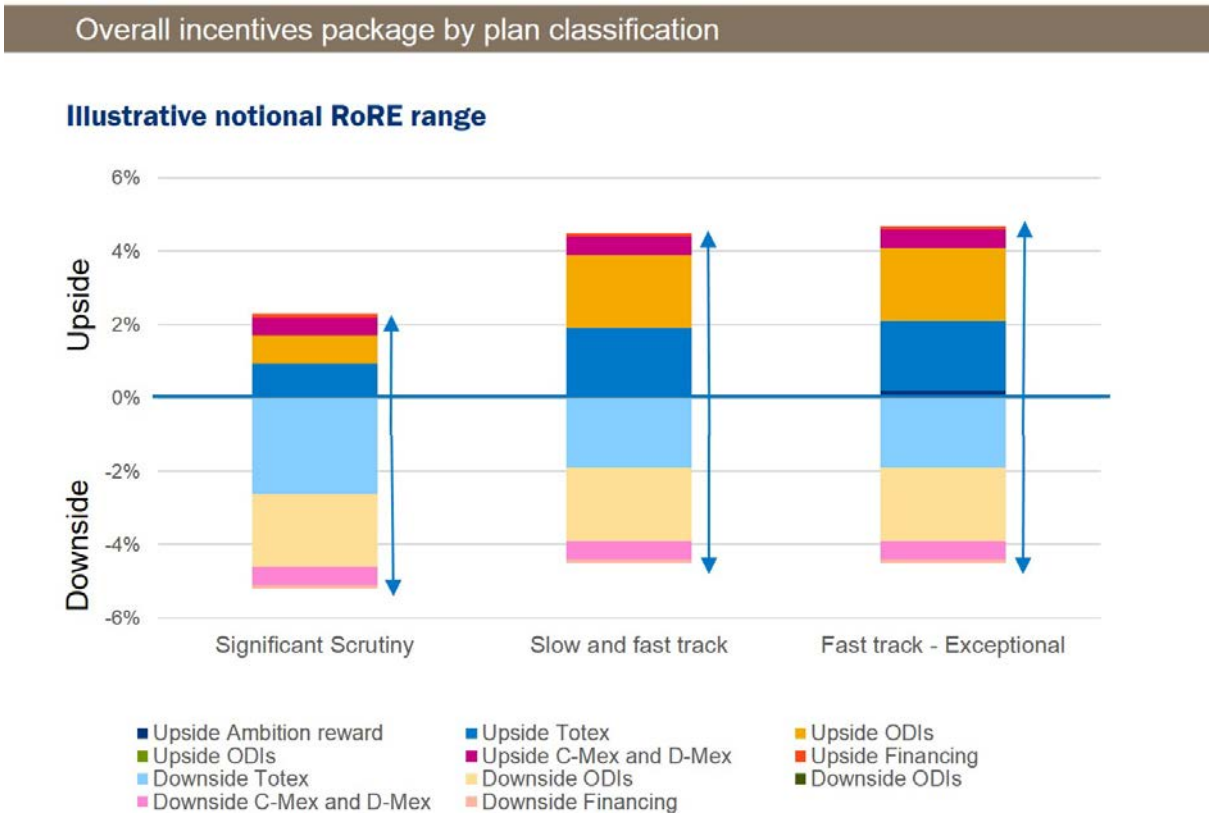
So our financial rewards package links the greatest reward to the delivery of business plans, rather than just submitting a great plan to the regulator, important as that is. Exceptional plans will receive an early draft determination, so they benefit from greater certainty and companies can take early steps to implement their plans. They'll also gain reputational recognition and status.

Fast track plans are high quality plans that don't require material intervention by Ofwat. They're efficient and stretching but do not push the frontier forward for all customers. These plans also benefit from an early draft determination and reputational benefits, but will not receive an upfront financial reward. Although we're confident that given these plans are efficient and stretching, companies could be more confident of achieving cost and outcome outperformance during the review period.

Slow track plans are plans that do require material interventions by Ofwat to protect customers, such as from inefficient costs, or insufficiently stretching performance commitments or over generous incentives. These plans will be revised by companies and resubmitted for a draft determination in July 2019. Companies with slow track plans are likely to find PR19 challenging. They'll be required to deliver on stretching cost and performance commitments, and will in effect start the new regulatory period behind these targets. So they're more likely to be exposed to ODI penalties and penalty cost sharing.

Significant scrutiny plans are plans that fall well short of our expectations and raise serious concerns as to whether the evidence and data provided by companies provide a satisfactory basis for the final determination. Now there's no reason why any company should end up in this category, and the consequences of poor quality plans are serious. It'll be difficult to rely on company information for example to set bespoke performance commitments and to make any special cost factors claims to name two points.

Therefore, to protect customer interest, we'll be setting tough cost sharing rates, to ensure there's little benefit to companies from any out-performance, and that companies will bear most of the risk around under performance. We're also proposing that rewards could be capped on bespoke outcome performance commitments to prevent the company from benefiting from submitting lower quality information. There will also be the reputational impact of being identified as having an inadequate business plan and potentially increased future assurance requirements.



The graph on the screen sets out the balance of returns across fast track, slow track, and significant scrutiny plans. I think the key point to make here is that although from a notional basis, both slow track and fast track plans have a similar level of potential upside and downside, clearly where the plans are starting from has some influence on where they'll finish, so companies that are submitting plans which are inefficient by Ofwat's definitions are going to have a higher bar to cross and therefore, are more likely to end up on the lower half of the graph than the upper half.

The fast track plans benefit from the upfront financial reward, but again – sorry - the exceptional plans are also going to benefit from the upfront reward, but also are going to be more likely to enjoy outperformance given that these plans will be by definition more efficient than the cost-allowance that will be set by Ofwat.

So moving on to customer involvement and decision making. We expect companies to present business plans that are built from the ground up around the needs of their current and future customers and we'll be assessing this evidence in our review of business plans, including the evidence from the customer challenge groups on the quality of company engagement processes. We consulted on and confirmed our decisions in May 2016 on our customer engagement policy statement and expectations for PR19, so companies have had very early notice of our approach here.

Focusing companies on what matters to customers

Customers engagement on outcomes, assurance on engagement provided by CCGs.

14 common performance commitments covering customer service, asset health and resilience.

We expect companies to set **stretching** performance commitments.

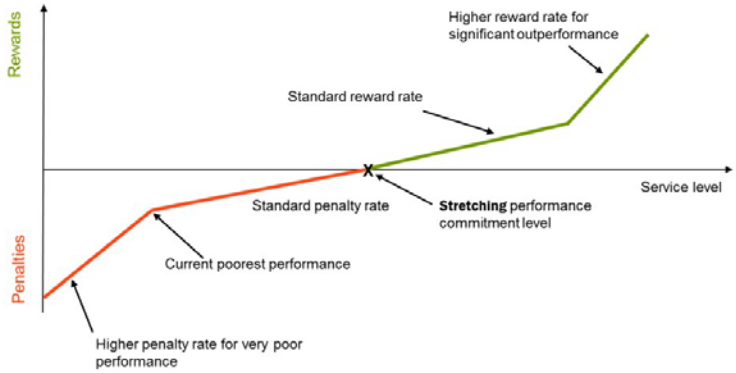
More **in-period ODIs**

More revenue linked to service: Removal of aggregate cap on ODIs and proposing **indicative range of ±1 to 3% of RORE**

New customer experience measures including a cross-sector challenge.

Enhanced rewards and penalties for frontier-shifting performance (see diagram).

Illustration of proposed enhanced reward and penalty curves at PR19



Moving on to outcomes. Our approach to outcomes; so outcomes are the high-level objectives that matter most to customers. Again, we made an early consultation on our approach last year. We're expecting companies to engage extensively with their customers in setting their outcomes with assurance on this engagement process provided by customer challenge groups. We'll be encouraging companies to propose stretching performance commitments, supported by a long-term projection to at least 2035 of their expected performance levels, so that customers can benefit from improved service quality and companies focus on the longer term.

We're proposing to set 14 common performance commitments for all companies. Common performance commitments enable customers and other stakeholders to easily compare company performance, which really strengthens the potential challenge on stretch. We're expecting companies to set stretching performance commitments. For the common performance commitments, we expect these to be based on forward looking upper quartile levels, and we're also expecting the bespoke performance commitments to reflect their customer priorities and have set out a number of potential tests to assess the stretch on these commitments.

To compliment the stretching performance commitments, we are making outcome delivery incentives more powerful to better align interests of company management and investors with those of customers. These include bringing awards and penalties closer in time to the performance generated by companies, by making greater use of in-period ODIs. We're also recognising that frontier-shifting performance has more value to customers, and that companies that succeed in shifting the frontier forward by outperforming at least the

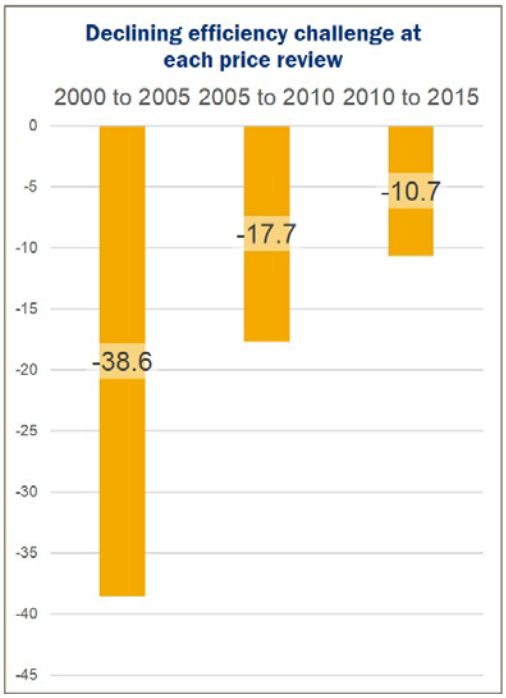
performance level of the current leading company will earn a higher reward than those that just beat their performance commitments.

And this stepped reward curve is set out on the slide.

We're also introducing a new customer experience measure and a developer experience incentive and both of these will stretch companies to deliver better service to a wider range of customers. The customer experience mechanism replaces the SIM and whilst Cathryn notes the SIM has prompted a real improvement in service, the sector still lags behind other sectors in terms of customer service and there's also a significant degree of convergence among water companies in their performance.

The customer incentive will expand coverage beyond customers who currently contact their company to all customers, and it will include a comparison with other sectors and will look at customer satisfaction with the overall service and not just the customer service. The developer service incentive is intended to address potential concerns about the quality of service that companies provide to their developers.

A step change in cost efficiency at PR19



Strong expectation of **step up in efficiency** for PR19, sharing efficiency benefits of totex and outcomes framework with customers.

Challenging efficiency baselines, which will incorporate forward looking dynamic efficiency as well as catch-up efficiency.

A new **cost sharing incentive** to reward efficient business plans and penalise inefficient business plans. No menus.

Symmetrical special factor adjustments to cost baselines.

On **retail controls**, an econometric approach to benchmark companies' costs and set efficient baselines, with no glide path and take account of cross sector comparators.

Moving on to cost efficiency. An important element in company business plans, is that plans are efficient. Customers should not pay extra for inefficient services. As Cathryn mentioned, we're expecting companies to make a step change in their efficiency to PR19, and this will be reflected in their business plans. Efficient costs can help keep bills affordable for customers, both domestic and business customers, for whom water is an important cost. And we note the efficiency gains being achieved in the wider UK economy.

There are many examples of this and one of my favourites is the North Sea oil and gas sector which in response to falling oil prices has halved its unit operating cost since 2015 and improved capital efficiency. In another sector, retail banks have stripped out cost in response to the new economic environment they face. Yet in the water sector, as set out in this graph, the efficiency improvements in recent reviews has fallen away. In PR14 we introduced the new outcomes and totex framework to enable all water companies to innovate and improve efficiency.

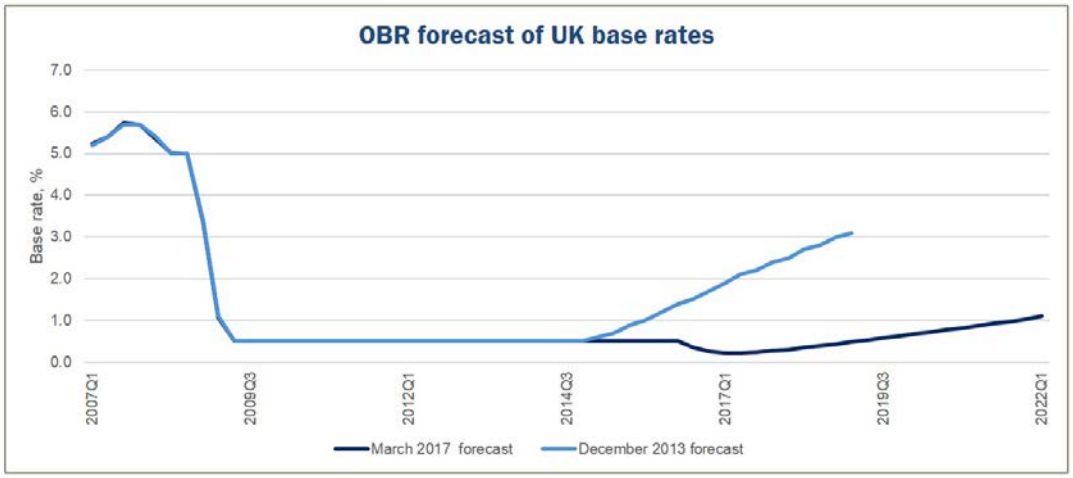
We also see significant opportunities in expanding the scope of markets. Now there's some evidence in the early years of the current period that companies are making efficiency gains. There's also evidence of strong efficiency gains from the energy sector under a totex approach. So it should be no surprise that at PR19 we're expecting to see tangible efficiency gains for customers and that these will be reflected in company business plans.

If companies are unwilling to set business plans with a real efficiency stretch, then we will of course intervene to ensure that customers do not pay for inefficiency. We will set challenging efficiency baselines incorporating both the frontier shift that is the change in the level of dynamic efficiency for the sector, as well the catch up efficiency approach used in PR14. We're also proposing a new cost sharing incentive to encourage companies to submit efficient business plans that really deliver for their customers.

To simplify regulation, we won't be using a menu regulation approach for PR19. Our cost sharing approach means that the more efficient a company business plan is compared to our view of efficient cost allowances, the better the cost sharing rate and conversely less efficient plans will benefit less from outperformance and be forced to take a greater share of cost underperformance.

Our approach to cost baselines. On adjustments to cost baselines we are proposing to make the process more symmetrical to protect customers and allow for downward as well as upward cost adjustments to our cost models. In terms of retail controls, we're moving away from the Average Cost to Serve approach used in PR14 to use an econometric approach to benchmark company efficient cost and to set efficient baselines with no glide path to the efficient frontier. We also propose to use evidence on efficiency in the provision of retail services in other sectors to inform our cost baseline for water companies.

Setting the cost of equity for PR19: lower for longer



Source: Ofwat analysis of Office of Budget Responsibility data

Aligning risk and return to encourage innovation and delivery for customers. Our objective with the incentive framework is to align the interest of companies and their investors with those of customers. Companies need to be remunerated for the risks associated with their investment. We're proposing for PR19 that risks are borne by those best able to manage them, and as with PR14 we'll set a very high bar before accepting any company proposals for a risk transfer mechanism towards customers. We've also set out our approach to setting the cost to capital.

We promised to provide an early view of the cost of capital alongside our final methodology in December. We'll be consulting on our cost to debt. Sorry, we consulted on our approach to setting the cost to debt late last year and along with this consultation we're proposing that the cost of new debt will be indexed to an efficient benchmark with a fixed allowance for embedded debt.

We have also set out our proposals on how the new indexation mechanism will work. And we'll continue to set embedded debt on the basis of market evidence, including the historical averages of corporate benchmark debt, and evidence on sector performance, including sector outperformance against debt benchmarks. We propose to set the cost of equity by reference to market evidence in a way that reflects the economic conditions expected through 2020-2025.

We have published our thinking on setting the cost of equity in PR19 alongside our methodology, including a study from PwC on the balance of incentives and approach to the cost of equity. We're all well aware of the macroeconomic environment and as explained on the graph, the much lower interest rates since 2008. And that these are expected to continue into the future. There are different views on why interest rates are much lower and when and how they might rise, but compelling reasons to expect this environment will remain to 2025.

As we've seen from the slide, the expected upturn in rates that we forecast when we set the PR14 risk and return guidance has not materialised, rather rates have fallen. All of this evidence, raises questions of how to set allowed returns. On the cost of debt, it seems

reasonably straightforward. The move to indexation reduces dependence on forecasting future rates. Embedded debt is based on historical evidence, so there's no problem here either. On the cost of equity, regulators have traditionally drawn on a mix of historical long-run returns and forward-looking market evidence with most weight being placed on long-term historical returns. This approach assumes that long-run returns are the best forecast for expected returns over the next control period. We think this approach is no longer justified. There's clear evidence in the current market environment that expected equity returns are lower. There's also evidence the equity returns are linked to the risk-free rate and that in times of low interest rates equity returns will also be lower.

It seems most likely that an expected equity return for PR19 will be also be much lower. PwC recommended putting more weight on the market evidence, including expected returns, transaction data, and investor surveys. Our assessment of the current evidence points to a much lower total market return, which is used to set the cost of equity. A current nominal total market return of around 8 to 8.5 percent, or around 5.1 to 5.5 percent on a real RPI basis. Which with other things being equal would result in a real cost of equity of around 3.8 to 4.5 percent. This compares with the PR14 cost of equity of 5.65 percent.

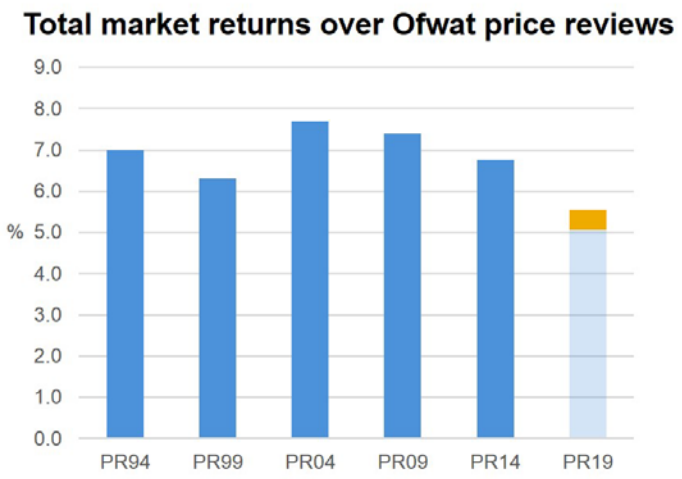
Now note that we haven't yet considered estimates of beta, which is another key component to the cost of equity, so the cost of equity was really provided for comparison purposes. But putting together the evidence on the cost of equity, along with the lower debt cost means that for PR19 the cost of capital may well begin with a 2 in the same RPI real linked terms as we estimated for PR14.

As you know, we've decided to move away from indexing prices and RCV from RPI to CPIH, so in this consultation we propose using CPIH as an index for PR19. That means that prices will be indexed to CPIH and 50 percent of the RCV at April 2020 will be indexed to CPIH with the remainder indexed to RPI for PR19. We'll be publishing our view about the cost of capital in both nominal and RPI- and CPIH-stripped terms for transparency. We will set tax allowances for each of the wholesale controls and we're proposing to introduce a pass through mechanism to allow for significant changes in elements of the tax framework outside company control, such as corporate tax rates and capital allowances.

Financeability, efficient companies should be able to raise finance on reasonable terms. Each company will be required to submit a financeable business plan with board assurance that its plan is financeable on both notional and actual capital structures. We interpret our financing functions duty to apply to the ring-fenced activities of the appointee and so we propose to assess financeability at appointee level by reference to the notional capital structure that underpins the cost of capital. We note that companies have a number of options to address financeability constraints that arise under a notional financing structure and we'll be looking for evidence of customer support where companies take steps to address such constraints. As a reminder, the choice of the actual capital structure and financing is a matter for companies and their shareholders, and companies should not expect customers to bear the cost of addressing any financing constraints resulting from the actual financing structure or an inefficient financing strategy.

Early view of total market premium for PR19

Based on current market and forward looking evidence suggests that the total market return, in nominal terms of 8.0% to 8.5% or 5.1% to 5.5% in real RPI terms.



This is lower than previous reviews but the variation is in line with changes over previous reviews

All right, I can skip this slide. That slide just sets out the total market return and compares it with what Ofwat set over previous price review periods, just in case you were curious to know, so the proposed total market return is clearly lower than in previous reviews, but the change between reviews is very much in line with what's been observed over previous price control periods.

One final point. Moving on to markets. In our May decision document last year, we focused on markets for water resources, bioresources and direct procurement for customers for large new projects. Companies have now accepted the license changes to enable these new resource controls. For bioresources our focus is on appointees efficiently procuring bioresource processing and disposal. We expect appointees to consider opportunities to process beyond their boundary and potentially with other sectors. We will set price controls for PR19 on a building blocks basis, but we'll explore the potential to move to a market-based approach to setting price controls at PR24.

As part of the transition to markets, we've provided protection for the RCV in the bioresource control up to 2020, beyond 2020 investment in bioresources will depend on revenues earned within this control. For PR19 we see little if any increase in risk as we are using the same approach to setting price controls as in previous control periods, although we note the appointee will bear some volume risk. This is not new to the sector, as all price controls were set on a volume basis pre-2010.

For water resources, we're expecting a separate control to facilitate increased trading by appointees and the development of bilateral water resource trading and to provide more transparency around costs. We are continuing to use a regulatory building blocks approach to set revenue allowances for PR19 and consistent with our regulatory framework set out

last year we expect companies to bear risks around any new entry from water resource providers in the bilateral water resource market. We note that the market is not expected to open before 2022 and will be limited to retailers in the business retail market and that our framework incentivises new entry on new resources in areas where they're needed most. So any additional risks for PR19 are modest.

We are also proposing that where appointees are proposing significant new investment in water resources that they propose a risk-sharing mechanism around demand. This is to help better align incentives of investors, companies and customers and ensure that new investment is valued by customers. We also set out more details on our approach to direct procurement for customers in our consultation, setting out our expectations on the model in terms of the DPCs and the balance of risk between appointees and the direct procurement provider.

In summary, in PR19 water companies must deliver more of what matters for their customers through a step change in efficiency, a step down in returns and a step up in service. Our methodology provides opportunities for ambitious and innovative companies that can set new standards for the sector. They can expect to earn higher returns from delivering value to customers as well as procedural and reputational benefits. Companies that don't meet the challenge and step up to the stretching commitments in cost efficiency will face a more challenging environment with a lower base return and more returns dependent on service performance and a sharper cost efficiency challenge.

Thank you and I will pass back to Cathryn for the Q & A.

Q and A with Jonson, Cathryn, David, Aileen and John

Cathryn:

Okay. Thank you very much, David. So, you've heard what we had to say. We've talked quite a bit. You have also had the luxury of having the actual documents since 7 o'clock yesterday morning. So, we've left plenty of time for Q&A. If you want to ask a question, do put your hands up. Please wait for the roving mikes to come to you. We have a couple of those, and they will make their way to you. Then I will ask you to state your name and where you come from please before you ask your question. And, if I'm not recognising you, it's because you can't see but I can, there's a very bright set of lights up here. So, you're a little dim and fuzzy in my view, but don't take it personally.

Right. Who would like to kick us off? So, question at the back. Second row from the back. So, give us your name and where you come from please.

Guy MacKenzie:

Hi, it's Guy MacKenzie from Credit Suisse. Three questions from me, please. Firstly on the cost of equity. David, you mentioned that you hadn't yet looked at the beta for the next review, but PWC did some work on it in the publication that came out yesterday and it was actually pointing to quite a bit higher than what you said at PR14. So, presumably that will feed into your thinking when you present your range in December.

Basically what I'm asking is, you know, should we be thinking about this 3.8 to 4.5 percent indicative cost of equity that they presented yesterday and mentioned today is effectively an absolute floor? It's highly unlikely that we go any lower than that.

A second question just on financeability. You discussed pay-as-you-go, and RCV runoff rates in the consultation and companies' ability to utilise those. There wasn't that much discussion from what I saw on intergenerational equity considerations. I'm just wondering if we should expect Ofwat to be just as generous in company's use of those levers as you were at PR14?

And, then final question just on the in-period ODIs. Obviously the range has expanded and you've removed the caps on ODIs overall. Wondering if you've given consideration to the fact that, you know, certain customers in certain regions might have a lower willingness to pay, if any willingness to pay, for financial rewards and how that might feed into your thinking.

Cathryn:

Yeah. That's really helpful to get us started. I mean, David, I'll come to you in a second. I mean just the point that you're raising about ODIs is I think quite an important one because one of the things that we know was an issue in PR14 was making sure that those, particularly the rewards the companies could receive under the ODIs, have real legitimacy with their customers; and the customers understood why in return for getting materially higher performance from companies that actually, ultimately their bills would go up to pay for that. So, I think you're quite right to raise that, and I think you're also right that to the extent that companies are looking to take advantage of the higher end of the RORE range for ODIs.

Then we would really be placing great weight on the quality of their customer engagement because it's really critical that that is seen to be legitimate.

So, I think you've got a good point on that one. David, do you want to pick up the other point on financeability and cost of equity?

David:

Sure. I guess in summary. “No” and “No” is the answer. So, in terms of on the cost of equity is a 3.8 percent a floor, no. So, when I said PWC have looked at some beta estimates in terms of reaching a view about the cost of equity, that's true. There is some evidence as you note that some of the beta numbers are going up, but what that means for our estimate of beta it is just too early to tell. There's obviously going to be more evidence by the time we get to December and what we're actually doing is that we will do further work and further thinking about how we go about estimating betas for PR19. So, there's no expectation that we'll use the same approach as we used in PR14. So, that's not to say they're going to go down or going to go up. I'm just saying that it's just too early to say. So, I don't think you can infer. So, the 3.8 to 4.5 is the best view that we've got now. That number could go down if we took a lower view about beta. It could go up if we took a higher view.

In terms of the pay as you go rates and the RCV runoff rates, what we have set out in our methodology is much clearer guidance to companies about how they should anchor these rates in terms of their business plans and the kind of evidence we would expect them to set out. So, in fact relative to PR14 where there wasn't so much said about how the companies were to set their rates, nor was it so visible in the business plans about how they set these rates, there will be much greater clarity. We're expecting them to explain where they have departed from what might be understood as the natural rates of pay as you go rate and RCV runoff.

And on the customer support, I think that is an important point. And exactly that, we have set out guidance about the range of one to three percent, but notably in PR14 our guidance was one to two percent but, many companies still had reward levels below our guidance, and that was because they needed to engage with their customers and get customer support for that. So, that process remains for PR19. We're just setting out expectations that there is more scope for reward and penalties on outcome performance commitments.

Cathryn:

Right. Now we had a question down here, and then I'll go in the front. So, Stewart if you can. So, we've got one, two, third row. Ah, Natalie, I think you're closer aren't you? I think we can bring the microphone down on this side towards the front. That'll be ready for the next question.

Dominic Nash:

Hi. It's Dominic Nash, Macquarie. It's sort of one theme question with two parts to it. So, first is obviously cost of capital. You're adopting, it looks like you're going to be adopting a CAPM model again for your regulatory review. So, on that would you or are you not thinking that the cost of capital philosophy may well have changed over the last few years into a sort of a

private equity cost of capital model or indeed if you want to do international money, a DDM-based approach like they do in the US.

Then secondly, one of the fundamental issues about the CAPM is that it is diversifiable risk and it seems to me that what we're increasingly going to be seeing in this sector is an undiversifiable risk appearing over the horizon. Which is a potential for nationalisation from the next election. Which may mean to sort of quote David there, that financing your functions on a reasonable basis might get significantly more tricky if the probability of a Labour administration increases. Is there a scope for a non-diversifiable cost of capital premium to start coming in to take into account the failure of the CAPM model?

Cathryn:

Yeah. I'm going to ask David to come in, in a second. Jonson, you might want to say something about the nationalisation point, but I mean you know as well as I do there are a thousand different ways of approaching cost of capital calculations and regulators can spend years gazing at their own navel and not actually shed a great deal more light on this stuff. So, I mean although we are using a particular model, I would place greater weight on the judgment call than the arithmetic in the model itself. But, David.

David:

So, I mean part of the PwC work was to look at the various approaches to cost of capital. I mean they did favour the CAPM model which is being used widely by regulators. I think, you know, certainly some of the work they've done has put more weight on the dividend growth model; and so, that's one of the pieces of evidence we're going to look at in this price review. So, you know, you can argue about the case for a premium from an undiversifiable risk, but we have quite a robust approach in terms of setting the WACC which we've used in previous reviews. We're updating that. We're refreshing that for elements where there have been material changes in particular from the current economic environment and that points to a much lower WACC rather than higher.

Cathryn:

Jonson, did you want to come in on the non-diversifiable risk associated with nationalisation?

Jonson:

Yes. I'm not going to say anything about nationalisation because it's not currently on the agenda. But, what I will say something about is to remind you of what Cathryn said early on. That the social and parliamentary expectation of what should be delivered by those who invest in social infrastructure, public infrastructure is changing; and it doesn't matter which party you listen to. That is a changing view in society and we need to reflect that; and everyone in this sector is going to have to reflect that. And, it's a particular challenge for companies, I think, to reflect it. I think it's seen. It's actually completely consistent with the shift we're making in returns. To put more of the out-performance, more of the return

dependent or contingent on management and companies performing at the top of their game.

And, that if you think about it is an eminently reasonable thing for us to do. And, with the declining cost of capital that we see in the current circumstances, clearly in a bizarre way, I think the regulator and investors are more aligned on this they've ever been before.

Cathryn:

I have to say, I mean the way that you pose your question, Dominic, it almost sounds as though you're thinking about nationalisation as some sort of exogenous risk, and I sort of very much encourage the sector and it's investors to think about nationalisation as potentially an endogenous risk. In the sense that, you know, the companies have the freedom and they have the tools available to them to really demonstrate that they are delivering for customers, and society, and they're returning a fair return to investors; and if they're not, they're going to have some questions to answer. And, if they are, then things be will looking better, fairer, and more credible over the long term. So, yeah, I wouldn't view it as being something that was purely exogenous.

Now we had some questions down here. So, I'll take the chap in the front row first and then the lady on the end.

James Brand:

Yes, James Brand from Deutsche Bank. Just a couple of questions, both cost of capital related. First on the embedded cost of debt. You've said in vague terms how you're going to approach that, but it's a very important part of the overall cost of capital. And without kind of prejudging future evolution of your thought, I was wondering whether you could just give a bit more detail on how you're going to go about thinking about that historic evidence weight versus current debt cost for the companies. Where you might strike the balance.

Secondly, you haven't really mentioned leverage at all. We're in a similar position to the last review, where a lot of companies have much higher leverage than the assumption. At least the assumption you used last time 'round for your cost of capital. Have you any early thoughts on whether that could be going up or not?

Cathryn:

David?

David:

Okay. So, in terms of the embedded cost of debt. So, just to be clear, we will set an amount that will be the cost of finance related to new debt which in PR14 terms was 25 percent. Then the embedded debt is the remainder of that. So, in terms of our approach to that in PR14 we used the historical evidence over the previous 10 years in terms of corporate bond rates, and made adjustments for sector out-performance against that rate. So, from memory that was about a 15 basis points adjustment. What we're proposing for PR19 is we'll look at historical evidence in terms of benchmark rates. So we used iBoxx rates previously. We'll

probably use them again, and then we'll also look at what companies are actually raising their finance costs on, and we'll look at making an adjustments to that embedded rate. I think the only other point I would make is that, you know, when we look back at PR14 in some ways that looks quite a generous approach to setting the cost of embedded debt. So, if there's a case that the sector's still out-performing those debt benchmarks, then I think we'd want to put more weight on that for PR19.

And, your point about leverage. So, what we've said is that we used a gearing rate of 62.5 percent in PR14. We've said we won't go higher than that for PR19 and we'll look at setting the point estimate on that when we set out our view on the WACC in December.

James Brand:

Thank you.

Cathryn:

I just wonder if Jonson, you might want to come in and say something on this because I think one of the things that I mentioned when I was talking earlier on, is the fact that we are seeing some adjustment I think. Certainly in some companies of gearing levels. I think, you know, one of the things we observe when we look across the sector is a number of companies undergoing quite fundamental strategic reviews. I think that's a very good thing. I think you can see companies thinking long and hard about what it is they're here to do; and also thinking about the risk profiles that are associated with the different parts of their activities. I think if that results in a revisiting of some of those gearing levels, that might not be an unwelcome thing. And, indeed we are seeing some of that at the moment. Jonson, do you want to comment?

Jonson:

No. I'd just echo that. The gearing up. We have about 10 companies which are geared at a level above 70 percent. It's been attractive for most but not for everybody. Some would have been better to have stayed at our notional level; and that reminds me that that's at their risk. But, it also reminds me there is, you know, a question for companies to answer about the corporate resilience of those structures; and I know there's fierce debate about that. It's welcome to see some companies thinking about it and adjusting.

And, just back to your other comment about embedded debt, I mean I think there's been an expectation that we would sort of rather slavishly follow iBoxx indices. What I'd remind you is in every other respect we expect to see upper quartile or better efficiency in the way companies operate. And, I would expect to apply that to how we thought about historic debt as well because out-performance on your balance sheet is one of the core measures that can benefit customers. It's an important part of the gain companies and investors can make, but we would be right, in my view, to set our expectations at a level of only rewarding those who are really very high up on the efficiency ranking, or to set it with that in mind.

Cathryn:

Now, there's a question on the end back there.

Deepa Venkateswaran:

Thank you. This is Deepa Venkateswaran from Bernstein and I have two questions. One a follow on from the previous one on the cost of embedded debt. Clearly with the efficiencies I think companies can do something to improve their performance, but if they're stuck with higher cost debt which they can't really change, given that they'd have to pay a huge premium. Is it really in their control and could that lead to unfinanceable structures for some?

And the second question that I had was on the link between the business plans, your baseline totex, and then how you would deal with, you know, with companies' assumptions for enhanced capex where there's also a complication on you wanting them to consider direct procurement. So, the key question I want to ask is if a company has a good quality plan, but they have, you know, an enhanced project which maybe your model doesn't recognise or maybe you think it should go under direct procurement, does it then risk that business plan getting, you know, classified to slow track or the last category? And, then, you know, does that endanger the rest of the proposals?

Cathryn:

Okay, so I'll ask David to answer that last question in a second about the initial assessment of plans and how particularly the enhancements feed into that, but I think, Jonson, you wanted to comment on the embedded debt point. One thing I think it's really important to say on that point about embedded debt is, and I said it earlier on, we have been consistent for years now in saying that the choice of capital structure and the choice of financing is a matter for companies and their investors, but that those companies and investors are on risk for those choices. Now, you know, as it happens, the difference between expectation and outturn has been that people have done rather well out of that. But, equally that risk cuts both ways and I suspect we may well see some companies if not necessarily in the next control period then certainly in the control period after that are experiencing some difficulties as a result of the choices that they've made, but that is the way that risk allocation works I'm afraid. It's symmetrical and not asymmetrical. But, Jonson, do you want to comment on the embedded debt part?

Jonson:

I'd just state that we're very firm believers in putting risks where they're best managed. And whether that's the efficiency of operations, efficiency of managing your asset health, or the efficiency of managing your debt structure, or indeed your capital structure, those risks best sit with management and the boards of the companies. So, we would expect only to reward those - or only to recognise those that are somewhere towards our frontier of operation. Those who've fallen behind, for instance, in raising debt inefficiently clearly that is at their risk because what we look for the boards of companies to do is to manage themselves very efficiently. So the liability customers take is only, if accepted, is towards the efficient frontier. Sorry, I didn't get your name, but I hope that answers your question.

David:

Just in terms of the enhancement schemes in the IAP. So, in contrast to PR14 where the risk-based review didn't take account of enhancement schemes, for the PR19 price review we are planning to consider the special cost factor adjustments as part of the initial system of business plans. So, by the time we get to that point we will have considered whether or not a company does require any change in the allowances for a proposed enhancement scheme. And, so if we're of the same view as the company, that their enhancement scheme is efficient, then obviously that would help them perform well under the initial assessment of business plans. If in terms of our view about efficiency, if it didn't look efficient then it wouldn't score well.

In terms of whether it should be done as a direct procurement for customers that's also one of the elements of IAP. So, if they don't propose something as a direct procurement for customers when we think they ought to have, if they haven't gone through a proper cost benefit analysis, and worked through what projects they ought to be taking through the market process, and what they should be doing in-house, then that would count against them in terms of the initial system of business plans.

Cathryn:

Well, let's see if there are any more questions out there. So, we've got one there and then one in front. So, Lakis you go ahead.

Lakis Athanasiou:

Lakis Athanasiou, Agency Partners. Again, three questions. Firstly on visibility of the frontier for companies prior to submitting their business plans, will they have any idea where that will be or rather what your expectation of that will be, or is that going to be a big mystery for them until after they submit their plans?

Secondly, companies' possibility of being at the efficient frontier, do you think there's any read across from where they were in PR14 in terms of their submission versus your baseline, or do we just have to wait and see what's going to happen and what they submit?

And, thirdly. A cheeky question. Do you think you could have got as low as you did on allowed cost of equity or allowed returns, had you not moved to CPI, or partial CPI indexation, and stuck with a hundred percent RPI?

Cathryn:

Okay. We got three questions. I mean I just want to pick up that second one Lakis, and ask David to comment on all of them actually, but I think your point about can we essentially read across where companies were in PR14 to where they are in PR19. I think the answer is sort of a cautious yes, but. So obviously, you know, good performing companies stand a better chance in PR19. See everything we've said about good quality business plans and efficiency, and of course to go from being a not so great performing company to being a good performing company takes time. And, so you'd expect to see a degree of correlation there, but, and this is a really important but, one of the things we saw in PR14, which you'll

remember from the conversations we had when we said that South West and Affinity were going to be enhanced, was that it was a good thing that some of the companies that might not necessarily have been the most highly regarded in the sector, had really managed to pull their socks up and do some great business plans for PR14.

So, my answer on your second question is a sort of yes, but I wouldn't rule out somebody coming up the inside and really managing to do something radically different for the next review and we'd really welcome that. But, Jonson,

Jonson:

Can I stick my neck out on that Lakis and say I would be really disappointed in two things in answer to your question. The first one is, if there was real visibility of what the frontier levels are going to be. That would be us failing in our job because our job is to simulate, to some extent, competitive markets. This is an open competition. The frontier will be set by those who really define how to set the frontier. We're not the people to do that. So, I look forward to companies really setting that. Both by what they've done and by what they promise. Backward looking and forward looking. And, to add to what Cathryn said, I'd equally yes, but. And, I might even say I'd be a bit disappointed if you could predict from the past because one of the things, as many of you know I've been in the sector for a very long time, and one of the things that has disappointed me has been the lack of movement in this sector between relativities.

What was so great about the enhanced process last time was you couldn't predict who was going to get it. And, it gave an opportunity which at that time was only based on the plan. In the next review it will be based on performance to date plus plan. For someone to really pull themselves up and say, "I'm sick of being low down in the league table. I'm going to do something about it." Now, I think that's in customers' interest. I think it's in the investors' interest too. That we create that sense of dynamism that for too long there hasn't been in the sector.

Cathryn:

Okay.

Jonson:

Happy to pick that up afterwards Lakis.

Cathryn:

I'm going to ask David particularly to pick up that last point about your cheeky question, Lakis, about moving to CPI. But, I wonder if Aileen might want to say something about what we're doing to monitor companies' performance at the moment and then how that might feed through into the review. But, David, do you want to go first?

David:

So, no there isn't any link between the move to CPIH and the WACC. So, I think what you're alluding to is that there may be potential for companies to bring cash forward from the change in index, but we are quite clear that we do expect companies that are doing that, that they have to engage with their customers and demonstrate support to Ofwat for that change. So, we don't think that the move from RPI to CPIH means that there's a change in customer preference about how cash is recovered over time. So, we do think there is some validity in that in that current allocation between generations that's reflected in what they've done at present. So, the answer is no.

Cathryn:

Aileen.

Aileen:

Yes, so just a kind of broader comment across the company monitoring framework and how that then feeds into the new price review. I think, you know, over PR14 and the way the companies were assessed at that time and then building on that with the company monitoring framework we are seeing companies and we're really encouraged by companies telling us that they are learning through that process about what more they need to do. What they are learning from their customers and what really makes sense for their customers is actually driving them forward. And, having that as an annual process that then will feed into the price review means that, you know, you are seeing changes in where companies stand. You are seeing them develop and we have said that in the company monitoring framework it will be possible to move out of the lowest category within 12 months if companies do enough.

And, so we really are looking to what happens at the assessment this year and then feeding in next year; and then we will look at the IAP process and that will also be informed by where companies have been up to that point.

Lakis Athanasiou:

I wasn't asking just in respect of how companies have learned and performed. I was also I think asking as well how you have learned and performed. So, you've got movement on the companies' submissions and what they plan and what they can do, but you'd also get movement on the baseline.

Cathryn:

Yes.

Lakis Athanasiou:

I'm just wondering how much would there be much movement particularly relative movement between companies. You clearly indicated you're going to make things tougher. It's going to be upper quartile dynamic, et cetera. So that sets the average, but in terms of differences between companies do you think your methodologies will shift your baseline assumptions relative between companies.

Cathryn:

Yes.

Lakis Athanasiou:

... given you've gone through a, you know, a learning experience?

Cathryn:

I mean the short answer, Lakis, I think is yes. Yes, it definitely will. And of course as we get to the price review we'll have more years of data in terms of actual performance in period, but I think what we are seeing is a sort of two things that are happening. One is that companies are responding to mitigate the downside that they're exposed to. Both on totex and through ODIs. And, I think that's not only in this period. I think historically companies have proved themselves quite adept at responding to and mitigating the downside. Which of course moves the baseline. But, then we're also seeing some companies, and you'll be seeing the same things that I'm seeing, who are really driving their business particularly in line with those ODIs and who are out-performing significantly. Which of course then has an effect on the other half of the data. So, it's moving the baseline, as it were, by moving that frontier as well.

So, yes, I do think the baseline will shift. And, of course, companies will be able to see that data, as we can. You know, emerging through the period. But, of course, what they won't see, and this is where Jonson's challenge and frankly where our job as a regulator really comes in, is the extent to which we build on that historic analysis to then say, okay, and here's what we think you can achieve looking forward. And, that's where our challenge will really come in, but it will be a challenge on top of a shifted baseline. I'm sure that's true.

Now we had another question down here, didn't we?

Iain Turner:

Yes. Iain Turner from Exane.

We always end up I guess thinking back to PR14, but clearly in this review how your business plan is assessed is really important in terms of which category you end up in. If I think back to PR14 and thinking about the quoted companies and perhaps also Bristol Water, in retrospect of those four companies three of them had no chance of ever getting a business plan that was going to get straight through; because they had some very big capital programs and it was inevitably going to be quite a bit of to-ing and fro-ing about. And, that's

obviously quite dis-encouraging for those companies. So, when you move forward to PR19, how do you resolve that? I mean and I remember particularly say for example with UU, you had this big to-ing and fro-ing about cost to serve and actually an approach you've abandoned this time around and perhaps even been forced to abandon. I don't know, but maybe that's a bit too harsh, depending on what the CMA said with Bristol Water. So, what's the message for companies that last time around maybe felt that they didn't get a fair crack at the whip or you know there was no way they could have ever got on the fast track?

Cathryn:

Yeah. I mean it really goes back to something that David was talking about earlier on as well in response to that question about, you know, how do we deal with enhancements. Essentially in the sense of assessing the quality of company business plans. And, I did hear a number of comments along those lines back at PR14. Certainly going into PR14, we did not think that companies with substantial capital programs were at a disadvantage. I think in practice it did turn out to be a more involved, more complex process of assessment than perhaps we thought it was going to be, and I think we've learned something from that. But, I mean, David, do you just want to unpack that a bit again in terms of how were going to approach-

David:

Yes.

Cathryn:

... the special cost factors for enhancement in the IAP?

David:

Yeah. So, in terms of the, you know, companies that are proposing enhancements. So, if they are proposing enhancement you might expect that they'll make a special cost factor claim, which is an allowance from the Ofwat cost models and arguably should be allowed an additional sum of money for that. And so, that's a process that wasn't included in the PR14 risk-based review, but it will be included in our initial assessment of plans for PR19. So, we're confident that we can consider those claims and reach a view about whether the proposal is efficient or not. So, I think that that proposition is addressable.

I think the other points you're making about UU to some extent were not matters of enhancements. Some of those were matters of efficiency as well. And, clearly what we're looking for in the initial assessment of business plans is for companies to demonstrate that they are efficient. So, they should be coming in with plans with lots of good evidence that they're efficient and that their enhancement propositions are efficient. In that case they can, you know, have a real chance of getting that exceptional or fast track status. But, if you are not, you know, if you're not efficient to begin with, then yes you have a problem. But, that's quite right too.

Cathryn:

Jonson?

Jonson:

Can I just add in my recollection of those companies and PR14 is very different from yours. I don't think-

Iain:

I hope so. Hopefully you're a bit closer to them.

Jonson:

I don't think you're probably talking particularly about listed companies and those two big ones I think you referred to. I don't think there was anything that would have prevented either of those companies, if so minded, of being enhanced. Yes, one of those companies we had a large capital scheme which was a lot of to-ing and fro-ing, but I would say, and I believe they might accept, that actually in hindsight that could have been done very differently on a different reading of what we were asking for. I don't think there was anything we did. And as David said on the other one, yes there was some very big cost disparities. They had some very difficult discussions with us. But, it started with a cost base that wasn't perhaps where in hindsight they might have started. So, I don't really accept that. I agree that the companies people thought might be going to get it, weren't the ones that got the enhanced status. And, for many of those there was one factor where they got things wrong on their cost lines, but it wasn't to do with, or inherently related to, enhancements.

Cathryn:

I think that there's a build on that which I think also helps this time around because one of the things that we found during PR14 was that we were asking companies questions. Particularly in relation to some of those big enhancement schemes, that perhaps weren't the sort of questions we'd asked before. So, one of the common questions we were asking was basically, how does this contribute to the delivery of the outcomes that your customers want to see? Can you demonstrate that you have done, you know, proper optioneering across all the different ways of mitigating the risk of delivering that outcome? Have you actually engaged with your customers about the risk reduction and the residual risks that they would be left with in your willingness to pay research? Et cetera, et cetera. And that was a more involved conversation than I think we had at previous price reviews, and I think companies have learned from that.

So, actually one of the things we're talking to companies a lot about now is that the real importance of that line of sight through from the outcomes that you're trying to deliver for your customers, through your optioneering, through efficient cost, et cetera, et cetera. And, I think they get that to a much greater extent than perhaps they did given where we were on the learning curve for PR14.

Now, I just want to bring Jamie in. Jamie Tunnicliffe who most of you will know, is patiently sitting on the front row monitoring our live stream and seeing if we have any questions coming in from that; and I did promise that we would answer some of those questions. So, Jamie do you want to give us a couple if there are some.

Jamie:

Yeah, there's two that are on the screen here that are quite different than the conversation we've had so far. So, I think worth throwing in. One is could your four themes for PR19 change if the strategic statements change? And the other is how will you assess whether companies have the capabilities to innovate?

Cathryn:

Oh, gosh. You're right. Very different questions. Both very, very good questions both. I think on that first one about the link with the strategic policy statements I'm going to hand over to John Russelll, who's been leading on this talking to government about these things. And, it is worth saying by the way, Government's been out to consultation on those. So, the four themes that we've come up with were not in a vacuum and completely divorced from that process of talking to government about their strategic priorities. John, do you want to say a bit more about that?

John:

Yeah. Sure. I mean first of all to say we expect the strategic policy statement to be finalised by the end of the year. So, hopefully that'll really nail that down. But, I think that the main themes that come out from the SPS around long term resilience and protecting customers, at least in the draft, are really essential to the sector and they're essential to the themes that we've devised. So, it's quite difficult to see that those are going to fundamentally change over time. Of course, we can't read ministers' minds, but I think that's a key thing. And, they are very, very embedded and aligned to the strategy that we have developed over time, the strategy we articulated last year, the themes of PR19. So, it's not just a PR19 thing for us as well. It's the whole strategy of Ofwat is around this, and we think there's a very strong alignment and these are things that we've been developing for a long time. I think they will continue to be some of the key themes for us post PR19 and into the future. It's difficult to see a world in which resilience and protecting customers are not going to be important to us.

Cathryn:

Yeah. I think that's the key point isn't it really? I mean yes the strategic policy statements are important for us, but actually, you know, we are all, us and government, trying to get at the things that really matter to customers. And, we think we've got at those with our four themes and we would expect those to resonate with whatever flavour of government and whatever it was saying about its priorities. But, I mean, David, going back to this initial assessment of plans and how we're going to assess capabilities to innovate, it is a good question because while we've said we're going to do payment by results and we're going to really incentivise innovation including through the ODI mechanism. But we have also said that we will look at

the company's capacity to innovate and implement those innovations. So, how are we going to do that?

David:

Yes. So, you're right that this is not the only way that we're going to promote innovation in the sector, that very much the framework we're setting in terms of totex and outcomes is designed to enable, and encourage, and drive innovation. But, for the first time - as part of PR19 - we do want to include the assessment of company's capability to innovate which will be partly based on looking at how they're approaching the question of innovation within the company. So, there's often lots of good activity happening in different parts of the sector around innovation, but we often observe it is a real struggle to turn that innovation from a pilot into mainstream reality in the sector. So, we're very much looking for evidence that companies are able to take, you know, that they do have a healthy system for developing innovation, for identifying new ways of doing things, identifying new technologies, for identifying new ways of working with customers, and that they're turning that and making that and embedding that as part of their businesses in PR19.

And, you know, we look at this process with interest. We'll have a crack at it in PR19. Then we'll have a look at how it's worked out when we get to PR24 and see whether we were right.

Cathryn:

Right. We promised we would finish by 4:30. We have five minutes left and I think that's my queue to hand over to Jonson just to close us and finish the session. So, Jonson.

Jonson:

Thanks, Cathryn. I don't think I'm going to say very much. I just want to thank you all for being here. I'd like to thank everybody throughout the sector who's had a hand in getting us to this point in our journey. I think the points have been well made. So, I'm not going to take the time to go through all the points we're making. But, what you've got is that in this price review is that we are determined to incentivise companies to push boundaries, frontiers further than ever before, and indeed to create that dynamism that I was answering a question on earlier. That dynamism in the sector that I think has not been sufficient for many years. I think we've emphasised the point that the sector needs to really create value for its customers, whose expectations are changing and we've stressed themes such as resilience, themes of innovation. We've also stressed affordability for customers and I think we're in an environment where that remains very, very important.

So, I think you've got the four themes. The resilience, step-change in customer service, new and innovative ways to deliver more for less, affordable bills and that's all underpinned by this real drive for frontier efficiency. So, I think every periodic review is a journey somewhere. We started it as far as most of us are concerned on PR14. You can see how that's shaped PR19. You can see the onus. Not only the onus, but the opportunity that we're putting back on companies to really set out their stall and lead in a way they've never perhaps had the opportunity to lead before.

So, that's the end of our City Briefing. I'm sure we'll be here again. Thank you to everyone who's attended or has taken part through the streamed event. If there's any questions we didn't answer, Jamie's logged them or others have logged them and we will get back to you if you asked a question we haven't had a chance to answer. So, thank you all very much. We'll all be around for a few minutes if there's anything else we can answer. Though we promise no long debates. Thank you.