We welcome responses to the following questions, particularly responses which consider how trust and confidence can be rebuilt in this sector by putting customers at the heart of company and investor considerations.

In terms of the principles involved, we support the themes of “trust” and “putting the customer at the heart”. We recognise that these are behaviour driven and feel that moves to improve transparency and comparability of company performance drives the right corporate behaviours. For example;

- The power of comparative data in the Discover Water website
- Comparative benchmarking of customer service versus other utilities and sectors such as analysis performed by the “institute of customer services”.
- Our plans to increase transparency of ODI performance at PR19 through clear website posting, social media and implementing a “customer panel” for oversight of this.

We also feel that this Company has a sound track record of responsible behaviour in relation to key legitimacy measures including distribution levels and executive pay.

Q1: Do you agree that companies should be required to propose mechanisms for sharing financing outperformance in their business plans, and that we should assess such mechanisms in the IAP?

We have a range of observations in relation to the consultation document which fall into two areas thematically; the principles involved (discussed below) and the mechanisms proposed (under question 3).

Principles involved

The consultation proposes a mechanism to share “out-performance” due to gearing with Customers. However, where companies are already adopting a balanced approach to distribution and not making distributions which are inconsistent with the notional dividend yield, the benefit is essentially already returned to the customer’s by re-investment in the company. In other words the assumption that investors “take the benefit” from gearing higher than notional levels does not necessarily hold unless that benefit is distributed; Ofwat has proposed a separate mechanism to address this point (pg 26 “companies with high levels of gearing should consider maintaining the same dividend yield”).

The consultation references an observation that highly geared structures potentially result in lower levels of financial resilience and potentially higher risk to customers with specific trigger levels of “high gearing” also referenced. Having regard to the water sector’s evidence based regulatory regime, we would welcome detailed empirical evidence to support these fundamental principles or the mechanism proposed.

The concept that companies are responsible for their own capital structures is a long standing one. Many of the current capital structures have been instrumental in driving down the cost of debt and, ultimately, cost for customers historically. For small companies, carrying legacy index-linked bonds, there was a pay off, at the time of their issuance, in terms of size of debt that was economic to raise (capital markets were much less flexible at the time) which in turn has tended to leave the WOCs more highly geared (as evidenced in the gearing analysis included in the consultation). However, this has contributed to a significant reduction in the cost of debt (through the reduction in small company premium) during periods of historically higher interest rates - which has been passed on to customers. It takes time (and can be costly) to shift the balance of capital structures. Whilst the consultation acknowledges the continued principle about where decisions on actual gearing sit, its mechanism appears to seek to penalise actual capital structures with higher gearing. There appears an implicit assumption that a move to the notional balance sheet is a readily available choice. As such this proposal appear inconsistent with the principle. In addition to this, as noted, there is little or no time available for Boards to attempt to effect such a move before the start of PR19, in the event that it was even possible to do so without punitive impacts on the business.

Q2: Where adequate mechanisms are not offered in business plans, do you agree we should intervene to impose a sharing mechanism, to ensure customers will receive an appropriate level of benefit from companies with highly geared structures?

We are highly supportive of the themes of legitimacy, customer centricity and transparency and feel that good progress is being made in these areas eg through the much wider use of comparative performance data. We feel the mechanisms proposed would benefit from further development and evidence based support.

Q3. Do you have views on our proposals for the design of the outperformance sharing mechanism for highly geared structures? Do you agree that the calculation should be on a nominal basis and take account of the actual, rather than notional, cost of debt?

Mechanism proposed

We have a number of observations on the technical design of this mechanism.

- The level of risk that is argued to be related to a given level of gearing has not been supported with evidence.
- Financial theory would contend that as gearing increases so would risk to equity; there is no recognition of this in the mechanism proposed. Nor has any empirical evidence been put forward that this principle does not hold.
- The mechanism does not account for the consideration that benefits should only be shared with customers to the extent that they are also being received by investors (ie need interaction with distribution levels).
- The mechanism assumes that companies will have discretion as to whether to sustain higher gearing at the expense of sharing any perceived outperformance, or to reduce gearing to mitigate higher potential sharing. The reality is that Portsmouth Water and several of its peers have inflexible debt structures that would incur higher cost to renegotiate in order to manage the impact of the outperformance sharing mechanism.
- No guidance is given as to how this would interact with the Company Specific Premium where relevant.
- To the extent that any mechanism was to be implemented, we concur that actual rather than allowed cost of debt should be used as this reflects the actual rather than theoretical "benefit".

Q4: Do you agree that companies should explain their approach to dividend policy in their business plans and that our IAP assessment should assess both transparency and how the policy takes account of factors which include obligations and promises to customers, delivery of service to customers, financial resilience and employee interests?

We concur that Companies should set out their dividend policy and be transparent as to the justification for higher than notional levels. We support the principle that distributions should be reasonable and sustainable but we are not in favour of a mandated cap.

We agree that there should be transparency on policy and explanation regarding any dividends in excess of policy. However we unclear why a "customer benefit's test" is relevant where higher dividends are paid since customer rewards and benefits are managed effectively through other regulatory mechanisms.

The reference to adjustment of dividends for sharing of "outperformance" seems to run contrary to the embedded principles of rewards and penalties. The regulatory methodology already has clear mechanisms to share the benefit of outperformance (totex sharing mechanisms) and give companies the benefit of ODI rewards (which have been supported by customers). Sharing "out-performance" at the levels referenced results in a second layer of sharing and devalues the existing sharing mechanisms in place. Equity shareholders already bear the downside risk of ODI underperformance and therefore to require sharing of out-performance would be asymmetric. Similarly the impact of underperformance through ODI penalties is shared by directly reducing bills.

Q5: Do you agree that companies should explain their approach to any performance related element of executive pay in their business plans and that our IAP assessment should assess both transparency and that policies for awards of any performance related element of executive pay demonstrate a link to exceptional delivery for customers?

It is wholly appropriate for company executive remuneration packages to be clearly articulated as this is already a requirement of the Corporate Governance Code. However, we question whether this is a necessary element of the Business Plan or IAP.

Companies need a balanced and competitive compensation package in order to attract a high quality management team. There therefore needs to be a balanced range of measures around compensation which are proportionate and Boards/Remuneration Committees should have flexibility to determine these.

Transparency of executive remuneration reporting is already covered by the UK corporate governance code, against which Companies must comply. Therefore there is a question as to why it is necessary to implement additional measures beyond those required by the Code, implemented by Boards through their Remuneration Committees (which are independent) and disclosed publicly in Annual Reports.

We feel that further clarity is required in terms of what is meant by a "substantial link" to *exceptional* delivery for customers. For example if one ODI is failed does that imply that no performance element should be awarded?

Q6: Do you agree with our proposed revisions to extend the confidence and assurance test area to include trust and with the revised wording of question 3 of this test area?

In our view the words "*to provide a fair balance between customers and investors*" should be included. However, it should be for the Boards to determine and support how this is achieved without referring specifically to the measures "which include outperformance sharing, dividend policies and any performance related element of executive pay".

Q7: Do you have any comments on the additional clarification of our approach to financial resilience in the IAP?

It is helpful for Ofwat to set out a range of specific tests in addition to Company specific ones…we understand how this will aid comparison.

However, we are concerned about some of the specific scenarios mandated. These should be "severe reasonable and plausible". In particular the 15% TOTEX variance appears extreme, it is difficult to see how this could arise in practice even in a severe but plausible scenario (particularly in effect every year for the 5 years of the AMP). We are also concerned that the mandated combination of *"As a minimum we propose that companies model a combined scenario comprising cost underperformance to include both totex and retail expenditure of 10% in each year of the price control along with an ODI penalty equivalent to 1.5% of RORE in each year and a financial penalty equivalent to 1% of revenue in one year"* is too extreme. Whilst it is recognised that companies can explain why they do not believe this is a scenario that could arise even under a "severe but plausible" scenario, significant analysis would still have to be undertaken to support what appears to be an overly bearish combination of scenarios.

We also have significant concerns about the requirement to have assurance about the assessment provided. Having spoken to two of the Big 4 neither could see a meaningful way of reporting on this due to the highly subjective and judgemental nature of the process. Therefore there is a concern that any assurance would not provide good value for the Company or the customer (or indeed give Ofwat what they need). Has this point been discussed further with assurance providers to determine that an appropriate level of assurance could be obtained?

Conclusion

In conclusion we are supportive of the key themes of legitimacy and customer centricity. We feel that some of the mechanisms proposed need further development, explanation and evidentiary support. We appreciate our opportunity to contribute to this debate.