

Alternative to Ofwat's "Putting the Sector Back in Balance" consultation proposals

1. Purpose of the note

Thames Water supports the principles as laid out in the Secretary of State's speech at the City Conference in March, but note that OFWAT's 'Putting the Sector Back in Balance' consultation has created a difference of opinion between Ofwat and privately-owned companies on how these principles should be implemented.

As a result, we have worked with a number of companies to develop alternatives that we think meets the Secretary of State's objectives for the water sector, but without the negative impact on investment and regulatory certainty that we believe Ofwat's proposals would create. We believe that such a package would also be in the best long term interests of customers and the environment.

2. City Conference: the principles set out by the Secretary of State

At the City Conference in March, the Secretary of State set out a series of principles that we agree should be upheld. In summary, we believe that a set of principles we should be held to account for should include:

- Transparency in corporate structures
- Financial resilience
- Highest standards of corporate governance
- A fair deal for customers, considering the needs of tomorrow's customers as well as today's
- Ongoing availability of investment to meet resilience challenges and to deliver DEFRA's 25 Year Environment Plan
- Consistent regulatory approach to maintain investor confidence in the UK's regulatory process and goals

3. "Putting the Sector Back in Balance"

The City Conference and the exchange of letters between the Secretary of State and the Chairman of Ofwat was the precursor to Ofwat's "Putting the Sector Back in Balance" document.

Without repeating all the arguments about its content, it is notable that the proposals in the consultation (and indeed its timing within the PR19 process) has been widely criticised by economists and analysts, as well as by companies.

The consequences for the stability and predictability of UK regulation more widely have been highlighted, including by Moody's, and concerns have been raised with Government by companies and investors.

4. Actions we have taken/are taking to meet the principles

We note that the sector has already, or is taking steps to, meet the principles above, without the need for the specific proposals in Ofwat's April 2018 consultation. These include:

a. Transparency in corporate structures

- removing Cayman companies (some have already, others will soon, all by end 2018)
- simplifying company structures where possible
- further improving company reporting in annual reports and on websites where needed

b. Financial Resilience

- improved reporting to highlight to customers that financial resilience is more than gearing levels
- commitments by many companies to move down to 'mid-70s' gearing at regulated entities

c. Highest Standards of Corporate Governance

- broad compliance with Ofwat's Board Governance, Leadership and Transparency (BGLT) principles
- full engagement with Ofwat on strengthening the BGLT principles, including in the case of Thames Water agreement to a new requirement in its licence to conform to the BGLT principles
- reviews of governance arrangements, such as the review of governance being undertaken by Thames Water

d. Fair deals for customers

- companies are taking on unprecedented levels of customer engagement in business plans and expect plans will fully reflect customers' views on priorities
- development of plans to provide effective support for customers that find themselves in vulnerable circumstances, and those who are struggling to pay
- adoption of challenging operating targets in key measures for customers to improve performance
- keeping bills to a minimum whilst being mindful of inter-generational investment needs, resilience challenges, and statutory investment requirements
- working constructively with Ofwat on proposals to ensure the long term interests of customers and the environment is at the heart of what companies do
- proposed introduction of a new mechanism to share financing benefits, as an alternative to the mechanism outlined in Ofwat's "Putting the Sector Back in Balance" document:
 - Ofwat's final methodology already includes an automatic sharing of some benefits by setting an allowance below the trailing market rate for new debt;
 - we would propose to go further than that and introduce a new mechanism for AMP 7 that shared with customers outperformance of the allowed cost of new debt;
 - for AMP 7, such a mechanism would be asymmetric, so as not to put customers at risk of companies failing to raise new debt efficiently during this period, whilst retaining an incentive on companies to raise debt efficiently; and
 - the mechanism would be reviewed as part of PR24

e. Ongoing availability of investment

- if the regulatory structures remain stable, investors are ready and able to deliver the investment to meet the needs of the UK as it seeks to enhance resilience and meet the ambitions of the 25 Year Environment Plan

f. Consistent regulatory approach to maintain investor confidence in the UK's regulatory process and goals

- This has been put under pressure by the recent proposals, but can be restored if the approach set out in this document were to be accepted, recognising that individual companies may wish to go further.
- To address residual investor concern that might still seek to apply the specific mechanism advanced in the “Putting the sector back into balance”, we suggest that the relevant Initial Assessment of Plans criteria be augmented with a number of explicit tests (see next section).

5. Suggested changes to the Initial Assessment of Plans criteria

Ofwat's Initial Assessment of Plans (IAP) could be redrafted broadly in line with the proposal set out in Ofwat's April consultation, augmented by a set of explicit tests against which Ofwat will assess companies' proposals (changes from April consultation in bold).

“To what extent has the company's full Board provided assurance that the company's business plan will enable customers' trust and confidence, through appropriate measures to provide a fair balance between customers and investors (which **may** include outperformance sharing, dividend policies and any performance related element of executive pay) and high levels of transparency and engagement, on issues that matter to customers (which extends to their ability to understand corporate and financial structures and how they relate to its long-term resilience)?”

“Outperformance sharing proposals will be considered by reference to the following criteria:

- **do the proposals help improve legitimacy, trust and confidence;**
- **do the proposals build on existing regulatory incentives for the company to make efficient financing decisions which operate in the long term interests of customers and the environment;**
- **are the proposals consistent with the letter and spirit of the long-standing regulatory principle that financial arrangements are a matter for companies; and**
- **are the proposals prospective in nature, practical, and simple to apply.”**