

For the attention of Aileen Armstrong
Senior Director of Finance and Governance
Ofwat
4th floor
21 Bloomsbury Street
London
WC1B 3HF

Dear Aileen

Putting the Sector back in Balance

Following the recent consultation on 'Putting the Sector back in Balance' and companies' responses, we are aware that there has been continued dialogue across the breadth of stakeholders within the sector about how to move forward.

In response, several companies have shared ideas to develop alternative proposals to those consulted upon. We are aware that other companies may be submitting similar proposals to those contained in this letter.

This letter does not seek to replace our response to the original consultation, but rather to propose an alternative approach, including the introduction of a mechanism for sharing outperformance on the cost of new debt.

We believe we have arrived at what is a constructive set of proposals that would further enhance the trust and confidence in the sector. We support the principles as laid out in the Secretary of State's speech at the City Conference in March and consider these proposals address those principles at the same time as managing the risks arising from the proposals consulted upon by Ofwat.

Principles for sector legitimacy

Based on recent discussions we consider that the following forms a set of principles to which we should be held accountable:

- transparency in corporate structures,
- financial resilience,
- the highest standards of corporate governance, and
- a fair deal for all customers, considering the needs of tomorrow's customers as well as today's.

Meeting the principles for legitimacy

We have already taken, or are taking steps to meet the principles set out earlier. These include:

Simpler corporate structures and improved financial transparency:

- simplifying company structures,
- removing Cayman companies,
- improving transparency in company reporting,
- improved reporting to highlight to customers that financial resilience is more than gearing levels, and
- commitments by many companies to move to reduce gearing of regulated entities.

The 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,
- moves to ensure a better balance of the number of independent Non-Executive Directors on Boards in relation to Executive Directors, and
- adoption and publication of governance charters.

A fair deal for customers

- we 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,
- driving challenging performance commitments in key service areas for customers,
- keeping bills as low as possible for current and future customers,
- working constructively on proposals to ensure the public interest is at the heart of what we do, and
- proposing a new mechanism to share financing benefits:
 - 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 AMP7 that shared with customers outperformance of the allowed cost of new debt,
 - for AMP7, 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 to be reviewed as part of PR24.

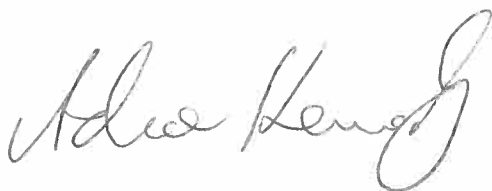
As part of PR19 we are developing our plans for sharing outperformance with customers and will be discussing these proposals with the Yorkshire Forum for Water Customers, (the CCG).

We hope these alternative proposals can be used to formulate an acceptable set of actions that, if progressed by companies, can maintain the legitimacy of our regulated industry and retain the trust and confidence that customers and other stakeholders have in the sector.

We would be welcome the opportunity to discuss these ideas further, and would be happy to meet with Ofwat either individually, or collectively with the whole sector.

I have copied this letter to Kirsty Innes at HMT, Sebastian Catovsky at DEFRA, Robert Light at CCWater and Andrea Cook (Chair of the Yorkshire Forum for Water Customers).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Adrian Kennedy'. The signature is written in a cursive style with a large, looping 'K' at the end.

Adrian Kennedy
Director of Regulation