PR19 initial assessment of business plans: Investor conference call 31 January 2019

Thank you and good afternoon and welcome to our 2019 price review initial assessment of business plans investors call. Today we'll update you on the results of our initial assessment of business plans, the first phase of the delivery of the 2019 price review. I am David Black, Senior Director, Water 2020, and with me on the call today, are John Russell, Senior Director, Strategy and Policy and Aileen Armstrong, Senior Director, Finance and Governance.

PR19 themes

We started on our journey to the 2019 Price Review with engagement on the challenges facing the sector and we identified four key themes which companies and other stakeholders considered vital to address. These were; great customer service, resilience in the round, affordability and innovation.

In our 2017 methodology we set out our expectations for business plans and how we would assess them. The strongest incentives with the price review, come with the delivery of business plans, through the incentives on outcome performance and cost sharing for totex out-performance.

Our initial assessment of plans provides further incentives for high-quality, ambitious and innovative plans. We group companies into the following categories: fast-track and exceptional companies with reputational, procedural and financial benefits; there are reputational, procedural and financial dis-benefits for significant scrutiny companies; and slow-track companies falling in between those categories.

I am delighted that this morning we announced three companies: United Utilities Water, Severn Trent Water and South West Water have meet the high bar for fast-track. I congratulate the board and leadership of these companies for seizing the opportunity to submit business plans that really move the dial for customers. Our assessment of business plans is comprehensive covering nine test areas including outcomes, cost efficiency, resilience and confidence and assurance among others.

I am also pleased that these companies have proposed ambitious proposals to share benefits with customers including South West's Watershare plus customer share scheme, Severn Trent's purposeful company and community dividend and United Utilities major contribution to improving affordability for customers struggling to pay their bills.

Their achievement in submitting business plans that meet our demanding requirements should not be under-estimated and they are now well placed to deliver for their customers over 2020-2025.

We did not recognise any companies as having exceptional plans; this was a category we reserved for companies who well beyond the bar for fast-track . And we didn't think any companies met this grade at PR19.

For the rest of the sector, the remaining companies, they now have opportunities to revise plans, taking account of our feedback on areas of concern and where we think they have not gone far enough for customers. We have also categorised four companies as being in significant scrutiny, which means that these companies have further to go in revising their plans. This, in part, reflects the challenges facing these companies and recognising this, we have decided to not to apply any financial consequences, in terms of tougher cost sharing or capped incentive rates at this point and to make a judgement on this issue at draft and final determination, based on how companies respond to our initial assessment of plans.

It is also important to note that the sector has taken a major step forward – with a major step up in customer engagement and improvements in performance such as; help for 1.5 million customers struggling to pay, a 40% reduction in supply interruptions and also pollution incidents and a 25% reduction in sewer flooding proposed for PR19.

So, today's announcement is an important milestone for PR19 and the three fast-track companies now have early clarity around the outcome. For other companies, there is more work to do and correspondingly, less certainty about the expected outcomes from the price review process at this point.

I'll now handover to my colleague John Russell to talk you through the highlights of our assessment of fast-track companies in more detail, before I come back on an overview of the sector on outcomes, cost assessment and risk and return.

Our IAP decisions at a glance

Thanks David. As you can see, we fast-tracked three companies, there are ten slow-track companies, and four significant scrutiny companies.

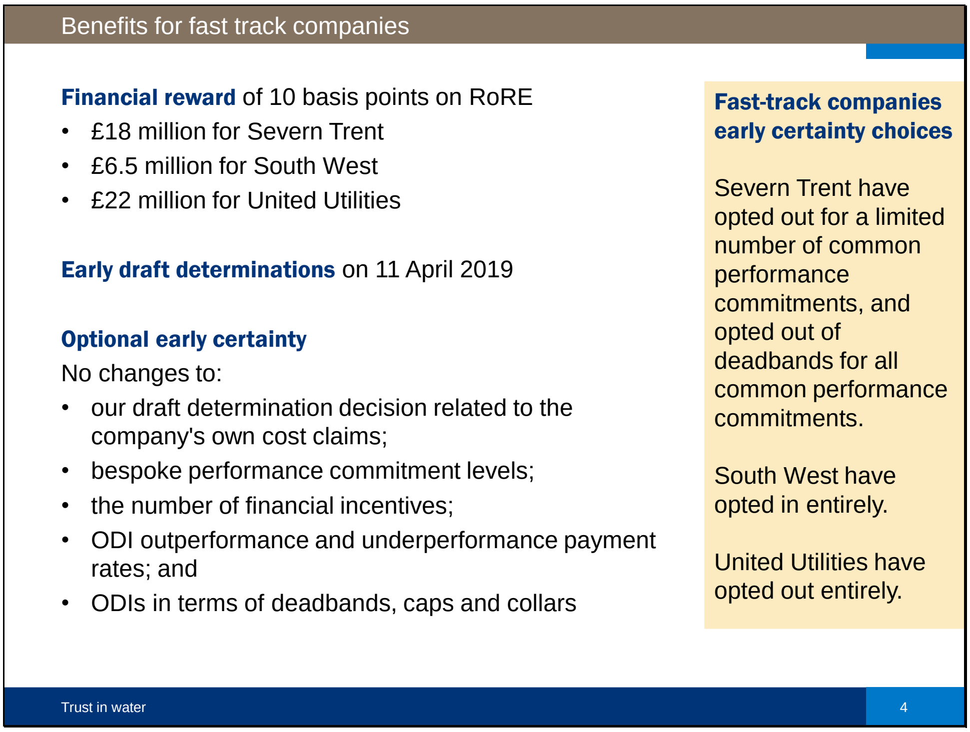
I'm going to focus on the fast-track companies - Severn Trent, South West and United Utilities. These companies are stretching themselves to increase cost efficiency, plan to cut bills in real terms and deliver benefits to customers. Each of the plans they offer are financeable, based on the early view of the cost of capital we set out in December 2017.

Severn Trent proposes a 5% fall in bills, in real terms, gets customer support for a large increase in assistance for customers struggling to pay and has many examples of best practice in innovation. Its plan is 5% below our baseline on costs, and it proposes a high-quality, voluntary way of benefit sharing, by contributing 1% of its profits to a ‘community dividend’ to be spent on projects to benefit customers and the community.

South West Water proposes a 14% fall in bills in real terms to 2025, with further falls to 2030. It leads the sector with its outcome performance commitments and its costs are within 5% of our view of efficient costs. It proposes an ambitious and voluntary way of sharing outperformance on the cost of debt with its customers, and an innovative scheme to offer shares in the company to its customers.

United Utilities proposes an 11% fall in bills in real terms. It includes ambitious, innovative and sector-leading proposals on affordability and vulnerability, shows the most embedded innovation culture and a sector-leading approach to resilience. At the company level, its costs are about 3% above our view of efficient costs. It proposes a high-quality package of voluntary benefit sharing, funding social tariffs and matching high dividend payments one-for-one with contributions to a fund supporting customers and communities.

Benefits for fast-track companies



To obtain fast-track status each of the companies accepted our proposed changes to a limited number of areas of its plan, including modest cost adjustments to efficient levels and some strengthening of selected performance commitments to upper quartile and more appropriate outcome delivery incentives. Along with reputational and procedural benefits, fast-track companies receive a financial reward of 10 basis points on the return on regulatory equity. That equates to; £18 million for Severn Trent, £6.5 million for South West, £21.9 million for United Utilities, over the AMP.

The three companies have chosen whether to receive early certainty on some elements of our determination.

Our early certainty principle was that there would be; no changes to our draft determination decision related to the company's own cost claims; no changes to bespoke performance commitment levels; no changes to ODI outperformance and underperformance payment rates; and no changes to ODIs in terms of deadbands, caps and collars.

Severn Trent Water chose to opt out of early certainty for a limited number of common performance commitments, and out of deadbands for all common performance commitments. United Utilities have chosen to opt out of the early certainty principle entirely, and South West Water have chosen to opt in to the early certainty principle entirely

At the other end of the scale, companies with 'significant scrutiny' plans fall well short of the required quality and need extensive material intervention to protect customers. Each of these companies needs to revise one or more areas of its business plan to address our concerns.

We are assigning significant scrutiny status to four companies – Hafren Dyfrdwy, Southern Water, Thames Water and Affinity Water. Our assessment recognises the challenges facing these companies – and the changes required to address customer interests. I won't go into our concerns with each of these companies' plans, except to note they vary between companies, in areas such as outcomes, cost efficiency and resilience.

We will be working closely with all the companies in significant scrutiny over the coming months, so that they can address the issues in their plan before we make our draft and final determinations.

I'll hand back over to David who will talk you through some of cross-sector insights we have.

High-level observations from initial assessment of business plans

High level observations from initial assessment of business plans (1)

Costs	At a sector level, the difference between our cost and the company view of total base costs is 7.9% compared to 7.3% at the same stage in PR14. Increase in enhancement expenditure from £9bn to £15bn. Much of the spending appears warranted although we require further evidence to justify ~30% of expenditure.
Cost of capital	12 out of 17 companies have used our early view of the cost of capital in their plan. Only Portsmouth Water has convinced us that its higher cost of capital is justified and supported by customers. Wessex Water propose a cost of capital that is above the range we stated, when calculated on a consistent basis with our early view

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Thank you John. As I said at the beginning, we set a high bar for fast-track and for assessing the business plans at 2019 Price Review. Many companies have risen to the challenge, taking a big step forward in areas of their plan, but on the whole, there is still a way to go for many companies with their plans.

In regard to outcomes, companies set outcome performance commitments for key aspects of their service, along with outcome delivery incentives that reward or penalise companies for their delivery.

For the common performance commitments, we said out in our methodology that we would expect companies to target upper quartile performance and where this hasn't been proposed in plans, we've asked companies to reconsider.

In reviewing companies' outcome delivery incentive rates for common and comparable performance commitments we have identified a substantial variation across companies, that isn't plausibly explained by evidence of differences between companies. We are therefore requiring slow-track and significant scrutiny companies to provide more evidence and signalling that we may intervene in our determinations on ODI rates, to reduce unexplained or unsupported variations across companies.

We also asked in our final methodology, for companies to consider means to protect customers, if outcome delivery incentive rates turn out to be much higher than the expected return on equity range for ODIs. Where companies haven't done this, we've asked them to put in place additional protections such as caps and collars on material individual performance commitments and enhanced sharing of returns, if companies exceed the 3.0% return on regulated equity for outcome delivery incentives.

In terms of our decisions on the fast-track companies, this provides an indication of what draft measures are likely to look like for these companies. So, we'll highlight three aspects. One is that we have asked companies to provide a common performance commitment on vulnerability to harmonise the proposals across companies, that they have made on increasing the number of customers on their priority services register and to check the validity of names on the register. We have also included enhanced sharing rates if outperformance was beyond 3% return on regulated equity and we are intervening in ODI rates where an ODI is materially out of line with the rest of the sector.

On costs, in our final methodology just over a year ago we set out a strong challenge to companies on cost efficiency.

We noted that totex and outcomes have delivered significant gains in other sectors, with early evidence of gains in the water sector too. So, we were looking for companies to take advantage of this flexibility in their business plans, with confidence that those companies that did so, would find themselves able to deliver both lower bills and improve services for customers.

We have raised the bar on our challenge on costs to reflect the benefits of totex and outcomes and the second-generation of retail price controls. We are using comparative benchmarking based on historical upper quartile with a frontier shift of 1.5% per year to set wholesale water and wastewater base costs. This compares to the use of historical upper quartile, without any efficiency frontier improvement in the 2014 price review. For retail residential costs, we are setting costs based on forward-looking upper quartile costs, compared to average historical costs at PR14.

For enhancement costs, we estimate using a range of approaches including bespoke econometric models and shallow and deep dives for specific cost areas. For around 30% of enhancement costs in business plans, we are not persuaded by the evidence in company plans and asked companies to reconsider, or to provide further evidence of efficiency or need for expenditure

I would add, at a sector level, the difference between our view of efficient cost and companies view, is around 7.9% for wholesale base costs. And this compares, to around 7.3% at the equivalent stage in the PR14 process. So I am pleased that we set out that we wanted a step change in costs and that our initial assessment sets out that companies are following through on this challenge. And that several water companies have really stepped up, both fast-track companies but also including some others like Portsmouth Water, to really improve efficiency. We want all customers to benefit, so we have now set out actions to support this and ensure that the remaining companies step up in efficiency too.

On the cost of capital, we asked companies to submit business plans based on our early view of the cost of capital, or to provide compelling evidence for a higher number. We are pleased that 12 out of the 17 companies have used our early view of the cost of capital in their plans, and provided board assurance statements that confirm their plans are financeable on this basis.

The remaining companies submitted various levels of evidence in support of their case for a different cost of capital, but only Portsmouth Water has convinced us that it has a different cost of capital and that this is justified and supported by its customers.

At this time, we have not updated our view on the cost of capital and we will continue to use the December 2017 view for early draft determinations for fast-track companies and we will publish an updated view on the cost of capital in July, when we publish our slow-track draft determinations. And then we will set out our final position at final determination.

High level observations from initial assessment of business plans (2)

Putting the sector in balance	Most companies have applied the gearing outperformance mechanism that we set out. Where companies have not adopted our mechanism or the equivalent, we require them to do so. Some companies have confirmed they are ensuring ensure their financial structures will be resilient in the long term and, in so doing, not expose customers to undue risk. Voluntary sharing mechanisms examples: • South West Water's Watershare Plus company share offer for customers • Severn Trent Water's community dividend • United Utilities funding of support for customers struggling to pay their bills
Direct procurement for customers	We were pleased to see United Utilities take advantage of DPC for the Manchester and Pennines resilience scheme (whole life totex £760m) and Thames for their Deephams Water re-use scheme (wholelife totex £530m). We are asking several companies to reconsider the use of DPC in their revised business plans.

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Back in balance; so we consulted on some changes to our methodology last July, to better align interests of company management and investors with customers. As part of this we asked companies to propose outperformance sharing mechanisms to share the financial gains from high gearing with their customers. And we also set out some factors that companies ought to take into account when setting dividends and executive performance pay policies, which then prove transparency in these areas. And we also set out scenarios we wanted companies to model to assess their financial resilience.

So, we've seen the sector take some steps to address the requirements we set out last July, including on dividend policies and on executive performance-related pay. However, most companies need to do more in these areas to make sure the incentives for their owners and executive teams will deliver the best outcomes for customers.

We note that most companies have put forward gearing outperformance sharing mechanisms where they are relevant. And that some companies have taken steps to ensure their financial structures will be resilient in the long term. Where companies have not adopted our mechanism, we will require them to do so. Where companies have exhibit more limited headroom in their actual financing structures then they can continue to expect that the evidence they present on financial resilience will be subject to greater scrutiny by us.

Direct procurement for customers; as part of PR19 we have developed a new approach to delivering large infrastructure projects, which we call direct procurement for customers. This gives companies the opportunity to promote innovation and reduce costs by competitively tendering for third parties to design, build, finance, operate and maintain schemes.

We were pleased to see United Utilities take advantage of this approach for their Manchester and Pennines resilience scheme (with a whole life totex value of around £760m) and Thames for their Deephams Water re-use scheme (with a whole life totex of around £500m). As part of their revised business plans, we are asking several companies to reconsider the use of DPCs when they return with the revised business plans.

So those were the key points I was wanting to highlight, from our decisions this morning.

Next steps

Next steps

	Next steps	**Date**
Fast-track companies	Companies must submit information, including: • completed business plan tables; and, • an actions tracker.	11 February 2019
	Draft determinations	11 April 2019
	Respond to draft determinations	24 May 2019
Slow-track and significant scrutiny companies	Companies must submit information, including: • a revised business plan; • completed business plan tables; • a completed Ofwat financial model; and, • an actions tracker.	1 April 2019
	Draft determinations	18 July 2019
	Respond to draft determinations	30 August 2019
All companies	Final determinations	11 December 2019

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In terms of the timetable from here; fast-track companies will receive an early draft determination on the 11th April. For slow-track and significant scrutiny companies, they need to resubmit their plans on the 1st April, responding to our actions and concerns and we will publish their draft determinations on 18th July. And then on the 11th December we will send out final determinations for all companies.

So that's it from John and I, we will now take questions, so I will hand back to the operator to take your questions or you can submit them online.

Questions and answers

Operator: And we'll take our first question from Iain Turner with Exane

Ian Turner: Good afternoon everyone. I know you've been doing a lot of work on corporate governance. It's clearly quite striking that the three companies that have been fast-tracked are the ones that have got equity listings. I know that back in the days of Sir Ian Byatt when companies were taken over, he was very keen to try and find a way of maintaining those equity listings, he felt it was a useful part of the governance of the companies. And I wonder if you've given that any thought as part of this process?

David Black: So in terms of the outcome of the IAP process, I think it's important to note that, yes, there are the three listed companies that have been fast-tracked. Obviously it's a very limited sample with 17 companies in total and only three listed companies, so I think we need to be careful not to read too much into the results. But we do accept the point that you make around the importance of the principles around board leadership and governance and we have been taking action in that space to improve those for all companies. So we do think that there are important lessons for the rest of the sector, but there are alternative ways of implementing those other than via the listing process as you note.

Aileen Armstrong: And I think the only thing to add, just in terms of revising the board leadership transparency and governance principles, is that we do acknowledge that we've got different ownership structures in the sector. And one of the aims of those principles is really to ensure that the regulated company is focusing on the right things no matter the ownership arrangements.

David Black: Thank you, Aileen.

Operator: And we'll take our next question from Alex Wheeler with RBC.

Alex Wheeler: Afternoon, everyone. Three questions for me, please.

Can you give an idea of what was required from the fast-track companies to get to the exceptional status? Were there any common points that you think these companies should be focusing on in AMP7?

Secondly, on the update of the cost of capital in July, given early draft determinations for the fast-track companies will be using the existing cost of capital, can we assume this won't be subject to significant change?

And then finally, can you give some colour on the process for the significant scrutiny companies and the potential penalties that may be applied? I guess here I am just curious around, do all of the shortfall points you've mentioned have to be met to avoid penalties?

Thank you.

David Black: So taking ... so, shall we take the last question first, if I can see how we go. So, John, do you want to address? Okay. Sorry. Yes, sorry.

So in terms of the ... so we are expecting companies to make in terms of the significant scrutiny companies, what we've said is that the potential penalties were tougher cost-sharing rates, so lower potential gains from cost out performance and a higher portion of cost under performance and potentially to cap bespoke outcome delivery incentives, not to allow any out performance.

So we'll look at the changes that companies make to their plans at draft determination in terms of their revised business plans, and take a view on this when we set out our draft determinations. What we will be looking for is for companies to take on board the feedback and to come back to us with revised plans which address the issues that we've set out and/or to provide very compelling evidence where they think their views differ from Ofwat’s.

In terms of your second question ... What's that? Oh, WACC. So in terms of regarding the WACC will be ... so we've set an early view on the WACC, which was our best view in terms of December 2017. We'll be updating that for the July draft determinations and those changes will be reflected in the final determinations for fast track companies as well. And then in terms of the exceptional status, I'll ask John to address that question.

John Russell: Yeah, so I mean, when we were looking for exceptional, we were really looking for a stretch and ambition over and above the norm in a number of our key areas, particularly in relation to innovation in the sector and resilience in the round, which is a thing we've been pushing, as well as excellent customer service. And we saw lots of good things to like in the plans but we didn't really see across the board a company that really had pushed itself into that exceptional category. And I think particularly in those innovation and resilience areas, those are themes that we are going to be exploring further as we think about our longer-term regulatory strategy over the rest of this year.

Operator: Our next question comes from Lakis Athanasiou of Agency Partners.

Lakis Athanasiou: Hi guys, it's Lakis here. A few questions for me, one on efficiency and the other one on cost of capital.

On efficiency, I'm looking at your table at the back of your summary of test area assessments, page 129, and I get there but your industry aggregate view of costs is 15% below the business plan submissions. I think you mentioned something like 7.9% in your presentation? Or have I misinterpreted that? Just wanted to confirm that that is the table that I should be looking at.

And my real question is that looking at the listed companies costs, business plan submissions versus your view, all of them are about 3 to 3.5% above your view, which says that if they perform in line with their business plan there ain't going to be any totex incentive gains, just penalties, and zero if they perform in line with your view. Is that a correct interpretation?

David Black: So, in your first question, Lakis, so I think the table you're looking at is the table for totex costs, the difference I was referring to was around base costs which-

Lakis Athanasiou: Ah understood, I understood, yeah.

David Black: And the 7.9% I quoted actually merges base costs with un-modelled costs to compare with base costs of PR14 which I think is the right comparison, and it terms of getting a feel for efficiency in the sector I think looking at base costs is most relevant.

In terms of your question about the 3-3.5% out performance, sorry, the 3-3.5% cost differential on the fast-track companies, certainly that's true in terms of projected costs, however the experience with business plans during the current price review period would suggest that companies may well be able to still out perform the projections in their business plan. But that's obviously an issue for them to address, and of course, we say that these companies obviously accepted the adjustments to their cost as part of entering into the fast-track process. So, I'm sure that…

Lakis Athanasiou: But they all seem to be on the same level at 3-3.5% percent, UU, Severn Trent, and South West Water above your assessment, and if they didn't just meet your view there would be no totex incentive gain. It is that if that matters, rather than expecting them to beat it.

John Russell: So just going back to on base costs South West Water, our differentials are 0.0% and Severn Trent 3.1% ahead, and United Utilities are 2.8% off, so it terms on their base costs, there's certainly evidence that these companies are very close to our allowances or even better than that. Differentials on enhancements certainly are manageable for companies in terms of the scale and scope of the programs that they run as well. So I think ... so that's a question that companies can better answer themselves, but as I say, their performance during the 2015-20 period does demonstrate that companies are able to outperform our view of efficient costs that we set in the previous price review. So I'd remain confident that there is still some prospect of that for these companies.

Lakis Athanasiou: And my second question, and you'll probably answer you don't want to comment, but we had Ofgem come in in December with a half percent lower nominal RORE than you guys. I mean, do you have any thoughts at this stage on that or are just going to reserve your position until July?

John Russell: So we'll obviously look at the WAC again as part of the July draft determinations, yes we obviously work closely with Ofgem and we note their lower view on the cost of capital. There are certainly some specific factors in the energy sector that we're looking at such as the persistent out performance on costs and incentives in the energy sector which don't apply in the water sector, but certainly there are some common areas such as views on risk-free rates which have eased since our early view. So we'll be looking at all of those factors and we'll continue with Ofgem on cost of capital issues as well. So we'll look at these factors in the round and reach a view on the cost of capital for the July draft determinations.

Lakis Athanasiou: Thank you.

David Black: Thank you, Lakis

Operator: Our next question comes from Dominic Nash with Barclay's.

Dominic Nash: Yes, good afternoon everyone. I've got two questions, please.

Sort of following on from Lakis' efficiency against your efficiency benchmark, I was led to believe that the companies would be benchmarked and that upper-quartile would be taken as the start of the benchmark for the target to beat on a moving economic gain basis? Are any of the water companies in the round in the upper-quartile at all? Because I'm surprised that the fast-track companies aren't going to be having an out performance against your benchmark on day one.

And secondly on the beta calculations for companies, you obviously rely on the market beta of the listed companies in order to derive a sector-wide CAPM-driven cost of equity. And my question is, is there any difference, do you think, between the issue that these three listed companies happen to be the three high performing companies against the beta for the sector and whether the cost of equity should be different to the one that you see on the performance of the three listed ones? Thank you.

David Black: Okay. So in terms of the upper-quartile point, the point is around base costs and in terms if you do look at the view on base-cost efficiency, the Appointee level, you'll see that there are four companies either at or below the level of efficient cost that we set out. The point is that when you add in the enhancement costs and take a view around the efficiency of that, that the three fast-track companies come out slightly over, it's important to emphasize that our decisions on fast-track are not just based on cost alone and that indeed the company that has the most efficient cost in the sector is also in significant scrutiny. So it's not just about the cost efficiency which drives our IAP decision, but nonetheless, it's clear that the fast-track companies are either close to or more efficient than our benchmarks and that for two of the companies the differentials purely relate to enhancement costs, and for one of the companies, United Utilities, there is some differential on base. And that is part of Ofwat setting a tougher efficiency challenge at PR19 and it follows that companies probably ought not to expect on day one to be outperforming, but nonetheless, as I said, the history of the sector suggests that having set a cost challenge, companies strive hard to achieve that. And evidence from the current and previous periods suggest that they will be able to manage that.

In terms of your point about betas and listed companies and their performance. So this is all around the measuring the relative risk. I'm not sure the fact that they are higher performers necessarily reduces their validity in terms of as a risk estimator, because risk about variance on the upside and the downside as well, but also your point is obviously about historical data and it's certainly true that not all those companies were high performance as you look further back. And so there's obviously a question to debate about how much we put a weight on historical data versus more current and more contemporary beta data.

Dominic Nash: Could I follow up on that one, then, please? Because if you use historical data but you're basically saying you're only going to be using a two year beta as we roll into 2020. So the changes between now and December is nearly half of our beta data. How is it ... can you just remind me again how is it consistent to set a cost of equity over a five year period based on a two year timeframe? Particularly in light of what you just said over the beta calculations of the three listed ones might be different if you look at the historical numbers.

David Black: So I think the point he's making more generally on betas is that there is a debate about how much evidence you should ... how much weight you should place on evidence that's older. Clearly a longer time series produces a more accurate beta estimate from a purely mathematical sense. Equally, the longer the time series you allow the more likely it is to be less relevant to pointing to risk at the current time. And so, in terms of reaching a view about beta, we all have to consider that when we set the view of beta in July. We don't work instantly so we will obviously be looking at data from around March, April this year, so most of the data is still going to relate to the period prior to our announcements of fast-track status for these companies. So I don't see a significant issue there, Dominic, but it is something, of course, that we look at as part of our view when we reach our view on the betas and on the cost of capital.

Dominic Nash: Great. Thank you.

Operator: We'll next hear from Fraser McLaren with Bank of America.

Fraser McLaren: Hi. Good afternoon, everyone. Just one question for me, please. You've mentioned the elements that won’t change for the fast-track companies between now and the final determinations and you've remarked on the steps to confirm WACC. But can you just remind us, please, what elements and benchmarks could still change, please, over the year, particularly as many of the companies who are not fast-tracked still have to resubmit their plans, clearly.

Thanks.

David Black: Yes. Good question, Fraser. So our view on cost allowances, our view on base cost efficiency and on efficiency of enhancement remains open, and so as we get more data on that we will finalize with a view on that later in the year. And similarly our view on outcome performance commitment levels, also remains open at this time. So the early set principle applies to any specific elements of the determination at this point in the process.

Fraser McLaren: Okay. Thanks.

David Black: Thanks.

Operator: If you would like to ask a question, as a reminder, it is Star 1. And we'll take our next question from James Brand with Deutsche Bank.

James Brand: Hi, two questions, please.

The first is on the sector as a whole. I remember that after you presented your framework documents as I remember a comment being made that if companies were not fast-tracked that they would find the review process extremely challenging, and it sounded a little bit ominous. And at that point, I think, the view of most people was that therefore a more substantial number of companies would be fast-tracked. So I was just wondering how we would should view the sector as a whole in light of that. Should we be expecting the vast majority of the sector to have an extremely challenging and difficult review process? And does that signal that the majority of the sector is just not rising up to the mark that you expect the companies to be hitting?

And secondly, just wondering whether you could talk a little bit about what the benefits of being fast-tracked are. At the last review there was an uplift to the base return which obviously is also going to be the case for this review. There was also a greater retention of any totex out performance. I'm not sure whether that has been determined yet for this period, but if you could just comment on whether there's any guidance you could give on that.

And then the third benefit was that by and large, I think you said, the ODIs last time round and companies broadly over fast-track just kept their ODIs as largely as proposed. I can see from some of the documents that you put out today that there are quite a lot of adjustments being proposed to the ODIs for three companies. I was just wondering how substantive we should view those changes or whether you've by and large left the ODI proposals intact.

Thanks.

David Black: Okay. So in terms of the challenge of PR19 I think we've been clear all along that we saw the PR19 process as raising the bar for the sector as being challenging. But we've also said all along that we think the ingredients are there for companies to do much better. So I think at the start of the exercise for developing our approach to the Price Review we identified relatively low productivity growth in the sector in the preceding years, issues with around a lack of innovation, and so we are very keen that those are addressed in PR19.

And so we have raised the bar for companies but we've also, we think, enabled higher performance through the adoption of totex and outcomes and more flexibility for companies. So we do think it's within their power to improve their performance. I think it's important not to judge the overall quality of what the sector's done in terms of the number of companies that are fast-tracked. I think we do see there are certainly lots of good features in business plans that are not fast-tracked. So we're seeing, for example, the commitment to a 15% reduction of leakage across almost all companies, which is certainly a major step forward. So that's as much as is being delivered by any company in the current end period.

So there's some real steps forward by companies certainly on cost efficiency. We've talked about in this call about the increased cost efficiency that we're asking for from the sector, but equally the fact that the cost delta at this point in the process is similar to last time tells us that the sector has stepped up. So there's quite a lot of positives coming through.

I think in terms of the number of companies that get to be fast-tracked, this is always going to be an inherently limited number. So some of our measures such as cost efficiency and measures of relative performance, when you're setting it up for upper quartile challenge, it's unlikely that you'll get, for example, much more than upper-quartile of companies that are going to qualify as efficient. It's possible, but less likely.

So I think the fact that we've got three companies covering around 30% of customers is, I think, still a pleasing achievement. It would be nice to have more companies across the line but I don't think we should take that as a reflection on the whole in terms of the progress by the sector.

In terms of the challenges for those companies, you can see that from what's set out on the material we've put it on the website. And so not all of this is just about costs or outcomes. We've made ... put quite a lot of effort into reviewing company's positions on resilience, things like innovation, things like how they’ve taken into account their past delivery in terms of driving their future plans. And so we do think there's quite a rich set of material there for companies to look at and to draw into their business plans and in terms of their approach to PR19.

Definitely, I think some companies do face a major challenge on their business plans in terms of their current levels of efficiency or stretching outcomes. But I think you can look to the fast-track companies and see that they have been able to reach the bar in the round and that gives us quite a lot of confidence that other companies can get there as well.

I think on your point in terms of interventions into the fast-track plans. They have been relatively limited but they were, in some cases where we have in terms of upper-quartile performance commitments, we have said, for example, that we are expecting on water supply interruptions more companies to get to a forward-looking upper-quartile measure. And both Severn Trent and United Utilities needed to adopt a tougher performance commitment in that area. Similarly, there were issues around sewer flooding for United Utilities. So there has been some adjustments for South West Water. We've asked them to adopt a special bespoke penalty only performance incentive around reaching a four-star rating on the Environment Agency's performance which we think is important to address issues around their historical performance on the EA's star rating system.

So there are interventions that we've made, but in the round we think these plans measure up well and that those changes will have an impact on both the upside and downside of RORE. We will be able to give details on that when we publish the draft determinations when we work those through our model.

Thank you.

James Brand: Thanks.

Operator: We have a follow-up question from Agency Partners.

Lakis Athanasiou: Hi guys, again.

I just want to understand a little bit more about your view on out performance. Firstly, when you talk about expecting them to outperform, are you talking versus their business plans or versus your view?

And also, would you expect differential out performance? So, for example, the listed companies that are 3% ahead on totex of your baseline versus the industry 15%, would you expect them to outperform less versus their business plan than the industry? i.e. it's ... they'll only outperform by 5% while the industry outperform, by 15% or it's a blanket thing that they all outperform by 10% or whatever. Just want to understand a bit more about this concept of yours about expecting out performance, because I think it’s quite important. I mean, I guess I'm asking, do you think the listed companies are being more honest than the unlisted companies in their business plans?

David Black: So I think expectations of out performance, Lakis, you're probably in a better place to assess then I am, in fact, because I'm a mere regulator. So it would obviously depend on your view about the stretch in the business plan, and that's something that's quite difficult to observe, actually. So as a regulator we can reach a view about what an efficient level of stretch is. Companies will obviously have some private information around that.

So we certainly note that some companies have made major reductions to their current costs they are spending and so that might suggest that their business plans are inherently more challenging, while other companies have come in with business plans which are materially up on their base costs for PR14. So, for example, we observed that United Utilities have made significant reduction to their current spending of PR14 by around 20%. So that's quite a major shift down in costs. So that's obviously demonstrating an ambition on costs. Clearly we're going to set a view around an efficient level of costs, and their out performance will be measured for PR19 against that.

Other companies may have come in with business plans which they have challenged themselves less on, and inherently have more upside in. But it requires that you need to take a view on that between what a company's view about its efficient level of cost is, and what our view is. And we obviously only have part of that information, so in terms of their outperformance over PR19 and reach a view of what that's likely to be, that's more of a question for analysts than it is for me as a regulator.

Lakis Athanasiou: Okay. I guess ... yeah. Fine. Thank you.

David Black: Thank you, Lakis.

Operator: And from Verity ... we'll hear from Verity Mitchell with HSBC.

Verity Mitchell: Afternoon, everybody. I've just got two questions.

The first one is about financeability. So do we assume that the companies that are fast-tracked have cleared the hurdle as far as your concerned on financeability?

And my second question is about investing for the future which is on page 19 of your overview document. You've mentioned this £360 million of strategic water resources. Is that something that's already been allocated under business plans or is that a pot that can be allocated? You also mentioned that companies might be expected to fund studies for these transfers that aren't actually funded in their business plans. So a bit of explanation about that, please, too?

David Black: Okay, so ... sorry, what was the first question again? Financeability? Oh, yes.

So, financeability, yes, so as part of our assessment of the business plans in IAP, we assess the evidence that they provided on their financeability and for all of the fast-tracked companies, we are comfortable with their views on their assurances that they provide on financeability. We will finalize our views about pay-as-you-go and RCV run-off rates as part of the draft determinations noting that the slight changes we have made to their cost baselines may have implications for things like their pay-as-go and RCV run-off rates. But, effectively, yes, they have financeability. And, indeed, most other companies also provided good evidence on their financeability as part of their business plans.

In terms of the £360 million pounds of funding, so what we did see across the southeast is that a number of companies put forward proposals to bring forward water resources from a whole variety of schemes, such as from effluent reuse to water transfers. What we felt we were trying to decide on as a regulator is obviously optimal schemes in each company's area. But we could see there was quite a lot of interrelationships between schemes, and that a scheme brought forward by one company could be used to supply water to another company and vice versa.

We also were concerned that in terms of major schemes, that under the current water resource management planning framework, companies were tending to identify one option and then do feasibility work around that. For very big decisions where there's multi-billion pounds infrastructure investment being made, we thought it was appropriate for companies to look and bring forward multiple schemes, and so therefore we've taken a step as a regulator to allocate additional funding to companies, and that is reflected in our views of cost for the IAP and that would allow companies to bring forward multiple options. However, we've also asked them to propose to Ofwat, in terms of their revised business plans, appropriate gates for taking forward those options.

So there are schemes like the North South Transfer, the Abbingdon Reservoir, and other water schemes in the south east that we would like to see taken further forward by the sector. Some of these schemes we are not looking for decisions in PR19, but the idea is that we have shovel-ready projects for PR24, and have more confidence that we've got the right information in front of us to make a good decision.

Thank you.

Operator: And there are no further phone questions at this time.

David Black: Okay. Well in that case I think we'll wrap it up here.

So thank you for your time today. So, yes, the next steps from here, as a reminder the fast-track draft determinations in early April, slow-track in July, and we think there's obviously a significant amount of certainty for the first-track companies. There's clearly some way further to go for slow-track and significant scrutiny companies, and so we'll see where we get to come 1st of April when the revised plans come in.

So, thank you very much for your time and attention today.