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Ian Marchant
Chief Executive
Thames Water Utilities Ltd
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3 July 2019

Dear Ian

PR19 update

I wanted to provide you with an important update about our assessment of Thames Water's revised business plan, submitted to us on 1 April.

We set out in our methodology that we expect water companies to make a step change in efficiency over the next five years so that customers get more of what matters. We are concerned that there is a substantial difference between our view of efficient and justified expenditure and the expenditure that was included in your revised business plan for base costs for retail and wholesale water control areas. We are providing this information early to give you the maximum amount of time available to ensure your cost submission for the final determinations is efficient and well justified. At draft determination on 18 July, we will set out full information on our assessment of the efficient allowance for total expenditure across all price controls for base and enhancement costs.

Your September business plan proposed an increase in base costs from historical expenditure and, in our initial assessment of business plans, we assessed Thames Water's plan as falling significantly short of demonstrating cost efficiency. We are pleased that the revised plan submitted in April 2019 Thames Water proposed lower overall costs compared to its September 2018 plan. While this does mean that the gap is lower than compared to the September plan, we remain concerned because our current assessment of your revised plan suggests that there will remain a significant gap between the base costs proposed in your plan and our view of the efficient level of base costs for wholesale water and retail.

Customers expect water companies to deliver essential water and wastewater services in an efficient manner. The gap on base costs is particularly important because it reveals inefficiency in the year on year costs that a company incurs running its business. Efficient base costs are essential for a well-functioning company. The table below summarises the price controls that are driving the gap for base costs.

Key differences between Ofwat and company view of base costs

	April plan (£m)	Our current view (£m)	Gap (%)
Water	4,003.8	3,548.5	11.4%
Retail	876.9	753.5	14.1%

Wholesale expenditure expressed in 2017-18 CPIH deflated prices. Retail figures in nominal prices. Figures presented reflect updates to our approach to assessing costs since the initial assessment of plans. In water, base costs now include 'new development', 'new connections', and 'addressing low pressure', which were previously classified as enhancement.

Our current assessment is still subject to change, although at this stage we do not expect any material changes to the size of the gap before the draft determination. We note that we have not necessarily been able to take full account of all late evidence, submitted after the 1 April business plan. While we will reflect on this information for the final determination, we consider that Thames Water needs to take urgent action to address the efficiency challenge on base costs.

Given the material difference for Thames Water, we want to give you as much time as possible to reflect on your plan for 2020-2025 and reconsider your proposals in responding to our draft determinations.

It is not our intention to discuss this further until we publish our draft determinations, but we expect this issue to form part of the consultation process after that date.

Yours sincerely



David Black

Senior Director, Water 2020