

July 2019

Trust in water

# PR19 draft determinations

**Thames Water – Securing confidence and assurance actions and interventions**

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## PR19 Draft Determinations: Thames Water – Securing confidence and assurance actions and interventions

Following our initial assessment of plans, we categorised two types of actions for slow-track and significant scrutiny companies:

- required actions for companies which in general were required for draft determinations (or final determinations for some aspects of past delivery); and
- advised actions for companies to do by a specific date but that are not required for our draft determinations.

Table 1 below sets out the required and advised actions, a summary of the company’s response to the action, our assessment of the company’s response, and any further interventions we are making as part of the draft determination.

Each action has a unique reference. The prefix ‘TMS’ denotes the company Thames Water. The central acronym references the test area where the action has been identified, please see the ‘PR19 draft determinations: Glossary’ for a key to these acronyms. Actions whose numbers are preceded with an ‘A’ denote required actions and actions whose numbers are preceded with a ‘B’ denote advised actions.

Table 2 below sets out any further interventions that are not resulting from an action which we are making as part of the draft determination.

Each further intervention that is not resulting from an action has a unique reference. The prefix ‘TMS’ denotes the company Thames Water. The central acronym references the test area where the action has been identified, please see the ‘PR19 draft determinations: Glossary’ for a key to these acronyms. Intervention numbers are preceded with a ‘C’.

For all other documents related to the Thames Water draft determination, please see the [draft determinations webpage](#).

**Table 1 – Thames Water’s response to required actions and interventions for draft determinations**

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
Securing confidence and assurance	TMS.CA.A1	Required	Provide restated Board assurance that the Board has identified the risks associated with delivering the plan. The original statement did not provide assurance that the Board itself is aware of, and had explicitly demonstrated ownership of, the risks associated with delivering the plan.	1 April 2019	Thames Water provides the following updated Board assurance statement: "We have, and will continue to: fully consider and accept the inherent risks associated with delivering our ambitious and stretching Plan, for example we are setting ourselves a 30% pollution reduction target, putting us at the forefront of the industry; alongside continuing with our risk management maturity improvement programme ensuring effective risk mitigation and management plans."	No intervention required.  The Board of Thames Water provides a compliant assurance statement.	N/A
	TMS.CA.A2	Required	Provide restated Board assurance that the risk mitigation and management plans the Board has in place are appropriate. The original statement did not provide assurance that the Board itself is aware of, and had explicitly demonstrated	1 April 2019	Thames Water provides the following updated Board assurance statement: "We have, and will continue to: fully consider and accept the inherent risks associated with delivering our ambitious and stretching Plan, for example we are setting	No intervention required.  The Board of Thames Water provides a compliant assurance statement.	N/A

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			ownership of, the risks associated with delivering the plan.		ourselves a 30% pollution reduction target, putting us at the forefront of the industry; alongside continuing with our risk management maturity improvement programme ensuring effective risk mitigation and management plans."		
	TMS.CA.A3	Required	Provide restated Board assurance that the company's business plan is financeable on both the notional and actual capital structure and the plan protects customer interests in both the short and long term. The original statement did not provide assurance that the plan protects customer interests in the short and long term.	1 April 2019	Thames Water provides the following updated Board assurance statement: "We have, and will continue to:  strengthen our funding from operations to (FFO) to net debt ratio from 4.8% to 6.1% to protect customers' interests in both the short and longer term. We also obtained independent specialist assurance that this approach ensures we remain financeable on both the actual and notional basis."	No intervention but further action required by Thames Water.	Please refer to TMS.RR.A2 for details of our assessment and rationale and the further action required by Thames Water.
	TMS.CA.A4	Required	Provide restated Board assurance that the Board's governance and assurance processes will deliver resilience in the round and the long-term. The original statement did not provide assurance on the Board's governance and assurance processes.	1 April 2019	Thames Water provides the following updated Board assurance statement:  "We have, and will continue to, maintain our customer led commitment and, with oversight from our governance and assurance processes, will deliver operational, financial and corporate resilience through 2020-25 and in the longer term."	No intervention required.  The Board of Thames Water provides a compliant assurance statement.	N/A
	TMS.CA.A5	Required	On gearing outperformance sharing the company has not included our default sharing mechanism from our 'Putting the sector in balance' position statement or an alternative proposal which provides equivalent customer benefits, despite forecasting high gearing over 2020-25. We propose to include our default mechanism in the company's draft determination in the absence of company action to include it in its resubmitted business plan, so that customers will receive bill reductions if gearing in any year is above the 70% threshold.	1 April 2019	Thames Water sets out that it does not agree with the principle of a gearing sharing mechanism. However, the company proposes an alternative mechanism to the default mechanism which we put forward in our 'Putting the sector in balance: position statement', comprising: <ul style="list-style-type: none"> <li>- a tiered sharing arrangement; and</li> <li>- increase in the reference point from gearing of 65% to 70%.</li> </ul>	Intervention required.  Thames Water is highly geared and expects to remain highly geared through 2020-25 and with gearing declining, but remaining above 76% at the end of 2025.  We are intervening to introduce our default mechanism as described in the 'Putting the sector in balance: position statement.'  Our assessment is that Thames Water's mechanism does not deliver equivalent benefits for customers in the round compared with our default mechanism. While the company proposes to take steps to improve financial resilience in 2020-25 which may reduce risks to customers in the long term, the company will remain highly geared, and we seek further assurance from the company about the levels of financial resilience it will achieve as a consequence of the interventions in its plan. We are not convinced the proposed gearing reduction, combined with the lower level of benefit sharing proposed by Thames Water provides benefits that are equivalent, in the	We expect Thames Water to apply our default benefit sharing mechanism. If the company does not apply the default mechanism set out in the 'Putting the sector in balance: position statement', we intend to make an adjustment at PR24 to ensure benefits are adequately shared with customers.

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
						<p>round, to our default sharing mechanism. The company provides insufficient evidence that this constitutes a transition that is in the customer interest.</p> <p>Therefore, we do not accept Thames Water's sharing mechanism proposal.</p>	
	TMS.CA.A6	Required	<p>On dividend policy the company is required to confirm that it is committed to adopt the expectations on dividends for 2020-25 as set out in 'Putting the sector in balance: position statement' to include:</p> <p>commitment to transparency about how the dividend policy in 2020-25 takes account of obligations and commitments to customers for the dividend policy that is applied in 2020-25 and when determining dividends.</p> <p>Please provide an update on the steps you are taking to fully meet the expectations as set out in our 'Putting the sector in balance: position statement.'</p>	1 April 2019	<p>Thames Water confirms it will be transparent about how the dividend policy in 2020-25 takes account of obligations and commitments to customers. When assessing the impact of any dividend payments on customers its Board will consider both past performance and expected future performance on issues such as customer service and performance commitments.</p>	<p>No intervention but further action needed by Thames Water.</p> <p>The company provides sufficient evidence of its intention to meet the expectations on dividends as set out in 'Putting the sector in balance: position statement' but its response lacks detail on how it will demonstrate annually to stakeholders that it has met them.</p> <p>It provides insufficient transparency as to:</p> <ol style="list-style-type: none"> <li>the specific obligations and commitments to customers;</li> <li>the level of performance delivery they will be considered against; and</li> <li>how they will impact on dividends.</li> </ol>	<p>We expect Thames Water to be transparent about how the dividend policy in 2020-25 takes account of obligations and commitments to customers and to demonstrate that in paying or declaring dividends it has taken account of the factors we set out in our putting the sector in balance position statement. We expect the company to respond to this issue in its response to our draft determination.</p> <p>We expect the company to demonstrate that its dividend policy for 2020-25 takes account of obligations and commitments to customers and other stakeholders, including performance in delivery against the final determination. In doing so, the company should refer to the examples of best practice we have identified among companies.</p>
	TMS.CA.A7	Required	<p>On executive pay the company is required to confirm it is committed to adopt the expectations on performance related pay for 2020-25 as set out in 'Putting the sector in balance' to include:</p> <ul style="list-style-type: none"> <li>- visibility and evidence of substantial linkage of executive remuneration to delivery to customers;</li> <li>- clear explanation of stretching targets and how they will be applied;</li> <li>- clearer explanation of how the policy will be rigorously applied and monitored;</li> <li>- commitment to report how changes, including the</li> </ul>	1 April 2019	<p>In addition to the initial assessment of plans response, Thames Water provided further information on its proposed policy for 2020-25.</p> <p>Thames Water states its commitment to aligning to the expectations of 'Putting the sector in balance: position statement'. The company is in consultation with its remuneration committee and the TWUL Board regarding the finalisation of the policy for AMP6 which will form the basis of the policy for AMP7. The proposed policy contains:</p> <ul style="list-style-type: none"> <li>- Annual bonus consisting of 30% customer (20% customer complaints, 5% sewer flooding and 5% supply interruptions), 30% EBITDA, 20% other corporate priorities and 20% personal objectives.</li> <li>- Long term bonus consisting of 40% customer (20% C-Mex and 20% NPS), 40% customer</li> </ul>	<p>No intervention but further action needed by Thames Water.</p> <p>Thames Water's proposed policy demonstrates the company's commitment to move in the direction of the expectations set out in 'Putting the sector in balance: position statement.'</p>	<p>There remain some details to be finalised, for example detail on which target metrics will be used and the formal approval of the policy by the remuneration committee and TWUL Board. Once finalised, we expect Thames Water to provide an update in its response to the draft determination to demonstrate that it is committed to meet the expectations we have set out in 'Putting the sector in balance: position statement'.</p> <p>We expect the company and its remuneration committee to ensure its performance related executive pay policy demonstrates a substantial link to performance delivery for customers through</p>

Test area	Action reference	Action type	Action	Date required	Summary of company response to action	Our assessment and rationale	Required interventions
			<p>underlying reasons, are signalled to customers; and</p> <ul style="list-style-type: none"> <li>- commitment to publish the executive pay policy for 2020-25 once it has been finalised.</li> </ul> <p>Please provide an update on the steps you are taking to fully meet the expectations as set out in our 'Putting the sector in balance: position statement.'</p>		<p>delivery (20% leakage and 20% EPA) and 20% RoRE.</p> <ul style="list-style-type: none"> <li>- Targets will be stretching as metrics will reflect those used in the final determination taking account of the performance levels specified. In addition, where appropriate, the remuneration committee and TWUL Board may consider historical or cross sector benchmarks to ensure targets are sufficiently stretching.</li> <li>- The remuneration committee has discretionary powers to reduce in part or full any payment for exceptional circumstances i.e. failure to hit minimum regulatory or health and safety standards.</li> <li>- Full details of the policy will be published in the annual report and accounts including any changes and the underlying reasons.</li> </ul> <p>Thames Water states that papers will be submitted to the remuneration committee in September and thereafter the TWUL Board, with the policy being completed by March 2020.</p>		<p>2020-25 and is underpinned by targets that are stretching. Trust and confidence can best be maintained where stretching performance is set by reference to the final determination and taking account of stretching regulatory benchmarks (for example delivery of upper quartile performance) and should include a commitment that it will continually assess performance targets to ensure targets will continue to be stretching throughout 2020-25.</p> <p>We expect the company to report transparently, in its annual performance report, about further updates to the development of its policy that will apply in 2020-25.</p>
	TMS.CA.A8	Required	Provide a revised financial model (based on version 16z released on 31 January 2019) and data tables on 1 April 2019.	1 April 2019	Thames Water provides a revised financial model based on version 17z (as communicated to companies since the initial assessment of plans action was set) and data tables.	<p>No intervention required.</p> <p>Thames Water provides a satisfactory response to this action.</p>	N/A
	TMS.CA.A9	Required	Provide normalised performance (%) values consistent with ODI reporting. This action specifically relates to data table App3 – Abstraction Incentive Mechanism.	1 April 2019	Thames Water confirms that the values entered for the normalised performance are correct and are intended to be zero for 2016-17 and 2020-25 (AMP7). The company will provide 2018-19 values after the end of financial year.	<p>No intervention required.</p> <p>Thames Water provides a satisfactory response to this action. The estimate of 0% cumulative normalised performance over AMP7 appears consistent with its projected performance of 0 Megalitres per year under the Abstraction Incentive Mechanism.</p>	N/A
	TMS.CA.B1	Advised	Provide an updated financial model that uses the wholesale cost of equity to calculate dividend yield.	1 April 2019	Thames Water provides an updated financial model with a combined dividend yield and growth of 4.27% (2.99% dividend yield and 1.28% growth).	<p>Intervention required.</p> <p>Thames Water provides an unsatisfactory response to this action as the combined dividend yield and growth are below our early view of the real (CPIH based) cost of equity.</p>	We are intervening to use Ofwat's view of dividend yield and growth.

**Table 2 – Further interventions for draft determinations**

Intervention reference	Our assessment and rationale	Interventions
N/A	N/A	N/A

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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July 2019

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