

Meeting held on Thursday 23 May 2019

Venue: Bloomsbury House, 21 Bloomsbury Street, London WC1B 3HF

Attendance

Board attendees	
Jonson Cox	Non-Executive Director, Chairman
Martin Lawrence	Non-Executive Director
Tim Waggott	Non-Executive Director
Mark Bayley	Non-Executive Director
Catherine Waddams	Non-Executive Director
Alison Munro	Non-Executive Director
Christine Farnish*	Non-Executive Director
Rachel Fletcher	Chief Executive
Aileen Armstrong	Executive Director
David Black	Executive Director
John Russell	Executive Director
Jenny Block	General Counsel and Board Secretary
Other attendees	
Lisa Commane	Senior Director, Business Improvement
Claire Forbes	Senior Director, Corporate Communications
Emma Kelso	Senior Director, Customers and Casework
Alena Kozakova	Chief Economist
Keith Mason	Senior Director, Thames Tideway Tunnel
Andrew Chesworth	Director, PR19
Tim Griffiths	Director, PR19
Ynon Gablinger	Director, PR19
Colin Green	Director, PR19
Anita Payne	Director, PR19
Bart Schoonbaert	Director, PR19
Stephen StPier	Director, PR19
Sophie Shaw	Director, Legal, PR19

Jamie Tunnicliffe	Director, PR19 (Investor Relations)
Dena Barasi	Associate Director, PR19
Peter Jordan	Associate Director, PR19
Martin Malinowski	Principal, PR19
Milton Salas	Principal, Analytics (PR19)
Andy Titchen	Principal, Analytics (PR19)
Kate Kendall	Director, Finance and Governance
Elinor Mathieson	Principal, Finance and Governance
Heather Katsonga-Woodward	Principal, Analytics (Finance and Governance)
Sarfraz Nawaz	Director, Finance (Operations)
Carl Pheasey	Director, Strategy Hub
Richard Collard	Senior Associate, Strategy Hub

*Christine Farnish joined the Board meeting by conference call up to the end of the PR19 items.

1. Opening Items and Declarations

- 1.1. The minutes of the Board meeting held on 25 April 2019 were approved subject to some minor amendments.
- 1.2. There were no conflicts of interest to declare by reference to the matters on the agenda.

2. Chief Executive's Report

- 2.1. The Chief Executive gave an update on the Comprehensive Spending Review. The Board provided its views on the Executive's initial thinking.
- 2.2. The Board discussed the Public Accounts Committee hearing which took place on 20 May.

3. PR19

Overview

- 3.1. The Executive presented an overview of the PR19 programme providing a summary of key issues to be discussed in more detail at the meeting, and noting certain proposed interventions to company plans.
- 3.2. The Board discussed the proposed approach to draft determinations for the slow track and significant scrutiny companies (ST/SS). The Board also discussed key interventions on PR14 reconciliations, the emerging assessment of companies' approach to direct procurement for customers (DPC) schemes and received an overview of the assessment of customer engagement in and board assurance on companies' revised plans.
- 3.3. The Board received an update on our engagement with water companies and their responsiveness to the actions Ofwat required in the IAP decisions in January 2019, and considered the Executive's proposal on the application of different cost sharing rates to the significant scrutiny companies. The Board received an update on our engagement with external stakeholders and considered the Board forward agenda leading to draft determinations for slow track and significant scrutiny companies, and following receipt of company submissions in September 2019.

Outcomes – common and comparable performance commitments

- 3.4. The Executive presented the proposed approach for draft determinations to the service levels and financial incentives associated with slow track and significant scrutiny (ST/SS) companies' common and comparable performance commitments (PCs).
- 3.5. The Board considered all recommendations on the approach and principles for setting the levels for common and comparable PCs. The Board considered that compared to other areas, companies could have shown more ambition on per capita consumption (PCC). The Board debated whether it was appropriate to set a more stretching target for PCC, given the importance of this issue. Reservations were also expressed, including by reference to the role of metering in moderating consumption levels, recognising that not all companies have the ability to introduce compulsory metering.

- 3.6. The Executive noted that in developing this particular PC, the Defra target would be taken into account and by the end of the price review period there would be more convergence as a result of Ofwat's current proposals. There were other tools that could be used in this context and the Board noted ongoing work with the EA and DWI on long-term targets for the sector that would incorporate measures addressing usage. Indeed a more holistic measure in the future might take account of water abstracted from the environment overall.
- 3.7. The Board concluded that this was an important issue that Ofwat should consider further and that Ofwat should take every opportunity to drive greater ambition in this area. Ofwat fully supported setting ambitious targets, addressing legislative anomalies, and approaching standards holistically, addressing environmental impacts in a rounded way.
- 3.8. In relation to asset health measures, the Board noted in particular the fundamental point that companies were expected to fulfil their legal obligations through the revenues allowed under the price control, including having regard to asset maintenance and long-term resilience.
- 3.9. Overall, in relation to common and comparable PCs, service levels and outcome delivery incentive rates for slow track and significant scrutiny companies, the Board approved the approach and principles proposed and authorised the Executive to decide the specific levels and rates for each company in light of this decision.
- 3.10. The Board noted that the decisions made on common and comparable PCs for the ST/SS companies will have implications for certain fast track companies. The Board noted the next steps to come back to Board in June for approval of the proposed key interventions for all companies.

Cost efficiency

- 3.11 The Executive presented an overview of the proposed modelling changes and revised cost allowances for the wholesale controls and the retail control. The Executive set out its assessment of company proposals for enhancement expenditure and cost adjustment claims.
- 3.12 The Board considered and agreed the proposed recommendation to make changes to the retail model and recalibrate the efficiency challenge for the retail price control, noting the anticipated impacts.

- 3.13 The Board noted the changes to models for the wholesale price controls since the IAP decision in January 2019, taking account of company representations and company data submitted with revised business plans, including some revisions to historical data. The Board noted the anticipated impact of these changes to modelling data for companies, and agreed in principle with the Executive's approach for draft determinations, while noting that cost models in wholesale water will be updated based on revised data received more recently.
- 3.14 In relation to enhancement costs, the Board noted that generally companies had not materially improved the quality of the evidence provided to support claims for enhancement cost allowances, for example in terms of the need for the underlying investment, the solution chosen and cost efficiency. The Board recognised that the lack of evidence did not necessarily mean that companies did not have to undertake the work and that the Executive was evaluating this carefully. The Board noted ongoing work to review enhancement allowances and that the Executive was seeking further information from companies on some points.
- 3.15 The Board noted the next steps to come back to Board in June with decisions on key enhancement items, and to present and discuss the overall (totex) challenge per company. The Board noted that fast track companies do not generally have early certainty around base or enhancement allowances, so changes for draft determinations for ST/SS companies may impact on these companies.

Real price effects and frontier shift efficiency

- 3.16 The Executive presented proposals on the approach at draft determinations to frontier shift efficiency and real price effects, also highlighting the overall level of the efficiency challenge for water companies.
- 3.17 The Board considered and agreed the proposals put forward for draft determinations.

Risk and return – initial recommendations

- 3.18 The Executive highlighted a number of issues arising in the area of risk and return including: a proposal from one company for a different form of control; proposals from two companies concerning Ofwat's proposed gearing outperformance mechanism; and a proposal for the application of an uncertainty mechanism. The Board agreed with the Executive's recommendations for dealing with these specific issues.

- 3.19 The Board discussed and provided its views on the Executive's current assessment of proposed Pay As You Go (PAYG) and RCV run-off interventions. The Board noted the proposed responses to the companies' approaches in relation to performance-related executive pay and dividend policy.

Risk and return – company specific adjustments

- 3.20 The Executive presented an overview of its assessment of requests by certain companies for Company Specific Adjustments (CSAs) to the cost of debt.
- 3.21 The Board considered the proposed recommendations on the basis of the tests set out in the Final Methodology that there be compelling evidence for: the appropriate level of the requested adjustment; benefits that adequately compensate customers for the increased cost; and customer support for the proposed adjustment.
- 3.22 The Board agreed with the Executive's recommendations for draft determinations.

Regulatory treatment of the proposed Havant Thicket reservoir

- 3.23 The Executive presented an overview of the Havant Thicket winter storage reservoir project proposed by Portsmouth Water and Southern Water and the proposed regulatory treatment of this reservoir with a view to reflecting this in Portsmouth Water's draft determination. The project will enable water transfers to Southern Water and make a significant contribution towards Southern Water meeting their legal obligations to resolve a 200MI/d deficit in the Hampshire region.
- 3.24 The Board considered possible regulatory approaches for Havant Thicket and approved the proposed approach.

4. Strategy Hub

Innovation

- 4.1 The Executive presented proposals to provide companies with an additional revenue allowance as part of PR19 to provide additional impetus to sector innovation during the next price control period.
- 4.2 The Board discussed and provided its view on the options for structuring a funding mechanism alongside other potential interventions. It considered there was value

in exploring further how we could encourage the involvement of the supply chain. The Board agreed in principle to propose providing companies with a combined increase in totex allowance over the next period, subject to development of further detail on customer protections ahead of final determinations. It would be important to allow for sufficient flexibility in selecting initiatives to receive this support, whilst also aiming to ensure focus on priority issues for the sector.

- 4.3 The Board noted the next steps to continue to develop proposals, and the intention to issue a consultation document shortly after draft determinations in July.

Strategic Comms: “fake news”

- 4.4 The Executive presented a paper on the risks associated with “fake news” which could undermine trust in the water sector and what this meant for Ofwat as economic regulator.
- 4.5 The Board discussed and endorsed the proposed approach to addressing these risks and urged the Executive to remain vigilant and to support the work of the industry and other bodies in their efforts to deal with the issues “fake news” presented.

5. Finance and Governance

Financial Resilience: consultation on ring fence

- 5.1 The Executive presented proposed recommendations on decisions following responses to Ofwat’s consultation on first steps in strengthening the regulatory ring-fencing framework that was published in November 2018 and closed in January 2019.
- 5.2 The Board considered the responses and agreed with the proposed recommendations. It noted that a consultation on the related licence modifications would follow the decision document and that further work may be undertaken in the future of the regulatory ring-fence to ensure the ongoing efficacy of the underlying licence conditions.

6. Business Improvement

Draft Annual Report and Accounts 2018-19

- 6.1 The Executive presented the draft Annual Report and Accounts 2018-19. The Chair of the Audit and Risk Assurance Committee (ARAC) reported on the special ARAC meeting at which the Committee reviewed the draft annual report and accounts, enabling members to highlight key issues. The Chair of the Committee reported that the revised report presented to the Board reflected the Committee's comments well. The Finance Director noted the initial conclusions of the external auditors following completion of their final audit.
- 6.2 The Board discussed the key themes contained within the draft annual report and the proposals made by ARAC. The Board noted the areas that had not yet been included.
- 6.3 Subject to a review of the Chairman's and Chief Executive's forewords, the sustainability report and the performance summary, and there being no material issues subsequently raised by Ofwat's external auditors, the Board referred to the Audit and Risk Assurance Committee the final recommendation to the Accounting Officer on whether it was appropriate to sign off the Annual Report and Accounts.

7. Update from Committee Chair

Audit and Risk Assurance Committee

- 7.1 The Chair of the Committee reported on the May meeting at which the Committee focused on the annual report and accounts 2018-19.
- 7.2 The Committee also discussed the current approach to risk management in the Finance & Governance programme highlighting how the programme is managing risks also at a strategic level and ensuring that the programme is aligned with Ofwat's corporate risk appetite.
- 7.3 The Committee noted the internal audit report on Business Management which had received substantial assurance. The Committee also noted the draft annual internal audit report 2018-19 from Mazars and received an update on the development of the IT strategic roadmap.

8. AOB

- 8.1. There was no other business and the Chairman closed the meeting.

Jenny Block

Board Secretary
23 May 2019