Transcript of the Ofwat investor call
16 December 2019

Jonson Cox, Chairman

Good afternoon everybody and welcome to our PR 19 price review call. In a moment I'm going to ask Rachel Fletcher, our chief executive to speak and she'll then pass to David Black senior director who led the price review and other colleagues , we will turn finally to Q and. A. Just like to make a few observations to get us going. These determinations are arrived at independently by a board of 11 directors and an experienced leadership team. We use rigorous analysis, active listening, including to investors and business judgment. Our independent process enables the best managements to deliver new frontiers and maintain a resilient service. Second observation, the gap in totex which gets a lot of attention between the company's final business plans and our final determination is one of the smallest ever, 0.4% on base and only 4% across all totex. There's only one company, it's a large one, but where there is a meaningful difference between base and what we've provided, and there's one WOC where there's a meaningful difference on enhancement, but overall the very, very small difference is a sign of the positive engagement we've had with the sector.

And I'd also like to say, well, something, this is a tough determination. It does exactly what we said at the start in 2016 and please look at it as a package. Four points I'd pull out for you. First, very significant investment and that's investment to protect the environment, improve service and boost resilience. I sometimes hear that we're anti investment. That's a myth, and I hope this package will put that to bed. Just as an example for you. All water industry national environment plan and all water resources plan outcomes have been supported in these determinations. We added a very small efficiency challenge to that, but we've supported all the outcomes. If you're not convinced. Let me give you another example. We're allowing a billion pounds of investment that wasn't requested by the companies. This is a pretty unprecedented move; there's three elements. There's about 470 million for the rapid unit for intercompany water transfers. There's 200 million for an innovation fund. The first time we've done that, and there's a 480 million package of investment for London, a contingent package over and above the company's plan. I will come back to that.

The second point I want to make is the strengthening of the performance commitments and ODIs. We introduced these last time around and some have done very well in the current period. Severn Trent has led the way followed by Anglian and Wessex - each adding between fifty and a hundred basis points to their RORE. This is an important and powerful part of our regulation to meet customer's expectations and reward well-performing companies. You'll note in the final determinations we've moderated on the challenge of some of the ODIs giving more upside to companies. Third key fact for us of this review was the challenge on productivity and innovation. The challenge has moderated from the draft position as companies have improved and sharpened their plans. The best performers have clear sight of how to meet at least the next few years and will take the efficiency frontier further forward to in the outer years of the period. The demand side challenge of productivity and innovation is for the first time ever supported by the innovation fund.

Lastly, the low cost of capital. This is exactly in line with analyst expectations and of course one of the effects it has is it has enabled the reduction in bills; on average around 50 pounds. I know this may not be what companies wanted, but affordability is one of our key priorities. Our determination of WACC is supported by the CAPM model, the benchmarks by other regulators and by market evidence. And I just point out that some companies have also shown how with commitment, skill and focus, they can secure impressive returns, sustained returns in the current period. Three companies have achieved an average RORE of between nine and 12% over AMP6; Severn Trent, South West and Wessex. Now penultimately, I just want to make a word on the package we've done for Thames. The difference between the company's final plan presented to us and our determination in totex terms was only 4% but we were not satisfied that the plan had enough investment for London's resilience. We've taken the unprecedented step of allowing a contingent fund, 300 million of the 480 in that is contingent on stringent gateway conditions, which don't apply to other companies. Co-funding by the company's owners and specific performance measures for London.

And so to the final thing I want to say before handing over, please look at the Determination as a package. Amid the cut and thrust, the political and public scrutiny, the demands we make of companies, we believe water still remains an attractive prospect for long-term investors. We know in the global infrastructure market returns have come down for all classes of infrastructure; but we believe this offers an investible package where you've got guaranteed index-linked revenues, an index-linked asset base, predictable, stable base returns, potential for out-performance of up to 300 basis points on RORE, a nominal dividend yield of 4% and a transparent and independent system of regulation. We think that's a fair balance and we urge investors to work with their companies to focus on service delivery and in doing so, getting the results you want to see too. With that, I'm going to pass to Rachel.

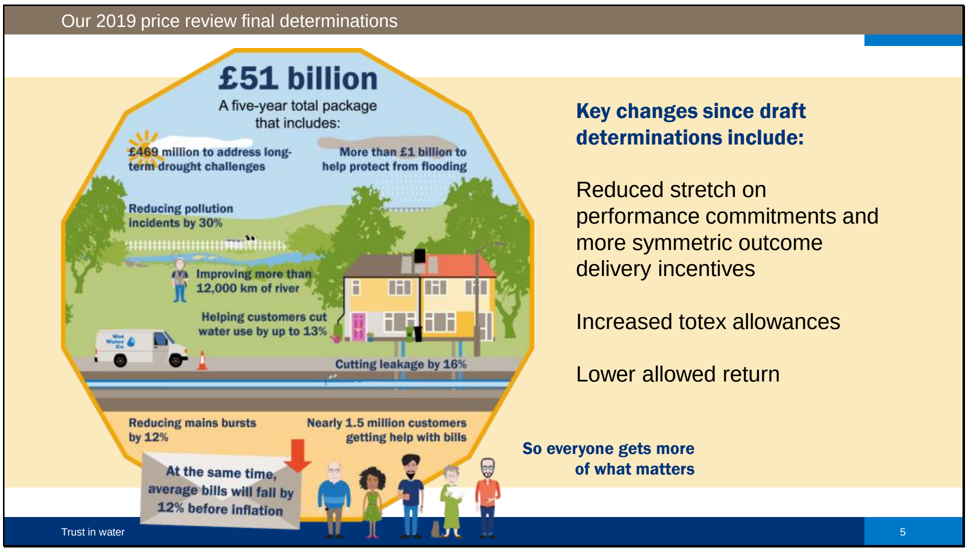
Rachel Fletcher, Chief Executive

Thanks Jonson. So this is a really important and significant moment for us and for the future of the water sector from the threat from climate change and population growth, concern about the state of our rivers and persistent or poor and unreliable service in some parts of the country. And the questions about the sector's legitimacy. Change is needed in the water industry. And we've been saying for the past three years that PR 19 is all about driving that change. This current AMP under PR 14 has shown the power of incentives and improving performance and getting companies to show what they can do when they put their mind to it. PR 19 is all about taking that further. So the sector can be in a different, brighter place in five years' time. And I'm confident that we have given companies the revenues, the incentives and the ability to attract the finance they need to improve performance and service for customers; to play an active role in improving and being good stewards of the environment; to improve the resilience of their assets for future generations; and to improve efficiency, keeping bills affordable; and innovating to drive productivity further.

If companies respond well to the challenges and priorities before them, they will help rebuild the reputation of the industry and they'll do well for their investors at the same time. PR 19 is a key building block to driving that change, but it isn't the final word and let me assure you we will not be going quietly into the night from now. As we set out in our strategy, which we published a couple of months ago, we will continue to drive change to transform performance, to address long-term challenges and get the sector to add even greater public value. On this last goal, in particular, the water industry has the potential to lead the way and show others how it is done. Translating this into action will mean, for example, that Ofwat continues to push on board leadership, including to see how companies are implementing the new policies on executive performance pay and dividends, which we talk about in our package today.

Also in the new year we will be publishing our consents, guidance and taking the steps we consulted on already to strengthen the regulatory ringfence. We'll also be driving markets and competition including through DPC projects and exploring strategic projects to move water around the country. We'll be funding innovation and we'll be meeting regularly with companies to discuss their performance, culture and financial resilience. We understand that you will want time to absorb our PR 19 decisions and reflect on implementation. But I very much hope this will not be the end of our engagement with you as there is much for us all to do in the years ahead. I'm now going to pass to David to give you more of the detail.

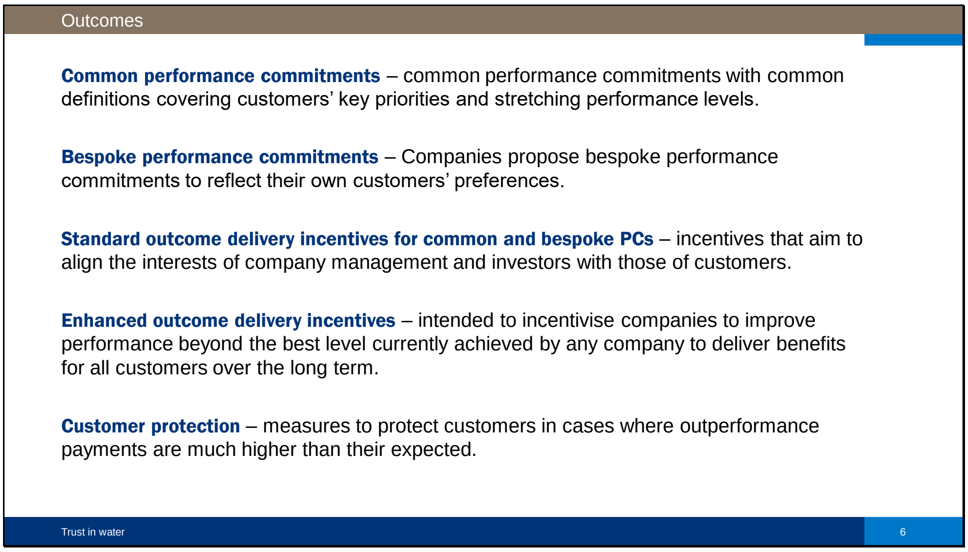
David Black, Senior Director



Thank you Rachel. So firstly I was going to look at some of the changes since draft determinations and then talk a little bit about outcomes and costs before handing over to Andy Chesworth, our director for risk and return to talk about the allowed return and financeability. We set out in PR 19 to encourage companies to engage with their customers to develop business plans that look to the long term and to address the issues facing them and their customers. We wanted to see a step up in performance and innovation, taking advantages of the changes to the price review framework and new markets. Key elements of PR 19 included the outcome performance commitments and associated delivery incentives with 15 common performance commitments enabling comparison and benchmarking across companies and bespoke performance commitments to reflect company-specific challenges. We set out an approach to cost assessment based on totex or total expenditure where we provide efficient cost allowances for companies to deliver the overall outcomes package.

We draw heavily on econometric modelling using historical cost data from the sector to identify catch-up efficiency against the best performers in the sector and a frontier shift to reflect economy-wide productivity growth. The allowed return on capital reflects market evidence of a reasonable base return on equity and the cost of debt. In January this year, we announced the results of our initial assessment of plans and identify three companies that challenged themselves and earned fast track status. Severn Trent Water, South West Water and United Utilities. They received early draft determinations and a financial reward equivalent to 10 basis points on the cost of equity for fast track status. Ten companies were classified as slow track and four companies were on significant scrutiny with extensive work required on their plans. These companies all resubmitted their plans in April. Despite significant progress in April business plans, at draft determinations in July there remained significant gaps in cost efficiency with an overall cost gap of 11% and a base cost gap of around 5%. There are also still some major gaps on outcomes, with some significant differences, particularly around water supply interruptions and leakage for some companies. Companies submitted representations to us on our draft determinations, and we've looked at these carefully along with those we received from other stakeholders. We were pleased to see that companies took the opportunity to look again at their costs and how they could reduce them and where we received compelling evidence that we should revise our approach, we have done so. So the three key changes to discuss since draft determinations are: the revised stretch on performance commitments and more symmetric outcome delivery incentives; the increase in totex allowances; and the lower allowed return.

So these changes along with the shift by a number of companies in their views of costs and acceptance of their increased stretch on performance commitments means that many of the gaps between companies and ourselves are now resolved at final determination.



On outcomes we focus on encouraging companies to deliver to today's customers and also future customers and the environment. Companies put forward performance commitments in their business plans, which we expect to be: stretching; meet customer needs; and backed up with financial and reputational incentives. Across the price review we have challenged companies on the level of stretch and incentive on their performance commitments and we've acted to drive improvements in companies' performance particularly on those that currently lag behind and to ensure that these performance levels are achievable within the base level of costs. In terms of the key changes since draft determination, we've set three, forward looking upper quartile challenges for companies on water supply interruptions, pollution incidents, and internal sewer flooding. In response to representations on stretch we've considered all three of these performance commitments against historical data, including the update for 2018-19. For pollution incidents and for internal sewer flooding we've retained our draft termination positions. On supply interruptions we've moved the target level from three minutes in 2025 to five minutes, accepting evidence from companies that it will take them longer to achieve the three minute level. So we’ve revised the performance commitment accordingly. On mains repairs, we have reduced the stretch taking into account evidence in the relationship between mains repairs and reducing leakage. And on leakage we've also considered in a few cases evidence from companies for revised leakage levels. And we've also provided funding for the upper quartile companies, to achieve stretching performance commitments.

Outcomes – stretching but achievable performance commitments

Three upper quartile common performance commitments – gap closed between Ofwat and companies at final determination

	Difference between Ofwat final determination performance commitment level and company August 2019 representation		
	Supply interruptions	**Pollution incidents**	**Internal sewer flooding**
ANH	10%		
WSH	37%	7%	20%
HDD			
NES			
SVE			
SWB			
SRN			
TMS	17%		
UU			
WSX			
YKY			
AFW			
BRL			
PRT			
SES			
SEW			
SSC			

Key

No difference between Ofwat FD and company representations

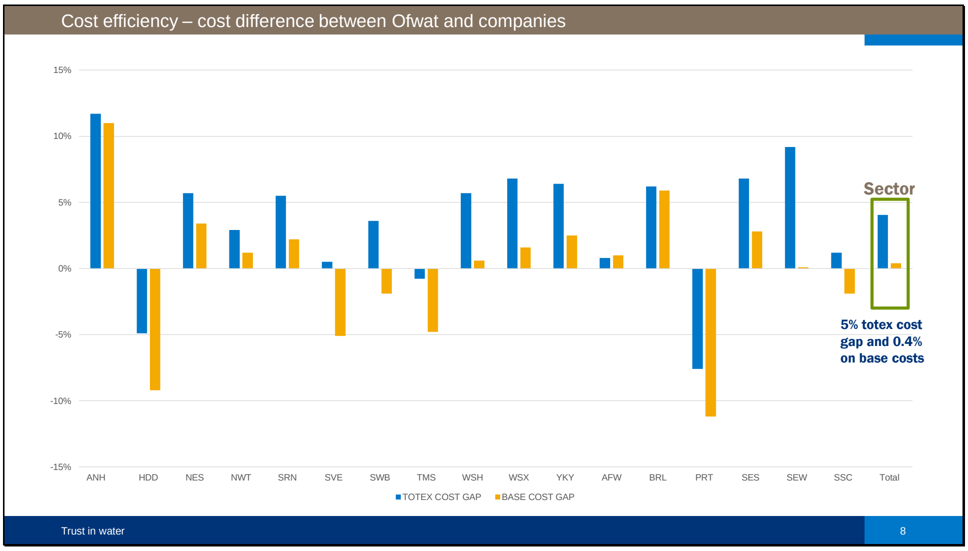
Difference between Ofwat FD and company representations

Trust in water 7

All of this means that at final determinations there are relatively few areas where there's substantial differences between Ofwat and companies. For example, on the three common performance commitments, in only five out of the 37 commitments, is there a difference between Ofwat and the company's view in their representations. So we consider that in the round, the performance commitments in our final determination are stretching but achievable at a sector level and across the period. In regards outcome delivery incentives. So firstly I would note that we set performance commitments on an absolute basis. So it's possible, if very unlikely that all companies could outperform on their performance commitments and earn net ODI out-performance payments in the next period. For the 2025 period, we expect the outcome delivery incentive to be in the range of plus 1.3% on the upside, to minus 1.9% for the sector as a whole.

So there is a negative skew, but we note there was a negative skew at PR 14 of between plus 0.6 to minus 1.7%. And companies on the whole have achieved around a zero outturn, with some companies doing significantly better than others as Jonson noted earlier. So at final determination relative to the draft determination that negative skew has been reduced and the symmetry of performance payments has been improved as we've reduced the downside and increased the upside on a number of key outcome delivery incentives including water supply interruptions, leakage and internal sewer flooding.

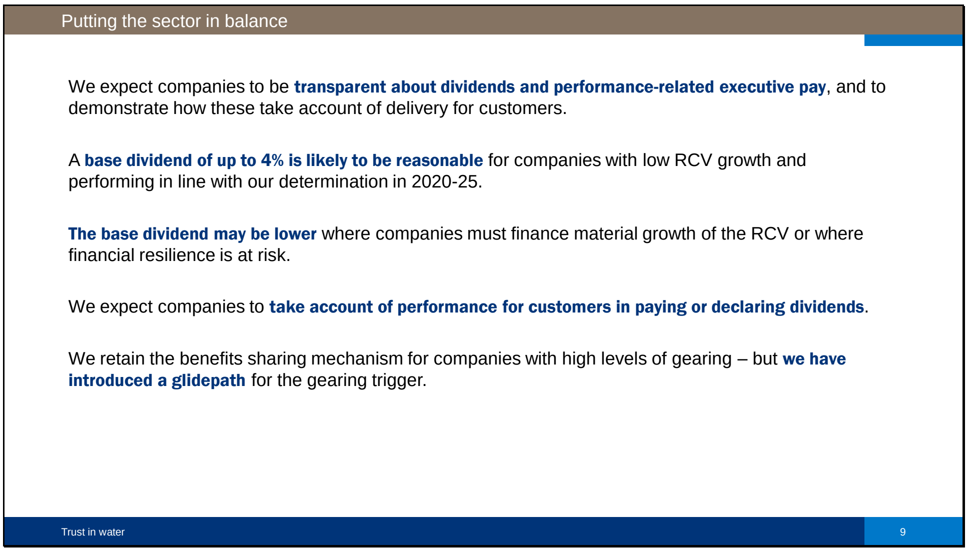
The evidence from the PR 14 review period shows that companies are able to outperform on performance commitments and beat expectations set in the final determination. But we also offer the option in our final determination that where outcome delivery incentives, adjustments exceed plus or minus 1% of notional equity companies are able to ask us to defer the excess to subsequent years.



Moving on to costs. The overall cost allowances for companies at final determination is 50.6 billion pounds and this compares with the 56.3 billion requested in company's original September business plans, which they revised downwards to 52.2 billion in their final representations. Around 13 billion of this allowance is for growth and enhancement costs.

And as Jonson mentioned, the gap between Ofwat and companies has fallen from draft to final determinations from 11% to 5% and this compares to around 7% at PR 09 and is comparable to Ofgem's RIIO-ED1 gap of 7% and in RIIO-GD1 a gap of 8%. The gap on base costs is much lower again, around 200 million pounds for the sector as a whole or just 0.4% of total costs. The graph shows the base and total cost difference and final determination across companies. And you can see that the companies with the significant differences are Anglian Water, whose difference is almost half of what it was at draft determination but nonetheless, it's still considerable. And South East Water who have a challenge, but mainly on enhancement costs.

And as Jonson's noted we've allowed significant additional funding for strategic water resources of 470 million through a gated process, for London resilience setting aside 480 million pounds for Thames to bid for to improve resilience of water networks and treatment works and the 200 million pound innovation fund. In addition to the allowed costs for enhancement, there's provision for three direct procurement for customer schemes and final determinations and potential for another three schemes during the period. So these three are United Utilities' Manchester resilience scheme, Dŵr Cymru's Cwm Taf water treatment works and Anglian Water's Elsham treatment and transfer scheme.



And a quick word on back-in-balance. On dividends and executive pay. As we made clear on our back in balance statement in 2018, the public service nature of the water sector means that we expect companies to be transparent about their arrangements for performance-related executive pay, dividends and financing and show how these reflect the delivery of their services to customers. We're pleased to see the evolution of these to meet our expectations during the price review process and we expect good practice will continue to evolve and we look forward to companies demonstrating how they're delivering against these commitments throughout the 2020 to 2025 period. In terms of dividends, we've said that for companies with little or no RCV growth and that perform in line with our determination that we think a reasonable base dividend, could amount to up to 4%. We acknowledge that where companies need to finance real growth of the asset base, or where long-term financial resilience is at risk, companies may need to reduce this level of dividend, or investors to invest more equity.

And finally in 2018 we set out a default mechanism for companies with high levels of gearing to share some of the benefits of his high gearing with customers. We have retained this mechanism at final determination. However, we have recognised that it may take some time for companies to adapt and also to sharpen the marginal incentives, we've set a glide path so that the arrangement will transition with the trigger point starting at 74% in 2021, falling to 70% by March 2025. I'm now going to hand you over to Andy Chesworth to talk to you about the allowed return on capital and financeability.

Andrew Chesworth, Director

Allowed return on capital

Component	Component of the allowed return on capital			Draft determination[1] (CPIH 2%)
	Nominal	Real (RPI 3%)	Real (CPIH 2%)	
Allowed return on equity	6.27%	3.18%	4.19%	4.47%
Allowed return on debt	4.18%	1.15%	2.14%	2.33%
Notional gearing		60%		60%
Ratio of embedded to new debt		80:20		80:20
Allowed return on capital - Appointee	5.02%	1.96%	2.96%	3.19%
Retail Margin deduction		0.04%		0.11%
Allowed return on capital – Wholesale	4.98%	1.92%	2.92%	3.08%

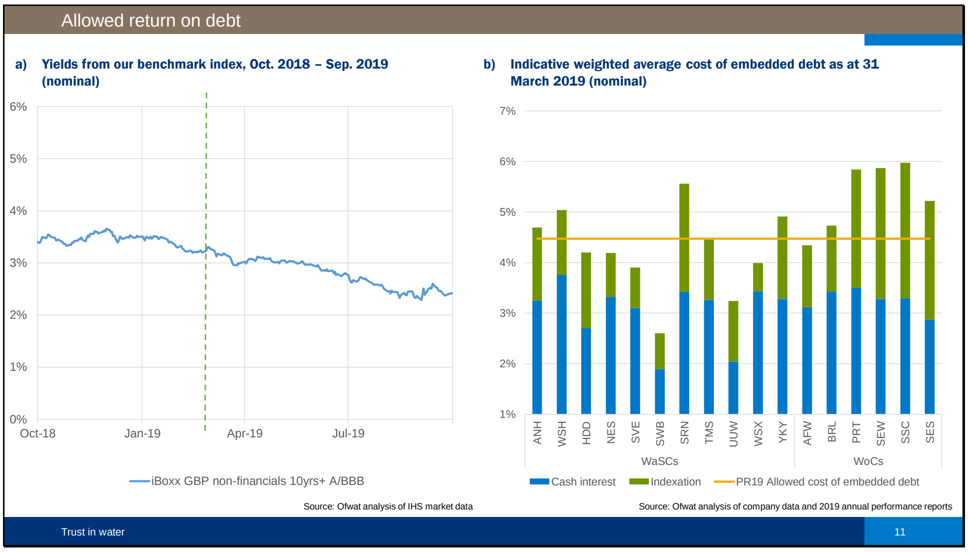
[1] Draft determinations for slow track and significant scrutiny companies; the draft determinations for fast track companies used the 'early view' allowed return on capital stated in the PR19 methodology.

Trust in water 10

Thank you David and good afternoon everybody. The PR 19 methodology set out that we will transition to CPIH as a credible measure of inflation. The transition to CPIH from RPI means that we have parts of the RCV that are indexed to CPIH and parts are linked to RPI. And so for PR 19 we state our allowed returns in CPIH and RPI terms as well as in nominal terms. The allowed return on capital for the appointee is 5.02% in nominal terms, this is 2.96% on this CPIH real basis, 1.96% on an RPI basis. This is based on a CPIH of 2% and a 100 basis point wedge to RPI. Consistent with the early view, the allowed return is calculated on the basis of a notional capital structure that is 60% debt financed. The allowed return lies broadly in the middle of the range recommended by our advisors, Europe Economics, and is consistent with analysts' forecasts.

The allowed return for all wholesale controls is 4.98% in nominal terms. In real terms, this is 2.92% on a CPIH basis and 1.92 on an RPI basis. Our retail net margin is unchanged at 1% this applies to household retail controls in England and for all customers in Wales. For the wholesale allowed return we have revised our calculation of the adjustment from the appointee allowed return. This lowers the adjustment we make to calculate the wholesale allowed return from the appointee allowed return, and as shown in the slide, this reduces it from 11 basis points to four basis points in the final determination.

The majority of the reduction in the allowed return in our final determination is due to declines in market data in 2019; primarily related to lower expectations for the risk free rate and expected yields on the cost of debt. Taking account of views expressed in representations, we have revised our approach to the calculation of the risk free rate which is now based on a one month of trailing market data. We and our advisors have considered a wide range of evidence and methodologies in determining the total market return which we have retained at 6.5% in CPIH terms. Assessment of beta is a parameter that involves some judgment. Our draft determinations were based on two year data for beta consistent with the recommendations of Europe Economics. Two year betas are lower in more recent data but for final determinations, taking careful account of representations, we've placed a bit more weight on five-year data, and in doing so we have kept our beta at 0.29 and this is one basis point lower than PR 14. We consider our decision on the allowed equity return for PR 19 taking account of the risk free rate, beta and total market return provides companies with a reasonable return that is in line with market expectations.



We retained the draft determination approach to set both the cost of embedded debt and the cost of new debt by reference to a market benchmark. We have considered further the weighting we apply to embedded and new debt which we retain at 80:20. Our benchmark index has fallen since our draft determinations. This leads to a substantial drop in our cost of new debt estimate and a small drop in our allowed cost of embedded debt. There is substantial evidence that companies in the water sector tend to outperform our benchmark index, so we apply an outperformance adjustment. We retain the 25 basis points adjustment for embedded debt, but reflecting some uncertainty about the persistence of this outperformance, we've reduced the adjustment to 15 basis points for new debt. Finally, we uplift the cost of debt by 10 basis points for issuance and liquidity costs.

The cost of new debt is subject to reconciliation at PR 24 which protects both companies and customers in the event of market movements on the cost of debt. Four companies applied for a company specific adjustment to the cost of capital. We accept the proposed adjustments for Portsmouth Water and South Staffs Water, uplifting their cost of debt by 33 basis points. We have not accepted the adjustments proposed by Bristol Water or SES Water as we do not consider the benefits outweigh the costs.

Financeability

Summary financial ratios for final determinations for notional company structures (2020-25 average)

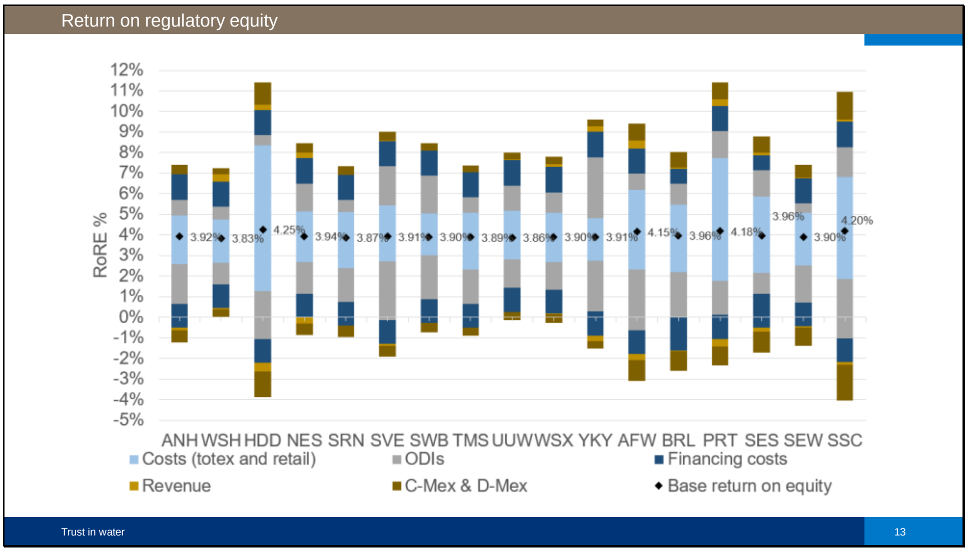
Water company	Gearing	Adjusted cash interest cover ratio	Funds from operations/net debt
Anglian Water	60.0%	1.50	9.49%
Dŵr Cymru	59.5%	1.51	8.28%
Hafren Dyfrdwy	61.5%	1.72	12.34%
Northumbrian Water	59.5%	1.50	9.84%
Southern Water	60.0%	1.50	11.46%
Severn Trent Water	59.8%	1.69	10.44%
South West Water	58.4%	1.46	11.26%
Thames Water	60.5%	1.50	8.88%
Wessex Water	60.1%	1.50	9.81%
United Utilities	57.0%	1.52	10.83%
Yorkshire Water	60.5%	1.50	10.06%
Affinity Water	60.6%	1.50	10.82%
Bristol Water	58.8%	1.47	13.53%
Portsmouth Water	59.5%	1.45	8.03%
SES Water	62.2%	1.50	13.31%
South East Water	59.6%	1.53	9.86%
South Staffs Water	60.4%	1.50	12.69%

Trust in water 12

Turning to financeability, we consider our determinations to be financeable for efficient companies on the basis of our notional capital structure. We retain our overall approach to the assessment of financeability. In doing so, we assume each company is able to achieve the benchmarks and performance commitments in our determinations. All companies state a target credit rating that is at least two notches above the minimum of investment grade for the notional capital structure.

And so this is the basis on which we have assessed our final determinations to be financeable. The financial ratios companies targeted are slightly higher than PR 14 reflecting credit agency views. We have reflected these in our assessments. This means the financial ratios for the notional company structure are slightly stronger in our final determinations than at PR 14. Two companies, Severn Trent Water and United Utilities use financial levers to replicate the effects of a full transition to CPIH. We have accepted both proposals. Both companies evidence the resulting bill profile is supported by customer preferences. Equity should have a role to play in financing material growth of the RCV. For companies whose real RCV growth exceeds 10% we restrict dividends to maintain gearing close to 60% at the end of 2025. Where a financeability constraint remained, we advanced revenue through the targeted use of pay as you go and RCV runoff levers. We consider such revenue advancements is appropriate. Taking account of our statutory duties and we applied it to 12 companies.

The financeability constraint is a particular issue at PR 19 because the real return is a proportion of the nominal return for the RPI indexed part of the RCV is at its lowest level compared with any determination since privatisation. Our view is that revenue advancement is, is the same in effect, as a faster transition to CPIH. Where we advanced revenue, we do so to support a notional financeability constraint. We would not expect companies to use such revenue to support unsustainable dividend policies. Companies are responsible for their choice of financing and capital structure and should bear the consequences of their choices. Reflecting the expectation of a lower allowed return on capital at PR 19 we have for some time signalled a need for companies to ensure the actual financial structures will remain resilient and where necessary take steps to ensure long-term resilience. Some companies have already taken such steps and a number of companies have set out proposals to improve financial resilience in their plans. But companies may need to take further action to improve financial resilience reflecting the lower allowed returns in our determination. Where companies have indicated they intend to take steps to reduce debt levels or to restructure their financing arrangements we will monitor the implementation of those proposals and if we do not consider that companies are taking effective steps to improve their financial resilience then we will challenge companies further.



Moving on to the RORE ranges. Companies will report their performance, measured against return on regulatory equity in 2020 to 2025. We also use the return on regulatory equity to calibrate the expected returns and to understand risk in the determinations. For the final determinations we have adopted a standard approach to the calculation of the RORE risk ranges taking account of information on past performance across the sector. As David set out, we do not expect the sector as a whole should expect to receive returns that are skewed to the downside. Rather, companies should expect to be rewarded for the provision of high quality and efficient services and inefficient companies should bear the cost of under-performance.

So in conclusion, our final determination set out a substantial financial settlement for companies that will allow efficient companies to finance their functions. Companies can of course ask us to refer our determination to the competition and markets authority. But our determinations also represent an opportunity for companies to become more efficient, harness the power of innovation, and to deliver today and tomorrow for customers and the environment. Companies that embrace this opportunity will earn rewards.

Questions and answers

Dominic Nash:

Good afternoon everyone. And well done on getting the final determinations out. Two questions from me please. Firstly on the cost of capital looking through your risk-free looks exceedingly low; you've only got 0.58% in there. That was obviously the rate at the time when you set it. It has bounced quite strongly from that. Do you think you're at risk really of sort of freezing in these low returns for the coming five years? And secondly on your efficiency numbers, I think you've dropped your underlying efficiency case from 1.5% to 1.1%. Any rationale as to why your degree of efficiency in the water sector is lower going forward than in the previous documents?

David Black:

Thank you Dominic. I'll deal with the efficiency question first then hand over to Andy to deal with question on the risk free rates. So in terms of the change in the view about the frontier shift, when we set out our view on this at draft determination, the 1.5% - we were taking account of advice both from Europe, economics and KPMG. There was two parts to that calculation. One was around the general productivity shift in the wider economy, which Europe Economics estimated at 0.6 to 1.2%. Then there was an amount on top of that which, which we took a view around the impact of the gains from moving to the totex and outcomes framework which we began at PR 14. But we could see considerable benefits in and considerable gains to be had, still at PR 19. So effectively there was a, view of around 1% on the productivity shift and about an additional 0.5% from the gains from totex and outcomes. When we looked at the 2018-19 cost and outcomes data it suggested that perhaps the gains from totex and outcomes had been a bit less than we'd be hoping to see in this current period. And looking at the evidence in the round we thought it was appropriate to reduce the level of frontier shift from 1.5 to 1.1%. But I should also note that we've changed how we've applied the frontier shift. So it now applies to a broader base of costs. It applies to all base costs and metering enhancement costs. So although the frontier shift has been reduced, it applies to a broader base of costs.

So the net impact is a relatively small attenuation in the efficiency adjustment. And then in terms of the risk free rate, Andy?

Andy Chesworth:

Yeah. So in terms of the risk free rate, we use data from the month of September and the forecast from September. In terms of setting the risk-free rates at the appropriate level for 2020 to 2025. We have looked at this in the round. So taking account of the risk free rate, the total market return, and beta, we consider that the cost of equity in the round - taking account of all of those factors - is reasonable for 2020 to 2025. Of course things like risk free rates do move, but we consider that the allowed cost of equity and the overall allowed return is appropriate for the period.

Dominic Nash

So can I just follow up on that one please, which is are you basically saying that you usually like a five year risk free rate rather than the a long run risk free rate in calculating the cost of equity. Actually - because I mean it was quite a fall between draft determination and final determination in that number.

Andy Chesworth:

So our approach is to set, to determine the appropriate risk free rate for the period of the price control. And so yes, we looked at data on 15 year gilts through September, but we consider - looking at the risk free rate and wider evidence on TMR and equity beta - that the cost of equity is set at the appropriate level.

Fraser Mclaren:

Good afternoon. Just two questions please. First of all, I see you've made a 54 million adjustment to UU’s revenues, due to forecasts of population growth being lowered. I'm just wondering if that, if this change is unique to the North West and what happens if reality turns out to be different. A second question is just for clarity really. Could you confirm that your tax assumptions are unchanged please and how any differences would be recovered, assuming that the rate doesn't reduce under the current Government .

David Black:

Okay. So just in terms of the growth adjustment first. So we have looked across all companies and made adjustments for growth. It is a symmetric adjustment. So companies with higher than average growth rates get a positive adjustment. Companies with lower than average growth rate get negative adjustments. And so

UU had a significant negative adjustment because of the lower than average growth rates in its area. There is a true-up on the outturn for a growth forecast. And so there will be an adjustment made at the PR 24 reconciliation if growth is either higher or lower than what was forecast in the price review. And your second question, was around tax and changes in tax rates. Andy did you want to talk about the true-up for changes in tax rates?

Andy Chesworth:

So we've retained the approach to tax that we set out in the draft determination. Retaining the corporation tax rates as applied at the DD because those are current, but of course, companies receive protection from any changes in tax rates, which we will apply through a reconciliation mechanism at PR 24.

David Black:

Okay. So there's also a question from, online from Graham Taylor at Moody's about how much we increased, our base totex allowance compared to draft termination. I'll try to deal with that. So in terms of the total change in totex, based on base and enhancement is around 1.5 billion, including the conditional allowance of around 480 million for Thames Water. And of the billion remaining around 400 million pounds of that relates to base costs and 600 million to enhancement. However, I do have to caution about comparisons between the draft determination base costs and the final determination base costs. There has been some changes in cost definitions, which does make it difficult to do a strictly like for life comparison. Particularly the treatment of enhancement opex costs, which have moved from base to enhancement. So I'm sorry, it does make it more difficult to track between the two. So it's worth looking at the total change. But in terms of the estimate of the impact of the change in base is around 400 million pounds. Next question please.

Verity Mitchell:

Afternoon everybody. I'm quite interested in the changes and in some of the targets that you have and, and I look at the relative lack of change on internal sewer flooding and pollution and then the perhaps the less challenging targets on water supply interruptions and mains repairs and also leakage. And I just wonder whether that is a bit of a bias against companies that have challenges in their clean water networks, like Severn Trent relative to those who are perhaps more challenged in their wastewater networks?

David Black:

Thank you, Verity. No. So, as mentioned in my discussion, there's three measures where we've set our performance targets on a forward-looking upper-quartile measure. So that was taken from company business plans and looking at their forecasts of upper-quartile and taking upper quartile of that. One of the challenges we received in terms of the draft determination representations for all three of those metrics, but more so on the water supply interruptions, was that this wasn't a realistic measure. So at that point the expected reduction in water supply interruptions was 64%, versus around 30 to 40% on other measures. So we looked hard at all three measures. We've looked at the performance data, over the last five to six years. I mean, how long it's been available for, looked at the rate of change both for good performers and for the sector as a whole. And looking at that, we became persuaded that on water supply interruptions, that it wasn't realistic to expect companies to achieve the 64% reduction over the five year period and particularly the outturn performance in both 2017-18 and 2018-19 there had been a marked deterioration in performance in water supply interruptions. While acknowledging the volatility of that measure, we didn't think therefore it was reasonable to assume that the forward-looking upper quartile projections by companies would form a robust basis. And so we've adjusted the water supply interruptions measure, whereas the other two measures, both there were less representations in terms of companies on the stretch in those measures, but compared to historical rates of change, those forward-looking up quartile measures, looked realistic and credible. In terms of the leakage side, there has been no change in the Severn Trent leakage target.

David Black:

There has been an adjustment to the United Utilities' leakage targets to what was set at draft determination. That reflects taking a consistent approach in terms for companies where we had gone at draft determination and asking more than 15% reduction. And there are a number of those companies, we've looked at those relative to the, to the changes that we're asking from Thames and others and recalibrated those performance measures. So we, we do think that the challenge on both water and wastewater is stretching but achievable. And we have looked at the companies in particular that are poor performers on those wastewater measures and looked at their cases for why they couldn't reach the upper quartile challenge and weren't convinced that there was any particular company-specific explanation. We have allowed differences in the way the collar around the downside exposure works for three of those companies to, to reduce the risk in, in transition. But we've left the performance commitment as it was. Thank you.

Dominic Nash:

Oh, okay. I've actually got a question I think for Jonson. At the start of this presentation, it seems to me that you were probably responding to criticism in the press about the difficultness of this potential review from a number of water companies by saying that the gaps totex isn't that wide and this is an eminently achievable plan and, et cetera, et cetera. Would you actually be disappointed if there was not a single CMA referral for this periodic review?

Jonson Cox:

Oh, Dominic, thanks for the question. I'm not going to answer what we might think about the number of challenges there may or may not be. All I would say is the process of asking us to refer a determination to the CMA is something we're fully prepared for. It's a part of the process. But I won't make any comment on how many of them there may or may not be,

Dominic Nash

But you wouldn't be disappointed if there wasn't any at all?

Jonson Cox:

As I say, as you know, these determinations are judgments that we make using all the tools available to us. We do our best job. Companies may accept them; they may decide to take a different view. That's their call. And we will wait and see in January and February what the outcome is.

David Black:

Thank you, Jonson. We have another question from online as well, from Jenny Ping at Citi on the proportion of embedded debt. Which we've set at 80:20 which is the same as at the draft determination. And she was suggesting that I think the numbers came up as 85:15, which some companies have flagged. What's the reason that this was ignored and you've stuck with 80:20? Andy do you want to...

Andy Chesworth:

Okay. so yes, we've very definitely not ignored this issue. It is set out, our approach is set out in detail in the allowed return on capital appendix so you can read what we said there, but we've looked at the split between new and embedded debt in a number of different ways. And two of the approaches which sort of look at it on a bit more of a notional basis, give an estimate in the range of 17 to 21% for new debt which is consistent with that assumption of 20%. So you may well want to go to the technical appendix to the section on the cost of debt to work through the detail of what we've done on that issue.

Martin Young:

Yeah. Good afternoon to everybody. Just the one question about comments earlier in the presentation which reference affordability. If I look at a lot of the political narrative both in the run up to the election and since we have what one might describe as a reasonably conclusive outcome to that election and infrastructure and the environment have obviously played quite a significant part in that. That leads me to think that could be suggesting that there could be upward pressure on the amount of infrastructure investment going forward, which obviously would have to be paid for. How do you think about that when you think about the longer term direction of the water industry through that sort of lens of affordability because more investment quite clearly will mean that the public will have to pay for it.

David Black:

Thank you for the question. I'll have a go and ask Rachel to contribute. So just to be clear in terms of the approach to the price review. We don't target a particular bill level reduction. That is an outputs of a process of working through both the efficient level of investments, efficiency challenge and the allowed rate of return. We've been quite clear in terms of asking companies to look to the long term in terms of their plans and we've actually stepped in to companies' business plans to add in more funding for investment and by requiring them to really take a more coordinated approach to development of strategic water resources. We certainly see issues such as climate change and population growth as requiring more investment for the sector. Some of that can be met from companies becoming more efficient. And so it's not just the case that these costs get passed pass through to customers. But we, we have provided for more investment at PR 19 than we've had in PR 14. So I'm confident that we have provided a long term basis for investments. Rachel, do you want to add?

Rachel Fletcher:

I mean, no, I mean just to say Martin, it's one of the reasons we continue to press on efficiency and why we have taken this very seriously. But also why innovation is a big part of what PR 19 is all about. Cause I think in many cases it's only going to be by doing things differently that we're able to address the real long term challenges, get the investment needed in the North, et cetera whilst keeping bills affordable.

David Black:

We have another question online from Iain Turner, which is why have you changed the price profile - in the DD it was a big upfront cut followed by flat real; FD is much more sculptured - why? So it's a good question. So we have changed the approach to bill profiles for most companies which has been to put less weight on the P zero reduction with a more continuing reduction across the period. And this was a reflection of both submissions from companies and customer representations and CC Water. There was quite a strong preference expressed for bills which were flat or flattish in nominal terms. And so we have attempted to replicate that in terms of the bill profiles for companies. However, we're also mindful of the importance of financeability ratios. And so for some companies we have attenuated that profile to maintain financeability ratios over the period. And for other companies there particular circumstances such as the payments of penalties which were agreed to have a particular profile with Ofwat - so that does result in some companies having different individual profiles. And in other cases, companies have made particular representations about their desired profile as well. So we've tried to take that into account, but that's the short answer on that.

And then we have a question from Jenny. As you look forward into the next regulatory period, can you remind us on your latest thinking about M&A in the sector, especially about mergers between exiting companies, which I might take as existing companies? So in terms of in, in brief, so it's up to companies to put proposals to us if they wish to merge activities. The merger regime was revamped in recent years to be more accommodating of mergers in the sector. Nonetheless comparative regulation is very important in the sector in terms of both cost and outcome benchmarking. And so clearly where we have a merger between two companies that may reduce the number of comparators and that has a potential consequence for customers - so that's something that gets taken into account of the process. That doesn't mean it's a flat refusal to consider mergers. Rather, there is a, there's a process set out whereby those costs and benefits are taken into account.

Orlando Finzi:

Hi, good afternoon. Could I just ask you to just elaborate on the additional totex spend for Thames Water; another 480 million. I just want to make sure I understand why you added this. I know obviously they were not happy with the final business plan. And were asking for more. So why is this an optional and gated - can I just get some clarification on that please?

David Black:

Thanks Orlando. So the so we've made provisions for conditional allowances for teams for both north east London, resilience scheme and water network resilience. So firstly, in regard to the 300 million pound contingent allowance for water network resilience - this arose out of our concern around resilience on Thames Water networks. So in terms of the high and rising, high and increasing, number of mains bursts in particular we thought that action needed to be taken to address this. We didn't see this addressed in Thames' business plan or in their representations. We felt was very important from a customer perspective that this issue is addressed. So we have made the provision in the final determination for Thames to come back to us with a plan which shows that they can address this issue and to put in shareholder funding to address this issue. The second area is on north east London resilience. Which was an issue that they did raise in their business plan around potential resilience issues. We were comfortable with some aspects of their proposed solutions, but the more important or the more significant elements to them, we felt hadn't really fully considered the options that were appropriate to address these solutions. And we wanted, and again, given the significant consequences of these issues for customers, we wanted Thames to go away and come back to us with a plan to address that. Both of these processes go through a gated allowance process. If Thames do not demonstrate to our satisfaction that the plan is efficient, effective, and works then the money, the allowance, will not be made available and the money will returned to customers.

David Black:

So we have another question from Iain Turner. Do you benchmark against Scottish Water? On my numbers, every English water company except South West, will be cheaper than Scottish Water by 2025. However, as a state-owned company, it is a paragon of virtue apparently despite having much worse bathing water performance than any English company? So the short answer from that is we don't include Scottish Water in our benchmarking. But I think it is a good question and one that we have discussed with Scottish Water about the potential to involve them in our price review process. There are certain practical logistical challenges around that in terms of providing information on the same basis as what happens in England and Wales. And obviously we're aware that the Scottish regulator will take an interest in the efficiency comparison as well. It's a really good question for them in terms of the relative efficiency of Scottish Water. But we've certainly welcomed any additional benchmarking information that we can get hold of. Any further questions?

LakisAthanasiou:

Hi guys. Well done on getting the review out. Just one follow up regarding mergers and comparative competition. What would your attitude be to one of the listed companies, de-listing, say on a takeover by private equity? Is that something you could possibly allow or is the fact that you would lose so much market information, something that would be beyond the pale?

David Black:

So, in terms of the particular model for any takeover of a listed company, obviously their financing arrangements is firstly a question for the company itself and for their board in terms of ownership. But one point to note obviously is with the gearing mechanism, a takeover which was primarily debt-financed would incur that sharing mechanism and so would mean that some of the gains from any increasing gearing would be shared with customers, which I assume would also make the arrangement less favourable from a private equity perspective.

LakisAthanasiou:

But that, that wasn't my question. My question was, if you're going to take out of the listed company, you will lose market information in regard to what the allowed returns would be. Would that be something you would not like?

David Black:

Yeah, so certainly it would be unwelcome in terms of we have at the moment two pure play listed companies and they are valuable in terms of providing information on the cost of equity. Clearly many regulated sectors do not have the luxury of having pure play listed companies. It's rather unique in that respect and so we welcome and value that.

Andy Chesworth:

We've had a question asking have we published the financial models for the companies? It is on our website. If you go to the webpage for our final determination, there's a blue box on the left hand side. You can get the link from that.

Verity Mitchell

I'm just curious that you've changed your base dividend from five to four percent and yet you've allowed some reprofiling of bills. So you seem to be working in a couple of directions. If you could maybe talk through just finally your thinking about that. I mean, clearly we know the allowance on equity has fallen, but you have made some allowances. So how much discretion could companies have?

David Black:

So in terms of the view on the base dividend which we set out as guidance in terms of back in balance. So our original 5% was developed when we were looking at the cost of capital back in 2017 and if you can remember those days the allowed cost of equity was somewhat higher. And so it was based on a view around the nominal allowed return on equity. So that's obviously fallen significantly since then. And so we have made an adjustment in terms of our view about base dividend hence the up to 4%. In terms of the changes in the bill profiling. There's no relationship between that and our view in terms of base dividend. That's very much driven by both what we hear and see from customer views around the bill profiles as well as taking account of the impacts on companies' financeability ratios and ensuring that there is adequate cash flows to meet commitments around debt. So there's no link between that and views around dividends. Obviously companies will have to form their view about dividend policy over the period and we would expect to see company's performance for customers central to that. And we point out that performance for customers could mean dividends could be higher or lower than the base dividend amount. And we're looking forward to seeing companies applying these policies and in practice in 2020 to 2025.-

Jonson Cox:

With that I think we should thank you all for joining us this afternoon. And as the chair of Ofwat, I'd like to express a massive thank you to our teams here who have run a very disciplined process, with more engagement with investors and companies than we've probably ever had before. And successfully published over 200 documents this morning. And thank you very much for joining us.