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**Our draft methodology for PR24**

**David Black**

Good afternoon, everyone. And welcome to the Ofwat PR4 draft methodology city briefing. Thank you very much for joining us. We also have quite a number of people online. So, welcome to all, and it's good to see those of you back in person. It's been some time since we've had an event. I think the end of PR19 was the last time we had a City Briefing. Today is all about the PR24 draft methodology. The format - we will hear briefly from and introduce our new chair, Iain Coucher. I will give a brief overview, and then Aileen Armstrong, will be talking us through the PR24 draft methodology.

I'm David Black, Chief Executive of Ofwat. We have Iain Coucher, who's been chair of Ofwat for one week now. I'm hoping he's not expecting one of these events every week. Aileen Armstrong Senior Director for PR24, Andy Chesworth, Director on Risk and Return for PR24 and Jamie Tunnicliffe, hopefully most of you know, our Director for Investor Relations. So, great to have you here. I'll now hand over to Iain to introduce himself.

**Iain Coucher**

Thank you, David. And yes, welcome everybody. As David said, my name's Iain Coucher. It's a huge privilege to be the new Chairman of Ofwat. As David said, I have been here a week. So don't expect me to say a great deal today. In the run up to taking up my position, I've been out there talking to some stakeholders, listening to views, and my intention is in the coming weeks and months I will get out and see as many people as I possibly can. I have joined the industry at a difficult time. There's lots of challenges out there, not least of course, the impact of climate change and the environment, but also, a cost living crisis. I've also joined right in the middle of a periodic review.

So, I look forward to engaging with people on that. It is an opportunity for us to make a real impact and make a difference on some of those big challenges. But as I said today, my role is simply to listen to what you might have to say in response to our questions. I'm very much looking forward to working with everybody in the sector and I'm also delighted that we have got David, Aileen and the rest of the team around us. I'm delighted we've got such great people already at Ofwat, with a great deal of experience in price reviews. So we are not going into this blind. We're going into it with a lot of experience and capability. Thank you.

**David Black**

I'll spend about 10 minutes giving a brief overview. As Iain has noted this is an important moment for the water sector and for the next price review, PR24. So PR24 will take us through to the end of this decade and will be a key milestone for the delivery of a broad set of resilience and environmental goals over the period to 2050. In the time of a cost-of-living crisis with growing environmental concerns and ongoing legitimacy questions for the sector, business as usual is not the answer. Alongside the challenges facing the sector, though, we do see a range of opportunities. Catchment-based approaches and nature-based solutions, such as reed beds, rain gardens, land management, all help improve water quality, but also deliver a broader range of environmental benefits, such as biodiversity and carbon abatement. The development and rollout of new technology in the sector offers a lot too. So, remote sensors, artificial intelligence, enable much better management of networks, for water and waste. And a third opportunity is working with customers and business retailers to influence the way customers use water and make use of sewers. So we see opportunities, alongside the challenges the sector faces. Aileen will shortly talk about how PR24 and future price reviews will help embed a long-term approach and drive better value for customers and the environment. I'll start with a brief reflection on customer experiences within the sector, and then set out what we aim to achieve from the sector and the broader regulatory context around PR24.

Earlier this year, we conducted research into sewer flooding with CCW. I heard directly from customers who had suffered sewer flooding in their homes. For many this was an horrific experience. People told us about coming into contact with sewage; properties damaged, long-term anxiety and sleepless nights. And consistently – unfortunately - we heard from participants that the response from companies was often making an awful situation worse. This brought home to me the daily importance of the service the companies provide and the need for companies to get the basics right. It also emphasises a wider point. The value provided by water companies is much greater than the cost of the service. Economic regulation was originally developed of course, to prevent monopoly abuse by companies raising prices, to extract this value from customers. Some observers criticise Ofwat for being overly focused on customer bills. It's right, that we are concerned about affordability and getting best value for customers. Customers cannot choose their supplier and rely on Ofwat to protect their interests. But I also want to be clear that we see the customer interest as much broader than the level of the bill. We're concerned about the quality of service, resilience and the environment. A better-quality service is better value for customers, and customers really do care about how companies treat the environment.

Our aim is to drive water companies and markets to create and deliver value for customers and the environment. This will be at the heart of our approach to future price reviews. We want to incentivise companies to discover and develop new ways to increase the value delivered by the sector. We also want customers to get a fair share of this value. Investor returns will be linked to the ability of companies to create and deliver value for customers and the environment. We expect companies to take significant action to improve the environment and resilience in PR24. I am pleased that a number of companies have committed to reduce the use of storm overflows by 45% by 2025, setting the new benchmark for the sector. And I'm also very aware that reducing the harm done from excessive use of storm overflows is only one of the environmental challenges facing rivers. Alongside environmental improvement, the sector needs to take a major step forward on the transition to net zero and improve the resilience of water supplies alongside reducing abstraction from sensitive catchments. That also requires a major step up on the demand-side too, to improve water efficiency. All of this requires significant investment and must be coupled with new ways of working to get better value.

We are working to play our role too. We've got a range of tools we can use to help drive change, in addition to the price review and greater use of markets, which Aileen will talk more about. We work in partnership with other regulators. We have licence enforcement powers, and we use data monitoring, communications, and influencing. Some recent examples include, coming out of PR19, we established RAPID, to work in partnership with the Environment Agency and the Drinking Water Inspectorate, our two other regulators in the sector, to remove barriers to bringing forward major new water resources. More recently, we've worked with the Environment Agency to reform their water industry national environment programme, to shift towards a more outcomes-based approach. This will enable a broader range of environmental benefits to be realised from this investment. And of course, in PR19, we established the £200m innovation fund to provide a pipeline of future innovation and change the culture of the sector. I look forward to seeing these innovations being rolled out at PR24.

I will touch briefly now on licences and enforcement. The Environment Act 2021 has given us new powers to change company licences in England. And we have set out two key areas where we think licences need to be updated. The first is around customers. We see a strong case for a new high level licence obligation to provide binding obligations on how companies treat their customers and the most vulnerable in society. We see this as complementing the customer experience incentive in the price review, enabling us to hold companies to account if they fall short for their customers.

The second area we are looking at licence changes is for financial resilience. I strongly believe in the power of incentive regulation to drive up performance of regulated companies and the proposition that management teams and investors will be motivated by the opportunity to improve returns by outperformance. And also that companies will bear the financial consequences when performance falls short for customers and the environment, and this in turn requires companies to have a sufficient equity buffer to absorb this risk. As most of you know, we introduced outcome delivery incentives at the 2014 price review and we increased their power in the 2019 price review. And we look to go even further in PR24. We also are seeing increasing fines where companies fail to comply with environmental law with the most recent being Southern Water hit with £90m of fines, in addition to the £127m of penalties from Ofwat

These failures, along with persistent poor performance saw the need for a £1bn equity injection to Southern from new owners and significant dilution of the previous investors' interests. We welcome last week's announcements from Thames Water on a new equity investment of up to £1.5bn, to back a plan to turn around their poor operational performance and improve financial resilience. We remain concerned at inadequate financial resilience of some companies in the sector and the potential risk this poses for customers. Customers of all companies need to be protected from risky financial structures and we will set out proposals to strengthen their regulatory ring fence under a separate consultation later this summer. Company board decisions on dividends and executive performance-related pay must demonstrably reflect performance delivered to customers and the environment. We have already taken significant steps to encourage companies to meet our expectations and those of wider stakeholders. We'll also consult on licence changes to give effect to these expectations on dividends, as part of the financial resilience consultation. We live in a time of elevated inflation. Inflation is part of investor returns, but high inflation and stretched consumer finances create challenges to the regime.

If companies are aligning themselves with our dividend expectations, the benefit to equity investors from high inflation on the RCV should be retained to reduce gearing and improve financial resilience. For companies that are already resilient, these gains provide capacity to move further and faster to deliver improvements in key areas, such as river quality.

Turning now to enforcement. You've seen that we have an unprecedented number of enforcement cases into six wastewater companies, Anglian, Northumbrian, South West, Thames, Wessex and Yorkshire, relating to whether these companies have been complying with their statutory and licence obligations in relation to unpermitted releases of sewage into the environment. We also retain a broader investigation on other wastewater companies, alongside these six cases. This is a clear indication of our determination to ensure that companies meet their responsibilities. Given the nature of actions that we are taking you'll understand that I cannot say anything further to that today beyond what we've already said publicly.

In summary, water companies face unprecedented challenges from climate change, the environment, in the context of a very difficult position for customers in regard to the affordability of bills. They're also dealing in a number of cases with a damaging legacy of excessive focus on financing outperformance and insufficient attention to long term improvements in operational performance for customers and the environment. We are committed to using a full range of our regulatory tools, both to enable and to challenge companies, to step up and to create value for customers and the environment while keeping bills affordable. I'm now going to ask Aileen to discuss how the draft PR24 methodology will deliver on these goals. And then we'll go into our Q&A session. I hope you'll have a few questions ready.

**Aileen Armstrong**

Good afternoon. I'm really pleased to be able to see some of you in person. As David said, our goal is to drive companies to create and deliver value for customers and the environment. I'm going to start with a reminder of the four ambitions that we've set for PR24. I'll say a little bit about how they have shaped our approach to this price review. And then I'm going to go through some of the details of the proposed methodology, which we've set out in the document this morning. You may already be very familiar with our ambitions for PR24. I'm just going to say a few words about each of them. The first ambition is the need to focus on the long term. I want to be clear that it has always been the case that we expect companies to plan for the long term, but we're explicitly requiring every company to present its five year business plan in the context of a clear long term delivery strategy – this will sharpen the focus, helping to identify what really needs to be done in the next five years, as well as making companies more accountable for the improvements that they need to deliver over the longer term.

And our second ambition is for the sector to deliver greater environmental and social value. PR24 will build on previous periods with stretching expectations on a range of outcomes, including pollution incidents, use of storm overflows, river water quality, biodiversity, and carbon emissions. And we're aiming to give more clarity on funding to enable more nature-based solutions as well as to drive greater partnership working, to deliver solutions for customers, communities, and the environment.

And our third ambition is for PR24 to reflect a clearer understanding of customers and communities. We want the voices of customers, residential and business, to be heard more clearly and understood better than in previous price reviews.

And our fourth ambition is for companies to drive improvements through efficiency and innovation. We really need companies to work in different ways to achieve more, and we will set stretching, but achievable service standards for the whole sector. So our draft methodology is a series of proposals to help deliver these ambitions. I want to give you an overview of what we set out in our document this morning. I'll highlight a few of the changes we're proposing for the process, including the key role of customers. And then I'll go through the key elements of encouraging quality and ambitious business plans, delivering outcomes for customers, setting efficient expenditure allowances, aligning risk and return and promoting financial resilience. And I'll end with a few points about how we'll use markets more.

At PR24 we've made changes to ensure that customers and wider stakeholders are heard clearly. Customer research has been a feature of previous price reviews, but it wasn't always high quality and it wasn't always easy to draw direct comparisons. We need to understand what customers see as priorities and the outcomes they want companies to deliver. A new approach to research will give us robust and comparable information on a company-by-company basis, which will help us make decisions that reflect the needs of customers and communities. And we're also ensuring that the voices of customers and local communities are clearly heard as companies develop their business plans. We plan to introduce open challenge sessions, which will give customers and stakeholders a chance to share concerns and ask companies questions. And companies will need to build plans that are affordable, including for those struggling to pay. And reflecting different ways of working in England and Wales, we are also implementing a collaborative approach to identifying the high-level outcomes to be delivered through PR24 in Wales.

We are proposing to categorise companies' business plans into one of four categories at PR24. We'll call them "outstanding", "standard", "lacking ambition" or "inadequate". Our goal here is to incentivise all companies to propose quality business plans with stretching levels of service at efficient costs, which will deliver affordable value for customers and the environment. We intend to attach strong incentives to the business plan categories. The very best plans will attract substantial rewards. They'll get a financial reward of 30 basis points on the return on regulated equity. And they will also attract the most favourable cost sharing rates for the period. They'll also gain protections from any reductions in the cost of capital or the base cost allowances between draft and final determinations. But if plans fail to meet our minimum expectations across a range of areas, there will be significant penalties. A poor-quality business plan will result in a 30 basis point penalty coupled with a tougher cost sharing rate.

These penalties are intentionally strong, and I just want to say that I think there's no good reason why any company should be in the bottom "inadequate" category. All companies should be able to meet our minimum expectations, but of course, just meeting our minimum requirements is not what customers and the environment deserve. The two remaining categories, "standard" and "lacking ambition", distinguish plans on the basis of the level of ambition that they show. We will apply penalties if a plan fails to demonstrate ambition.

Let me turn now to outcomes. For the sector to succeed, it is vital that companies deliver the right outcomes for their customers, communities and the environment. We're streamlining our outcomes framework to create simpler and stronger incentives to deliver the important outcomes that customers pay for. Our outcomes framework holds water companies to account for delivery, and it incentivises them to go further where that will deliver greater value.

We're proposing to focus on key outcomes and we're expecting most performance measures to be common to all companies. This makes it easier to benchmark company performance in a transparent way. Our common measures include a stronger focus at PR24 on environmental outcomes with new measures, including on use of storm overflows, carbon emissions and biodiversity. And this is in addition to our continuing focus on customer service and asset health that we have at PR19. We may also have a small number of bespoke performance commitment measures for individual companies where necessary to address an issue of specific local importance. But we expect this to be at most one or two per company. We expect to set stretching, but achievable service commitments for companies over the 2025-2030 period based on what the best companies can deliver. All of these outcomes will be financially incentivised with symmetrical outperformance and underperformance payments on most areas.

Companies returns will be strongly linked to their performance, both good and bad and companies will be able to earn further outperformance payments for innovation that pushes the frontier in certain areas. The key outcomes we incentivise in PR24 are likely to be important beyond this price review period. So any company that outperforms the pack will continue to be rewarded in future price reviews and any company that falls behind will feel pain. Overall, we expect risk from ODIs in PR24 will remain between a 1 and 3% return on regulatory equity each year, and to limit the overall level of risk to customers and to companies we're proposing an aggregate sharing mechanism that will share payments between customers and companies, if total incentive payments each year surpassed the 3% level - that's what's on the slide at the moment. If ODI payments hit plus or minus 3%, they will be reduced by 50% after that point. And if they reach plus or minus 5%, they will be reduced by 90%. In PR19, sorry in PR24, we propose to use caps and collars for individual performance commitments only on a targeted basis, which is a development. So - for example - we'll use them perhaps on new performance commitment measures.

Turning now to costs, companies will need to be efficient both in their PR24 business plans and throughout the 2025 to 2030 period. It is critical for the sector to deliver the improvements required by governments and regulators in an affordable way. We will continue to scrutinise cost proposals closely. Companies receive funding for basic expenditure, which reflects their day-to-day activities and for enhancement expenditure to deliver new investments. And we'll continue to set expenditure allowances for companies based on projected efficiency for the period 2025-2030. And we will set a stretching, but achievable efficiency challenge. Our PR24 approach to modelling will build on our approach at PR19, making improvements where appropriate. We'll be making greater use of benchmarking in our assessment of enhancement expenditure, including taking account of historical expenditure when setting future allowances. We propose to retain cost sharing between companies and their customers for any over- and under-spending against our cost baseline. This will drive all companies to spend efficiently throughout the regulatory period. Most enhancement expenditure proposals come through structured planning frameworks, such as the water resources management plans, the drainage and wastewater management plans and the environment programmes. We're engaging early with companies to ensure that their proposals there consider an appropriate range of options and take account of customer stakeholder views and are optimised over the long term.

We need to see rapid improvements in the use of storm overflows. We've been clear that current outcomes are unacceptable, and we need to see ambition from companies to address the problems. From 2025 we expect all companies at least to have reduced average spills to 20 per overflow. And we expect them to go further from base expenditure in PR24. Our proposed new performance commitment will drive this. And to facilitate rapid progress towards government targets we will consider proposals from companies in England for additional enhancement expenditure here. And in Wales, we expect companies to propose storm overflow investments, where there is evidence that they will improve river water quality that is not already funded.

And we want all companies to make progress towards net zero and reduce greenhouse gas emissions. We expect improvements again from base expenditure and for companies to deliver enhancements in a way that minimises emissions. We propose to allow specific enhancement expenditure to reduce greenhouse gas emissions to a common target. And we intend to introduce a net zero funding challenge to allow efficient companies to go further, faster through a bidding process. And we want to give greater certainty around funding for nature-based solutions which are wholly or primarily based on ongoing operating expenditure. If issues can be overcome, we're proposing to allow companies to treat OPEX solutions as investments that can be added to the regulatory capital value.

Moving on now to risk and return. As for previous price reviews. Our aim here is to allocate risk to those best placed to manage it and to align the interests of companies and their investors with customers. We propose to continue to use the return on regulated equity metric – "RoRE" - to help calibrate the determination package and as a metric to measure in-period performance. Our simple additive, and indicative, PR24 RoRE risk ranges for the notional company, which is excluding the base equity return, are plus 5.25% and minus 5%. And we expect efficient companies to have a reasonable prospect of earning the allowed return on equity; as illustrated in this chart, the RoRE ranges are symmetric and the illustrative ranges are additive. We expect the overall range achieved in practice will be narrower. And we will provide an early view of the cost of capital in our final methodology, in December. We propose not to index the allowed return on equity and to set the allowed return on equity using the capital asset pricing model – "CAPM". We don't propose departing from the CAPM-derived central point estimate, unless there is strong and compelling evidence from market-based cross-checks. We also propose to retain the PR19 approach of calculating separately the allowed return on embedded debt and to index the cost of new debt. We propose to focus on balance sheet debt as the primary method of setting embedded debt and, in doing so, we propose to exclude swaps and non-standard debt instruments from the analysis.

For the cost of new debt, we are considering how to make our index allowance more aligned with debt rates companies achieve. And for small companies, we have set out a proposal to simplify how we consider requests for company-specific adjustments. We will set out our view on the appropriate notional capital structure in our final methodology. We consider there may be a stronger role for equity in the notional capital structure. A greater buffer may be needed to protect against supply or demand side shocks, to manage future uncertainties and to reflect the increased role of regulatory incentives over time. We also note that in a period of elevated inflation, we would expect the notional company and most actual companies to reduce gearing ahead of 2025. We propose to fully index the RCV to CPIH from April 2025. And this means water bills will no longer be influenced by a discredited inflation metric, the RPI, and it will simplify our PR24 models.

Our draft methodology sets out that, as for previous price reviews, we expect companies to submit business plans that are accompanied by board assurance that the plan is financeable under the notional capital structure. The financeability assessment should target a credit rating of at least two notches above the minimum of investment grade. And while there are a number of options available to address financeability constraints, we consider equity has an important role to play in funding real RCV growth, such that notional gearing should not increase materially from the opening level. Pay-as-you-go and RCV runoff rates will be used to balance recovery of costs between different generations of customers. And we expect business plans to provide evidence to support that the rates proposed represent a reasonable balance between current and future customers, for each of the wholesale controls. We propose to provide guidance for a narrow range for RCV runoff rates for each wholesale control in our final methodology and, reflecting our recent experience, we are placing a stronger emphasis on financial resilience. We will ask for board assurance that the actual structure will be financially resilient over the period of the price control and beyond, and where necessary companies should identify any future planned steps to strengthen financial resilience. And as David has said, we're carrying forward work on options to strengthen the regulatory protections from risky financial structures. We'll consult separately on this, but we may apply an incentive-based mechanism in the price review if we are not satisfied progress is being achieved by other means. And we will ask companies to set out policies for dividend and performance related executive pay, and to show that the policies are aligned with what is delivered for customers and the environment. We also encourage companies to set out their proposals for any voluntary sharing arrangements where benefits arise to investors.

And finally, I want to just mention our use of markets at PR24. We intend to make more use of direct procurement for customers, or "DPC", which is where competitively appointed providers, design, finance, build, operate, and or maintain new strategic infrastructure. We propose to require companies to use DPC by default to deliver projects above around £200m. Projects for PR24 may include the strategic water resource solutions, which are currently being developed through the RAPID gated process. PR24 will introduce more scope for innovation in the areas of developer services and bioresources. We are seeing rapid growth in developer services markets with self-lay providers and new appointees competing with incumbent water companies for site-specific developer services work. So, we are proposing to remove site-specific developer services from the price control, where there is evidence of strong competition. And in bioresources, the treatment, transportation and recycling of sludge costs companies over half a billion pounds a year. At PR19, we introduced a separate bioresources control to unlock economic and environmental value. And in our draft methodology for PR24, we're proposing to further this through more market-based regulation.

In summary, our draft methodology sets out a package of proposals to drive a greater focus on the long term to deliver greater environmental and social value and to better reflect the views and needs of customers in the community and to drive improvements to efficiency and innovation. Thank you very much for listening. And I'll now pass back to David for some Q&A.

**Questions and answers**

David Black: Thank you Aileen. Thanks very much for getting through that. It's a very comprehensive presentation on the methodology. So hopefully you've had a chance to see the documents, the methodology itself, and the supporting information. We're really happy to take people's questions now and we'll allocate them as appropriate. When you ask a question, can you wait till you get a microphone and then identify yourself? And then once we've gone around the room, we'll see if we've got space for some online questions as well.

Jenny Ping (Citi): Thanks very much. Jenny Ping from Citi. Two questions please. One firstly for David, just on enforcement, I know the investigations are live and you can't go into details, but can you just talk a little bit about timeline in terms of when we are expecting to hear further news around this? And then second one for Aileen, just in terms of your comment on market-based evidence for further adjustment to the WACC numbers. Obviously, we've seen evidence in the energy space where transaction multiples have been very high and Ofgem hasn't really done much in terms of a further adjustment. So, I just wondered what you are referring to in terms of market-based evidence and what is the threshold for intervention if you like? Thanks.

David Black: Thanks Jenny. So in terms of the question about enforcement cases, we're very conscious of the high level of public interest in these cases and also of the seriousness of the issues. And we've committed to providing regular updates. The nature of these processes is that there isn't a pre-defined timetable. We've asked companies a set of questions. We've gone back to them for further information. We're obviously keen to progress these cases as rapidly as possible. There's also a parallel investigation by the Environment Agency. And we're looking to share information across both organisations as relevant on that. There is nothing further I can say in terms of definite timelines, but we're obviously keen to address these issues as soon as possible. And equally we will keep updating the public over time. And in terms of the question on the cost capital Aileen, do you want to start on that? And Andy, you might want to add.

Aileen Armstrong: I think just broadly and the main point that I'm just trying to get across is obviously, we look at the CAPM midpoint, but we will look at the other evidence. And so, it will be a question at the time, but we will use those cross-checks intelligently to set the WACC. So that was the basis of the point we were trying to make.

Andy Chesworth: Well, I don't think there's much more to add. We've said we'd use the CAPM estimate that would derive a range for the cost of equity. We use the midpoint and then we will look at cross checks, but there will be a high bar to moving from that mid-point. But obviously this is a live issue. If you look at the market to asset valuations, clearly water companies continue to trade at quite a healthy premium compared to the long-term average. So it's obviously something that we will look at as part of the review process.

David Black: Thanks, Andy. Mike?

Mike Osborne (InfraRed): Two questions, if I may. I'm interested in your comments on net zero funding. And I think, we would agree that some of the journey is self-funding for instance, building your own renewable generation seems like a pretty no-brainer idea at the moment, but some of it, the journey is inevitably going to be quite expensive. For example, in relation to fleet. So there was reference to a competition, but what is the philosophy that's coming from and the scale of it, is it coming from the idea that net zero, is a funded, legitimate cost or is it largely a company problem where there'll be some help around the edges? And then the second question was on DPC, just a quick one in terms of the £200m, is that CAPEX or whole of life TOTEX?

David Black: Thanks, Mike. So probably turn to Aileen on that. I think in terms of net zero, obviously we're conscious that there is a big, big task involved and particularly I think for wastewater businesses, you're absolutely right. There's been considerable progress by companies over time and that has to be funded within base costs, but equally we're mindful of fact that in itself won't get us to net zero, but Aileen, do you want to add?

Aileen Armstrong: Yeah. I think that's right there, there will be a need for something more, but I also maybe wanted to just expand your point about the philosophy Mike, in terms of where this is coming from. At the moment, I think we don't know what can be achieved. And so there's merit of actually putting the challenge out there and saying to the most efficient companies, "What can you do?" And actually having this bidding competition will both get those companies moving further and faster and provide the information of actually: what is the best way to do this?; what are the options? And so that's where this is also coming from.

David Black: And then the DPC question.

Aileen Armstrong: So that's whole life TOTEX.

David Black: Yeah, yeah. So it's the same. We had a whole life TOTEX approach at PR19 as well. And so this is virtually doubling the size - that was a £100m TOTEX at PR19. That's £200m TOTEX for PR24.

Mark Freshney (Credit Suisse): Hi, Mark Freshney from Credit Suisse. Two questions, firstly, on the aggregate sharing mechanism and the range for the RoRE , I mean, you're proposing doing what Ofgem does and putting in enhanced sharing at 3% and 5%, but surely that range chart that you show should actually be a lot more compressed given that sharing, given it doesn't include that. And secondly, I mean, what incentive does a company have to go for RoREs above three? So you're going to get a lot of bunching just below three. So I was just wondering why you would feel the need to follow what Ofgem does? And just secondly, on the inflation exposure, clearly you've already moved away from RPI to CPIH, and that addresses a lot of problems before 2030, but what are your thoughts on companies seeing pretty substantial ratchets up in RAB? Because I think David, you made the comment that companies trade at healthy RAB multiples, but actually if you look at inflation and share prices, the actual RAB multiples have come down pretty substantially because of inflation. So I was just wondering what your thoughts on those two elements were. Thank you.

David Black: Yeah, sure. I'll turn to Aileen on the aggregate sharing rate point. On the inflation exposure, we're very conscious that we are in times where customers are going to be facing - so it'll be next April - will be the first time we'll really see water bills escalated with inflation. And we're also conscious companies are facing rising cost pressures, particularly on energy and construction costs. Companies obviously benefit from revenue streams protected by inflation, and they're facing some exposure on the cost side. But you are, you're right in terms of the RCV, which is also going to benefit significantly from indexation. And so the observation that I made in my speech was about making the point that this is an opportunity for companies with stretched balance sheets to improve those.

David Black: Obviously there's an uplift in the RCV. There's some debt costs that are also linked to inflation - so they also rise in line with that. But for fixed rate debt or debt not linked to inflation, there are clearly benefits there. And so our view is that those benefits should remain inside the regulated entity and either be used to improve financial resilience or used to make an early start on the environmental investments that companies are going to need to make. So that's, I think the key point of inflation; Aileen do you want to pick up the sharing rates?

Aileen Armstrong: Yeah. And Mark, just to clarify your question, I think you were asking two questions, but the first one about the indicative, additive RoRE indicators. I don't know if we can get that slide back or not, but if we look at that, basically we've just taken the 2% ODI midpoint in there. That's what that is showing. I think your main point though, was, why even have an aggregate sharing mechanism and the worry about bunching. Our expectation at the moment is 1% to 3% annually. We do want incentives to be there, but there is a balance in terms of the risk to customers and the other way to companies. And so that's why we are proposing that. We'd like to hear views, but that's why we're proposing it. And the incentive is still there with 50% sharing of the payments from 3% to 5%. And then yes, 90% after that. But we think that proposal is a sensible, balanced proposal.

David Black: I think, just to add to that, we've obviously seen experience in previous price view periods where companies have actually been, in our view, not sufficiently ambitious in the main on the incentive packages, so they're quite weak. And so we're wanting to push companies. We talk about a range of 1% to 3%. A lot of companies have been clustered around the 1%, rather than the upper end of that range. Obviously, some companies do have broader ranges and are earning more on that side or experiencing more pain on the downside, but we are keen to see those incentives have an impact, but the other concern obviously as a regulator is we may get this wrong. We want companies to be rewarded for great performance, but if we're starting to talk about 4% to 5% returns on outcome performance, that may be an indication that there's something wrong, either set too stringent or set with insufficient challenge. And that's not likely to be an enduring arrangement anyway, so we think it's really helpful actually to set out in advance those key areas where we would start to share the benefits or the pain with customers.

Aileen Armstrong: I'm just going to ask Jamie to pick up one point.

Jamie Tunnicliffe: It was just to be very clear that the aggregate sharing mechanism is just on outcomes. When you're looking at that RoRE chart, the aggregate sharing mechanism is only related to the +/-2% range on the chart and relevant to our 1% to 3% indicative guidance on outcome regime strength. Mark - you made a comment about bunching and made a comparison with the Ofgem RAM mechanism – do remember Ofgem's mechanism covers TOTEX and ODIs. Ofwat's mechanism just covers the outcome side.

David Black: Graham?

Graham Taylor (Moody's): Hi, David. Couple of questions. First, one of the interesting points you raised at the beginning was moving away from, I think, the local customer challenge groups, which created a little bit of distance between customers and companies, to open hustings where customers can air their views. And that made me think very possibly we will be in a position going to next price review where we're seeing nominal price rises of 10% or something like that and may have done for a couple of years at that point. God knows what's going to happen. The true up mechanisms that you put in place in PR19 are likely to be going in the company's favour too. There will be automatic increases to reflect things have happened in the past and there will be some pretty chunky real terms, as well as nominal terms, bill increases at the beginning of the next period. Are you not concerned this is going to make for quite a raucous price control if customers are out there airing fairly obvious, fairly predictable views on those increases? And then second, a more specific question, with respect to your new campaign on sewer overflows, are companies' starting points, which are a function of their historical legacy and can be grandfathered. Will companies be encouraged to improve from where they are, or is this likely to be a mechanism that means the more storm sewers by accident of history you have or combined sewer overflows you have by accident of history, the more penalties you're likely to endure?

David Black: Thanks, Graham. Perhaps I can have a go at the second question first. We wrote to companies earlier this year, inviting them to come forward with commitments to a target or reduction in the use of storm overflows. I think there's recognition across the sector and society that the current use of overflows is well above what people would expect, so averaging around 29 per year across the sector in 2020. We've had four companies now commit to a reduction to 20 by 2025 and two other companies commit to quite significant reductions on other metrics.

David Black: One of the questions we'll have to face when we set the price review in PR24 is what's the efficient level of performance? And if you follow a standard upper quartile approach, obviously four out of 10 companies starts to look like an upper quartile. The starting point we think is that we've got companies coming from very different positions out there promising to get down to the 20 among other targets that they've set themselves. We think that's a good starting point for the sector, but obviously as with any of these things, there's an option for companies to make a case that things ought be treated differently. Aileen - do you want to add to that?

Aileen Armstrong: There's not particularly anything more on that I don't think. Should I take the customer point?

David Black: The customer point.

Aileen Armstrong: The customer question. Just to be really clear that we are not mandating customer challenge groups (CCGs) for PR24, but there are a range of expectations that we have about how companies are going to engage. But one of the points - and what I was highlighting there - was this new step to make sure that there is open hearings so that we hear directly from customers. And I think the question was very much are we worried about what direction that takes? And I think the inference I took from your question was those are quite basic points that you can guess. Well, I'm really keen and I'm not worried about hearing directly from the people affected by the companies and the sector.

Aileen Armstrong: I think it's really important that there's a clear voice and we can hear, and we will draw insight from that. Everything is contextualised. There's a lot of work that needs to be done. There's a lot of interactions with companies that need to be done. The other thing I was highlighting was we do put a lot of store by customers' views, but we really need the research to be robust and clear and really give insight to inform the review. I think having open meetings, hearing directly, companies having to respond directly to customers is a really important part of a focused price review that is there to deliver the outcomes for customers and the environment.

David Black: Thank you, Aileen.

Will Price (Macquarie): Hi, everyone. Will Price. On the CPIH change, I think that's well telegraphed, not a surprise. You didn't talk about - so you say companies do have a legacy of RPI liability exposure. How are they supposed to transition or are companies just expected to bear that risk?

David Black: Thanks, Will. That's obviously a question we looked at when we started on this journey in PR19. And so I think we did publish research at the time, which did talk about the potential upsides and downsides in terms of risk. But we have always been clear that financing structures obviously are at a company's own risk. And so this is one element of that, but Andy, do you want to add to that?

Andy Chesworth: The piece of work that was done in 2016 was an Oxera report and it looked at the transition to CPIH, and there is a benefit from the fact that CPIH is a less volatile index than RPI, and that was one of the benefits that was flagged in that report. I mean, to the extent that there is costs. If there's compelling evidence, that there are costs out there, then clearly we would look at that as part of our process, but we would have to be convinced on it.

Peter Dooley (NatWest): I thought at the time you said it would be NPV neutral. And that was certainly for this period, and I believe for the next?

David Black: That's Peter?

Peter Dooley: Yes, it's Peter Dooley.

David Black: Hi Peter. Yes, so we have a commitment to the transition being NPV neutral. And our point on that was very much about not playing games, if you like, with setting the WACC. Clearly, when we work out the allowed cost of capital, there's a nominal amount and a real amount. And so making sure that we are not using the, if you like, the transition to make that a positive or negative adjustment. And so we think we've obviously delivered that as part of PR19. And we'll obviously look to do that as part of PR24.

Peter Dooley: It was less the cost...

Aileen Armstrong: Well, if you just wait for the mike, just for a moment. Thank you.

Peter Dooley: The cost is only one side of that equation though, isn't it? Mechanically, how do you expect companies to transition?

David Black: Sorry, just to clarify your question. You mean in terms of how they're going to arrange their debt portfolio-

Peter Dooley: Correct.

David Black: Through inflation-linked instruments?

Peter Dooley: Yeah.

David Black: We think that's up to the companies themselves. We will obviously have to make assumptions about that for the purpose of the notional financing structure and the financial model that we use for the price review. But we observe at the moment quite a wide dispersion across company's financing choices and the use of risk instruments. This will be no different. Companies have had early notice about this. We started talking about this, Andy said, in 2016. This transition will obviously happen from 2025.

David Black: So, companies have been looking at this. There has obviously been some CPI debt raised. This will be something that companies will have to look at, and no doubt already are, as part of their debt portfolios. We don't see ourselves as a regulator, I guess setting a prescription about what companies ought to do in this case.

Andy Chesworth: I think it's worth adding that clearly, we set the determinations on the basis of the notional capital structure in our financeability assessment. We have, in the last three price reviews, assumed a proportion of index-linked debt. We propose to do that again this time round. And of course, we're in a position of transitioning away from RPI and we will be assuming a stock of RPI-linked debt within the notional company for the purposes of the financeability test, and that's what we set out in the draft methodology.

David Black: Any other questions? Jamie, I want to go to the online questions. We've actually got about, I think a hundred people online, is that right, Jamie? They might have some questions as well.

Jamie Tunnicliffe: The first one is on inflation – from Martin Young at Investec – and it links to Ofgem asking consultation questions at the draft determinations for electricity distribution, and the suggestion that considerably higher than expected inflation benefits equity and potentially leads to equity returns that challenge legitimacy, and ask for Ofwat's view on that topic.

David Black: Thanks, Jamie. I've mentioned this - as has the previous chair - about inflation having a benefit to equity holders, but in particular in the context, I think, of customers facing a sharp increase in the cost of living and falling real incomes. And that's potentially quite challenging, I think, for the model. We've set out our views in terms of how we think that should be addressed in terms of this period. Obviously, there's a question about inflation choices in the next period, but Andy, do you want to add anything to that point?

Andy Chesworth: Yeah, I suppose the point is, we're two years out from making the determination. Things could change on inflation in that period, depending on what forecast we believe. We do make assumptions about long term inflation when making our decisions in the price review, and typically that draws from market forecasts and the Bank of England target. I guess if there is an expectation that long term inflation wouldn't be close or wouldn't meet that 2% target, we might have to consider that as part of the review, but the question is about, is that long term rate, is it broadly achieved?

David Black: Thanks, Andy. I think the other point we just observed is that we do obviously work closely with colleagues at Ofgem. In particular, Jamie wears two hats, of course, as director of investor relations for Ofwat and Ofgem, so we will be obviously following up with their consultation and looking at the responses with interest as well. And so if you've got views, you are welcome to share them with us as part of your response as well. Jamie?

Jamie Tunnicliffe: Next one is from Paul Dew at Fidelity - what elements will Ofwat be considering when deeming if a financial structure is risky? Are you able to comment on what options could be used to strengthen protections?

David Black: Thanks, Jamie. Might turn to Andy on that. We've set out last year, on a discussion paper, basically a range of licence changes that we were contemplating to strengthen the financial ring-fence. So, that's one way of protecting customers from risky financial structures. I should emphasise, that our focus is about customer protection. And so, that's the set of possibilities. Obviously, we have used financial mechanisms in the PR19 process to encourage companies to reduce gearing. Andy, do you want to add?

Andy Chesworth: Yes. The discussion paper that we put out at the end of last year talked about the issue of financial resilience. We publish the monitoring financial resilience report annually, which sets out a number of metrics and considerations that are relevant to financial resilience. Obviously, there's lots of issues that can impact on a company's financial resilience, which can be linked to the level of debt, the makeup of that debt, the cost of that debt, and the company's performance, amongst other things.

Andy Chesworth: Now, we set out a number of proposals in that discussion paper, which ranged from improvements in reporting and reporting requirements that we could put in place through to proposals around licence modifications. And I guess the question that we're still mulling over is, is there more that we should do as a regulator to protect customers from risky financial structures?

David Black: Thanks, Andy. Jamie?

Jamie Tunnicliffe: Dominic Nash from Barclays asks - on your point on swaps not being included in cost of debt calculations, are you saying that if companies have fixed interest rates using swaps, then you'll be using their lower variable rate on their balance sheet versus the higher fixed rate?

David Black: Andy, do you want to answer that?

Andy Chesworth: I think the point on swaps is that companies put swaps in place for a variety of reasons. You might put a swap in place when you raise debt at the outset, and that's what might be in place for the duration of that debt. But also companies put swaps in place for reasons of managing cash flow risks over time. I think our perspective, and this was the perspective that we had at PR19, and indeed at previous price reviews, was that we don't need to look at the swaps for the purposes of understanding the underlying cost of debt for the purposes of setting a price control. And that's what we've proposed to adopt in the draft methodology.

David Black: Thanks, Andy.

Peter Dooley: Does that apply to currency? People have done Japanese, they've done dollars, euros.

Andy Chesworth: I think for currency swaps, we've said we'd take those into account because they're a bit more problematic for our assessment when dealing with currency risk but yeah, sterling, we'll leave that.

David Black: Thanks Andy. Jamie?

Jamie Tunnicliffe: From Martin Young at Investec - what outcomes from the CMA PR19 rulings are you minded to include and what are you ruling out?

David Black: Thanks, Jamie. I'll turn to Aileen on that. I think obviously there was a number of appeals at PR19 to the CMA. We obviously lived through that experience and we're obviously keen to learn from that experience, but you'll be aware the regulatory regime is not a precedent-based one. So, each CMA panel makes its decisions. And we obviously look closely at what the CMA does, not just in water, but in other sectors as well. We think it was obviously quite a lot of really useful work done by the CMA at PR19, but Aileen, you were closer to all this than me.

Aileen Armstrong: Just to echo that and maybe just build on it very slightly. We do learn from a variety of sources and views, but really the basis of the question, isn't where I start. We approach PR24 in the context of our statutory duties and the Strategic Policy Statements (SPSs) of the English and Welsh governments. And what we're looking at is in that context, what are the sensible proposals for this review? And as David said, there's different panel views on different things. We also look at other regulators' judgements to pull together the proposals for PR24.

David Black: Thanks Aileen.

Jamie Tunnicliffe: Next one is from Pavan Mahbubani at JP Morgan. Is it fair to assume that the share of new debt and the cost of debt allowance will be lower than 20% in PR24, if notional gearing does end up lower in your final methodology?

David Black: Thanks – Andy?.

Andy Chesworth: We've addressed exactly this issue in the draft methodology where we've acknowledged that if there is a lower level of notional gearing at PR24, we'd have to take that into account in terms of the assumption that we use for the split of new and embedded debt. So yes, that question is covered in the methodology.

David Black: Thanks.

Jamie Tunnicliffe: Next one is from James Brand at Deutsche Bank and is on Direct Procurement. With more Direct Procurement, is there a cost from the greater fragmentation of asset ownership in the sector? For instance, could this make it more difficult for utilities to manage their local networks?

David Black: Thanks, Jamie. I guess a general reflection. I mean, there are costs associated with DPC schemes in terms of the transaction costs and the administration costs around that. We're still looking at a point of time where there's relatively few schemes. We've got three schemes going forward in different company areas. I think we're a long way from really getting to that question. In many cases, some of the major infrastructure that we look at coming forward will be used by multiple companies. So least that's the expectation. And I hope at this point, we're looking at new water as far as new transfers. And in that case, you have to deal with some of these issues in any case. So there is already some fragmentation on that. I think the other point is that with what we call the NAV model. So this is where a new appointee is appointed in development areas. We are seeing that as a rapidly growing market, and we don't observe many issues in that space in terms of the potential issues around fragmentation and network operation difficulties. So I think DPCs are probably quite a marginal change in the terms of the number of entities involved. Jamie, do you want to answer the question as well?

Jamie Tunnicliffe: To throw in one extra point; part of the criteria for direct procurement is if something is essential or integral to the management of their own network, then there's a case for not using DPC. So DPC is meant to be a separable project. I think that element of the criteria would counter the last part of that question.

David Black: It is an issue. It is a risk. It's something we take into account in the choice of the model.

Jamie Tunnicliffe: Last question we have online at the moment. Dominic Nash from Barclays asks why a fast-track approach has not been adopted in this methodology document? The water companies who were fast-tracked say they and customers benefited from this early start and were in a better position for green recovery, et cetera.

David Black: Thanks, Jamie. Aileen?

Aileen Armstrong: In terms of being able to move on and get that certainty, I think the expectations are pretty clear. And I think in trying to ensure that we've got a quite streamlined process here, then getting that clarity and putting it out there at draft determination should still allow companies to know where they stand. And I think we do have other mechanisms, transition funding and other things that we think will make sure that companies that are ready to and can, will be able to move forward at pace. I think one of the keys is really about making sure that those incentives for quality and ambitious business plans are really meaningful so that companies are doing that planning, hitting the ground running with the clarity of plans upfront and that will stand them in good stead when we make our final decisions.

David Black: Thanks Aileen. Any more questions in the room? No? So I think we'll close the session here. So just before we go, I'll just get Stephen to bring up the final slide showing the next steps and the process. So thank you very much for joining us today. So - the stairway to heaven – here are the next steps. The next step is obviously the final methodology in December, and that will feature our early view of the cost of capital. And then company business plans will come in October 2023. That will be a month later than the equivalent in PR19. Spring 2024 will bring the draft determinations and final determinations will be published in December 2024. So thank you very much for joining us today. Thanks for your interest. And I'll say goodbye.