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Creating tomorrow, together

Our final methodology for PR24 City Briefing transcript

Ofwat

Ofwat PR24 City Briefing 13 December

Transcript of presentation

David Black:

Good afternoon and welcome to Ofwat PR 24, final Methodology Investor Briefing.

Hi, I'm David Black, chief Executive of Ofwat. So today's session is a briefing on the PR 24 final methodology. I'm joined by Aileen Armstrong, the executive director leading our price review and Andrew Chersworth, who's director of risk and return for PR 24. Also with us is Jamie Tunicliffe, our director of investor relations. Aileen and Andy will take you through the main elements of PR 24 framework shortly and then we'll take your questions. You can start adding your questions now using the discuss tab at the side of your screens. Firstly, and I'd like to give some context, the sector has faced the harsh light of intense public scrutiny over the last 12 months and it's often looked like it is falling well short of public expectations, whether it is from regular sewage discharges or from high levels of leakage while asking customers to conserve water as part of imposing hosepipe bans. And these concerns are often heightened by perceptions that investors and their executive teams have been well rewarded even where companies fall short.

The 2024 price review presents both an opportunity and a challenge for the sector. It can and must be a time that the sector transforms itself, the service it provides and the perceptions of customers and communities. There is a real danger that the sector is too slow to change and continues to be perceived as falling short of public expectations. In 2019, we set out our ambition to transform performance of the sector . And as set out last week in our water company performance report. Too many companies are making too little progress. And the expectations of improvement since 2019 have only grown. Companies need to be ambitious and transform how they operate, anticipating and leading the delivery of resilience and environmentally, I should say sustainable services. And that means looking ahead, anticipating future challenges, as well as addressing the concerns of today we're looking to companies to accelerate their activity in a range of areas well ahead of PR24.

Taking action to reduce the use of storm overflows and reducing per capita consumption. We welcome companies that have shown real ambition on reducing overflows before 2025. Companies also need to ensure that their corporate behaviour on dividends and executive pay engenders customer and stakeholder confidence.

Companies will be making the case for more investment at PR24. It's vital that customers have confidence that increased costs will be used to deliver improvements and not be lost to inefficiency or to offset poor performance. And that the money will be invested for the benefit of our customers and the environment and not just returned to shareholders.

To support improved trust in the sector. We will continue to push companies to transparently explain the link between dividends and performance. We're also pursuing licence changes to put this on a formal footing as well as changes to upgrade financial resilience.

Transformation will require companies to rethink how they operate with smart networks and preventive rather reactive approaches to asset resilience and maintenance . It will require much greater use of partnerships to develop and operate nature based solutions and work with customers. These can no longer be at the fringe of company business plans, but need to be at the centre. We'll require companies to explore new approaches to charging, to better achieve water efficiency and affordability and to engage with markets. These changes will require companies to have sufficient financial resilience and poor performing companies may require additional support from shareholders to make improvements.

Our PR 24 methodology will also play a key role in enabling the sector to step up. We've stimulated new approaches in PR19 through our Innovation Fund and you'll see that being extended in PR24 and with a new fund for water efficiency. We'll continue to incentivize better performance with an expanded focus on the environment at PR24. So better performance on the environment will matter for investor returns and we've worked with the Environment Agency to reform the environmental investment process to better enable innovation and value.

The proposals we have set out today, taking account of your feedback on our draught methodology. That has included participation of some of you whether formally though consultation responses or through your published analysis. We appreciate your interest in the sector and insights that you bring. The sector faces high expectations for improved outcomes. We're confident that the framework we're publishing today gives the sector a firm foundation on which to build. It's essential that companies seize this opportunity and deliver substantial improvements. I'll now hand over to Aileen Armstrong to share the overview of PR24 methodology. Thank you everyone.

Aileen Armstrong:

Thank you David. Good afternoon everybody. As David said, we want to see companies stepping up through PR24 to deliver value for customers in the environment. I'm going to start with a reminder of the four ambitions we have set for PR24 and then highlight key elements of our methodology including drawing out some areas that have changed since our draught methodology. I'm going to speak for a little under 20 minutes and I'm going to leave time after that for Andy to go through the risk and return elements of the methodology. So let me start with a very quick reminder of the ambitions for PR 24 that we think companies need to rise to. Our methodology has been shaped through consultation and engagement with stakeholders. In light of these ambitions through this price review, we need to focus on the long term deliver greater environmental and social value, reflect a clearer understanding of customers and communities and drive improvements through efficiency and innovation.

We know that companies are going to have to deliver significant additional investment in the next period and that affordability for customers will be a key issue. Meeting these challenges will require them to plan effectively, harness innovations, and drive efficiencies to ensure that these ambitions are fulfilled. Now I'm going to step through some of the key aspects of the methodology, starting with how business plans will be assessed and the rewards and penalties that we will apply. Plans will be assessed for their quality and ambition and then categorised as outstanding standard, lacking ambition or inadequate. Our goal here is to incentivize all companies to develop quality plans that deliver stretching levels of service at efficient costs. Ultimately to deliver affordable value for customers and the environment. We've created strong incentive packages. The very best outstanding plans will receive a financial reward of 30 basis points on the return on regulated equity.

They will also attract the most favourable cost sharing rates and gain protections from any reductions in the cost of capital and base cost allowances between draught and final determinations. But inadequate plans will have a 30 basis point penalty coupled with a tougher cost sharing rate. We want to see that proposals are informed by listening to customers and communities and understanding and reflecting their views on affordability and acceptability. These insights will be drawn from customer research and the "Your Water, Your Say", public meetings. In addition, we want boards to give particular consideration to the scale of the investment programme, looking both at the capacity within the company and the supply chain. We're asking boards to give assurance that their plans are deliverable. For our final methodology, we have added a minimum expectation for each company to evidence that it can credibly deliver the proposals in its plan.

Practically, this means companies with poorer outturn performance will have to do more work to demonstrate that they can deliver ambitious proposals. Companies also need to ensure that they're setting out clear dividend and executive performance pay policies that reflect how the company delivers for customers and the environment. And companies should be striving to demonstrate how they can manage affordability concerns and they should be getting on with this now and not waiting for PR24. I'll now turn to the incentives to deliver great outcomes for customers and the environment. Our methodology is focused on companies delivering the right outcomes for their customers, communities and the environment and is trailed in the draught methodology with streamlining our outcomes framework. Compared with PR19, the outcomes framework will hold companies to account for delivery and it will incentivize them to go further where they can deliver greater value. And we are clear that the key outcomes we incentivize in PR24 are likely to be of lasting importance and this should underpin companies taking a long-term approach to investing in performance improvements.

Our common performance commitments reflect a greater range of environmental outcomes, some of which we have refined since the draught methodology. For example, we've refined our approach to measuring new environmental PCs such as river and bathing, water quality and biodiversity. There is also a continuing focus from PR19 on customer service and asset health. And as we said in the draught methodology, there may also be a small number of bespoke performance commitments, but we don't expect more than two or three per company.

Companies need to deliver a step up in customer service. We have seen customer satisfaction stalling in the second year of the current price control period and water companies continue to compare poorly against other sectors. We are increasing the size of the incentives attached to the customer measure of experience or cmex. We expect this to increase by 50% up to 18% of annual allowed residential retail revenue.

Subject to further review as we approach the determinations. We've also seen disappointing progress in driving efficient use of water on top of leakage and household consumption. We will set a new performance commitment for business consumption at PR24. In addition to these performance commitments, there will be a new fund of up to 100 million pounds to encourage and support the development of a range of fresh approaches to water efficiency. All PCs will have powerful financial incentives. We intend to set symmetrical outperformance and underperformance rates for every PC. The incentive rates for most performance commitments will be based on benefit estimates from the collaborative customer research, and we intend to set relatively high incentive rates through a benefit sharing factor that reflects the wider benefits associated with outperformance and to focus companies on improving their performance. Some PCs will have enhanced incentives on top of their standard incentive rates.

Enhanced incentives encourage innovation and very high performance providing benefits to customers of all companies. Enhanced incentives will be outperformance only and available for all companies that perform beyond the thresholds we set. Currently, we expect them to apply to six performance commitments. That's water supply interruptions, leakage per capita consumption, internal and external sewer flooding and pollution instance. We expect revenues at risk from ODIs to be equivalent to around plus or minus 1 to 3% return on regulatory equity. Payments. From the measures of experience, performance commitments will be on top of this. Our intention is that companies should be strongly incentivized to deliver great performance, but we will also protect customers and companies from the risk of very high payments.

We'll do this primarily through an aggregate sharing mechanism. We will keep the thresholds under review, but to illustrate as on the, the slide companies could earn or incur up to the 3% level without sharing any payments at the 3% level, the aggregate sharing mechanism would kick in to share net payments between customers and companies, and from 3% to 5% payments would be reduced by 50% and at the 5% level by 90%. We'll also manage risk exposure through the targeted use of caps and collars on individual performance commitments.

We expect to set caps and collars on all performance commitments that are new, bespoke or measure asset health, and we'll extend our use of caps and collars to include performance commitments that have the potential to be a significant source of skew in the outcomes package. I'm going to now turn to our approach to setting efficient expenditure allowances. Companies' planning and efficiency will be critical to the sector being able to deliver the improvements demanded by the public and government in an affordable way. We will continue to scrutinise companies plans for base and enhancement expenditure closely at PR24, we build on our PR19 approach with a continued focus on benchmarking and an increased focus on benchmarking, on enhancement expenditure, making a greater use of historical data. We want companies to continue to focus on improving asset maintenance and strengthening resilience. There are a number of challenges and we need to ensure that customers do not pay twice either for services that they've already funded in previous price control periods or for services that are covered by companies base allowances.

On main's renewals, given the very low renewal rates over the 2020 to 21 period, we expect companies to do more in future years, but companies will need to deliver the renewals levels that they promised before we allow additional funding. And it is clear that improved service to customers is needed across a range of other areas, including tackling sewer flooding, reducing storm overflow spills, and reducing water supply interruptions. But we have seen evidence to show that good service does not need to cost more. So we want all companies to demonstrate that they are stretching themselves to deliver better service from existing allowances before providing additional allowances. Past under-delivery, for example, storm overflow issues that are down to poor maintenance, won't warrant enhancement expenditure allowances.

Now on top of what can be achieved through base, we expect that a substantial increase in expenditure allowances will be required. We want to see fast progress towards government targets and for companies to be ambitious to deliver a transformative change in performance levels. Before highlighting a few key improvement areas. I want to pause on the importance of companies engagement with the strategic planning frameworks and WINEP and NEP. Given the scale of potential investments, it's more important than ever that companies identify the right investments to deliver best value solutions, for which Ofwat will then allow efficient costs at PR24. The planning frameworks and environment programmes are the key opportunities to do this. We've already provided detailed feedback on disappointing DWMPs and companies really must make the most of the remaining months to improve these and other strategic plans to ensure that the right funding can be allowed.

We are also very keen to enable funding for outcomes based focused WINEP and NEP schemes to help ensure that customers and the environment benefit as much as possible from money invested. So let's focus on a few key issues and how they can be tackled in PR24. First, the impact of storm overflows on our rivers, it's not acceptable. We expect all wastewater companies to reduce their use of storm overflows and go further where their legal obligations require. Where appropriate, we want companies to go beyond the proposed annual average of 20 spills per overflow from 2025, and that's without additional expenditure allowances. For PR24, we will provide extra funding to reduce harm from storm overflows where government targets demonstrably go beyond the current legal requirements. Second, we expect all companies to deliverto plan to deliver the long-term water demand reduction targets for leakage and per capita consumption.

Comparisons of performance across English and Welsh companies indicate that some companies have managed to achieve significantly lower leakage levels than others, we therefore expect companies with higher leakage levels to propose ambitious reductions going beyond existing national long-term targets and where we don't consider that company proposals are sufficiently challenging, we will intervene to adjust company performance commitment levels. And third, companies should make substantial greenhouse gas emission reductions reducing operational and embedded emissions in parallel. We've provided greater clarity in the final methodology on how transition to net zero emissions will be funded and incentivized. Net zero enhancement expenditure requests will be allowed on a competitive basis through a net zero challenge. This will concentrate funding on companies with more mature approaches to emission reduction and more efficient solutions. We also expect that the best companies will share their learning across the sector. I 'll just touch briefly on our approach to markets, which reflects the priorities set for us by the UK and Welsh governments.

First on bioresources, we want to help the sector to create economic and environmental value through technological changes and economies of scale. At PR24, we will set a more market oriented control for buyer resources and we will move to a fully reformed approach at PR29. On developer services, competition from self-lay providers and new appointees is increasing. We therefore intend to focus regulation in areas where it will provide the most benefits to developer services customers, and we expect to see projects progressing through. We expect to see more projects progressing throughdirect procurement for customers during PR24. DPC will be the default approach for all discreet projects, over 200 million pounds of whole life totex. Working with the pathfinder projects, our analysis shows that using DPC could deliver benefits for customers of between 12 and 80 million pounds on a 200 million pound project.

I also want to draw out some key elements of PR24, which will support companies to tackle the challenges of affordability and deliverability. Given the increased expectations about what the sector will need to deliver for PR24 and beyond. We're expanding the scope of the transition expenditure programme for PR24. We will allow transition funding for the last two years of the current price control period to allow companies to make an early start on certain schemes to help reduce overall delivery costs in 2025 to 30, and to support earlier delivery of customer and environmental benefits. I've already talked about the need for companies to step up on efficiency and innovation, which will be vital for delivering effective large scale investment programmes. To support this, we will increase the size of the innovation fund to at least 300 million pounds for this price review, at least a 100 million pound increase from the fund size at PR19.

And finally, I want companies to deliver the improvements that they have promised to customers. We'll require board assurance so that company boards fully own the delivery of their plans. Companies will be expected to meet price controlled deliverables for material investment where the risk to customers is not adequately protected using PCs and ODIs. This means that companies that overpromise on their plans, but underdeliver will be worse off as a result and customers will not pay for improvements that don't materialise. I'll now pass over to Andy to take us through the risk and return elements. Thank you.

Andrew Chesworth:

Thank you. Aileen. As Aileen has highlighted, there is expected to be a substantial increase in the investment in the next period. This will provide opportunities for investors who have a critical role in financing the expansion of the asset base. We will set determinations that provide a reasonable base level of return together with opportunities for investors to earn enhanced returns where great levels of performance are delivered for customers in the environment. We expect costs to be recovered fairly over different generations of customers and we expect companies to ensure that their own financial structures are resilient in the long term. We present the expected range of returns using the return of regulatory equity metric. Overall, the chart shows that the RoRe range is broadly symmetrical at roughly plus and minus 4.8%. This is similar to the risk range presented at PR19 and slightly lower than the risk range presented at the draught methodology.

This reflects a change in notional gearing and some other changes including the proposed increase in incentives aimed at targeting improved levels of customer service through the customer measures of experience. We have considered carefully the notional gearing level for PR24. We set this at 55%, a reduction of five percentage points from PR19. We consider equity should play a greater role in the notional capital structure to ensure co companies are resilient to uncertain future to ensure the effective operation of the incentive based regime reflecting strength of the incentives and to ensure that companies are able to maintain access to significant levels of finance that will be necessary to deliver the investment programmes. We consider a gearing reduction of this level is achievable for a company with a notional capital structure over a controlled period. We consider the current period of high inflation provides the notional company and many companies under their actual structures the ability to reduce gearing ahead of 2025.

We set the notional gearing level now as it provides an important signal to customers to companies should they wish to align with the notional level ahead of PR24. We set out our proposed methodology for determining the allowed return on capital at PR24. We confirmed that we will fully transition the indexation of the RCV to CPIH in 2025, and so all cost of capital parameters are stated in CPIH terms. We set out the methodology we expect to adopt in setting the allowed return following the framework set out in the UKRNs draught guidance for regulators and in setting our early view, we have drawn on a wide range of evidence including representations to our draught methodology, recent regulatory decisions, advice and challenge from FTI, our advisors on beta estimation, and from our expert academics and other sources including equity analyst reports and credit agency reports. Our methodology, our methodology draws on data to the 30th of September, 2022. We use a 30th of September cutoff date as we think that will be the date in 2024 that we will use for setting our final determinations. However, our approach is impacted by the material movements in interest rates that have recently been seen. And I will touch on this issue in more detail.

Our early view allowed return on equity is set within the campaign framework. Our approach uses data from 20 year RPI-linked gilts as a proxy for the risk -free rate, consistent with the view that we should set the allowed return by reference to a long dated investment horizon. Our risk-free rate is informed by data from the month of September together with a wedge adjustment to convert RPI inputs to a CPIH basis. The total market return is calculated using historical data sets of equity returns that are commonly used by regulators and a beta that draws on a longer term data series than we have used in the past. We state a point estimate for the risk-free rate and range estimates for both the total market return and beta from which we derive a cost of equity at the midpoint of our CAPM range.

Our cost of equity range is 3.67% to 4.6% with the midpoint of 4.14%. It is within the range inferred from our market to asset value cross checks, and so we do do not depart from our midpoint. Our methodology for the risk free rate is to set a fixed allowance without forward rate adjustments on the basis that our previous work suggested forward rate adjustments were no better predictors of returns over five years than shorter term evidence. And we have retained this position reflecting that we are two years out from our determination. However, as I've mentioned, the early view allowed return has been set at a time of significant volatility in borrowing rates and uncertainties about the path of future interest rates. Therefore, we keep open the option of using alternative samples of data to the one month's trail to inform our risk free rate and we keep open the option of revisiting indexation of the risk free rate.

If interest rate volatility were to persist into 2024, our early view allowed return on debt is 2.6%. We calculate separately the cost of embedded debt based on data from company balance sheets and the cost of new debt based on a market benchmark . Consistent with the approach to the risk-free rate, the cost of new debt stated in our early view is based on data for the month of September, but subject to a 15 basis point benchmark index adjustment, this reflects our continued observation that debt raised in this sector tends to be issued at a lower cost than the benchmark, and the adjustment itself is below the level we have observed in recent evidence. As for PR19, we include an allowance of 10 basis points for issuance and liquidity costs. And our calculation of the overall cost of debt is based on the split of new and embedded debt that is weighted 17% new debt and 83% embedded. Our cost of debt calculations reflect the Bank of England target of 2%. We consider the inflation target remains the most appropriate measure for determining the real allowed cost of debt reflecting regulatory consistency, and that we are setting returns for 2025 to 30 that take account of debt that is raised over a longer timeframe . We keep open the possibility of reviewing our approach. If we consider the Bank of England, target will not be be reflective of expected long-term inflation.

Overall, the allowed returns set in our early views 3.29% in CPIH terms some 33 basis points above PR19. The appointee allowed return is adjusted to allocate the return to retail and wholesale controls reflecting the approach rate previously used. But given the volatility and interest rates, we also illustrate that the allowed return would be 3.53% based on an update to the risk-free rate in cost of debt for the month of October. And this illustrates that there may be merits in adopting indexation of the risk-free rate of recent levels of volatility were to persist. The October figure is slightly above consensus estimates from our survey of analyst expectations, which illustrated a median allowed return of 3.44%. As for previous determinations, we expect business plans to include board assurance that plans are financable on the notional capital structure and consistent with business plan submissions at PR19 to target a credit rating of at least two notches above the minimum investment grade,. We retain the cost recovery building blocks used in our recent determinations, known as pay -as-you-go and RCV run-off. We will test company choices of pay-as-you-go and run-off rates in the business plans.

Our starting point for pay-as-you-go will be the natural rate, i.e. the level that is reasonable based on operating costs. For RCV run-off. We proposed in our draught methodology to provide guidance on acceptable levels of RRCV run-off for the next period. This reflected our experience from PR19 where we found that in some cases run-off rates were well above rates implied by average asset lives. And if sustained, this could store up a future financeability constraint. We have refined our approach. In the final methodology, we have set out guidance and the upper limits of acceptable levels of run-off reach control, which are 4.5% for wholesale controls and 8% for buyer resources. And we set a framework by which we will assess company proposals. These figures are above the levels of run-off that would be safe. The calculations were based on average remaining asset lives, and we expect companies to explain their RCV run-off by reference to average asset lives. And we will assess company claims within a framework that considers intertemporal fairness, customer affordability, and the need to manage financeability in both the short and the long term.

We have set up guidance for dividend yield to be used for the purposes of the financeability assessment. Based on our early view cost of equity, we signal a maximum 4% yield. There should be notched down where there is real RCV growth. Even where we notch dividends down, we propose to maintain a minimum yield at 50% of the reasonable base dividend yield. In other words, 2% based on our early view before assuming a notional equity injection where a financeability constraint remains. We're carrying forward work separately to encourage all companies to meet high standards of financial resilience. However, consistent with PR19, we expect that companies provide board assurance that their business plans will allow them to maintain financial resilience. We expect companies to put forward the evidence in business plans that support a board assurance statement based on the guidance and prescribed downside scenarios we set out.

We also expect companies to set out how dividend and performance related pay for executives shows alignment with delivery for customers, communities, and the environment. In the current period, we've seen a number of companies put forward voluntary sharing mechanisms, mechanisms to share out performance with their customers. We encourage companies to put forward such mechanisms in their plans, especially where out performance is the result of material out performance and the cost of debt that may not be repeatable by other companies or for example may be the result of miscalibration of the determination package. We will assess all of these issues being financial resilience, dividends, performance related pay, and voluntary sharing in our quality of ambition assessment. So to conclude, the continued interest of debt and equity investors is crucial to the successful operation of the regime. There are significant opportunities for investors to support companies in financing significant investment programmes and as I've set out, investors will receive returns such to commensurate with the risk associated with an investment in a monopoly utility water company with opportunities to earn enhanced returns where companies are delivering for customers, communities, and the environment.

And finally, we turn to the timeline. This slide sets out the key milestones and steps to be taken ahead of our final determinations. The timeline sets out the key steps relevant to the development of plans, including the Your Water, Your Say sessions that provide opportunity for customers and stakeholders to challenge company plans in open forum. It also sets out the ongoing work of ODIs and cost assessment. The key dates for this audience to note are those depicted by the triangles beneath the timeline. In other words, business plan submissions, which are due on the 2nd of October, 2023, draught determinations, around May or June, 2024 and final determinations in December, 2024. Thank you all for your time, and I'm going to pass back to David now and we'll go through the question session.

Ofwat PR24 City Briefing Q&A Section

David Black:

Thank you very much, Andy. And just to apologise for those that had difficulty connecting to the early part of the conversation so I understand there were some technical issues apologies about that. There will be a recording available so you can listen then to the full session if that would be of interest. So we'll go to the questions now. Jamie, can you start with the first question?

Jamie Tunnicliffe:

Sure, the first question is from Dominic Nash from Barclays. He asked when does the government publish its Environment Act? In particular putting into law CSO spill reduction, and how would this legal requirement dovetail into PR24 allowances if it comes out after business plan submissions?

David Black:

Thanks, Jamie. I'll go to Aileen on this particular question. Aileen

Aileen Armstrong:

Taking myself off mute. thank you. I mean, I think just in terms of clarity around this storm overflow reduction plan you know, we're looking to companies and I think companies are expecting to put those plans into their WINEP and so in terms of, you know, what comes through WINEP in terms of the requirements there that should capture those points.

David Black:

Yeah, exactly. So the government has set out, it's spill workflows plan, so the expectations on companies are clear. Obviously there may be changes to that plan over time. The government set a review for 2027, but I think the scale of a task is, is very clear and we're expecting companies to both respond to that and as Aileen said, build it into their environmental investment plans, but also show real ambition in this space – we'll expect to see innovation and new solutions coming to the fore. Jamie, next question. I think we start to get into the, the cost capital questions.

Jamie Tunnicliffe:

Yes, that's right. I'll just take another one from Dominic. He was quick off the mark. It is on the cost of capital. He said, is water higher or lower risk than power? And what evidence is there that the asset beta is lower than power and if lower, why run it at a lower leverage than power?

David Black:

Thank you, Jamie. So I'll come across to Andy to answer that question. Obviously we'll be looking at this through the lens of a, of a water regulator. and we've got the listed water comparators. Obviously we work closely with Ofgem, but it's for them to make the call on their view about energy risk. We can comment on the risk for water companies and how we've derived it. Andy...

Andrew Chesworth:

Yeah. So our cost of equity for the water sector is derived, taking account of beta estimates. and the beta estimates that we've used are derived by a report for us from FTI. And the beta range that we've used at an asset beta level is 0.26 to 0.29, which draws on long term betas over 5 to 10 years. I think historically if you, if you look at sort of determinations from around PR19 and Ofgem around the time of 2020, you do see a differential in beta between water and the energy sector. I think the one thing that I would say in water is that we do benefit from observations that are largely pure play. and that is, that is something that's helpful to our regime. so yeah, the cost of equity, it draws on parameters that are observational from the market, so drawing on the beta estimates from FTI report, but also drawing on market data on risk-free rates and long-term data on the total market return in terms of running at lower leverage than power.

Clearly you've seen Ofgem ED2, they reduced gearing levels by 5%. We're reducing gearing levels by 5% in water, but we are very focused on, on water and the gearing level that we consider to be right for the sector that we regulate.

David Black:

Thanks, Andy. Jamie?

Jamie Tunnicliffe:

Yes – we've got one in from Martin Young from Investec – once again on returns. appreciate that you and Ofgem are independent and set your own returns, but interested in your high level observations about the differences between your cost of equity in October, versus ED 2 – obviously notional gearing differences will be a part.

David Black:

Thanks, Jamie. so I think one again for Andy looking at ourselves, Andy.

Andrew Chesworth:

Yeah. So clearly, clearly there's a difference that's driven by notional gearing and the, the notional gearing level in ED2, at 60%, that that is one driver of the difference between water and energy. Another driver of the difference is that the beta in the ED2 determination is, is taken from Ofgem's determinations in 2020 where they haven't updated the beta for more recent data. We have seen if you take account of more recent data, there is a lower beta. There's also differences on the risk-free rate, for example, driven by the data cutoff. So Ofgem use a data cutoff, which is the end of October. They use data for the month of October. That is the data that flows through the, the indexation mechanism that they use. So clearly there's quite a difference in the, the October data set compared to September. and also this difference associated with Ofgem's use of forward rate in its risk-free rate assessment. and also the calculation that is used for deriving the wedge between RPI and CPIH based risk-free rate. Now those are issues, I expect that will flow through their reconciliation model over time. So some of the difference might wear out over time, but those really are the, the key elements of the difference between us and Ofgem.

David Black:

Thanks, Andrew. Jamie?

Jamie Tunnicliffe:

Question from James Brand at Deutsche Bank – several companies may have underspent their totex allowances in the regulatory period in areas where Ofwat feels that they should be investing, what methodology will be used to take this into account and setting allowances for PR24?

David Black:

Thanks, Jamie. so I think some of this refers to our recent publication, the Water Company Performance Report last week. and two points to draw out really. One is on enhancement spending, so that's the extra investment companies make to improve performance. There was significant underspending by companies, so companies spent around about 68% of their allowance in the first two years of this period. And some companies notably spent less than 50% of their allowances, which raised concerns for us in terms of a sector that needs to improve its performance. The other chunk of spending is base spending. That's the larger amount in any price review. And there companies were spending much closer to their totex allowances. So the total across base and enhancement, or total totex spending was slightly over on water and slightly under on wastewater. So in terms of the implications for PR24 cost will flow from a base modelling perspective and that's really, that, that will be important.

The enhancement underspend will be less relevant in terms of that takes a more bespoke costing methodology. So it's probably the number to focus on from a, from that perspective is the base spending number. But we are concerned about the slowness of some companies to spend their investment allowances, and we'll be thinking about how we reflect that at PR24, if you wanted to add anything on the approach to PR24 Aileen and incentivizing companies to make sure they stay on top of their investment programme?

Aileen Armstrong:

I mean, I think you've covered most things. I suppose a couple of just additional points just in terms of actually in PR19, but also in PR24, you know, the, the real the importance of the outcomes regime and actually, you know potential for rewards, but also under performance payments if companies don't deliver what you know, we are expecting them to. So you know, we're, we're really clear that, you know, we've got the signal for what's going to be incentivized in P24. So companies should know that if they invest now, they need to get themselves in the right position and the, the rewards and penalties will attach to that going forward.

David Black:

Thanks, Aileen. Jamie?

Jamie Tunnicliffe:

Yeah. Two questions here from Jenny Ping at Citi. First is based on your comments and given volatilities, am I correct in saying, depending on where the market is, there is risk that the FD numbers on returns could be outside of your early view range? i.e. you're not wedded to this range. And then the other one from Jenny was slightly off topic. When will we hear from Ofwat on its investigation on sewer flooding? Thanks.

David Black:

Thanks, Jamie. so go to you first Andy, on the cost of capital question, then I can pick up the sewage overflow investigation. So, Andy, on the cost of capital point.

Andrew Chesworth:

Yeah, so, just on the range, I think the key point at this point is the methodology that we have adopted for setting the allowed return, which is the methodology we would expect to, to adopt at the draft and final methodology stage. And of course market data will evolve, will change over the next two years. And that will impact on the, the book-ends of the range as well. Obviously, you know, things like index-linked gilts, risk-free rates will change and that will impact on the, the book-ends of the range as will changes in beta. So yes, we will update the range as well as the point estimate when we get through to the draft and final determinations.

David Black:

Thanks, Andy. Yes, and we do appreciate it is a vital time in financial markets but nonetheless think it's useful to provide the early view on the evidence that we see at this point in time. Obviously that'll inform people in terms of the approach in the final determination. In terms of the investigation, we've committed to keeping regular updates on our website as we make progress. We do appreciate it's critically important. We do understand the urgency of addressing the issues but equally the large scale and also the importance of a rigorous approach to investigation does mean it will take some time. So we will keep updating, as we progress and we will obviously look to make rapid as progress as possible but we won't be committing to particular dates or times as is the case with what are major investigations. Thank you, Jamie.

Jamie Tunnicliffe:

Yeah, just bringing two questions together from Dominic at Barclays and Martin at Investec. What was the point of setting a cost of equity and debt now? If these are used for financeability and leverage issues, then surely using a wrong number is more harmful than not using anything at all? And Martin follows that up which is to say, surely companies can provide compelling evidence that another rate is more appropriate in their business plan submissions?

David Black:

Thanks, Jamie. so we'll go to Andy on both of these questions. I think we touched on in the last answer as well, Andy.

Andrew Chesworth:

Okay. So the aim here was to set down the methodology that we will adopt for setting the allowed return at PR24. we, we did this at PR19 and that reflected experience from previous determinations where companies had put numbers on to the cost of capital and business plans, which, which vary quite considerably in, in some cases were well above the level that we may have considered reasonable at the time. So we are keen for companies to use the cost of capital that we've set in their business plans. but obviously the cost of capital will evolve. It will take account of more recent data when we come to set it at our draft and final determinations. So yeah, we would like companies to use our cost of capital and to consider that in building their business plan.

David Black:

Thanks. Thanks, Andy. Jamie

Jamie Tunnicliffe:

Andrew Moulder from CreditSights has asked whether you'll be making any financeability adjustments for companies with high levels of index-linked debt in this high inflation environment?

David Black:

Thanks. Thanks, Jamie. Andy?

Andrew Chesworth:

Okay. so the answer to that I think is knowing in the context that I, I read the question as being about a company's actual financial structure, and of course we set our determinations by reference to the notional structure the notional structure and our approach to the price determination sets out a clear allocation of risk and responsibility for dealing with issues associated with the choices companies have made about their financing structures and their financing arrangements. So the extent to which companies are impacted or have impacts on their financial structure as a result of the current high inflation environment, we see that very much as a, as a matter for the company and its investors to manage.

David Black:

Thanks. Thanks Andy. So any more questions?

Jamie Tunnicliffe:

Yes. There is one from Alex Wheeler at RBC. He said the document talks about a five year business plan in the context of a 25-year strategy. How will you define what investment needs to be done in AMP8 versus what can be deferred into future periods given the investment needed in the space? That's it.

David Black:

Thanks, Jamie. yes, a very interesting question. and that's something we've put a lot of focus on in terms of getting companies to take a long term focus at PR24. So I'll ask Aileen to expand on an answer to that, Aileen.

Aileen Armstrong:

Yeah. Thank you. And then I think the, the question goes to the heart of why we're asking for the long-term delivery strategies and for companies to really do adaptive plans. So in terms of, you know, using that 25 year framework and identifying, you know, where they need to get to and therefore what are the steps that need to happen in this first five years of that 25 years. And that's both the kind of low regrets steps of investment that's needed, but also investment that's going to be needed potentially to keep options open into future periods where we might have, and companies might have more information in order to make a decision. So, you know, I think it is looking at that whole long-term picture and using that planning to identify indeed as, as the question asks, you know, what actually needs to be done in this in this first or the next AMP.

David Black:

Thanks Aileen. Jamie, any further questions?

Jamie Tunnicliffe:

There aren't any more at the moment. No.

David Black:

Okay. So if there are no further questions – so thanks very much everyone for joining us 12 days before Christmas for the PR24 Final Methodology, and apologies again for difficulty people may have had in accessing this session so there will be a recording made available so you can see the whole piece start to finish. But thanks very much for joining and just checking… I don't think any further questions come through, Jamie. So I suggest we draw this session to a, to a close and wish you all the best for the festive period. And then our next planned City Briefing session will be the draft determinations in 2024. So thank you very much everybody. Goodbye.

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