May draft determinations analyst and investor call
Speech made by Sonia Brown, Chief Regulation Officer
30 May 2014

Good morning. Thank you very much for joining us.

My name is Sonia Brown. I am the Chief Regulation Officer at Ofwat. Today I am joined on the call by Graham Taylor who is our City Advisor.

This morning we issued draft determinations for Northumbrian Water and Dŵr Cymru (Welsh Water). For those of you following PR14 you will know that this means we are four down with 14 to go at the end of August.

Before getting into the detail around Northumbrian and Welsh Water, a quick reminder on how we have got here today.

We issued our final methodology for PR14 last July, following more than two years of consultation and engagement. We also issued risk and reward guidance in January this year which set out our expectations on the cost of capital and other key financial parameters. From December until March we carried out our risk-based review of companies' business plans, which resulted in South West Water and Affinity Water gaining enhanced status and draft determinations at the end of April.

Recognising that some companies would need to address only a small number of issues, we offered all remaining companies the opportunity to come forward for an early draft determination. Welsh and Northumbrian submitted their plans at the start of the month, and I am pleased that we are able to issue these draft determinations today – ahead of our original schedule.

Northumbrian and Welsh's plans, as revised and resubmitted earlier this month, were of high quality. Our feedback from the risk-based review challenged them, on behalf of customers, in a number of areas – and the companies responded. I know that some of you will have heard me say this before, but we really can see how the combination of greater ownership of plans by company boards, customer engagement and challenge, and regulatory incentives is leading to better outcomes for customers in this review.

Bills will be more affordable, more will be delivered and finance will continue to be attracted. This is critical for the sector as we all try to maintain trust and legitimacy with customers.

The draft determinations that we issued for the two enhanced companies were based on their own business plans. We have already signalled that the process for the non-enhanced companies is different – and we have today set out a series of relatively modest interventions that we have made into Northumbrian and Welsh business plans. We have only stepped into the companies plans where we consider it is necessary to protect customer's interests. I will explain these interventions later in my presentation this morning.

Depending on how well the remaining fourteen companies respond to our concerns when they revise their plans on 27 June, some of our interventions there may be more significant.

But first let's look at some headlines of what both of these companies will be delivering for their customers.

Northumbrian's customers will see bills broadly flat in real terms, falling 2% by 2020. By the end of the AMP, bills will be £6 lower than proposed in their original business plan submitted in December. Under their plan:

the company has committed to reduce the number of properties experiencing low pressure by 16%,

- reduce the amount of pollutants discharged into rivers, and
- improve catchment management to prevent pesticides entering rivers.
- 75% of customers found their plan acceptable.

In response to our challenges in the risk-based review Northumbrian made a number of changes to its plan including withdrawing its bad debt adjustment and its input price pressure adjustment. It also withdrew three notified items.

In terms of our interventions these included changing the level of several performance commitments to make them more stretching or to remove unwarranted deadbands, such as in overall drinking water compliance and sewer flooding. We removed the reward aspect related to other performance commitments related to leakage, bathing water compliance, and proposed asset health indexes in water and wastewater. In these cases we felt that willingness to pay evidence was Insufficient. We also amended the company proposal for an uncertainty mechanism for water business rate charges, so that 75% of cost variations would be passed through to customers.

We made adjustments on 2010-15 performance to that put forward by Northumbrian in relation to the revenue correction mechanism, opex incentive allowance and CIS [capex incentive scheme]. We have also made adjustments to the RCV [regulatory capital value] (and revenue requirement) in relation to a number of outputs from our final determination in 2009.

Both companies have adopted our financial guidance, although the RoRE [return on regulatory equity] range for both has been impacted by our interventions on ODIs [outcome delivery incentives].

Following our interventions, Northumbrian's appointee RoRE range is 0.6% to 8.9%, with a base case of 5.8% – higher than 5.65% for most WaSCs, due a water trading incentive. The downside skew is due to ODIs which, following our interventions, allow for 0.7% of outperformance and 2.6% of underperformance.

On financeability, you will note some significant differences between the notional ratios at Northumbrian and Welsh. In particular, Northumbrian has an average ratio of funds from operations to debt of 12%, while Welsh's is 7%. The difference is entirely due to the ways in which the two companies have chosen to use the financeability levers. Whereas South West and Affinity chose to run off their RCVs at 4-4.5 per year, Northumbrian is depreciating its RCV at over 6% per year, which produces relatively higher bills in this period but less RCV growth over the AMP.

The adjusted cash interest cover ratio does not benefit from this faster RCV run-off, but is affected by the company's decision on the PAYG [pay as you go] ratio, which determines how much of totex is recovered in the AMP rather than added to the RCV. Northumbrian's PAYG ratio averages only 51%, below the other companies for which we have issued determinations. This tends to reduce the adjusted cash interest cover ratio, as we calculate it.

Now moving on to Welsh's draft determination.

Welsh's customer bills will fall 5% in real terms. This is £3 lower than proposed in their original business plan. Under their plan:

- the company has committed to reduce leakage by 8% and properties suffering from sewer flooding by 20%.
- pollution incidents will fall by more than a third, and

- an enhanced range of social tariffs will be introduced to help customers struggling to pay.

94% of their customers considered the original plan to be acceptable.

In response to our challenges in the risk-based review Welsh made a number of changes, including withdrawing its input price pressure adjustment for 2015-20 and withdrawing its uncertainty mechanisms for logging up and down.

In terms of our interventions these included reducing the maximum rewards available for some ODIs, better reflecting evidence of customer willingness to pay or cost of delivery. We altered some performance commitments to ensure that they included private sewers recently adopted by the company as well as pre-existing assets. We included a shortfall for water infrastructure serviceability. We allowed an adjustment for doubtful debt, but smaller than that proposed by the company. And we allowed an uncertainty mechanism for water business rates that would pass through only 75% of the costs, consistent with our determination for Affinity, rather than 100% as Welsh had proposed. We rejected Welsh's proposal for an uncertainty mechanism for wastewater business rates.

Welsh's appointee RoRE range is 1.4% to 8.0%. This is centred around a slightly lower base of 5.6% as companies in Wales will face less competition in non-household. Again, ODIs have a negative skew of +0.2 to -1.5%.

Welsh has chosen a significantly longer depreciation life, running off assets at only 2.7% per year. This results in lower bills and cash flows during this AMP, but higher RCV growth.

By their nature, adjustments to the RCV run-off rate and PAYG ratio are value neutral. But by changing the balance of current and future cash flows they can have a significant effect on affordability and financeability.

The notional 7% [funds from operations] FFO/debt that we have calculated for Welsh is notably low, and we required a commensurately high level of assurance from the company. They provided us with evidence that a company with ratios in this range would have an investment grade rating, and that capital markets would be open to it. After lengthy discussions with the company we have accepted this assurance.

While bills will be lower in the period as a result of this decision, future bills will be somewhat higher. We have accepted the company's assurances that this balance of current and future bills is supported by their customers.

For the benefit of those who don't follow the sector closely, it is worth emphasising the distinction here between actual and notional capital structures. Welsh needed to assure us that its business plan is financeable under a notional capital structure. Under its actual capital structure, which has a lower level of debt and benefits from certain structural enhancements, they expect their rating to be significantly higher.

It is also worth emphasising that it was the company's choice to target this low FFO/debt ratio, and that it would have been possible for them to achieve a significantly higher ratio, while remaining consistent with our risk and reward guidance, by using the levers differently.

Northumbrian and Welsh will now have five weeks to provide their response to our draft determinations.

Looking ahead, we still have 14 draft determinations to make. Our approach will be the same – but the issues that were raised are more material for some of the companies. For example there are some companies where we have challenged their wholesale costs. The dialogue that we are having with all companies is constructive. It is important for me to be clear that constructive dialogue does not necessarily mean agreement.

We will be looking closely to see how the companies' boards respond to the challenges that we made on behalf of customers – and await with interest the resubmitted plans on 27 June. We will not hesitate to intervene for customers if we think we need to as this process reaches its conclusion.

Thank you for your time.

Happy to take any questions that you may have now.