City Briefing 2pm, 13 December 2022

Presenters: David Black, Aileen Armstrong, Andrew Chesworth

SLIDE 1 – TITLE SLIDE

<u>Introduction – David Black</u>

SLIDE 2 – DAVID BLACK

Good afternoon – thanks for joining us. I'm David Black, Chief Executive of Ofwat

SLIDE 3 -AGENDA

At today's session I'm joined by Aileen Armstrong, the executive director leading on the price review. And Andrew Chesworth who is director of risk and return for PR24. Also on the call is Jamie Tunnicliffe, director of investor relations.

Aileen and Andy will talk you through the main elements of the PR24 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.

First, I'd like to give some context

SLIDE 4 – CONTEXT FOR PR24

The sector has faced the harsh light of intense public scrutiny over the last 12 months – and it has often looked like it is falling well short of public expectations – whether from regular sewage discharges or from high levels of leakage while asking customers to conserve water as part of hosepipe bans. And these concerns are heightened by perceptions that shareholders and executive teams being well rewarded even where companies fall short.

The 2024 price review presents both an opportunity and 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. As set out last week in 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 resilient and environmentally sustainable services. This means looking ahead, anticipating future challenges as well as addressing the concerns of today.

We are looking to companies to accelerate their activity on a range of areas well ahead of PR24 –taking action to reduce use of storm overflows and reducing per capita consumption. We welcome companies that have shown ambition on reducing overflows before 2025. Companies also need to ensure that their corporate behaviours on dividends and executive pay engender customer and stakeholder confidence.

Companies will be making the case for more investment at PR24 – it is vital that customers have the 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 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 are 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 preventative rather than 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. It will also require companies to explore new approaches to charging to better achieve water efficiency and affordability. These changes will require companies to have sufficient financial resilience – and poor performing companies may require additional support from shareholders to make improvements.

Our PR24 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 new fund for water efficiency. We will continue to incentivise better performance with expanded focus on the environment at PR24. So better performance on the environment will matter for investor returns. We have worked with the Environment Agency to reform environmental investment process to better enable innovation and better value.

The proposals we set out today have taken account of the feedback on our draft methodology. That has included the participation of some of you, whether formally through consultation responses or through your published analysis. We appreciate your interest in the sector and the insights you bring.

The sector faces high expectations for improved outcomes. We're confident that the framework we publish 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 to share the overview of PR24

Overview of Final Methodology – Aileen Armstrong

SLIDE 5 – AILEEN ARMSTRONG

Good afternoon.

[As David said] we want to see companies stepping up through PR24 to deliver value for customers and the environment.

SLIDE 6 – PR24 FINAL METHODOLOGY

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 draft 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.

SLIDE 7 – AMBITIONS FOR PR24

Let me start with a very quick reminder of the ambitions for PR24 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.

SLIDE 8 – ENCOURAGING QUALITY AND AMBITIOUS BUSINESS PLANS

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 incentivise 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 have 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 allowance between draft 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 in the supply chain. We are 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 are 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 turn now to the incentives to deliver great outcomes for customers and the environment.

SLIDE 9 – COMMON PERFORMANCE COMMITMENTS

Our methodology is focused on companies delivering the right outcomes for their customers, communities and the environment.

As trailed in the draft methodology, we are streamlining our outcomes framework compared with PR19. The outcomes framework will hold companies to account for delivery and it will incentivise them to go further where they can deliver greater value. And we are clear that the key outcomes we incentivise in PR24 are likely to be of lasting importance. 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 draft methodology. For example we have refined our approach to measuring new environmental PCs such as for 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 draft 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 'C-MeX'. We expect this to increase by 50%, to up to 18% of annual allowed residential retail revenue, subject to further review as we approach the determinations.

We have 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 £100m 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 the customers of all companies. Enhanced incentives will be outperformance only, and available for all companies that perform beyond the thresholds that we set. Currently, we expect them to apply to six performance commitments: water supply interruptions, leakage, per capita consumption, internal and external sewer flooding and pollution incidents.

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 incentivised to deliver great performance. But we will also protect customers and companies from the risk of very high payments.

SLIDE 10 – ILLUSTRATIVE AGGREGATE SHARING MECHANISM

We will do this primarily through an aggregate sharing mechanism. We will keep the thresholds under review, but – to illustrate - companies could earn or incur up to the 3% level without any sharing of payments. At the 3% level the aggregate sharing mechanism would kick in to share net payments between customers and companies. From 3% to 5%, payments would be reduced by 50% and at the 5% level, by 90%.

We will 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 will 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.

SLIDE 11 – EXPENDITURE ALLOWANCES

I'm going to turn now 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 they have already funded in previous price control periods or for services that are covered by companies' base allowances.

On mains renewals, given the very low renewal rates over the 2020-22 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 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.

SLIDE 12 – SUBSTANTIAL INCREASES IN EXPENDITURE ALLOWANCES

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 is 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 have already provided detailed feedback on disappointing DWMPs, and companies 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-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 is 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, without additional expenditure allowances. For PR24 we will provide extra funding to reduce harm from storm overflows where government targets demonstrably go beyond current legal requirements.

Second, we expect all companies to plan to deliver the long-term water demand reduction targets for leakage and per capita consumption. Comparisons of performance across English and Welsh companies indicates 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 do not consider 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 incentivised. 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 reductions and more efficient solutions. We also expect that the best companies will share their learning across the sector

SLIDE 13 – APPROACH TO MARKETS

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 bioresources 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 more projects progressing through Direct Procurement for Customers during PR24. DPC will be the default approach for all discrete projects over £200m of whole life totex. Working with the pathfinder projects, our analysis shows that using DPC could deliver benefits for customers of between £12m and £80m on a £200m project.

SLIDE 14 – TACKLING THE CHALLENGES

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 needs to deliver for PR24 and beyond.

We are 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 2025-30 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 £300m for this price review – at least a £100m pound increase from the fund size at PR19.

And finally, we want companies to deliver the improvements that they have promised to customers. We will require board assurance so that company boards fully own the delivery of their plan.

Companies will be expected to meet price control deliverables for material investment where the risk to customers is not adequately protected using PCs and ODIs. This means that companies that over promise on their plans but under deliver will be worse off as a result. And customers will not pay for improvements that don't materialise.

And now I'll pass over to Andy to talk about returns and financial resilience

SLIDE 15 – ANDREW CHESWORTH

<u>Overview of Risk and Return and Financial Resilience – Andrew Chesworth</u>

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 that 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 and 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.

SLIDE 16 – INDICATIVE RORE

We present the expected range of returns using the return on regulatory equity metric – overall the chart shows that the RoRE range is broadly symmetric at roughly plus/minus 4.8%. This is similar to the risk range presented at PR19 and slightly lower than the risk range presented at draft methodology – reflecting a change in notional gearing, but a proposed increase in incentives aimed at targeting improved levels of customer service through the customer measures of experience.

SLIDE 17 – RISK AND RETURN

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, firstly, to ensure companies are resilient to an uncertain future, secondly to ensure the effective operation of the incentive-based regime, reflecting the strength of the incentives has increased over time, and thirdly, to ensure companies are able to maintain access to the 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 the notional capital structure over a control 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 companies should they wish to align with the notional level ahead of PR24.

We've set out our proposed methodology for determining the allowed return on capital at PR24. We confirm 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. Our methodology adopts the framework set out in the UKRN's draft guidance for regulators. And in setting our early view, we have drawn on a wide range of evidence, including representations on our draft methodology, recent regulatory decisions, advice and challenge from FTI (on beta estimation), from expert academics, and information from other sources, including equity analyst and credit rating agency reports.

Our methodology draws on data to 30 September 2022. We use a 30 September cut-off date as we think that will be the date in 2024 that will be used for setting our final determinations. However our approach is impacted by the material movements in interest rates and I will touch on this issue in more detail.

SLIDE 18 – EARLY VIEW

Our early view allowed return on equity is set within the CAPM 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 datasets 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 mid-point of our CAPM range.

Our cost of equity range is 3.67% to 4.60% with a mid-point of 4.14%. It is within the range inferred from our Market to Asset Value cross checks and so we do not depart from our mid-point.

Our methodology for the risk-free rate is to set a fixed allowance, without forward rate adjustment 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 have mentioned, the early view allowed return has been set at a time of significant volatility in borrowing rates and uncertainties about the future path of interest rates. Therefore we keep open the option of using alternative samples of data to the one-month 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 2.60%. 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 15bps benchmark index adjustment – this reflects our continued observation that debt raised in this sector tends to be issued at 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 10bps for issuance and liquidity costs. Our calculation of the overall cost of debt is based on a split of new to embedded debt that is weighted 17% new debt, 83% embedded.

Our cost of debt calculations reflect the BoE inflation 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 2025-30 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 BoE target will not be reflective of expected long-term inflation.

Overall, the allowed return set in our early view is 3.29% in CPIH terms – some 33bps above PR19 – as shown in the slide, the appointee allowed return is adjusted to allocate the return to retail and wholesale controls, reflecting the approach previously used. But given the volatility in interest rates, we also illustrate that the allowed return would be 3.53% based on an update to the risk-free rate and cost of debt for the month of October. - and illustrates that there may be merits in adopting indexation of the risk free rate if recent levels of volatility were to persist into 2024.

This October figure is slightly above consensus estimates from our survey of analyst expectations, which illustrated a median allowed return of 3.44%

SLIDE 19 – BUSINESS PLANS

Financeability

As for previous determinations, we expect business plans to include Board assurance that plans are financeable on the notional capital structure, and consistent with business plan submissions at PR19, to target a credit rating of at least 2 notches above minimum investment grade.

We retain the cost recovery building blocks used in our recent determinations – known as the pay-as-you-go(PAYG) and RCV run-off.

We will test company choices of PAYG and run-off rates in business plans. Our starting point for PAYG will be the natural rate – ie the level that is reasonable based on operating costs.

On RCV run-off, we proposed in our draft methodology to provide guidance on the acceptable levels of RCV run-off for the next period. This reflected our experiences from PR19 where we found that, in some cases, run-off rates were well above rates implied by average asset lives. If sustained this could store up a future financeability constraint.

We have refined our approach in the final methodology. We have set out guidance on the upper limits of acceptable levels of run-off for each control - which are 4.5% for wholesale controls and 8% for bioresources - and we set a framework by which we will assess company proposals – these figures are above the levels of run-off that would be set if the calculations were based on average remaining asset lives. We expect companies to explain their RCV run-off choices 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 out guidance for the 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 that 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 – ie 2% based on our early view) before assuming a notional equity injection where a financeability constraint remains.

Financial resilience

We are 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 supports their board assurance statement, based on the guidance and prescribed downside scenarios we set out.

We will 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 have seen a number of companies put forward voluntary sharing arrangements to share outperformance with their customers. We encourage companies to put forward such arrangements in their business plans, especially where outperformance is the result of material outperformance on the cost of debt that may not be repeatable by other companies, or for example may be the result of the miscalibration of the determination package.

We will assess all of these issues – financial resilience, dividends, performance related pay and voluntary sharing - in our quality and ambition assessment.

Concluding remarks

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.

As I have set out, investors will receive returns that are 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.

SLIDE 20 – TIMELINE

Finally, this slide sets out the key milestones and steps to be taken ahead of final determinations.

The timeline sets out the key steps relevant to 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 our ongoing work on ODIs and cost assessment.

The key dates for this audience to note are those depicted by the triangles beneath the timeline ie:

- Business plan submissions 2 October 2023
- Draft determinations in May/June 2024
- And final determinations in December 2024

SLIDE 21 – QUESTIONS