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PR24 final determinations

Transcript of investor briefing

Iain Coucher

Good afternoon everybody. Thank you for joining us, this afternoon. My name's Iain Coucher. I'm the chair of Ofwat and have been here for a couple of years.

Today I am joined by David Black, our Chief Executive Chris Walters, our Senior Director who's managed the price review process, and Andy Chesworth, who is the Director of Price Review.

Our intention is that David and I will say a few introductory remarks and then hand over to Chris and Andrew to take you through some of the detail. And then after our presentation, of course, we're happy to take any of your questions.

If you do want to ask a question, please go to the discuss tab, which you can find to the right of the player on which you're watching this stream. Please input your name and the organization and then you'll be able to type in your question and we'll try and get through as many questions as we can later on.

So today is a critical milestone for the whole water sector and for the millions of customers, people, and businesses that rely on the services that they provide. The program of investment and expenditure announced today when delivered will make a material difference to the service that customers receive, and a significant reduction in the environmental impact that these companies have.

In addition the program expands upon the number of long-term projects that need to be delivered. These are necessary to secure the water supplies for generations to come.

The price review process, as everybody knows, is a lengthy process involving hundreds of people at Ofwat over a number of years, and a similar number of people at each and every one of the water companies, as well as a considerable amount of consultancy input. This is an expensive process for everybody, and we recognize that. That said, you'll hear later that the combined spending plan for water companies that we regulate in England and Wales for the next five years, is over a hundred billion pounds, a hundred billion pounds of expenditure that ultimately has to be paid for by customers.

So it is right and proper that Ofwat challenges companies on these plans to ensure that every activity is justified, is efficient, and deliverable and represents the best solution, and that customers have not paid for this in previous price reviews.

And we also consider carefully the improvements in outcomes for customers environments that these investments will be able to deliver - setting targets that are realistic, achievable, but are stretching. And we know that to support this significant level of expenditure, water companies will need to rely on funding from external fund sources, their shareholders, and from borrowing money from investors. This is a very effective way of funding improvements, and we need to make sure that investors receive a fair return for the risks that they are exposed to.

Now since the draft determinations, we have listened very carefully to all the feedback, and we've made significant changes in response to what we've heard from all stakeholders. On expenditure, we've now included a number of schemes where we had asked for additional information. A number of new schemes

have been added in by the environmental agencies and drinking water inspectorate. We've increased allowances to reflect a different approach to pricing energy and business rates, as well as additional expenditure to mitigate the impact of climate change, asset health concerns, and to achieve a lower level of leakage.

You'll hear later on that we've recalibrated the performance regime to be more closely aligned to where we think the industry should be and to what could be achieved in the course of the next control period.

And you'll hear about changes we've made to the returns that investors can expect to receive, recognizing a very significant amount of new and refreshed funding that the sector needs.

I would like to assure everybody that this has been a very thorough and robust and rigorous process, a process that has involved the board at Ofwat at all stages, and has involved a significant level of external engagement. I would like to thank all those on the call that have engaged in the process. That has been greatly appreciated. Now, as you listen to the rest of this presentation, I hope you'll be able to see that we have taken on board feedback and achieved a balanced package that sees customers receive improved performance whilst getting greater protection for the environment, and that companies are incentivized to deliver better outcomes and that the overall risk reward package is fair and balanced.

I'll now hand over to David Black.

David Black

Thank you Iain, and thank you for joining us today, and apologies if I sound slightly hoarse. When we first announced our draft determinations in July, I talked about the heightened scrutiny the sector was under, particularly given customer concerns about company performance on environmental outcomes. These concerns have not reduced; in fact the focus on the sector has only increased, with growing interest in financial resilience in particular.

In the five months since, we have considered carefully the responses we've received, whether in writing as formal consultation responses or in engagement that we've had. We've welcomed the opportunity to have constructive engagement with all stakeholders as they've responded to the draft determinations. And these have provided valuable insight and information, which has helped inform our decisions.

The investment package we are setting out today will make a significant contribution. It backs an environmental investment program and improvements to resilience on an unprecedented scale. This will require companies to step up and innovate and improve performance, and investors have an important role to play in this as well, which is why we'll continue to link company performance to investor returns by the outcomes package. And as Chris will elaborate on further, we've recalibrated this package, but it is still clear that performance will matter for investor returns in the water sector.

So let's start today with the headlines. So we've set expenditure allowances, as Iain touched on earlier at 104 billion pounds. This is a 16 billion pound increase compared to draft determinations. So this change was driven by a number of factors, including companies receiving additional information on new regulatory

standards they were required to reach, and companies also provided additional evidence to support their cost claims.

We have increased the allowed rate of return to 4.03%. This is a return on equity at 5.1%, and a cost of debt allowance at 3.15%, and our notional gearing of 55%. So together the increase in investment and the increase in allowed returns results in an increase in average bills of around 157 pounds over the five year period. We appreciate this will be a cause of concern for customers. We've taken steps to mitigate the extent of the bill increase, including through our challenge to companies proposed expenditure allowances, and this has removed 8 billion pounds of unjustified or inefficient claims from cost allowances. This is important as part of our duty to protect customers' interests.

More broadly, we need to build customer support and understanding for how we, the government, and companies are addressing the sector's challenges. This is vital. This is a vital step in addressing the uncertainty the sector faces from perceived political and regulatory risks. In the 2025-30 period, we'll take forward our approach to monitoring company performance and financial resilience, and we continue to engage with individual companies where we have ongoing concerns around performance, financial resilience, or deliverability. In our draft determination we set out that we would apply a turnaround oversight regime to Thames Water. Since then, we've appointed an independent monitor, monitoring their progress on delivering the company's turnaround. Our monitoring of companies is a dynamic process and a number of companies remain subject to our enhanced monitoring regime. We expect some companies will need to revisit their financing arrangements and take action to ensure that they have adequate levels of financial resilience following our determinations.

I'll now pass over to Chris and then to Andy to go through more of the detail.

Chris Walters

Thank you, David.

Good afternoon, and thank you for joining us. I'll start with our decisions on expenditure allowances. The table shows our decisions on expenditure. We've included for comparison, the PR19 figures and companies' proposals. These use data from companies representation submitted at the end of August in response to our draft determinations in July. What was unusual about this price review compared to previous ones was that the company representations were higher than in their original business plans. The reduction in totex is 8.4 billion pounds from what was in companies' representations. That's around 7%. By comparison, the gap at PR19 was 5%. Our base allowance is 60.1 billion pounds. That's a 9.6 billion pound increase from our draft determinations, although it's 3 billion pounds or 5% lower than companies' August representations.

The change from our draft determinations reflects increases in three categories, energy cost allowances because of future energy price growth, business rates allowances, reflecting the likely impact of expected revaluations of water business rates allowances in 2026 and 2029, and network reinforcement costs to facilitate economic growth and ambitious housing growth targets. Drivers of the increase compared with PR19 include increased allowances for capital maintenance and an increased allowance for mains

replacement, with the expectation that companies will replace at least 0.3% of their network a year. Our enhancement allowance is 43.6 billion pounds. This is 9 billion pounds higher than at draft determinations, and represents a fourfold increase on enhancement expenditure at PR19. The enhancement allowance is 5.4 billion or 11% lower than in companies' August representations. Overall, around 30% of our cost challenge and enhancement expenditure is removing schemes, which we consider should be funded through base expenditure allowances with a further 10% from the removal of schemes previously funded. A large part of this is from Thames Water.

The principal areas of enhancement expenditure are: 12 billion pounds to improve storm overflows, including in investment in continuous water quality monitors; 6 billion pounds to remove nutrients from water bodies reflecting new requirements as part of WINEP, that's the Water Industry National Environment Program, and its Welsh equivalent, the NEP; and substantial investment of 8 billion pounds in water supply projects. This includes allowing 2.2 billion pounds of investment as development funding for companies to progress major projects. These include 9 new reservoirs and 12 water recycling plants. In total, 27 schemes will be progressed either through our Direct Procurement for Customers model, or using SIPR the Specified Infrastructure Project Regulations. There is also a major rollout of smart meters to help drive reductions in consumption.

Looking now at the outcome of our cost challenge for each company, starting at the right hand side of this chart, three companies have a total allowance that is either higher - for South Staffs Water and Portsmouth Water - or for Yorkshire Water, about the same as in their August representations. Including those three, 12 companies have a cost gap of 5% or less. I'll give more detail on the 5 companies which have significant cost gaps.

For Wessex, there is a 17% gap. The challenge on base is the result of an expensive capital maintenance cost adjustment claim, which we found was not well justified. On enhancement, the company requested far higher phosphorus removal costs than other companies.

With Thames, our challenge reflects our rejection of its request for customer funding to allow compliance with existing permits. The second request relates to complete its delivery of its PR19 WINEP program. We do not allow these requests as customers have already funded them, and we cannot expect customers to pay twice. There were also high costs across a range of benchmarked cost areas. In total, the challenge leads to a 16% gap.

For Sutton and East Surrey Water, there is a 14% gap. On base, this is largely the result of our assessments of network topography and our water softening cost adjustment claims, and on enhancement it's related to metering and leakage.

South East Water's 13% gap is mainly due to high enhancement allowances requested across a range of areas without sufficient supporting evidence.

And finally, for Southern Water, the cost gap is 11%. The enhancement component of 8% relates to strategic water resource options. We have rejected upfront funding for risks which are covered through separate mechanisms.

I'll now move on to outcomes. Our approach to performance commitments has been reviewed carefully taking on board feedback from stakeholders. At FDs, we have had access to 2023-24 performance data, which wasn't available for DDs in July, and we have taken into account our own revised cost allowances. This has led to a number of changes which have improved the proposed package, addressing unintended consequences while remaining consistent with our methodology. However, our fundamental goal remains unchanged; to deliver a set of performance commitments that will incentivize companies to drive improvement. We calculate that the outcomes that we have set will move the median efficient company expected payment from minus 1.88% of RoRE (minus 985 million pounds) at draft determinations to minus 0.2% of RoRE (minus 100 million pounds) at final determinations,

I'll take you through the principal changes. On performance commitment levels we've made changes so that the performance profile and stretch level reflects the latest performance data and cost allowances. A number of PCLs now have lower starting and endpoints, and there is more upside for the better performing companies for four performance commitments. On ODI rates, we've taken a more consistent approach to rate setting. We've taken a top-down approach based on equity return at risk, and also reflected customer priorities. This has led us to addressing a number of issues through a combination of targeted changes to rates, including 2023-24 data when setting rates and setting a rate floor at PR19 levels to maintain the strength of incentives. ODI rates have been reduced for 15 performance commitments compared with draft determinations compared with PR19, 8 are stronger, 3 are comparable.

And finally, our risk protections. This covers our use of caps, collars, and deadbands to mitigate the effects of extreme under- or out-performance. We have used these much more widely at final determinations; caps and collars apply to over 75% of all performance commitments up from just over 60% at draft determinations. There are additional or increased collars on internal and external sewer flooding, pollution incidents and biodiversity. There are additional deadbands on discharge permit compliance, mains repairs, and serious pollution incidents. It is important to note that a deadband relates only to the financial rewards from ODI payments. It doesn't prevent formal action being taken by the appropriate regulatory authority, if necessary.

I will now touch on delivery mechanisms that we've put in place. These reflect the substantial increase in enhancement expenditure and therefore the need for greater oversight of companies' progress and stronger protection for customers. Price control deliverables (or PCDs) set out clear expectations of what companies need to deliver on large projects so that customers can be compensated if these outcomes and outputs are not delivered in full or on time. They cover about three quarters of enhancement expenditure. Companies will be required to publish delivery plans, setting out their PCD targets and six-monthly updates on those plans. The delayed delivery cash flow adjustment mechanism claws back a proportion of the companies' revenues later in the period if it is behind in the delivery of its enhancement programs - so that bills more fairly reflect the actual profile of investment delivered. And finally, for Southern Water and Thames Water, we've confirmed a specific delivery mechanism. This provides the revenue they need when they're on track with delivery and ensures that customers only pay for investment that is being delivered. A total of 1.7 billion pounds of funding is covered by this mechanism.

Moving on to the movement in revenue. The outcome of the final determinations for bills is an average 36% increase over 5 years. That's front loaded with an average 20% increase in year one. This chart shows the breakdown of total revenue allowances, comparing PR19 and PR24. The revenue allowance increases from 68.2 billion to 91 billion, both in 2022-23 prices. The principal drivers are the increase in day-to-day costs because of price pressures and the need to improve service performance. Pay as you go (PAYG) allowances rise to 6 billion pounds. RCV runoff rates rise by around 3 billion pounds through the level of investment in new assets. And the return on capital leads to around an 11 billion pounds increase as you can see in the chart. 5.9 billion pounds is due to increased financing costs for existing investments with 5.1 billion pounds on new financing costs from the growth in investment.

I'll now hand over to Andy Chesworth. Thank you.

Andy Chesworth

Thank you, Chris. In response to the draft determinations, views were expressed that the draft determinations were not investible. The concerns fell into four key themes. The overall level of risk exposure for cost and outcomes was too great. The base allowed return was insufficient. Our interventions to run off rates were too great, and our financeability approach did not recognize the needs of certain investors.

We've made material changes in our final determinations that address each of these issues, and I'll address them in turn. First, I want to touch on the regulatory arrangements that support investment. These include full indexation of revenues and RCV, reconciliations for under and over recovery of revenue and our commitment to the RCV. We include material changes to the risk and return package compared with PR19. These include increased protection for real price effects. We estimate these apply to around 55% of cost now, compared to 30% at PR19. We have more protective cost sharing rates, including 40% for enhancement costs, 25% for large schemes and some other enhancement categories, 10% for business rates. We extend cost sharing to bioresources, and we make use of gated processes that will allow companies to apply for additional revenue allowances if certain conditions are met. We've introduced aggregate sharing mechanisms for costs and outcomes, and we set an allowed return on equity at the top of our range.

We've extended the protections for these uncertainty mechanisms in the final determinations. We've increased the use of DPC and SIPR for funding of large projects with 27 designated projects; with an additional 1 billion pounds worth of funding. The introduction of an outturn adjustment mechanism, will adjust returns on an ex-post basis where there is a material level of out- or under-performance across the sector. We make further use of enhanced cost sharing. We extend the 25% cost sharing rate to abstraction charges and to discharge consents. And we apply greater customer protection for costs associated with continuous river water quality monitoring and investigations. We include additional uncertainty mechanisms that will allow companies to apply for additional revenue allowances in period for PFAS (so-called forever chemicals), cyber, and potentially for asset condition.

As Chris explained, we have revised our cost allowances. We have recalibrated the outcomes package. And we have updated the allowed return. These changes have a material impact on the overall balance of

risk and return. They reduce the overall downward skew that companies may have perceived in the draft determinations. At a sector level, the changes are equivalent to around 400 basis points, return on regulatory equity had the draft determinations remained unchanged. We have set the determinations with the aim of striking a balance of risk and return. The determinations incentivize companies to improve performance and provide significant opportunity for enhanced returns while protecting customers where companies underperform.

Stakeholders generally welcomed the introduction of aggregate sharing mechanisms. Views were expressed that we should bring in the trigger points to make them even more protective or to apply a combined mechanism across both costs and outcomes; similar to the Ofgem mechanism. We consider there are benefits to maintaining separate mechanisms for costs and outcomes, noting the changes to the risk and return package already mentioned, and the need for incentives that are sufficiently strong to encourage companies to focus on performance. We have retained the trigger thresholds proposed in our draft determinations. These are at 200 basis points for costs and 300 basis points for outcomes with a second sharing rate of 500 basis points for outcomes. We consulted on an outturn adjustment mechanism in October to take account of the views expressed to us in representations. Our aim has remained to set a balanced outcomes package. However, we have introduced the OAM as a mechanism that is designed to adjust the returns of all companies in the event that performance of the sector is materially different to that expected. We've made some amendments to the consultation proposal. This includes applying the mechanism on an annual basis, applying it separately for water and waste, and to introduce a deadband before the trigger of the OAM mechanism. The aggregate sharing mechanism and the OAM work together, the ASM to protect customers and investors from the effects of extreme performance and the OAM to minimize the effect of materially different performance than expected across the sector.

As David set out, the allowed return in our final determinations is 4.03%; higher than our draft determination figure of 3.72%, and the allowed return set at PR19 of 2.96%. It aligns with, though is slightly above by three to five basis points, the median and mean of the return expectations of equity analysts surveyed ahead of our final determinations.

We have retained the notional gearing level of 55% that was first signaled in our PR methodology. We consider there is a strong case for the reduction in notional gearing from the 60% applied at PR19, and that the gearing reduction is achievable for the notional company. The allowed return on equity at 5.1% is an increase on our draft determinations figure of 4.8%. We've retained our decision to adopt a rounded figure at the top of our cost of equity range - although this is a decision that is finally balanced. Our advisors CEPA suggest there is little reason to depart from their midpoint estimate of 4.75%.

As we said we would do in our draft determinations, we have updated the allowed return on debt to take account of information reported by companies in their 2024 annual performance reports and to update information on debt issued and forecast to be issued in the remainder of this financial year. We set an index allowance for the cost of new debt. We include a positive benchmark adjustment of 30 basis points on the cost of new debt. This takes account of the increased debt spreads seen in primary and secondary markets.

We did consider an option of indexing the 30 basis point benchmark adjustment, but we've chosen not to reflecting implementation challenges and that this would be a late policy change.

Overall, our allowed return on debt is 3.15%, and we've increased the retail margin to 1.5% from 1.0% at PR19, also reflecting increases in financing costs.

Changes to Pay As You Go rates compared with company representations are largely technical in nature, reflecting the challenge we have made to cost allowances. We've reduced the challenge on run-off rates compared with our draft determinations. The run-off rates are higher for eight companies compared with the DD. Our interventions apply only to outlying companies and where there is material levels of headroom in our assessment framework.

In carrying out our financeability assessment, we have reflected on the actions and updated guidance from the credit rating agencies, and we have revised our approach to dividends to fully align with our guidance that a dividend yield of 4% is reasonable for a company performing in line with our determination. We have not restricted dividends as we did in our DDs as a means of providing equity support. But by revising our approach, we support companies under a range of financial structures to raise equity to support investment.

Our approach has increased the amount of fresh equity that is included in our financeability assessment to 12.7 billion. We provide equity issuance costs of 318 million, calculated as 2.5% of fresh equity up from 2.0% at draft determination. Taking account of this, the financial ratios assessed in our draft determinations support credit ratings that are well within the investment grade and align with a target credit rating of at least Baa1 or triple B plus.

In reality, companies will have a choice as to how that equity is delivered: through retained earnings or new equity. In practice this means that the equity financing requirement for the sector would be close to being met from a full restriction of dividends – which total 11.9 billion in our financeability assessment – and the unused allowance for equity issuance costs of around 300 million. In most cases, companies will need to revisit their financing plans, now they have the certainty of the final determination, but also to take account of the recent actions of the credit rating agencies and other factors. In some cases, companies will need to continue to take steps to strengthen their levels of financial resilience.

The RCV grows by 31 billion pounds in real terms to just under 128 billion pounds in 2022-23 prices by the end of the period. While some companies proposed a complete restriction of dividends, it is likely that the equity financing requirement is higher than the 7 billion pounds forecast in representations. Furthermore, companies will need to maintain resilient financial structures, if they are to raise debt on reasonable terms with company business plans forecasting a need to raise debt at 1.6 times the 2020-25 run-rate.

Our view remains that gearing levels that exceed 70% may not be suitable for long-term financial resilience. The recent actions of the credit rating agencies further support our view, and we note some companies have expressed an aim of maintaining gearing levels below this level going forward.

We've decided not to pursue the options previously set out to restrict companies from paying dividends beyond a set gearing threshold at this time. We will consider these issues separately as part of our forward-looking work on financial resilience.

Finally, to further support companies to raise a new equity, we confirm we will provide funding for the efficient costs of a company raising equity through a new stock market listing net of the 2.5% allowance already included in the determination. This will be logged up at PR29, and we encourage companies to engage with us at an early stage where they may contemplate claiming such costs.

Thank you.

David Black

Thank you, Andy. [coughs] Excuse me. Sorry. Right. We now move on to the opportunity to ask questions. So I'll read out the questions so you can answer.

So the first question from Kishan; Can you help me understand why Pay As You Go rates are significantly lower and RCV runoff rates are higher than the last few price reviews?

Andy, do you want to pick that up?

Andy Chesworth

Yeah. So the Pay As You Go rates will reflect the cost allowances, and at this price review, the enhancement cost allowance is four times greater than it was at PR19. And so that will be a driver of the difference on Pay As You Go rates. The RCV runoff rates are actually lower than PR19. They were lower in companies' business plans and they're lower in our final determinations than they were at PR19.

David Black

Thank you, Andy. Next question from Dominic Nash on the outcome adjustment mechanism. So he's got three questions. maybe four actually.

Does this institutionalize underperformance in half the sector, and is the median by licensee or by company, i.e. what is the treatment of Bristol? Second question is around WASCs and WOCs, and then the third is about would CMA changes impact this median impacting others?

Andy, do you want to pick that one up?

Chris Walters

Yeah, why don't I pick that one actually.

Thanks, David. So, I don't think that is the right way of characterizing it, Dominic, the OAM and the ASM I think should be seen as complimentary. They are both, about managing the spread of performance. The ASM exists to manage over and under performance at the extremes and the OAM, exists to manage over and under performance that might move around the middle. That reflects to me the fact that forecasting is

difficult. We've seen that over PR19, where company performance against the performance commitment levels that were set has been a long way, I think from what everyone was expecting, we wanted to find a way to deal with that. If you think about what it means in the OAM; to move the middle of that kind of distribution, you would need half of the companies seriously underperforming on half of the performance commitments to make the middle wobble very much. But it's in there very much as a stop gap, which is why there's a deadband around it, and it has to be seen in the context of the ASM.

Andy, do you want to pick up the other parts of the questions?

Andy Chesworth

So yeah, I think the deadband is, is important really for the construct of the OAM going forwards. In terms of the CMA, we have said that we will apply the mechanism irrespective of the outcome of any determination at the CMA. So there is a risk, for example, if there was a lot of determinations and the CMA didn't apply the mechanism, then it, that there would be very few companies in the sample to make the adjustment. So we've said we would, apply it to all companies within the period and it would apply separately to water and, and wastewater service, which is the, the answer to the second part of the question.

David Black

Thank you, Andy. So the next question from Mark Freshney, why have you decided to keep the limit on dividends? Or, sorry, why have you decided not to keep the limit on dividends when gearing goes above 70%?

Andy did you want to pick that one up?

Andy Chesworth

Yeah. So, our view remains as I said, that gearing levels above 70% do not appear to be in line with our expectations about long-term financial resilience. So, our view on that remains, and that is supported too by the recent actions of the credit rating agencies. In terms of why we've decided not to pursue it at this point in time, we think that going forwards and through our discussion with Board, that we are, best to take this forward as part of our future piece of work on financial resilience and sort of looking at the questions as to whether there is more or other things that we should be doing, for example, through the license to protect or to ensure customers interests are best protected in the long term. But we've decided that we don't need to do that as part of the final determination.

David Black

Thanks, Andy.

So, the next question; I'm not sure if we can help, but, I'd like to get more insight on Southern Water's investment for which you have said it's covered by another scheme. Could you please elaborate on this?

Thank you. I think that's probably referring to the deliverability mechanism, Chris do you want to explain our approach to that?

Chris Walters

The deliverability mechanism is essentially all the contingent allowances work on the basis of a process that involves a number of steps. The first is specifying, exactly what is going to be delivered. That could be programmatic, it could be scheme level, it depends on the scale of the investment. The second is looking at timetabling and how that's going to be delivered. So we know what milestones and gates and other processes are. The third is then, well, okay, well, what's going to be the reporting and monitoring the detail and the frequency, and that is something that does differ quite significantly between different mechanisms, different ring-fencing mechanisms, so that, so that the company, and we know that what's being delivered is being delivered. The fourth is, well, what's the level of assurance that goes around that? So, we need assurance, depending on the complexity of the scheme and the risk involved, that might involve independent third party assurance with a duty to Ofwat as well as to the company. The fourth, I think I'm up to four. The fourth is, what other contingencies, depending on the answers to the first three questions, are going to be needed to be in this contingent mechanism. And the fifth is okay, but if the contingent mechanism looks like it's not delivering the investment that needs to be delivered, what is the process for clawing customers money back and giving it to them in the form of lower bills and in one form or another, all ring-fencing mechanisms share those characteristics.

David Black

Thank you, Chris. So the next question from Andrew Chin on ODIs and OAMs. So will ODIs come off revenue and OAM come off RCV?

This one's a question for you, Andy?

Andy Chesworth

Yeah, so the OAM will apply at the same time on an annual basis as, as which we make the, in-period adjustment for ODIs. And in most cases, what the OAM will do is have the effect of reducing the scale of the ODI adjustment, which is a revenue adjustment. So it would have the effect of tempering the level of the adjustment where it's applied. So it's a, a revenue adjustment.

David Black

Thanks, Andy. So the next question is, how did you arrive, from Andrew Molder, sorry. How did you arrive at the 30 basis points positive adjustment on new debt? Is that really realistic given where we've seen debt instances this year?

Andy?

Andy Chesworth

Yeah. So I would encourage you to have a look at the detail that we've set out in the aligning risk and return - the appendix on the cost of capital, which sets out the full detail that we've taken into account for purposes of setting the 30 basis point adjustment. It's true to say that the spreads have been greater than historically through this year, but we're very much focused on setting an allowed return that is reasonable for a company with a notional capital structure that aligns with our target credit rating. So we have focused on what is a reasonable adjustment to make reflecting those criteria. So taking account of debt issuance at a credit rating that is consistent with a credit rating of Baa1/triple B plus.

David Black

Thanks, Andy. So the next question from Jenny Ping, can you please give us an update on ongoing sewer discharge investigations and timing of the final ruling across the 10 water wastewater companies now that the FD is complete?

Thanks, Jenny. we are progressing those cases. As you'll be aware, we've issued draft decisions on three companies, Thames, Northumbrian Water, and Yorkshire Water. We are moving to, progressing investigations against other water companies including - the first phase of that would be moving to a minded two decision before we move to a draft. And we are progressing the draft decisions against those three companies to finalize those as soon as possible. They are actually separate teams from the price review team. but we are, we are obviously anxious to conclude these as soon as possible, as, as I'm sure companies and markets are.

Next one from Laura Marconi; On the OAM, I believe you said you expect -0.2% median ODI RORE on average, but this falls into the deadband. So why did you keep the OAM then if it wouldn't be activated?

Thanks. Do you want to do this question?

Chris Walters

Yeah. Well, we kept it as a fail safe because forecasting performance is difficult. We knew that we at DDs when we had the representations and we saw the performance data for 2023-24, that our primary goal had to be to set an outcomes package, a risk and return balance that was balanced in and of itself on its own terms. But if you look back at PR19, it is clear that that is a difficult thing to do. So in order to encourage, in order to maintain investability, we wanted to put some mechanism in place, to, as a failsafe, as a backstop. Now we came up with the, in response to that. Some of the representations that we got talked about the difficulty of logging up and logging down at the end of the period, and the impact that might have. So moving from an end of period true up or true down to something that was more frequent than that with a deadband around it, is a way of managing that kind of risk. But the idea is, the OAM kicks in really only as a fail-safe. And the, and our goal is, and, and I think it's demonstrated in our FDs today to have an outcomes package and an overall balance of risk and return that is balanced to begin with.

David Black

Thanks Chris. So moving on. So Mark Freshney; as you have seen with off Ofgem's proposed debt relief plan, there are many people struggling to pay. How are you making price rises more affordable?

So yes. Our research shows that prior to the final determination around 20% of customers struggle to pay their water bill, we really appreciate that this increase in bills will be most unwelcome for people and particularly for those struggling to afford to pay their bill, we are expecting water companies to step up their social tariffs from around 4% of customers to around 9% of customers so any customer struggling to pay their bills should be contacting their water companies to seek assistance. So we think it's really vital that there's an extra helping hand. We welcome those companies that have put additional funding into those schemes, such as United Utilities.

Right. So Dominic Nash, were National Insurance changes pre the final determination included in the price controls?

Chris, do you want... or Andy...

Andy Chesworth

So the changes to National Insurance, of course, impact on all companies in the economy. They will flow through to inflation over time. We've taken the view that the impacts on the companies are uncertain at this time and will mostly be included in general inflation. And, and that's how we think they will be, will flow through to the companies' allowances.

Of course, companies are protected from cost sharing in any case where costs are greater.

David Black

Thanks, Andy. And then Kishan is asking for more guidance on the cost gap for Wessex Water, Chris, I think that comes to you.

Chris Walters

Yeah, there's, there's much more information in the companies' detailed information; but there was an expensive capital maintenance cost adjustment claim, which we didn't feel was a sufficiently well justified in, in comparison to cost adjustment claims and rates of capital maintenance of other companies. And on, Wessex Water's costs for removing phosphorus are outliers when benchmarked against costs across the sector. And the rationale they gave for that was very, it was very difficult to justify that against the scale of the cost difference and more specific information can be found in Wessex Water's documentation.

David Black

Thanks, Chris. And just to note, we've had very strong engagement with the company over the period since draft determination. Really appreciate the work that they've done and, we're confident that we had fully understood the companies' cost claims and we have also signaled that we are willing to work with the sector on capital maintenance claims to make sure that funding requirements are correct across the sector for capital maintenance.

So, Martin Young - question; you've noted competition for capital and have aimed up within your cost of equity range. Looking at Ofgem's SSMD range, the upper end would be above Ofwat's and transmission

business plans submitted all call, sorry, and transmission business plans submitted all call for a higher number. Why are you confident your cost of equity is attractive?

Andy?

Andy Chesworth

Okay. So, a couple of points. I'd say in response to this, we've calculated the cost of equity by reference to approaches that have typically been used in UK regulation, in past regulatory determinations. So our approach is largely predictable and, and understood. We've looked at crosschecks and the crosscheck evidence that we've seen, particularly from the market to asset valuations of the listed companies, would suggest, would support a cost of equity within the range of 4.3% to 6.3%, and we're well within that range. And actually, the cost of equity that we've set aligns very well with the survey we conducted of equity analysts in advance of our final determinations. And I would say it's not just the cost of equity that matters, it's also the incentive package and all elements of the, of, of the package that, that come together. And there are clear opportunities for companies to outperform our cost and service targets that we've set in our final determination.

David Black

Thanks, Andy. The next question from Farhaad, for those companies with high gearing i.e. above 70%, do you think enough has been given in the final determination to de-leverage and do you think the main sources of de-leveraging will come from equity injections?

Andy, do you want to pick that one up?

Andy Chesworth

So I, I'll go again. I think the tension here is the view between the notional world and the basis on which we've always set our price determinations and the choices that companies and investors have made in respect of actual financing choices. We've always set a gearing range within the range of 50% to 62.5%. And there are a number of companies that are geared above that, and in fact, well above that. And the question then arises as to who bears the risk associated with those capital structure choices and really who bears the responsibility for addressing risks associated with capital structure and whether, whether it is right that customers should bear the cost of addressing that or not. Our determinations are set on the basis of the notional structure, and the notional structure gives a very clear signal, regulatory signal about the allocation of risk and ultimately responsibility for matters related to capital structure as it has always done its privatization.

David Black

Thanks, Andy. So the next question about Thames, well, we've waited quite some time before we've got a question about Thames; that's impressive, Clearly - can you talk a little more about Thames? Clearly there's a danger this company fails and your inputs into the allowed return and cost of equity are highly indicative of what it has to pay. And so I think that probably just touches on Andy's previous answer to

recap. So the specific issues at Thames in terms financing now for Thames and its Board to address we've set out a final determination, which we think provides clarity for investors in Thames. then there'll have to be decisions by Thames itself in terms of raising new equity finance and reaching resolution with creditors. So that'll be a question for the company to address. We think our final determination does provide the certainty for them to make these decisions.

Mark Freshney; What would be the case that the outcome adjustment mechanism, pulls everyone back to plus or minus 50 basis points in RORE? Why can you not have all companies perform well and get better outcomes for consumers?

Chris, do you want to come back to that?

Chris Walters

I think all, all companies can perform well and generate better outcomes for consumers. It's a, it's a question of, the degree to which consumers or customers are going to pay for that. As I said, the outcome adjustment mechanism is seen in the context of the aggregate sharing mechanism as something that prevents customers paying excessive, rewards and also protects companies from paying excessive penalties. And the reason the OAM matters is because the lessons of PR19 and AMP7 are that forecasting future performance is difficult, and recognizing that, I think is what the OAM is all about.

David Black

Thanks, Chris. So question from James Sparrow; I think you say that the sector's equity needs could be met from a full restriction of dividends during the period. Do you think that makes the sector investible? And can equity investors ever expect to earn a sustainable dividend?

So probably hand that to Andy, but I don't think that's not, not understanding correctly what Andy has said, but, but can we...

Andy Chesworth

No, no, so that's right David. It, it's not a correct representation of what we have done in the final determinations. So we have set for the purposes of the financeability assessment, dividends on the basis of a 4% dividend yield. Companies have a choice as to how they go about funding the equity requirement that will be needed to deliver the investment in the next period. One option to do that is to raise new equity. Another is to retain earnings within the business. So we're absolutely not saying that companies need to restrict dividends, dividends are available and should reflect the performance of the company. What we are saying is if that equity was not forthcoming, then the needs of the sector are more or less met through dividend retention.

Chris Walters

Yeah, exactly. It's a way of us calibrating whether the package that we're setting is investible by saying if no investment came in, could it still be financed with retained earnings? Yes.

David Black

Thanks. Chris. Thanks Andy.

So Dominic Nash asking how many CMA referrals do you think there will be? And how few do you think before you think you're too generous? And how many before you think you've been too tough? I think we'll leave that question for companies. They have 60 days to decide whether or not to refer their determinations to the CMA for a full redetermination. We are confident our determinations, meet our duties and set the sector on a trajectory to transforming its performance. But that will be a matter for companies and their investors to consider.

Kishan is asking about what are the potential outcomes you foresee amidst the government's review of the water sector? And Iain, I was wondering whether you might like to offer some thoughts here in terms of the government. You know, clearly the government's got major concerns about outcomes in the water sector. They've established a review and we look forward to working with, we are working with review as they, examine the issues.

Iain Coucher

It's a good question. Thank you for that. Just a couple of things.

There are areas where we've, we've had conversations with people that, that I think the commission needs to be looking at. The first is probably in the area of systems planning. What we are seeing when we look to the future is a lot of challenge for new water sources where they might come from. And we start to see an elevation of these concerns being addressed at a national and a regional level, rather than a company specific level. So you're starting to see reservoirs built in one area, providing water sources to multiple other locations and transferring schemes around. And in the past, reservoirs and water sources have largely been the domain of a single company. So we think there's, an area of system planning that is worth pursuing and that relates not just to fresh water, but also sort of discharges and sewage treatment and, and runoffs. Because that starts to combine activities, water companies, farming activities, road runoffs. So something in the space of systems planning. We think there's mileage in looking at the periodic review process. This is a, a periodic review, which has seen a very significant increase in the amount of capital expenditure. So you'll see some of the numbers early on, in PR19, sort of 50 billion pounds of OMR costs and 10 billion pounds of, of enhancements that's now gone to 60 and 44. So the enhancement activity is very different pricing that, how you deal with that when the, the quantum is, is so big and it has so much implications. So we think how you do price reviews when you get significant levels of, of enhancements is worth looking at. There is the inevitable degree of some overlaps between regulators, that could probably benefit from clarity and tidying up. And then there's the overall roles and responsibilities when it comes to doing regulation. Whether or not, I think they'll probably look at whether or not regulation has been too much outcome, light-touch regulation, and whether that needs to be tightened in certain areas. So those are the sorts of areas where I think that, they'll be looking at. But you know, the independent commission is genuinely independent, and Sir Jon Cunliffe is currently out there scoping this and we'll find more out about it in the early parts of 2025.

David Black

Thank you, Iain. So next question for Farhaad, is how has shareholder engagement been prior to the FDs? Are you concerned that the sector may not be able to raise the 12.7 billion pounds of new equity across AMP8? so I can say there's been a lot of engagement with investors, since draft determinations. So I think, probably lost counts of the meeting we've had now, but it was numbering over 80 at some point a few months ago. So we, we have really appreciated the feedback and engagement from investors. We have made - and you know, what we heard, as Andy has set out earlier, was concerns around the balance of risk and return concerned concerns around the treatment of enhancement TOTEX claims, concerns around the setting of allowed returns. And we think we've addressed all of these issues at final determinations. We've seen, obviously companies raise new equity even as recently as, last week. So we are, I'm confident that the sector will be able to access new equity, but obviously the ball is now in the companies' court to do this.

Chris Walters

Yeah, I would echo that. Given the strength of many of the views held, the engagement has been incredibly positive and constructive. And speaking of someone that's done a lot of that engagement, I'd like to thank you all for approaching it, in that way.

David Black

So the next question from Helen Rodriguez; As the economic regulator, whose regulatory regime has enabled over-leverage and underinvestment, are you now inextricably so part of the regulatory solution, in which case, what practical use is your theoretical models in extremis?

I think maybe there's two or three questions in there. One of them is about the use of the notional capital structure. This is probably the, the key element. Andy, do you want to, or Chris, do you want to pick that one up?

Andy Chesworth

Yeah, so I can respond to that one. We've seen companies since the two thousands, there's been a number of companies that have increased the levels of debt within the capital structure and have undertaken a capital restructuring. At every point whenever companies went through those steps, we always set out that the risks associated with the capital structure were one for companies and investors to manage. So I think we have been consistent throughout time about the roles and responsibilities around capital structure and who bears the risk where things go wrong. And you can go back to statements that we have made at the time around highly leveraged structures being untested and needed, you know, to be tested against downside scenarios. So I think some of those issues now are coming back to roost. We do welcome the steps that many companies have taken and the investors in those companies have taken to reduce debt levels in recent years. However, in some cases, more needs to be done. And just on the, the equity point, we have seen 4.6 billion pounds worth of equity raised since 2021 by this sector. That's a huge amount of equity. We assess about two thirds of that has been necessary to support strengthening

balance sheets and improving levels of financial resilience. And the other third to support investment going forwards. Of course, it's a much easier, much better narrative for everybody involved, where the equity being raised is to support investment growth and growth of the RCV. So I would hope there is a strong story to be told there and, and that investors see the opportunities associated with, with the investment growth. And hopefully that will bring the equity to the sector that will be needed to, to support that investment in the next period.

David Black

Thanks, Andy. And I think that, you know, the point that you raised earlier, we will be looking at our approach to company debt structures in the new year and thinking about, whether they're adequate and sustainable for the long term.

So the next question from Pavan; How are you, how have you balanced, allowing nature-based solutions for environmental performance commitments, which may be cheaper for customers beyond a five year timeframe versus grey solutions, which are cheaper today, but are potentially more costly, longer term?

Chris?

Chris Walters

So we've included record levels of investment for nature-based solutions and including and we have new performance commitments around biodiversity and reducing embodied greenhouse gas emissions that show a commitment to green solutions. What we've also done is increase flexibility in the way that schemes can be delivered, with the, with the goal of enabling companies to switch from de-risking a companies' ability to switch from, grey to green, and including mechanisms that will deal with that uncertainty. Now, ultimately, of course, in order for a scheme to go ahead, environmental regulators have to be convinced that it's going to deliver the same benefits. It's no good if a grey scheme can deliver the environmental benefits needed with a hundred percent certainty, but includes no other benefits on biodiversity or embedded greenhouse gas emissions, for example, and a green scheme, delivers the same benefits with a lower probability, but has those external benefits. In the past, I think it's been quite difficult for companies to make that kind of investment case. I'm sensing certainly from the conversations I'm having with companies, that that mindset is moving and there is much more openness and willingness to, support green schemes. And we have had a step change in the investment allowances in PR24 to reflect that.

David Black

Thank you. And we've built flexibility into the price review to make sure that companies can switch from grey to green schemes or hybrid schemes where it's beneficial to do so. So really great opportunity for companies to do more in the space.

So, Pavan; Why was the p50 outcome for ODIs a negative 20 basis points versus a neutral position? It's small, but still implies a downside skew.

Chris Walters

Well, some of our performance commitments are compliance only, and they are significant performance commitments, because they matter to customers and to the environment and a small amount of negative RORE at, at the midpoint is the inevitable consequence of that. We think not only as we corrected the bigger skew that was identified - at FDs - but when seen in the context for outperformance financial and cost outperformance across the package of the whole, there is actually more upside in here than there is downside.

Andy Chesworth

And I would just add the point on the financial performance that the source of that is, is from inflation, so, where there is high inflation, and we've seen the inflation figures this week for CPIH at 3.6%; inflation does provide opportunities here and does provide upside against the 2% long-term inflation figure that we use for setting the cost of debt. So that creates an upward skew in the package.

David Black

Thank you, Andy. so the next question from Adrien; Which companies in the final determination have seen the best improvements in ODI penalties versus the draft?

I'm not sure we've got that information here.

Chris Walters

I don't have that information to hand, I'm afraid, it is there in the documentation.

David Black

Okay. next question from Jenny Ping, which I'll get Andy on.

Why was the percentage of new debt, why has the percentage of new debt fallen from 26% to 24% when the amount of TOTEX has increased from 88 billion to 104 billion?

Andy Chesworth

So this is simply an update to our calculations. So the calculation for the final determinations is based on the final determination levels of TOTEX and RCV growth at the draft determinations. We based it on the figures that were in business plans (at DDs).

David Black

Thanks, Andy. So the next question from Pavan; How have you thought about the longer term i.e. beyond 2030 investment requirements in this price review, if at all?

And the answer is yes, absolutely. So we did ask companies to prepare their business plans in the context of a 25 year longer term delivery strategy using adaptive planning methodology. So that would allow us to

see this price review as a building block in a 25 year strategy. And then a lot of the very large major projects which are coming forward, and so we've got 27 of these coming forward, multi-billion pound schemes. The construction period for these schemes spans from 2027 well into the 2030s. So particularly on the water resource side, this is very much a long-term price review. This is not just about addressing storm overflows in the near term, that's important, but it's really about making sure that we've got safe, secure drinking water supplies decades into the future. So I think this price review really does mark a change in the sense that every other price review has looked at 25 year plans in some form or rather, but I think we see real evidence of huge amounts of investment actually going in now to enable major schemes to come forward, at points in the future.

Nicholas Harrison; The average credit rating in the sector is currently Baa2 at Moody's. Do you believe the FD is sufficient to allay concerns raised by Moody's following the DD and avoid further downgrades in the near term?

I'll probably go to Andy on that one, although probably the best person to respond is someone from Moody's. But, Andy, do you want to...

Andy Chesworth

Well, yeah, I was going to say we'll wait to see what Moody's make of the final determinations, but clearly there's a number of factors that impact on a companies' credit rating, only one of which is, is linked to the determination itself. Company choices, as I've mentioned about their capital structure also impact on that and is, it's been clear in the Moody's narrative that one of the ways in which companies can respond to this and improve their credit rating is by adjusting their gearing levels. So yeah, the factors are broader than just our determination.

David Black

Thanks, Andy. The next question from Farhaad; Do you think the way that companies report gearing should be adjusted so that they include swaps which have debt-like features? And also do you think there should be more visibility given to the detail, more visibility given on the details of these swaps?

Andy Chesworth

So we did, amend the reporting requirements for swaps about two years ago now, to ensure that there was more detail and more information, both for us, for credit rating agencies and for other stakeholders on swaps. So that is a, there's a specific table within the annual performance report that sets this detail out. But welcome views as to whether the gearing measure should be, redefined and if, if there were views that it should be, that's something that we could consider on a forward looking basis.

David Black

Okay. So next question from Orlando Finzi, is your reliance on SIPR/DPC for new water also involving high leverage that's just not visible to the public? How do you justify should this route struggle to attract interest finances? What are the solutions?

So probably two parts to that question. So in terms of the transparency around financing for supplementary infrastructure vehicles and DPCs, I think they are transparent. So I think the details, for example, Thames Tideway's financing is transparent. So I think there is a level of transparency around that. We do think there is less concern around the finances of these investment vehicles relative to water company providing a service to customers. but it's certainly something that we have in mind as an issue. And it does relate to how risk is shared across, the procurement providers, the supply chain and water companies. And then there's a question about should this route struggle to attract interest and finances what are the solutions? So I think if that turns out to be the case, then we would have to look at whether water companies could take these investments forward. But then that itself may raise questions about whether water companies can raise finance on this basis, particularly given SIPR type structures, are licensed entities as well. So I'm not sure there's any easy answers, in that type of scenario, but we would obviously have to address it, should it arise.

Chris Walters

Hey, can I just add there that the motivation behind DPC and SIPR isn't about in-house delivery and balance sheets and gearing, it's about recognizing that these projects are different. They're separable and mostly they're multi AMP, and that opens up the possibility of competitively tendering out the delivery of those in a way that brings benefits to customers.

David Black

Thanks, Chris. Mark Freshney ; 10 year government bond yields are 4.6%. The allowed return is 4% real, adding 2% inflation implies that allowed return is 6%. At best industry is earning its cost of capital, most likely it is much less.

Well, more of a statement than a question, but Andy did you want to comment on it?

Andy Chesworth

Yeah, I'll comment to the extent that you're comparing bond yields to the allowed return for a regulated business. Of course, a regulated business is financed by cost of debt and the cost of equity. So, I would draw the comparison separately to debt and equity. And then, Mark, a question on your inflation assumption. Yes, the long term inflation target is 2%, and yes, we use that for the purposes of setting the cost of debt, but if you look at the swap implied levels of inflation, they're more like 2.7%. So we've raised this question with investors through various fora including the investor roundtables, but it is a question about how should a regulator and how are investors taking account of forecast levels of inflation going forwards. And I remind you of the points that CPIH was stated as 3.6% this week.

David Black

Yes. right. one more question. Leia; Do you think that the idiosyncratic risks faced by each company is fully accounted for by the notional company? For example, the cost of debt differs quite widely among companies in the sector.

Andy, do you want to pick that one up?

Andy Chesworth

Yeah, I would respond to that by saying that the credit ratings of the companies vary quite considerably. And of course, that is a very, it's the, it's a significant factor in, in terms of the, the cost of debt when companies go to market and issue their debt. The other point is that companies have financed themselves in different ways; to the extent that they have different amounts of fixed floating or index linked debt; to the extent that they have a greater proportion of debt on their balance sheet. So those things can impact on the, the cost of debt for each company individually.

Chris Walters

Just to add, I think that any one size fits all system, whether that's on financing or costs or outcomes here is going to need to reflect the fact that there are idiosyncrasies and variabilities in this. And, and one of the things that we've tried to do today is set out changes, not just from PR19, but in particular from DDs to today that we think go to addressing those idiosyncrasies.

David Black

Thank you very much, Chris and Andy, and I think that is all the questions.

So we're right on time. So, thank you very much everybody for your contributions today. Really appreciate you showing interest in the sector. Hopefully the presentation was informative. This is the final stage for Ofwat for PR24 but look forward to future engagement around future price reviews in the years to come.

Thank you.

Chris Walters

Thanks very much.

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is a non-ministerial government department.
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