Business Plan 2015 – 2020: June 2014

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Some of the information in this document has been redacted for commercial reasons.
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Board foreword

We, the members of the Board of Thames Water Utilities Limited, commend this June 2014 business plan submission to Ofwat for review and consideration.

We confirm our ownership of this business plan submission, and confirm that it has been prepared in response to Ofwat’s risk-based review. We have satisfied ourselves that governance and assurance arrangements have provided sufficiently robust processes and systems of internal control to confirm that the information submitted, as far as we are aware, is of a high quality, addresses areas where Ofwat’s risk-based review assessment has considered that further evidence is required, is materially accurate and complete, and conforms to Ofwat’s reporting requirements in all material respects.

In addition, we confirm that:

- the business plan has been produced under strategic leadership of the Board;
- the individual elements of the business plan operate together such that taken as a whole the Company is financeable on the basis of its actual capital structure and (with mitigating actions) on the notional capital structure;
- the Company is operating transparently, and the business plan has been produced through a transparent process;
- we, the Board, have overseen the development of outcomes and associated commitments and incentives that reflect customers’ views and priorities; also that our proposed outcomes are consistent with relevant obligations and statutory requirements;
- we have approved our statement of Company performance for the period from 2010 to 2015 (as set out in Appendix 3 to this submission), which includes our proposed adjustments to the 2015-2020 price controls;
- the Company operates in compliance with its licence; and
- the Company is compliant with the Financial Reporting Council’s ‘UK Corporate Governance Code’ where appropriate.

Chapter 10 provides a summary of the governance and assurance processes that give us the confidence to commend this business plan submission to you unanimously.

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1 The Code acknowledges that departure from its provision may be justifiable in particular circumstances and requires that companies explain those departures. A summary of our compliance with sections of the Code which require a specific response or statement is contained in ‘Thames Water Utilities Limited’s ‘Annual report and financial statements 2013/14’, published 11 June 2014.
Signed, as follows:

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<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Signature</th>
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<tbody>
<tr>
<td>Sir Peter Mason KBE</td>
<td>Independent Chairman</td>
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<tr>
<td>Martin Baggs (CEO)</td>
<td>Executive Director</td>
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<td>Stuart Siddall (CFO)</td>
<td>Executive Director</td>
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<td>Dame Deirdre Hutton</td>
<td>Independent Non-Executive Director</td>
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<td>Michael Pavia</td>
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<td>Ed Richards</td>
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<td>Lincoln Webb</td>
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<td>Dipesh Shah OBE</td>
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<td>Nick Horler</td>
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<td>Dan Boffery</td>
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24 June 2014
1 Executive summary

Our plans for 2015-20

This overview explanatory note provides a summary of our June 2014 submission. To inform this submission, we have carefully considered and reflected on all the feedback and new information that we have received. We are confident that the core of our plan is robust and designed to deliver what customers have told us they want. Whilst the core of the plan remains largely unchanged, we have made important changes to our risk and reward proposals to reflect Ofwat’s guidance in the context of the PR14 process as a whole. The changes we have made to our plan have been subject to full quality assurance processes and agreed unanimously by the Board.

This submission is endorsed by our customer challenge group (CCG) and the resulting prices, absent the Thames Tideway Tunnel, which is the subject of a separate price control, are supported by eight in ten of our customers in our updated customer acceptability testing.

Recent developments

Since we issued our business plan in December 2013 we have received new information from a number of sources, including:

- Further feedback from our customers and CCG as part of our ongoing customer engagement programme.
- Substantial useful feedback from Ofwat from its risk-based review.
- Further guidance from Ofwat, including the risk and reward guidance.
- A further six months of actual performance (in particular, dealing with our wettest winter on record).
- Additional external evidence, such as new information from Moody’s about how it assesses the risk of the water industry in general and the impact of the Thames Tideway Tunnel (TTT) project in particular.
- The affirmation of the challenge ahead as we travel towards increased competition in line with the Water Act 2014.

We welcome the feedback we have received, and have used it to challenge and enhance our plan and the evidence underpinning it.

Core plan outcomes and commitments

Having considered and reflected on all the feedback and new information, we are confident that the core of our plan is robust and designed to deliver what customers have told us they want. In line with the feedback we have received, our six outcomes remain as:
We will:

- Provide a safe and reliable water service that complies with all necessary standards and is available when customers require it.
- Provide a safe and reliable wastewater service that complies with all necessary standards and is available when customers require it.
- Demonstrate to our customers and stakeholders that they can trust us, that we are easy to do business with and that we care.
- Provide the level of service customers require in the most economic and efficient manner to ensure that bills are no higher than necessary.
- Limit our impact on the environment and achieve a socially responsible and sustainable business for future generations, including reducing levels of leakage.
- Provide our customers with a choice of easy-to-use contact options.

We have responded to the feedback and provide a clear line of sight from our extensive customer research through to our commitments, to demonstrate that our plan is designed to deliver what our customers want and value. Our commitments have been updated with some changes made to reflect feedback or new information.

We have planned for significant improvements in service. Over the plan period we expect to see customer satisfaction increasing further with our customer satisfaction (CSAT) score increasing to 4.65, leakage reducing by nearly ten per cent, the number of properties affected by odour reducing by over 6,500, an additional 2,000 homes protected from flooding and substantial progress on building the TTT (which will, when complete, dramatically reduce the discharge of combined raw sewage and rainfall into the River Thames).

**Cost assessment**

The service improvements will be made while keeping our costs low. Ofwat’s assessment has recognised that our plans show we will deliver efficiently for customers, particularly in wholesale water. As our deliverables over the plan period have not changed materially, so our costs have not changed materially. Excluding the changes to the TTT project (and the deferral of Lee Tunnel expenditure into AMP6) our totex estimates have increased by less than one per cent.

Ofwat challenged the size of our wastewater programme in December 2013. We provide further evidence in this submission supporting our expected National Environment Programme (NEP5) expenditure and our sewer flooding reduction programme, to demonstrate these costs are efficient and reflect what our customers want.
TTT price control

Following extensive discussions and collaborative working with Ofwat, we have separated the costs of our TTT works into a separate price control that will:

- Ensure that the non-TTT wholesale activities are on a comparable basis to those of other companies.
- Ensure that the costs allocated to the TTT are demonstrably efficient.
- Facilitate clear progress reporting and accountability for delivery.
- Secure an appropriate balance of risk between us and our customers that leaves us incentivised to deliver the project efficiently for the benefit of customers.

We have also proposed an alteration to the way in which we allow for changes in the timetable and the scope of activities that we will undertake.

Risk and reward

In its risk and reward guidance, Ofwat set out its views on outcome delivery incentives (ODIs), uncertainty mechanisms, retail margins and wholesale allowed returns. We have considered the guidance as a whole.

We have undertaken further customer research to understand better the views of our customers on the subject of ODIs. Following analysis of this customer research, we have made significant changes to our package of incentives, increasing the number of measures with a financial incentive from 9 to 23. An impact of this is that the Return on Regulated Equity (RORE) range resulting from our ODIs has increased significantly since December, as shown in Table 1 below.

Table 1 Change in ODI RORE range

<table>
<thead>
<tr>
<th>(12/13 prices)</th>
<th>December business plan</th>
<th>June submission</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£m</td>
<td>RORE (%)</td>
</tr>
<tr>
<td>P90 rewards</td>
<td>£26m</td>
<td>+0.1%</td>
</tr>
<tr>
<td>P10 penalties</td>
<td>£85m</td>
<td>-0.4%</td>
</tr>
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</table>

Source: Thames Water

We have also reviewed our proposed uncertainty mechanisms and in the light of Ofwat’s guidance, we have removed all uncertainty mechanisms, except for a business rates mechanism, which is aligned with that included in the Affinity Water draft determination. We have included separate uncertainty mechanisms for the TTT.

Consistent with Ofwat guidance, we have adopted margins of one per cent for retail household and 2.5 per cent for retail non household and a wholesale allowed return of 3.7 per cent.

However, taking into account the changes that would be necessary in order to adopt Ofwat’s guidance, as set out above, we consider that, on a standalone basis, a wholesale allowed return
of 3.7 per cent would be inappropriately low for our wholesale businesses for a number of reasons, including:

- The unique additional risk that the TTT places on us (Moody’s has highlighted the additional risk and increased the key PMICR\(^2\) credit metric for us relative to the rest of the industry\(^3\)).
- The squeeze to the retail margins arising from indexation of the wholesale controls.\(^4\)
- The asset beta at 0.3 appears low in comparison to the 0.4 calculated by the Competition Commission in the recent Northern Ireland Electricity (NIE) determination, using the same historical data sources.
- The increase in the expected RORE range (arising from a stronger set of ODIs) in accordance with Ofwat’s risk and reward guidance, is likely to lead to an increase in observed betas over historical levels.
- Changes in our proposed uncertainty mechanisms to comply with Ofwat guidance, which have increased our exposure.

However, we recognise that taking Ofwat’s guidance as a whole, including in particular the methodology for determining allowed revenues, in combination with our business plan costs should result in our actual returns\(^5\) exceeding the allowed return and as a consequence, we consider we would be in a position to absorb these additional risks. Hence, we make our June submission on the basis of adopting all of Ofwat’s guidance in the round. Our ability to continue to adopt Ofwat’s guidance, as a whole, is predicated on Ofwat accepting our June submission, as a whole.

**Affordability**

In undertaking our customer acceptability testing, we have estimated our allowed revenue and customer charges on the basis of accepting the whole of Ofwat’s guidance, in the round, and our understanding of its approach to setting allowed revenue, using the draft determinations issued to date as a guide. This approach should ensure that we undertake our acceptability testing using the most likely level of customer charges.

The changes that we have made since December result in customer bills that, before the TTT impact, are essentially flat in real terms (a 0.4 per cent reduction) in accordance with our commitment to customers in December 2013. When the charges arising from the separate TTT...

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\(^2\) Post maintenance interest cover ratio

\(^3\) Credit Opinion: Thames Water Utilities Ltd* 16 April 2014

\(^4\) Indexation of the wholesale controls will increase customer bills in nominal prices which will result in increases to bad debts and collection commission costs. As the retail income will be fixed in nominal prices this increase in costs will result in retail margins below one per cent. Consequently the adjustment of the appointed business WACC for the retail margin will be over-stated.

\(^5\) Providing we are able to deliver on our industry leading cost levels, particularly for wholesale water.
price control and the Infrastructure Provider (IP) are included, average household charges increase in real terms by around two per cent per annum as shown in the table below.

Table 2 Average household charges

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<tbody>
<tr>
<td>Average household bill (excluding TTT)</td>
<td>361</td>
<td>360</td>
<td>360</td>
<td>360</td>
<td>360</td>
<td>360</td>
</tr>
<tr>
<td>Average annual change (%) (excluding TTT)</td>
<td></td>
<td></td>
<td></td>
<td>0%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average household TTT charge</td>
<td>3</td>
<td>10</td>
<td>16</td>
<td>23</td>
<td>33</td>
<td>42</td>
</tr>
<tr>
<td>Average household bill (including TTT)</td>
<td>364</td>
<td>370</td>
<td>375</td>
<td>382</td>
<td>393</td>
<td>401</td>
</tr>
<tr>
<td>Average annual change (%) (including TTT)</td>
<td></td>
<td></td>
<td></td>
<td>2%</td>
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</table>

Source: Thames Water

Whilst charges are flat (before TTT) as per our December 2013 plan, customers benefit in a number of additional ways:

- If we perform as efficiently as expected, customers will get a reduction in their bills from 2020 of £12 pa.
- We have a stronger set of ODIs and fewer uncertainty mechanisms so customers bear less risk.
- In 2020 customer bills (including the TTT) will still be amongst the lowest in the industry. This therefore represents a significantly improved position for customers.

Our customers have supported our core plan (excluding the TTT) with eight in ten finding our plan reasonable in our updated acceptability testing. However, when the additional charges associated with the TTT are included, acceptability falls to nearly six in ten. Taken together with our previous acceptability testing carried out in November 2013 of a comparable bill size, these results demonstrate an acceptable level of customer acceptability. We have tested customer views on the timing of any price increases and have again profiled charges so that they rise gradually.

**Financeability**

Using the same revenue as used for our customer acceptability testing our June submission is financeable on both the notional and actual capital structure.

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Without the additional income arising from the operation of Ofwat’s approach to setting allowed expenditure, the Company would secure, when applying Ofwat’s guidance on the notional capital structure, credit metrics consistent with a BBB credit rating (and would not be expected to default on its debt). In order to meet ratios consistent with BBB+ we have considered mitigation options within the framework of the published guidance, but our advisors have questioned whether the rating agencies would recognise the full benefit of revenues brought forward through the use of totex levers. We would be concerned with regard to the impact on customer bills of bringing forward revenues to resolve notional financeability without first taking into account the likely impact on customers of application of Ofwat’s stated methodology for setting totex allowances.

That said we consider that we would be able to resolve the issues arising within the notional balance sheet assessment by adopting the following measures:

- Assumption of additional index-linked debt, noting that Ofwat’s notional assumption of 33% is considerably below the circa 40% average for the sector (improving the notional adjusted interest cover ratios on average across AMP6 by 0.1x).

- Strengthening the balance sheet by increasing retained earnings, reducing the level of dividend yield below the 4% return on regulated equity set out in Ofwat’s guidance – deferring equity’s return into the longer term via the RCV.

[Redacted]

In summary, in the absence of the efficiency assumptions set out in the plan, the Company is financeable on the basis of the actual capital structure. On the notional capital structure, the Company would secure credit metrics consistent with a BBB credit rating applying Ofwat’s guidance and would secure credit metrics consistent with a BBB+ credit rating with the mitigating actions set out above. On that basis, the Company is financeable on the notional capital structure. This would not, however, provide a return which is commensurate with the risk which equity assumes.

**Delivering our plan**

We are confident that our plan is good for customers, focusing on their priorities at a price they can afford. As we set out in December, we see the need to transform our organisational structure and our delivery capability if we are to achieve our customer commitments, rise to the challenge of increased competition and deliver on our challenging expenditure targets.

We look forward to the challenging times ahead and have continued to develop our contractors Alliance (which is one year old and now well established) and to progress actively the transformation of our organisation.

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7 As highlighted, for example, within "Speed of Money Cannot Address Potential Financeability Concerns", Moody’s Investors Service (16 May 2013).

8 These measures comprise the mitigating actions referred to within the Board Assurance statement.

9 This refers to the benefit of our planned costs being below the level we anticipate Ofwat’s baseline costs to be.

10 Our financial advisor, NM Rothschild, has confirmed that the mitigating actions outlined above would bring key ratios in line with a BBB+/Baa1 rating on a notional basis.
We have established our plans for the future and created destination and strategy maps, for the four business units and group services and completed our high-level target operating model. We are now progressing to develop detailed transformation blueprints and anticipate that the new business model will be in place by April 2015 and ready to deliver on our performance commitments for customers from day one of AMP6.

Prior to the business model development we designed a new vision and values and by the end of June 2014, 5,000 staff and contractors will have taken an active part in workshops to consider our new vision and values and to work through what this change means for them. This is the start of a major transformation that will ensure customers are at the heart of what we do and will be a key enabler of the delivery of our ambitious customer-driven business plan.
2 Introduction

2.1 Approach to June submission

In preparing our June submission we have continued to listen to our customers (including our CCG) and taken careful account of new information and feedback from Ofwat. This includes further direct customer engagement and willingness to pay analysis (WTP) on specific issues and nine meetings with our CCG. We have considered the various documents issued by Ofwat since the submission of our December 2013 business plan and the very constructive feedback provided in workshops and one-to-one meetings.

It is clear to us from the feedback we have received that, amongst other things, we needed to improve our presentation of information. An important aspect of our June submission is, therefore, to provide clearer evidence in support of our proposals, to address those areas highlighted by Ofwat as requiring more evidence. This is particularly the case with respect to our outcomes and commitments, where we are providing a much clearer line of sight between our customer engagement, research and WTP analysis and our outcomes, commitments and ODIs.

We have updated our cost estimates where we have material new information and have also taken into account the issues we raised in our December 2013 business plan, technical appendix (T0593 - additional disclosure).

Following extensive discussion with Ofwat, we have also separated most aspects of the TTT into a separate price control, providing greater clarity for customers on our core plan.

In the light of Ofwat’s risk and reward guidance, we have undertaken further customer research to explore our customers’ views on incentives and carried out WTP analysis in specific areas, both of which have informed our revised package of incentives. We have discussed this package with our CCG who are supportive of our analysis.

We have used this information to challenge our business plan. Our overall conclusion is that our December 2013 business plan remains a high-quality plan based on the firm foundations of our customer engagement.

2.2 Structure of document

Reflecting the above, this section provides an overall explanation of the structure of our June submission:

- Chapter 3 - provides an overview of our response to Ofwat’s challenge to show the line of sight between our research, customer engagement and cost benefit analysis and our outcomes and commitments.

11 These are the areas rated as C or D by Ofwat in their risk-based review. We have provided further information on areas rated A or B by exception and will provide any further information Ofwat require in these areas as requested.
• Chapter 4 - describes the main changes to our projected costs since our December 2013 business plan.
• Chapter 5 - outlines our updated view on the appropriate risk and reward balance covering outcome delivery incentives, uncertainty mechanisms, retail margins, wholesale weighted average cost of capital (WACC) and our updated RORE range.
• Chapter 6 - summarises our proposals for customer charges and our financeability assessment.
• Chapter 7 - provides a brief summary of our updated legacy adjustments.
• Chapter 8 - sets out the updated costs and our proposed approach to dealing with our wholesale Thames Tideway Tunnel expenditure.
• Chapter 9 - provides an update on our plans to transform the business into four separate business units.

These chapters provide a high level summary of any changes to our plan and our response to Ofwat’s risk-based review assessment. This document is supplemented with five key appendices providing more detail as summarised below.

**Table 3 June submission appendices**

<table>
<thead>
<tr>
<th>Document</th>
<th>Contents</th>
</tr>
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<tbody>
<tr>
<td>Appendix 1 - Gap Analysis</td>
<td>Providing our approach to responding to Ofwat’s feedback</td>
</tr>
<tr>
<td>Provided to Ofwat on 10 June 2014</td>
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<tr>
<td>Appendix 2 - Customer line of sight including</td>
<td>Providing improved linkage between our customer engagement, research and WTP analysis and our outcomes, performance commitments and ODIs</td>
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<td>• Annex 1 - Performance commitments responses (PCRs)</td>
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<td>• Annex 2 - Incentives and risk</td>
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<td>• Annex 3 - AMP6 performance reporting</td>
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<tr>
<td>Appendix 3 - Performance in 2010-15</td>
<td>Update on performance and legacy adjustments</td>
</tr>
<tr>
<td>Appendix 4 - Finance</td>
<td>Revised financial outputs of the plan and revised level of customer bills</td>
</tr>
<tr>
<td>Appendix 5 - Thames Tideway Tunnel</td>
<td>An update on changes since the December 2013 business plan submission and proposals for the separate price - control</td>
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*Source: Thames Water*
In addition, for each of the criteria in the gap analysis in Appendix 1, we provide a focused specific response in a supporting document referred to as a Gap Analysis Response (GAR). We also provide a supporting document for each change we have made, referred to as a Thames Water Internal Change (TIC). We are also providing data tables as requested by Ofwat including an additional set on 14 July 2014 associated with the separate price control for our TTT activities.

In addition, we are also producing an updated customer-facing document, which will be published on our website to keep our customers informed.

The overall submission structure is represented in the figure below.

**Figure 1 June submission structure**

Source: Thames Water
3 Outcomes

3.1 Introduction

This chapter provides a summary of how we have responded to Ofwat’s challenge, i.e. to show how our extensive customer engagement has guided the development of our plan, our customer outcomes and the basis upon which we have set our commitment levels.

More detail is provided in Appendix 2 (Customer line of sight) and its supporting Annexes. These show the justification for each commitment level and outcome delivery incentive and our proposals for data collection, governance and reporting. GAR A and GAR B provide specific evidence in relation to our stakeholder engagement process and the allocation of our commitments.

3.2 Customer engagement and WTP evidence

An effective customer engagement process

From the outset, customer views have influenced the development of our plan. It was developed to deliver the outcomes that they have told us they want, at a price they can afford.

We planned four distinct phases of customer engagement activity – each designed to feed into a specific date when information was needed for developing the plans:

1. **Core assumption studies**: these explored and developed the core assumptions that underpinned the business plan and provided us with WTP values.

2. **Delivery refinement studies**: these informed decisions and issues that influenced how we delivered our business plan, e.g. billing, means of contact, retail options.

3. **Business plan review studies**: these influenced final choices and decisions for the final business plan.

4. **Future plans** which will inform how we begin to plan the use of assets and our priorities for the next Price Review (2019).

In Appendix 2, we describe our programme of consultation, which has seen us carry out over 50 separate pieces of customer research and receive feedback from over 30,000 customers and 233 stakeholder groups, in addition to the day-to-day insight provided in customer queries and complaints.

In GAR A we show the process we followed, so that each piece of research built upon, and was influenced by, the previous work. We include specific case studies to illustrate the process, which is summarised in Figure 2 below.
Figure 2 Customer engagement strategy - process overview

Source: Thames Water
Our customer engagement used focus groups, telephone and face-to-face interviews, deliberative events, online surveys, computer assisted personal and telephone interviewing, public consultations and coverage in local newspapers, radio and television to interact with a representative sample of our diverse range of customers from all walks of life. All our research was implemented in accordance with Market Research Society (MRS) code of conduct and was peer reviewed by Professor Ian Bateman and Professor Ken Willis. To further support the development of our approach to customer research, in 2012 we engaged Accent, an external consultancy, to carry out a review of the customer engagement activities that had taken place up to that point, in the report they have stated:

“A detailed research plan was proposed during the early stages of the PR14 programme. It has been well thought through and looked to draw on lessons learnt during PR09.”

As a result of this review a number of recommendations were also made to improve our subsequent WTP surveys, these are detailed in the Technical Annex (T0184 - Accent Review of WtP research and TW response) that was submitted to Ofwat as part of our December submission.

**An effective CCG engagement process**

Our CCG has been an important element of our customer engagement and has assessed and challenged our customer and stakeholder engagement activities to ensure we embed the results of our research in the business plan. We note that the CCG was supportive of our customer engagement approach, and we have demonstrated to the group that our research has included the views of all our customers including those who only receive wastewater services from us.

By December 2013 we had conducted around 70 meetings with our CCG and its sub-groups, and prepared over 230 papers and presentations for them on a whole range of issues affecting customers.

**Wider stakeholder engagement**

We also engaged extensively with our wider stakeholder group including our various water quality and environmental regulators. We have met with the water only companies (WOCs) in our area and have discussed issues such as the introduction of the social tariff. We have also talked at length to local communities and groups. These conversations tended to focus on particular local issues, for example, the presence of a sewage works, or water quality in a nearby river. The groups we spoke to included district and borough councils, Mencap, London Sustainability Exchange, Thames21, Blueprint for Water and the Group Against Reservoir Development. Details are included in GAR A.

Along with our customers, we have consulted with these groups on a number of occasions to ascertain whether or not our long-term priorities and outcomes were representing their views. In addition to the consultations, we ran a bespoke deliberative event with our various stakeholders, where they were able to comment on and influence the look and language used in our long-term strategy, from which our outcomes were developed as shown in Figure 3.

---

12 T0139 - Accent, PR14 Research programme review, December 2012
We included all stakeholder responses in our research which influenced the development of our December 2013 business plan. In addition, specific issues raised by stakeholder groups have also directly affected the plan, for example, discussions with the Environment Agency on NEP5.

**Approach to gathering WTP data and mapping to its outcomes, PCs and ODIs**

Our CCG has been fully involved in the development of our quantitative analysis and supports our use of the data. We have verified the use of our analysis by independent expert review and best practice.

We consider that our WTP data is comprehensive and tested and has been cross checked with other data to ensure it is robust. We have considered other pressures on household bills when understanding our WTP data, which through our cost benefit analysis (CBA) (which is described in more detail in GAR C) has had a major impact on developing our outcomes, performance commitments and ODIs. This process is described in more detail in Appendix 2 and for each performance commitment in its Annex 1.

Following the feedback we received from the risk-based review, we have undertaken further WTP analysis to help us develop specific incentive schemes including leakage and sustainable drainage. We have undertaken this analysis with eftec and ICS, who are leaders in this field, to ensure our research follows best practice.

Our CCG remains supportive of how our analysis has been used to inform our plan.

Overall we are confident that our customer engagement and use of WTP data has resulted in a plan that delivers what our customers want and value.
3.3 Performance commitments

Following the risk-based review feedback, we have reviewed all our performance commitments and have made modifications as appropriate. Our assessment indicated that most of our commitments were well evidenced, reflecting our customer engagement and CBA.

Our performance commitments have been derived, where appropriate, from our CBA, which has been based on our WTP data and arrived at after considering a range of options, whole life costs and current performance levels as described more fully in Appendix 2, Annex 1. This sets out, for each and every customer commitment, the basis of our commitment level and addresses the issues raised by the risk-based review feedback. It also sets out our longer-term vision of how our commitments will change over time, in accordance with our customers’ views and how we have protected customers’ long-term interests.

Figure 4 below sets out the process we have followed to develop our commitments and associated measures and targets. There is a clear line of sight that can be drawn from the company outcomes through to the measures and targets that comprise the performance commitments in our plan.

**Figure 4 Approach overview – development of our commitments**

![](image)

*Source: Thames Water*

It can be seen that the high level company outcomes are underpinned through the associated wholesale/retail service outcomes and performance commitments, thus providing a hierarchy, that is intrinsically linked through to cost benefit and ultimately customer WTP and/or incremental costs.
For wholesale water, we have amended our performance commitment relating to compliance with new environmental requirements and either removed or amended three more output-related commitments. For example, we have changed the commitment to install water efficiency devices to a commitment to reduce average water consumption. For wholesale wastewater, we have combined both our flooding, due to rainfall, commitments into a single combined measure. In addition, we have made modifications to the definition, and level, of our pollution incidents commitment. For retail household, we have introduced a new ODI relating to our investment in a new customer relationship management and billing system (CRMB).

Some of our performance commitments are common to more than one business unit. We have provided more clarity over the allocation of these commitments to demonstrate that there is no double counting (see GAR B).

In its risk-based review, Ofwat raised concerns over our ability to deliver some of our improvements, for example in customer service. We are confident that the significant improvements in customer service that we have committed to deliver can be achieved through our increased focus in this area, together with the necessary investment, which is already having a positive impact. Our Service Incentive Mechanism (SIM) score for 2013-14 increased by 12 per cent over 2012-13 and our plan includes a substantive transformation programme to put the customers of each business unit at the heart of what we do. We include in Appendix 2, Annex 1, the initiatives that we will undertake to deliver the improved customer service.

We recognise it is important that our commitments can be measured and recorded consistently and that we have appropriate governance and quality assurances processes.

We have developed our proposed approach further in this area, supported by Deloitte to ensure we follow best practice. We provide our proposals, which include our proposed processes to allocate clear responsibility for each commitment, to capture data in a robust manner and to monitor and challenge performance, in Appendix 2, Annex 3.
4 Cost assessment

4.1 Introduction

In this chapter we summarise the changes we have made to our business plan costs and how we have responded to comments made by Ofwat in its risk-based review. We have not repeated the comments we provided on 3 June 2014 regarding Ofwat’s approach to econometric modelling and cost assessment. In general, we have only updated for material new information and to correct the minor issues that we identified and provided to Ofwat in Technical Appendix T0593 (Additional disclosures) as part of our December 2013 submission.

4.2 Update to wholesale water costs

Our wholesale water costs (Table 4) have been updated to reflect three main changes.

1. In our December 2013 business plan, we included an uncertainty mechanism to cater for the uncertain outcome of the cumulo rating review in 2017-18 for wholesale water and therefore did not make any allowance for an increase in our cost projections. We have dropped this method of dealing with the uncertainty and have instead adopted the notified item approach used in the recent draft determinations. As a consequence we have included our (P50) estimate of the likely increase in our updated projections.

2. We have updated costs to reflect the cost allocation issues identified in our Technical Appendix (T0593) submitted in December.

3. Following our wettest winter on record, our insurance premiums have increased following negotiations, by £12.6m, most of which (£9m) is allocated to wholesale water.

<table>
<thead>
<tr>
<th>£m, 2012-13 prices</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 2013 business plan totex</td>
<td>3,160</td>
</tr>
<tr>
<td>Expected increase in cumulo rates</td>
<td>39</td>
</tr>
<tr>
<td>Allocation changes arising from T0593 and Ofwat guidance</td>
<td>50</td>
</tr>
<tr>
<td>Increase in insurance premiums</td>
<td>9</td>
</tr>
<tr>
<td>Other changes</td>
<td>(5)</td>
</tr>
<tr>
<td>Revised business plan totex</td>
<td>3,253</td>
</tr>
<tr>
<td>Change</td>
<td>93</td>
</tr>
</tbody>
</table>

Source: Thames Water

13 The comments are included as an annex to Technical appendix – TJ049
14 It was included in table W11 as the p50 estimate.
15 We note our expected increase of 12 per cent is almost identical to the percentage increase estimated by both South West Water and Dwr Cymru.
4.3 Update to wholesale wastewater costs

Our wholesale wastewater costs (Table 5) have been updated to reflect four main changes:

1. We have removed TTT-related costs, as these are now included in a separate TTT price control. The costs have also been revised and are shown in chapter 8 and in more detail in Appendix 5.

2. Following the comments in the risk-based review, we have reviewed our approach to NEP5 costs and reduced the projected cost from £177m to £130m. This change is described in more detail in GAR D.

3. We have updated costs to reflect the cost allocation issues identified in our Technical Appendix (T0593) submitted in December 2013.

4. Our estimates of the completion date of the Lee Tunnel have changed since December. We now anticipate that the final £38m of expenditure will be incurred in AMP6.\(^\text{16}\)

Table 5 Changes to wholesale wastewater totex

<table>
<thead>
<tr>
<th>£m, 2012-13 prices</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 2013 business plan totex</td>
<td>4,308</td>
</tr>
<tr>
<td>Removal of TTT works to separate price control</td>
<td>(508)</td>
</tr>
<tr>
<td>Changes to NEP5 projections</td>
<td>(47)</td>
</tr>
<tr>
<td>Allocation changes arising from T0593 and Ofwat guidance</td>
<td>(49)</td>
</tr>
<tr>
<td>Lee Tunnel deferral</td>
<td>38</td>
</tr>
<tr>
<td>Other changes</td>
<td>12</td>
</tr>
<tr>
<td>Revised business plan totex</td>
<td>3,754</td>
</tr>
<tr>
<td>Change</td>
<td>(554)</td>
</tr>
<tr>
<td>Change excluding TTT changes</td>
<td>(46)</td>
</tr>
</tbody>
</table>

Source: Thames Water

\(^{16}\) This will also result in a new cost assessment exclusion to treat the expenditure as an overlap project. See Technical appendix Cost assessment exclusions TJ049.
4.4 Update to retail household costs

Our retail household costs (Table 6) have been updated to reflect four main changes:

1. [Redacted].

2. There have been reductions in allocated insurance costs following the change in allocation approach by Ofwat.\textsuperscript{17} \textsuperscript{18}

3. We have updated our calculations of bad debt, including the impact of TTT and reduced our estimates.\textsuperscript{19}

4. We have corrected and removed the deflation of costs used in December 2013 following a better understanding of how Ofwat’s feeder models interact.

In addition, consistent with our aim of improving customer service, we have brought forward the start date of two initiatives planned for AMP6 to 2014-15. We introduced our social tariff with effect from 1 April 2014 and we will respond to emails within two days with effect from October 2014.

Table 6 Changes in retail household expenditure

<table>
<thead>
<tr>
<th>£m, 2012-13 prices</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 2013 business plan</td>
<td>852</td>
</tr>
<tr>
<td>[Redacted]</td>
<td>[XX]</td>
</tr>
<tr>
<td>Reduction in insurance allocation</td>
<td>(20)</td>
</tr>
<tr>
<td>Reduction in bad debts (incl. TTT element)</td>
<td>(17)</td>
</tr>
<tr>
<td>Correction of price base</td>
<td>22</td>
</tr>
<tr>
<td>Other changes</td>
<td>16</td>
</tr>
<tr>
<td>Revised business plan</td>
<td>[XX]</td>
</tr>
<tr>
<td>Change</td>
<td>[XX]</td>
</tr>
</tbody>
</table>

Source: Thames Water

\textsuperscript{17} 2014 price review cost allocation for retail and wholesale price controls, 24 March 2014

\textsuperscript{18} We have included Ofwat’s retail cost allocation checklist as technical appendix TJ080 with supporting analysis in technical appendix - Retail Cost analysis, TJ081

\textsuperscript{19} In response to updated guidance from Ofwat received 19 June 2014, we have provided additional information in relation to our retail price controls - see technical appendix TJ078 – Bad debt allocation.
4.5 Update to retail non household costs

Changes to our non-household costs are largely dominated by a £6m reduction in the allocation of water efficiency costs (as highlighted in T0593).

Table 7 Changes to retail non-household costs

<table>
<thead>
<tr>
<th>£m, 2012-13 prices</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 2013 business plan toex</td>
<td>130</td>
</tr>
<tr>
<td>Water efficiency</td>
<td>(6)</td>
</tr>
<tr>
<td>Other changes</td>
<td>6</td>
</tr>
<tr>
<td>Revised business plan toex</td>
<td>130</td>
</tr>
<tr>
<td>Change</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Thames Water
5 Risk and reward

5.1 Introduction

In this chapter we consider Ofwat's risk and reward guidance applying to outcome delivery incentives, uncertainty mechanisms, retail margins (including adjustments to ACTS) and the allowed return for our wholesale businesses. We set out our approach to considering the risk and reward package in the context of Ofwat's guidance as a whole, our revised proposals and show our updated RORE analysis.

5.2 Ofwat’s risk and reward guidance

Ofwat’s position on outcome delivery incentives was set out in its risk and reward guidance: 20 “An effective package of rewards and penalties will benefit customers by providing meaningful incentives to encourage the best service”. Ofwat also found that “The risk and reward proposals in companies’ business plans currently provide little incentive for outperformance…This means that the balance of risk and reward is not sufficiently aligned with the best interests of customers.”

Ofwat’s guidance recognised that companies face uncertainty over future costs and revenues and that good risk sharing mechanisms provide companies with incentives to reduce costs and provide better services. It also highlighted that there were a range of standard uncertainty mechanisms that would be applicable to all companies. In addition, Ofwat stressed that where a company is able to materially influence the probability or magnitude of impacts, or mitigate the effect efficiently, the risk should remain with the company.

Ofwat set out its views on the appropriate retail margins for household and non-household of 1 per cent and 2.5 per cent respectively, and its view that the appropriate cost of capital is 3.85 per cent for the appointed business and 3.7 per cent for the wholesale business, when the appointed business rate is adjusted for the retail margins.

5.3 Our approach to the risk reward package

In our view, it is not possible to consider each item in Ofwat’s risk and reward guidance on an individual basis as each element is inter-related to a greater or lesser degree. For example, views on the appropriate level ODIs will have an impact on risk and therefore the appropriate return for the risk taken.

Our approach instead is to consider Ofwat’s risk and reward guidance in the round, with the totality of Ofwat’s published guidance and models (in particular Ofwat’s approach to cost assessment and the setting of allowed expenditure and allowed revenue, through the published menus).

20 Setting price controls for 2015-20 – risk and reward guidance, 27 January 2014
In adopting Ofwat’s guidance as a whole, we have estimated the allowed expenditure in our June submission by following Ofwat’s stated approach, its published menus and its latest econometric models. We have used our updated June submission costs in our assessment and made the assumption that Ofwat find acceptable the additional evidence we provide, relating to our TTT works, NEP5 and our sewer flooding reduction programme. We have also assumed that our P50 estimate of business rates is broadly equivalent to the approach Ofwat is developing to determine a business rates allowance.

In following this approach, our estimate is that our wholesale costs are nearly 14 per cent more efficient than Ofwat’s baseline for wholesale water and 4 per cent more efficient than Ofwat’s baseline for wholesale wastewater, based on our current understanding of Ofwat’s approach as shown in the table below.

### Table 8 Updated baseline

<table>
<thead>
<tr>
<th>£m, 2012-13 prices</th>
<th>Wholesale water</th>
<th>Wholesale wastewater</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Ofwat baseline</td>
<td>3766</td>
<td>3583</td>
</tr>
<tr>
<td>Modelling changes</td>
<td>(32)</td>
<td>49</td>
</tr>
<tr>
<td>Business rates change</td>
<td>39</td>
<td>-</td>
</tr>
<tr>
<td>Lee Tunnel deferral</td>
<td>-</td>
<td>38</td>
</tr>
<tr>
<td>NEP5</td>
<td>-</td>
<td>130</td>
</tr>
<tr>
<td>Flooding programme</td>
<td>-</td>
<td>117</td>
</tr>
<tr>
<td>Updated Ofwat baseline</td>
<td>3773</td>
<td>3917</td>
</tr>
<tr>
<td>June submission totex</td>
<td>3253</td>
<td>3754</td>
</tr>
<tr>
<td>Difference</td>
<td>(520)</td>
<td>(163)</td>
</tr>
<tr>
<td>Difference as % of baseline</td>
<td>(13.8%)</td>
<td>(4.2%)</td>
</tr>
</tbody>
</table>

*Source: Thames Water*

We have sought to protect customers by adjusting the speed at which this additional revenue is collected, mindful of both its effect on bills in the period and that 50 per cent of any outperformance of the allowance will in any event be shared with customers from AMP7 (and we expect to deliver our plan). We have therefore deferred the benefit on the water side to the extent that our plan is more than 10 per cent below Ofwat’s baseline, with the benefit taken through the RCV (effectively as ‘slow money’) rather than as ‘fast money’ in AMP6. £108m of revenue has therefore been deferred to later AMPs, by decreasing the RCV run-off rate. This benefit is therefore added instead to the RCV.

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21 Including change in treatment of capital contributions between totex and revenue - wholesale water £8.7m, wholesale wastewater £4.5m
5.4 Our risk and reward proposals

Outcome delivery incentives

In order to adopt Ofwat’s guidance as a whole, we have undertaken further customer research to understand better the level of incentive our customers regard as reasonable. Our research showed that while our customers have some reservations over incentive upsides, they would support a RORE range of up to +/- 1.5 per cent. As a consequence of this customer support, we have revised our approach to determining where financial incentives are appropriate and taken account of Ofwat’s requirement for rewards to be earned for stretching performance. Our revised approach results in a significant increase in the number of financial incentives, from 9 to 23 as described in more detail in Appendix 2, Annex 2.

Our revised RORE range compared to the range in our December 2013 business plan is summarised in section 5.5 below and the ODI specific changes are shown in Table 9 below.

Table 9 Summary of changes to ODIs

<table>
<thead>
<tr>
<th>(2012-13 prices)</th>
<th>December business plan</th>
<th>June submission</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£m</td>
<td>RORE (%)</td>
</tr>
<tr>
<td>P90 rewards</td>
<td>£26m</td>
<td>+0.1%</td>
</tr>
<tr>
<td>P10 penalties</td>
<td>£85m</td>
<td>-0.4%</td>
</tr>
</tbody>
</table>

Source: Thames Water

Uncertainty mechanisms

Adoption of Ofwat guidance on uncertainty mechanisms has resulted in substantial changes in our June submission that increases the risk borne by shareholders, to the benefit of customers.

We have now included only one uncertainty mechanism, which relates to business rates for wholesale water and is consistent with the mechanism, which we noted was set out by Ofwat in the draft determinations for Affinity Water on 30 April 2014. Details of our proposal are included in Appendix 2, Annex 2. We describe the TTT uncertainty mechanisms in chapter 8 and in more detail in Appendix 5.

Retail margins

In adopting Ofwat guidance, we have used margins of 1 per cent for retail household and 2.5 per cent for retail non household.

In our December 2013 business plan, we put forward a proposed average cost to serve (ACTS) adjustment to reflect the additional bad debt costs associated with the TTT bill impact. In common with all other companies, Ofwat did not accept these adjustments. In this submission we have maintained this proposed adjustment and responded to Ofwat’s feedback, in detail, in GAR G.

In December we also included additional depreciation costs for a new CRMB. The proposed new system enables the delivery of the retail household service outcomes. We have addressed Ofwat’s concerns in GAR H and to protect customers have proposed a penalty-only ODI.
Wholesale allowed return

We have adopted a wholesale allowed return of 3.7 per cent consistent with the adoption of Ofwat’s guidance as a whole.

However, for the avoidance of doubt, our overall view is that on a standalone basis 3.7 per cent WACC is too low and, over time, could be expected to have an adverse effect on the attractiveness of the industry for investors and put long-term investment at risk.

In particular:

- The unique additional risk that the TTT places on us (Moody’s has highlighted the additional risk and increased the key PMICR credit metric for us relative to the rest of the industry).
- The squeeze to the retail margins arising from indexation of the wholesale controls. This means the adjustment to the appointed business WACC for the whole of the retail household margin is an overstatement without an ACTS adjustment for input price pressure.
- The asset beta at 0.3 appears low in comparison to the 0.4 calculated by the Competition Commission in the recent Northern Ireland Electricity (NIE) determination, using the same historical data source.
- The increase in the expected RORE range (arising in part from a wider ODI range), in accordance with Ofwat’s risk and reward guidance, is likely to lead to an increase in observed betas over historical levels.
- Changes in our proposed uncertainty mechanisms to reflect Ofwat guidance, which has increased our exposure.
- The assessment of the risk-free rate and overall market returns have been affected by views of low growth rates, although we note that the Governor of the Bank of England has signalled that growth is returning to “normal levels”.
- In estimating a forward-looking cost of debt Ofwat takes current corporate bond rates and adjusts for expected increases in interest rates. It uses a pass through rate of 0.6 per cent for each one per cent movement in expected gilt yields. Our view, which is supported by our advisers, is that this understates the forward-looking cost of debt.

---

22 Post maintenance interest cover ratio
23 Credit Opinion : Thames Water Utilities Ltd 16 April 2014
24 Indexation of the wholesale controls will increase customer bills in nominal prices, which will result in increases to bad debts and collection commission costs. As the retail income will be fixed in nominal prices, this increase in costs will result in retail margins below one per cent. Consequently, the adjustment of the appointed business WACC for the retail margin will be over-stated.
25 Inflation Report May 2014, opening remarks by the Governor
Consequently, we believe that Ofwat’s suggested wholesale allowed return is too low on a standalone basis. Our ability to continue to adopt Ofwat’s guidance as whole is therefore predicated upon Ofwat accepting our submission, as a whole.

5.5 RORE range

The net effect of the changes we have made to our proposed uncertainty mechanisms and ODIs is to increase the expected RORE range to a level that is consistent with our customer research and the ranges expected by Ofwat. The updated RORE range is described in more detail in Appendix 2, Annex 2 and summarised in the figure below.

Figure 5 Updated RORE range

Source: Thames Water
6 Affordability and financeability

6.1 Introduction

This chapter sets out the revised level of bills associated with our June submission, the updated acceptability testing we have undertaken and our financeability assessment using the notional capital structure.

6.2 Affordability

In undertaking our acceptability testing we have followed Ofwat’s approach to determine allowed revenues and hence customer charges. As a consequence our allowed revenues used to estimate customer bills are largely based on the independent cost baselines that Ofwat have estimated.

We have used Ofwat’s models and approach and the costs contained within our June submission to derive the appropriate updated cost baselines. This approach means that our acceptability testing has provided customers with our best estimate of future customer charges.

Table 10 below shows our estimate of customer charges before and after the TTT. Before the additional costs of the TTT are taken into account, bills are 0.4 per cent below 2014-15 levels. With the TTT, charges increase by around two per cent per annum in real terms.

Table 10 Average household bills

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Average household bill (excluding TTT)</td>
<td>361</td>
<td>360</td>
<td>360</td>
<td>360</td>
<td>360</td>
<td>360</td>
</tr>
<tr>
<td>Average annual change (%) (excluding TTT)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>Average household TTT charge</td>
<td>3</td>
<td>10</td>
<td>16</td>
<td>23</td>
<td>33</td>
<td>42</td>
</tr>
<tr>
<td>Average household bill (including TTT)</td>
<td>364</td>
<td>370</td>
<td>375</td>
<td>382</td>
<td>393</td>
<td>401</td>
</tr>
<tr>
<td>Average annual change (%) (including TTT)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Thames Water
We have undertaken further acceptability testing of our June submission with a representative sample of our customer population. The plan for the acceptability testing was agreed with our CCG. Absent the TTT, which is the subject of a separate price control, 8 in 10 customers say the plans and bill impact are acceptable.

When the charges attributable to the TTT are included, nearly six in ten said the company’s plans, including building the TTT and the resulting impact on bills are acceptable.

When comparing the results of the most recent survey with the one we ran in November 2013 (where 78% of customers found our plan, including the TTT acceptable), it is important to note that there has been a change in methodology. The November 2013 survey was conducted face-to-face but in June 2014 only half of the household interviews were conducted face-to-face, with the other half online. We saw a difference in the results of the online survey when compared to the face-to-face one. If we only look at the face-to-face interviews for June 2014, we see greater acceptability, with 64% of customers saying the plans and bill impact are acceptable. In November 2013, 7 in 10 household customers said our plans were acceptable. Taken together, our acceptability testing of a comparable bill size in November 2013 and June 2014 demonstrate an acceptable level of customer acceptability of the bill impact of our plan including the TTT.

We considered altering our PAYG levels to mitigate the impact of the TTT on current customers. However, our customers tell us that they would prefer a gradual increase in bills rather than putting off a larger increase to a later date.

Further detail on customer charges is provided in Appendix 4.

26 The figure excluding the TTT is 85 per cent, with a confidence interval of 77 – 93 per cent.
27 The main result from the analysis of the customer survey data establishes that the overall level of acceptability, including the need to build the TTT and the related bill impact, for the proposed 2015-to-2020 business plan is 59%. This result has a confidence interval of 51 – 67 per cent, which represents the expected bounds of the level of acceptability of the proposed plan. A conservative interpretation of the main result is that over half of customers find our plan acceptable. As part of this survey we spoke to a representative sample of 859 household customers and 151 non-household customers, including 390 of our waste-water only customers.
28 The result for household customers completing the survey face-to-face in June 2014 was 64 per cent, with a confidence interval of 56 – 72 per cent, and the result for household customers in November 2013 was 78 per cent, with a confidence interval of 70 – 85 per cent,
29 Revenue Allocation Research, an Opinion Leader report for Thames Water, May 2014.
6.3 Financeability

We have tested financeability on the basis that allowed totex equals our business plan totex (data tables basis), using the notional capital structure. On this basis the Company achieves credit metrics levels consistent with a BBB credit rating (and would not be expected to default on its debt) as shown in Table 11.

Table 11 Financeability assessment using notional capital structure, data table basis

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash interest cover (CIC)</td>
<td>2.5x</td>
<td>2.82x</td>
<td>2.64x</td>
<td>2.49x</td>
<td>2.46x</td>
<td>2.52x</td>
</tr>
<tr>
<td>Adjusted CIC</td>
<td>1.4x</td>
<td>1.27x</td>
<td>1.25x</td>
<td>1.24x</td>
<td>1.24x</td>
<td>1.23x</td>
</tr>
<tr>
<td>FFO/debt</td>
<td>6%-10%</td>
<td>8.3%</td>
<td>7.6%</td>
<td>6.9%</td>
<td>6.8%</td>
<td>7.1%</td>
</tr>
<tr>
<td>RCF/debt</td>
<td>6% - 8%</td>
<td>6.4%</td>
<td>5.2%</td>
<td>4.5%</td>
<td>4.3%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Gearing (net debt/RCV)</td>
<td>65%</td>
<td>64.2%</td>
<td>64.6%</td>
<td>64.9%</td>
<td>65.2%</td>
<td>65.0%</td>
</tr>
</tbody>
</table>

*Source: Thames Water financial model*

In order to meet ratios consistent with BBB+, we have considered mitigation options (which are set out in more detail in Appendix 4) within the framework of the published guidance, but our advisors have questioned whether the rating agencies would recognise the full benefit of revenues brought forward through the use of totex levers. We would be concerned with regard to the impact on customer bills of bringing forward revenues to resolve notional financeability, without first taking into account the likely impact on customers of application of Ofwat’s stated methodology for setting totex allowances.

That said, we consider that we would be able to resolve the issues arising within the notional balance sheet assessment by adopting the following measures:

- Assumption of additional index-linked debt, noting that Ofwat’s notional assumption of 33% is considerably below the circa 40% average for the sector (improving the notional adjusted interest cover ratios on average across AMP6 by 0.1x).
- Strengthening the balance sheet by increasing retained earnings, reducing the level of dividend yield below the 4% return on regulated equity set out in Ofwat’s guidance – deferring equity’s return into the longer term via the RCV.

[Redacted].

30 We also undertook the analysis setting allowed expenditure equal to Ofwat’s notional totex generated from its cost assessment models with identical results.
31 As highlighted, for example, within “Speed of Money Cannot Address Potential Financeability Concerns”, Moody’s Investors Service (16 May 2013).
32 These measures comprise the mitigating actions referred to within the Board Assurance statement.
In summary, in the absence of the efficiency assumptions\textsuperscript{33} set out in the plan, the Company is financeable on the basis of the actual capital structure. On the notional capital structure, the Company would secure credit metrics consistent with a BBB credit rating applying Ofwat’s guidance and would secure credit metrics consistent with a BBB+ credit rating with the mitigating actions set out above.\textsuperscript{34} On that basis, the Company is financeable on the notional capital structure. This would not, however, provide a return which is commensurate with the risk which equity assumes.

When we adopt all of Ofwat’s guidance, including its approach to setting allowed revenue the credit metrics, using our business plan expenditure, achieves target credit metrics, for our actual capital structure and the notional capital structure as set out in Table 12.

**Table 12 Financeability assessment using notional capital structure, submission basis**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash interest cover (CIC)</td>
<td>2.5x</td>
<td>3.03x</td>
<td>2.88x</td>
<td>2.77x</td>
<td>2.77x</td>
<td>2.86x</td>
</tr>
<tr>
<td>Adjusted CIC</td>
<td>1.4x</td>
<td>1.47x</td>
<td>1.47x</td>
<td>1.49x</td>
<td>1.51x</td>
<td>1.52x</td>
</tr>
<tr>
<td>FFO/debt</td>
<td>6%-10%</td>
<td>9.4%</td>
<td>8.8%</td>
<td>8.3%</td>
<td>8.3%</td>
<td>8.8%</td>
</tr>
<tr>
<td>RCF/debt</td>
<td>6% - 8%</td>
<td>7.2%</td>
<td>6.4%</td>
<td>5.8%</td>
<td>5.7%</td>
<td>6.2%</td>
</tr>
<tr>
<td>Gearing (net debt/RCV)</td>
<td>65%</td>
<td>63.4%</td>
<td>62.8%</td>
<td>62.2%</td>
<td>61.6%</td>
<td>60.6%</td>
</tr>
</tbody>
</table>

*Source: Thames Water financial model*

The target levels of the adjusted cash interest cover reflect the statement from Moody’s\textsuperscript{35} that our target levels are higher than the rest of the industry as a result of the additional risk arising from the TTT.

---

\textsuperscript{33} This refers to the benefit of our planned costs being below the level we anticipate Ofwat’s baseline costs to be.

\textsuperscript{34} Our financial advisor, NM Rothschild, has confirmed that the mitigating actions outlined above would bring key ratios in line with a BBB+/Baa1 rating on a notional basis

\textsuperscript{35} Credit Opinion: Thames Water Utilities Ltd* 16 April 2014
7 Company performance in 2010 – 2015 (legacy adjustments)

7.1 Introduction

We have updated our 2013-14 performance figures to reflect our actual reported performance and our 2014-15 figures to reflect our budget. The net effect of this is not material, with an overall change of £2m.

Full details of our performance over the AMP5 period are provided in Appendix 3.

7.2 Overview of changes in performance

The key changes in our AMP5 adjustments relate to:

- A reduction in the CIS adjustment as a result of increased TTT expenditure offset by other reductions, mainly relating to the deferral of expenditure on the Lee Tunnel.
- An increase in our SIM penalty to reflect our performance in 2013-14, making assumptions about the performance of other companies.
- A reduction in our opex outperformance as a result of our 2013-14 actual opex performance being slightly worse than anticipated at the time of the December 2013 business plan, as a result of the wet winter.

Table 13 below summarises the adjustments compared to our December 2013 business plan.

Table 13 AMP5 True-up adjustments

<table>
<thead>
<tr>
<th>£m, 2012-13 prices AMP5 adjustments</th>
<th>December 2013 business plan</th>
<th>June submission</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMP5 capital adjustments (incl. CIS and unfunded TTT expenditure)</td>
<td>(96)</td>
<td>(75)</td>
<td>21</td>
</tr>
<tr>
<td>Revenue correction mechanism</td>
<td>129</td>
<td>135</td>
<td>6</td>
</tr>
<tr>
<td>SIM estimate</td>
<td>(57)</td>
<td>(74)</td>
<td>(17)</td>
</tr>
<tr>
<td>Opex outperformance</td>
<td>12</td>
<td>0</td>
<td>(12)</td>
</tr>
<tr>
<td>Total adjustments</td>
<td>(12)</td>
<td>(14)</td>
<td>(2)</td>
</tr>
</tbody>
</table>

Source: Thames Water financial model
8 Wholesale TTT – separate price control

8.1 Introduction

Following discussions with Ofwat, we have separated our wholesale TTT costs (including category 2 & 3 works) into a separate price control (TTT Price Control). At one level, this price control is, in itself, an uncertainty mechanism within the wholesale wastewater price control. This chapter provides an overview of our proposals.

In addition, there have been a number of refinements to the TTT project as a whole in the light of new information. This new information includes changes in the timetable and the scope of Government support mechanisms, as well as new information on costs and Ofwat’s risk-based review feedback. As a result, the project timetable is somewhat different, and this, in turn necessitates a different allocation of tasks between us and the IP. This chapter provides an overview of changes to costs since our December 2013 business plan and our proposals to protect customers from the significant uncertainty surrounding this project. This chapter does not consider the IPs costs. (We will provide an update of expected IP costs in the autumn as the current tender progresses.)

8.2 Expenditure

In our December 2013 business plan, we included £508m of expenditure within our wholesale wastewater plan for works using the Rev06A costing base.

We now have an updated cost base, Rev06C_2, which reflects a number of changes including the expected delay in licence award to autumn 2015. In order to mitigate any delay in the final tunnel completion date, we are likely to have to undertake additional work, which was previously expected to be undertaken by the IP, to keep the project on-track. This is the major reason for the increase in the costs, although there are a number of other relevant changes.

Table 14 Changes in expenditure

<table>
<thead>
<tr>
<th>2012-13 prices</th>
<th>£m</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 2013 business plan (Rev06A)</td>
<td>508</td>
<td></td>
</tr>
<tr>
<td>Development</td>
<td>(11)</td>
<td>Removal of design costs now included within construction</td>
</tr>
<tr>
<td>Construction</td>
<td>107</td>
<td>Includes transfer of resilience activities from the IP totalling £55m</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Scope/cost/schedule and risk review on Cat2/3 construction activities £34m</td>
</tr>
<tr>
<td></td>
<td></td>
<td>AMP5 to AMP6 programme slippage £9m</td>
</tr>
<tr>
<td>2012-13 prices</td>
<td>£m</td>
<td>Comments</td>
</tr>
<tr>
<td>----------------</td>
<td>----</td>
<td>----------</td>
</tr>
<tr>
<td>Beckton scope brought forward via Lee Tunnel transfer for works performed by MVB c£4m</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>(3)</td>
<td>Major Land Acquisition – removal of 2015/16 acquisitions in AMP6 –£7m Compensation - transfer from Thames Water to Infrastructure Provider, Statutory -£14m for Section 10 claims and Non Stat -£27m for off-site mitigation and compensation. Of which -£27m applicable in AMP6 time period. Land re-sale and rental income - culmination of income receipts expected later in project life £31m</td>
</tr>
<tr>
<td>Indirect costs</td>
<td>51</td>
<td>Seven months programme management (IP/PMC) and IP running costs due to IP award date slippage</td>
</tr>
<tr>
<td>Risk</td>
<td>2</td>
<td>Disaggregation of risks and review of Cat 2 and Cat 3 risks</td>
</tr>
<tr>
<td>D&amp;PG</td>
<td>1</td>
<td>Reflects bottom up approach and resultant impact of changes processed above</td>
</tr>
<tr>
<td>June submission (Rev06C_2)</td>
<td>655</td>
<td></td>
</tr>
</tbody>
</table>

Source: Thames Water

### 8.3 Separate price control

In our December 2013 business plan, we included our TTT expenditure within our overall wholesale wastewater plan. Following the risk-based review feedback; Ofwat expressed some concerns over the potential to mix our TTT expenditure with normal wholesale wastewater expenditure and activities. They expressed a preference for a separate price control for our TTT wholesale costs, including the existing Regulatory Capital Value (RCV) related to the TTT. The advantages of this approach are that it:

- Makes it easier to ensure that the non-TTT wholesale activities are on a comparable basis to those of other companies.
- Makes it easier to ensure that the costs allocated to the TTT are demonstrably efficient.
- Facilitates clear progress reporting and accountability for delivery of the TTT.
- Can be used to secure an appropriate balance of risk between us and our customers.
- Means we are incentivised to deliver the project efficiently for the benefit of customers.

We therefore support the development of the separate price control for our TTT wholesale costs. We have discussed the scope of the TTT price control with Ofwat, and reached a consensus that the scope of the control should include:
• Development, land and compensation costs.

• Programme management and construction works (i.e. Cat 2 and 3).

• Our integration team (co-located with the IP), supportive assurance resources and insurance costs.

• Depreciation and return on existing TTT-related RCV (i.e. AMP4 and AMP5 TTT costs).

• The marginal tax impact of the TTT (including IP revenue and our capex impacts).

• Activities, which would have been undertaken by the IP, but which we will carry out to mitigate the delay in the overall programme (i.e. design and mobilisation work for the IP Cat 1 works).

• Incremental Ofwat fees caused by the TTT.

We have adopted this scope in our June submission. It should be noted that the business plan is predicated upon the current understanding of the set of contracts for the IP and those that relate to us. The agreements are still not finalised and are part of ongoing discussions between the various parties (Thames Water, Ofwat, Government and the early IP representatives) and will also be subject to IP bidder mark-ups. Furthermore, the costs of a split financial close between the IP and main works have not yet been fully evaluated or reflected in our assumptions.

We have agreed with Ofwat the additional data tables that would need to be submitted to support the separate sub control.

We need to commit to delivering the activities covered by the price control. To the extent that they are within management control, we make the following commitments. To:

• Procure a newly formed Infrastructure Provider (IP).

• Undertake the construction activities (Cat 2 and 3 works) included in our business plan in line with the current programme schedule.

• Procure the necessary land for the TTT and complying with S106 agreements with London boroughs and other obligations consistent with our Development Consent Order (DCO) application.

• Engage effectively with the IP both in terms of integration and assurance.

• Comply with the relevant project compensation policies and establishing independent governance arrangements to oversee compensation arrangements.

• Limit the extent of delays on the overall programme timeline.\(^{36}\)

\(^{36}\) We recognise that there is a possibility that there will be a temporal disconnect between the main works contract award and the IP Licence Award. We have set out in Appendix 5 the types of additional activities which we may be
These commitments are consistent with our DCO application and the currently envisaged overall timetable. However, it should be noted that to a large extent many of these commitments are outside of our control. We include AMP6 deliverables consistent with the above in our submission. More details are set out in Appendix 5.

8.4 Dealing with uncertainty

Many of the activities that need to be carried out with respect to the TTT have an inherently high level of uncertainty, above and beyond anything faced by the rest of the industry. We, therefore, consider that it is reasonable, that appropriate uncertainty mechanisms are put in place. In our December 2013 plan, we proposed two uncertainty measures relating to our TTT works. Since then we have had extensive discussions with Ofwat to design appropriate uncertainty mechanisms that do not expose us or our customers to undue risks.

We propose that the TTT price control should be a five-year price control, based on the “totex” principle.

We have proposed three different groupings of costs with different risk sharing properties:

- ‘Typical utility activities’ – where we would adopt Ofwat’s totex P50 menu with 50/50 sharing.
- ‘Higher risk development activities’ – where we would adopt a totex approach with P50 cost as a benchmark with 90/10 sharing.
- ‘Land’ - where we would adopt a no pain/no gain principle, which would be equivalent to a totex approach with a P50 baseline and 100/0 sharing ratio.

Consistent with treating our TTT expenditure as part of a separate price control we have included tax payments on a standalone basis, and adopted a 3.7 per cent WACC (on the assumption that the PR14 Final Determination represents an overall acceptable package given the scope for totex outperformance under the wholesale water price control).

To reflect the specific risks of the project and in particular the high level of uncertainty related to factors outside of our control, we have proposed the following arrangements, which are the subject of ongoing discussions with Ofwat:

- A mechanism to allow any savings below P10 or costs above P90 for ‘higher risk development activities’ to be passed fully to customers.

prepared to fund in the interim in order to enable the Project to be progressed, subject to such activities being agreed between us and Ofwat in accordance with the terms of the preparatory works notice. In respect of both resilience works and the works to be carried out at Blackfriars Foreshore, we may consent to commence and progress such works, if it is clear that the potential liability for such works does not exceed that which we would ordinarily undertake as part of our core business. In addition, we would need to be adequately protected and funded for taking on such works and the risks (direct or indirect) we would be assuming by carrying them out.
• A change mechanism to deal with transfers of scope between us and the IP on a consistent basis and to deal with overall changes in the scope of the programme.

• To the extent that we are able to defer tax liabilities, an uncertainty mechanism to credit the return on the money collected for tax liabilities that were deferred to customers at PR19 by way of a negative RCV adjustment.

• To the extent that the tax liability itself is different to that assumed (as opposed to deferment of the liability) an uncertainty mechanism to refund or collect the difference in cash terms over uniformly over the final four years of AMP7.

We have also proposed appropriate reporting and auditing proposals to support the above. Further details are set out in Appendix 5.
9 Business transformation

9.1 Introduction

In our December 2013 business plan we described our plans to transform our business. We set out our ambition to re-organise ourselves around four distinct business units (broadly aligned with the regulatory price control structure). This chapter provides an update on the progress we have made with this journey.

9.2 Reasons for change

Since December 2013 we have continued our transformation journey apace, with the development of a series of work streams and initiatives to prepare us for readiness for AMP6. Whilst the programme has developed considerably over the past six months, as set out below, our motives for making these changes remain the same: the journey we have begun is our response to the significant changes we are beginning to see in both the regulatory and wider external environments and to enable us to continue to improve customer service. From a regulatory perspective, for example, with the move towards an outcomes-based approach to regulation, Ofwat is giving companies more flexibility to deliver the services customers really value. We will need to reflect this flexibility in the way we operate as a business. In addition, with competition imminent in the retail non-household market, we have an increasing responsibility to ensure that we maintain appropriate relationships between the wholesale and retail elements of our business.

9.3 Developments since December 2013

We have confirmed our view that the best way to respond to these challenges from an organisational perspective is to operate our business through four distinct units:

- Wholesale water: responsible for water abstraction, treatment and distribution.
- Wholesale wastewater: responsible for wastewater collection, treatment and sludge disposal.
- Retail household: responsible for the delivery of retail services to our household customers.
- Retail non-household: responsible for the delivery of retail services to our business customers.

There will also be a group services function providing corporate and other shared support services to the individual business units.

Clearly, a key part of our transformation programme is determining which aspects of our business should operate from each business unit – a task we are currently undertaking. But our journey is more than simply a restructuring of our business: we are taking this opportunity to
transform our business on a more fundamental level, by redefining what our vision should be, and the values that we want to see in our people. The thinking in these areas were developed by a group of people taken from all levels and all areas of our business – an approach we believe to be critical to achieve our ambition of being an organisation whose people are led by their joint values. The new vision and values are shown in Figure 6.

We believe it is important that everyone in our business has the opportunity to experience the same process as the original group, which is why all of our people will be attending an event at which we will share and discuss our new vision and values. By the end of June 2014 we will have held a number of workshops with around 5,000 of our people (including contractors) attending.

At the same time as embedding our new vision and values, we have been developing new strategy maps for the individual business units – a process sponsored by the new managing directors of these units. These strategies are intended to allow us to effectively deliver our business plans, while at the same time preparing us for challenges and opportunities beyond 2020.

Underpinning the business unit strategies and the wider transformation journey is the recognition that, in order to maximise the benefits of our new business model, we need to provide real autonomy to each of the business units. We will be devolving much of the decision making that currently sits centrally. This new flexibility – including significant financial autonomy and accountability – will allow the business units to deliver their plans and strategies in the way that is most effective for them and their customers and it will improve cost control and transparency. It will also provide the platform to develop and engage with future reforms.

The next phase of the transformation will be to define in detail what our new operating model will look like, and to put in place some of our longer-term initiatives. We will look to develop and implement this quickly in order to build on the momentum we have already generated, aiming to be operating our new business model by April 2015.
Figure 6 Our new vision and values
10 Board assurance statement

10.1 Board endorsement

The following statement was approved unanimously at the Board meeting on 24 June 2014.

We confirm our ownership of this business plan submission, and confirm that it has been prepared in response to Ofwat’s risk-based review. We have satisfied ourselves that governance and assurance arrangements have provided sufficiently robust processes and systems of internal control to confirm that the information submitted, as far as we are aware, is of a high quality, addresses areas where Ofwat’s risk-based review assessment has considered that further evidence is required, is materially accurate and complete, and conforms to Ofwat’s reporting requirements in all material respects.

In line with the general characteristics of high quality business plans contained in Ofwat’s guidance,37 we confirm that we believe that our plan:

- Is designed to deliver good outcomes for current and future customers and the environment.
- Has a coherent narrative based on sound reasoning and contains proportionate evidence.
- Is designed to meet our statutory obligations.
- Is based on good quality engagement with customers and consumers, and that the results of this engagement are reflected in the proposed outcome commitments and the plan more generally.
- Is cost efficient and contains projections and estimates based on reasonable assumptions.
- Contains estimates and data that have been arrived at appropriately, and independently of other companies and competitors.
- Does not seek to game the regulatory process in any way.

We confirm that these characteristics apply to the new evidence contained in this June 2014 submission, which includes our responses to Ofwat’s risk-based review feedback, and that the new evidence provided addresses areas where further information was required.

37 p11 Ofwat. ‘Setting price controls for 2015-20 – final methodology and expectations for Companies’ business plans’, July 2013
We confirm that the individual elements of the plan operate together such that the plan, taken as a whole and having regard to the Efficiency Assumptions set out in the plan:

- Proposes a reasonable balance of risk and reward between customers, investors and other stakeholders, with efficient proposals to share ‘pain and gain’ with customers;
- that the company is financeable on the basis of both the actual and notional capital structures; and
- Is affordable.

Further, in line with the requirements set out in Ofwat’s Information Notice IN 14/11, we confirm that:

- Appropriate target credit ratings have been selected;
- The calculations included in Tables A8 and A20 are materially accurate and complete, and conform to Ofwat’s reporting requirements in all material respects;
- The financial ratios have been stress tested in line with the approach specified by Ofwat in IN 14/11 (disregarding the Efficiency Assumptions), and the results are set out in Table A20 and in Appendix 4; and
- In the absence of the Efficiency Assumptions set out in the plan:
  - the Company is financeable on the basis of the actual capital structure
  - on the notional capital structure, the Company would secure a BBB credit rating applying Ofwat’s guidance and would secure a BBB+ credit rating with the mitigating actions set out in Appendix 4. On that basis, the Company is financeable on the notional capital structure.

In approving this submission, we note that there are a few non-material areas where our plan departs from Ofwat guidance and where in our final Quality Assurance we identified a small number of discrepancies following financial model closure. These are set out in our Additional Disclosures document (TJ070).

In addition, we confirm:

- That the production of the business plan, in line with overall Company activity, has been delivered based on strategic leadership from the Board.
- That the Company is operating transparently, and the business plan has been produced through a transparent process.

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38 For the purposes of this assurance statement this refers to the benefit of our planned costs being below the level we anticipate Ofwat's baseline costs to be. Please note that this assurance statement also addresses financeability in the absence of the Efficiency Assumptions, in the section below.
• That we, the Board, have led the development of outcomes and associated commitments and incentives that reflect customers’, and wider consumers’, views and priorities; also that our outcomes are consistent with relevant obligations and statutory requirements.

• Our approval of our statement of Company performance over 2010-2015 (Appendix 3, Company performance in 2010-15), which includes our proposed adjustments to 2015-2020 price controls.

• That the Company operates in compliance with its licence.39

• That the Company is compliant with the Financial Reporting Council’s ‘UK Corporate Governance Code’ where appropriate – the Code acknowledges that departure from its provision may be justifiable in particular circumstances and requires that companies explain those departures. A summary of our compliance with sections of the Code is contained in Thames Water Utilities Limited Annual Report and Financial Statements 2013/14. We also note that on 31 March 2014, Thames Water issued its Corporate Governance Key Principles, developed in line with Ofwat’s proposed principles.40 The implementation of these Key Principles requires a number of changes to Thames Water’s constitutional documents. Subject to shareholder approval, Thames Water intends to give effect to its revised corporate governance framework by 1 April 2015.

The governance and assurance arrangements that have been established for the delivery of a high quality plan are summarised below.

10.2 Governance and assurance arrangements

Throughout the process of developing the PR14 business plan, including updates to our plan as part of this June 2014 submission, we have understood the importance of having controls in place to ensure that our business plan is of a high quality. We, the Board, are accountable for the Company strategy and the business plan itself, including its quality and completeness. As such, we have led the development of our business plan, and have established governance and assurance arrangements that have enabled us to deliver a high quality plan.

The framework which has been followed to assure the quality of the June 2014 submission is consistent with that implemented for the original submission in December 2013, with a particular focus on the areas of the plan that have been updated in response to Ofwat’s risk-based review feedback and highlighted in their gap analysis.

The framework consists of:

• Governance forums – Regular meetings have been held from Board-level to working-level to direct, manage and coordinate the further development of the business plan. These meetings have enabled the Board to lead the business planning process, and

39 A breach of Licence Condition C was reported in Thames Water Utilities Limited’s Annual report and financial statements 2013/2014, published 11 June 2014. Immediate steps have been taken to rectify the breach.

40 Board Leadership, transparency and governance – Principles, 19 September 2013
have ensured that all material developments have received appropriate scrutiny and direction from the relevant forums. The key Board-level governance meetings that have directed the Company’s response to the risk-based review ahead of the 27 June 2014 submission are set out in Table 15 below.

**Table 15 June 2014 submission – Board leadership**

<table>
<thead>
<tr>
<th>Date</th>
<th>Meeting</th>
<th>Topics associated with the June 2014 submission</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 Jan 2014</td>
<td>Board</td>
<td>Approach to June 2014 submission including: known departures, agreed recommendations from assurance partners, known changes (e.g. early implementation of Social Tariff) and incorporation of better information (e.g. updated information on environmental regulations.)</td>
</tr>
<tr>
<td>6 Feb 2014</td>
<td>Audit and Risk Review Committee</td>
<td>Quality assurance framework for June 2014 submission.</td>
</tr>
<tr>
<td>20 Feb 2014</td>
<td>Board</td>
<td>Implications of Ofwat’s Risk &amp; Reward guidance, particularly in relation to: financeability, Outcome Delivery Incentives and uncertainty mechanisms.</td>
</tr>
<tr>
<td>6 Mar 2014</td>
<td>Board</td>
<td>Further direction in light of the implications of Ofwat’s Risk &amp; Reward guidance, particularly in relation to: financeability, Outcome Delivery Incentives (ODIs) and uncertainty mechanisms.</td>
</tr>
<tr>
<td>25 Mar 2014</td>
<td>Regulatory Committee</td>
<td>Proposed core planning assumptions for the June 2014 submission. Approval of a draft submission document structure.</td>
</tr>
<tr>
<td>29 April 2014</td>
<td>Regulatory Committee</td>
<td>Approach to responding to Ofwat’s gap analysis requirements. Summary of Ofwat’s risk-based review feedback. Forward programme for the June 2014 submission, including customer engagement approach on Risk &amp; Reward and final acceptability testing.</td>
</tr>
<tr>
<td>1 May 2014</td>
<td>Board</td>
<td>Key changes in approach from PR09 to PR14, including: allowed expenditure, cost thresholds and menus. Summary of the Ofwat risk-based review feedback. Forward programme for the June 2014 submission, including: Thames Tideway Tunnel (TTT), NEP5,</td>
</tr>
</tbody>
</table>
### Topics associated with the June 2014 submission

- **Sewer flooding and customer engagement.**

<table>
<thead>
<tr>
<th>Date</th>
<th>Meeting</th>
<th>Topics associated with the June 2014 submission</th>
</tr>
</thead>
<tbody>
<tr>
<td>14 May 2014</td>
<td>Regulatory Committee</td>
<td>High level principles for our approach to the June 2014 submission, including.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Revised approach to the AMP6 sewer flooding costs; Proposed position on logging and transition costs; Adoption of Ofwat’s retail margins for both household and non-household price controls; and Proposed package of ODIs and uncertainty mechanisms.</td>
</tr>
<tr>
<td>20 May 2014</td>
<td>Regulatory Committee</td>
<td>Separate price control arrangements for TTT. SIM penalty adjustment.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Financeability of the plan.</td>
</tr>
<tr>
<td>3 June 2014</td>
<td>Audit and Risk Review Committee</td>
<td>Quality assurance framework and status. Assurance of the gap analysis ahead of provision to Ofwat by 13 June 2014.</td>
</tr>
<tr>
<td>3 June 2014</td>
<td>Regulatory Committee</td>
<td>Approach to June 2014 submission including: TTT price control, NEP5, AMP6 sewer flooding, ODIs and uncertainty mechanisms, transition costs, retail margins, WACC, SIM penalty.</td>
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<td>Gap analysis (for 13 June 2014)</td>
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<td>5 June 2014</td>
<td>Board</td>
<td>27 June 2014 submission</td>
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<td>Approach to June 2014 submission including: TTT price control, NEP5, AMP6 sewer flooding, ODIs and uncertainty mechanisms, transition costs, retail margins, WACC, SIM penalty.</td>
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<td>Legacy adjustments, financeability, bill profile. Gap analysis approval.</td>
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<td>June 2014 submission status update.</td>
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<tr>
<td>23 June 2014</td>
<td>Joint meeting of the Audit and Risk Review Committee and Regulatory Committee</td>
<td>Final status of 27 June 2014 submission</td>
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<td>Final quality assurance position</td>
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<tr>
<td>24 June 2014</td>
<td>Board</td>
<td>27 June submission approval</td>
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- **Challenge sessions** – Business plan content has been subject to review and challenge throughout the process. Internal meetings and detailed sessions have been held at timely intervals with the Board, the Executive and Senior Managers which have shaped
the direction of the plan. The Customer Challenge Group has been engaged since February 2012, and has provided robust, independent challenge, in line with its required scope, throughout the process. Challenge has also been requested and received from informed external parties. The feedback from all of the above stakeholders has been factored into the business planning process.

- **Audit and assurance** - Over the course of its production, the business plan content has been subject to quality assurance procedures, and a programme of audits, through which it has been challenged and refined. In line with our December 2013 submission, a coordinated programme of assurance has taken place in the preparation of this June 2014 submission to provide the Board with an overall view of the quality of the plan.

An independent top-down assessment of the business plan against the RBR principles and detailed assessment methodology as set out in Ofwat’s internal methodology publication\(^{41}\) has been completed by Mott MacDonald.

Business plan financeability, in terms of both Ofwat’s specific RBR tests and broader financeability considerations have been reviewed by KPMG and Rothschild respectively. The data within the business plan has been subject to internal data quality reviews, and a programme of bottom-up audit by Halcrow Management Sciences.

KPMG LLP has provided an agreed upon procedures report, in respect of certain tables.

Our Internal Audit function has been involved in auditing specific aspects of business planning activity as well as the overall assurance framework to assess its scope, adequacy and effectiveness.

Finally, the plan has been subject to a legal review, including an assessment of the evidence underpinning the content of this Board statement. The findings of these audit activities have been reported to the Board and its Audit and Risk Review Committee at timely intervals, with any areas of concern identified for further action.

- **Declaration sheets** – As part of our standard assurance arrangements, declaration sheets have been signed by all contributors to business plan content up to Company directors. These forms demonstrate the degree of responsibility and ownership taken by individuals in the process, and request confirmation of, amongst other things, compliance with regulatory requirements, and consistency of business plan content with our longer term strategy. These declaration forms have been presented to the Board to support the overall assurance position.

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\(^{41}\) Ofwat ‘2014 price review risk-based review – internal methodology’ April 2014
10.3 Material issues and relevant factors

Our process has enabled the identification of the material issues that, at this point in time in the price review timetable, we consider will arise, or we have reasonable grounds to expect will arise in 2015-20 or might impact beyond that period. The Board considers, however, that it cannot reasonably provide for the implications of any material change in global economic circumstances and in this eventuality the Company would seek to review its plans as part of the remaining price review process.

Our plan continues to contain the relevant factors known to us at this time to enable Ofwat to commence the determination of fair and reasonable price limits for our customers and the Company consistent with our statutory duties. Where items are uncertain we have commented as necessary. There are a few non-material areas where our plan departs from Ofwat guidance and where in our final Quality Assurance we identified a few small discrepancies following financial model closure. These are set out in our Additional Disclosures document (TJ070).

Based upon the processes and internal systems of control described above, the Board confirms, on the basis of this plan that it continues to have sufficient processes and internal systems of control to meet its obligations for the provision of information to Ofwat.