TMS-DD-041:
Risk and Return

August 2024

Risk and Return

Key messages:

- Our business plan requires us to raise more than £10 billion of new financial capital from debt and equity investors. Ofwat's PR24 determination must support, not hinder, our efforts to obtain this money if we are to deliver our plan and smooth the costs over time, benefiting customers.
- Ofwat's draft determinations contain a significant imbalance between risk and reward at both industry and company level, jeopardising our ability to raise the necessary finance.
- Ofwat's final determination needs to provide for a more pronounced rebasing of expected sector returns in order to make the sector attractive versus competing investments. There also needs to be a much better balance, more generally, between the opportunity for companies to earn rewards from efficiency / good performance and the scope to receive penalties for over-spending / poor performance.
- In our specific case, merely applying the same regulatory framework that Ofwat applies to all other companies is unlikely to be sufficient to support the planned turnaround in performance.
- We therefore set out in this chapter additional measures that Ofwat needs to implement as part of its proposed "turnaround regime".

1 OVERVIEW

1.1 DD summary

Alongside the cost allowances and performance targets outlined in the expenditure and outcomes sections of the draft determination, Ofwat's proposed revenues for the 2025-30 regulatory period provide for:

- a return on the regulatory capital value of 3.66%;
- zero allowance for corporation tax payments, in line with Thames Water's expectations that the regulated business will not be in a tax-paying position prior to at least 2030; and
- run-off of the RCV at an average rate of 3.98% per annum.

The draft determination also provides for a risk allocation in which:

- around 16% of our Ofwat projected totex allowance, including a £1 billion allowance to improve our asset health, is to be 'gated', so that costs only pass through to customers' bills if Ofwat becomes satisfied with our expenditure plans or can be clawed back if we are unsuccessful at the gate;
- we will need to hand monies back to customers via brand new price control deliverable (PCD) adjustment mechanisms if we do not deliver investments in accordance with the schedule laid out in Ofwat's draft determination;
- we will bear between 25% and 40% of any under-spending and between 25% and 60% of any over-spending against our PR24 cost allowances;
- any aggregate under- and over-spending beyond 200 basis points of RORE will be further split 50:50 between company and customers; and

- any aggregate ODI under- and out-performance beyond 300 basis points of return on regulatory equity (RORE) will be shared 50:50 between company and customers, while RORE under- and out-performance of more than 500 bps will be shared 10:90.

Ofwat's assessment is that a notionally efficient company, with a notional 55% starting level of gearing, will be able to obtain all of the finance that it requires to deliver its obligations while operating under this framework.

1.2 Context

Ofwat's PR24 is taking place during an extremely challenging period for the water industry, and for Thames Water in particular.

Over the course of the 2020-25 regulatory period, companies have increasingly struggled to meet the 'stretch' targets that Ofwat set in its PR19 price control decision. While the sector as a whole is generally delivering a higher level performance than at any time in the past, companies have been paying growing financial penalties as a consequence of a collective failure to set regulatory performance targets at a realistic, achievable level. Companies have also faced multiple headwinds on costs, including from an input price shock and unprecedented demands from regulators and from the public for investment that was not factored into Ofwat's PR19 cost allowances. The net result is that companies are ending the current five-year period earning unsustainably low returns.

We have been one of the companies that has been most affected by the miscalibration of 2020-25 revenues and targets. In March 2024, our shareholders announced that they were not in a position to provide further funding for the business. We have subsequently been clear that we have sufficient liquidity to keep funding operations until May 2025, but that our ability to deliver the plan that we think meets the needs of our customers, our communities and the environment depends on us identifying the means of obtaining new equity investment worth more than £3 billion as the PR24 process progresses to the final determination.

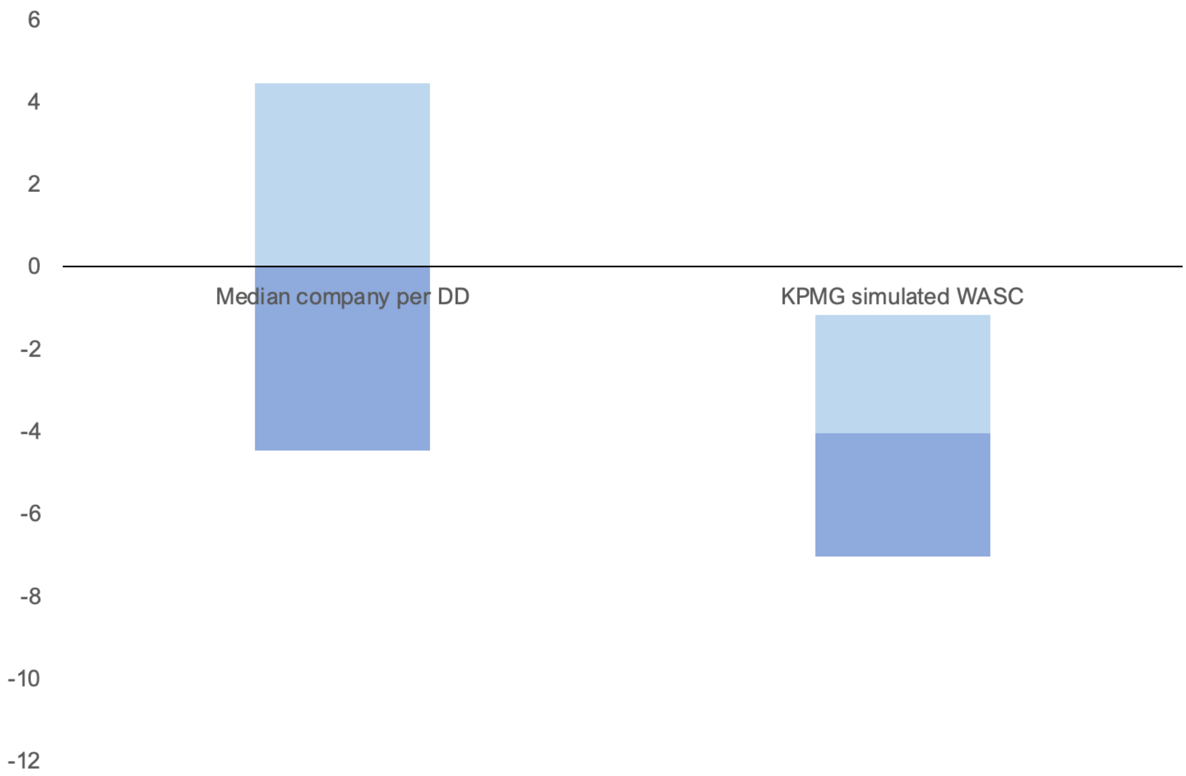
No one is forced to invest in the water industry or in Thames Water. Investors can only be expected to support our plan if they see the prospect of a sustainable return that at least matches the return that they can secure from other, alternative investments (i.e. the "cost of capital"). This requires, as a minimum, that Ofwat factors an appropriate base level of return into our price controls. But it also entails Ofwat setting cost allowances and performance targets at realistic levels, and showing investors that there is a symmetric and contained range for potential future out- and under-performance.

1.3 RORE assessment

Ofwat's draft determination does not meet these minimum requirements.

Along with a group of other water companies, we asked KPMG to provide an independent review of expected returns in the sector. Figure 1 shows that KPMG found that the average water and sewerage company is looking at a return that is more than 400 bps below the allowed return on equity. The chart also identifies potential further downside against this central-case outcome, with the lower bound of KPMG's P10:P90 confidence interval sitting approximately 300 bps below the mid-point of the distribution.

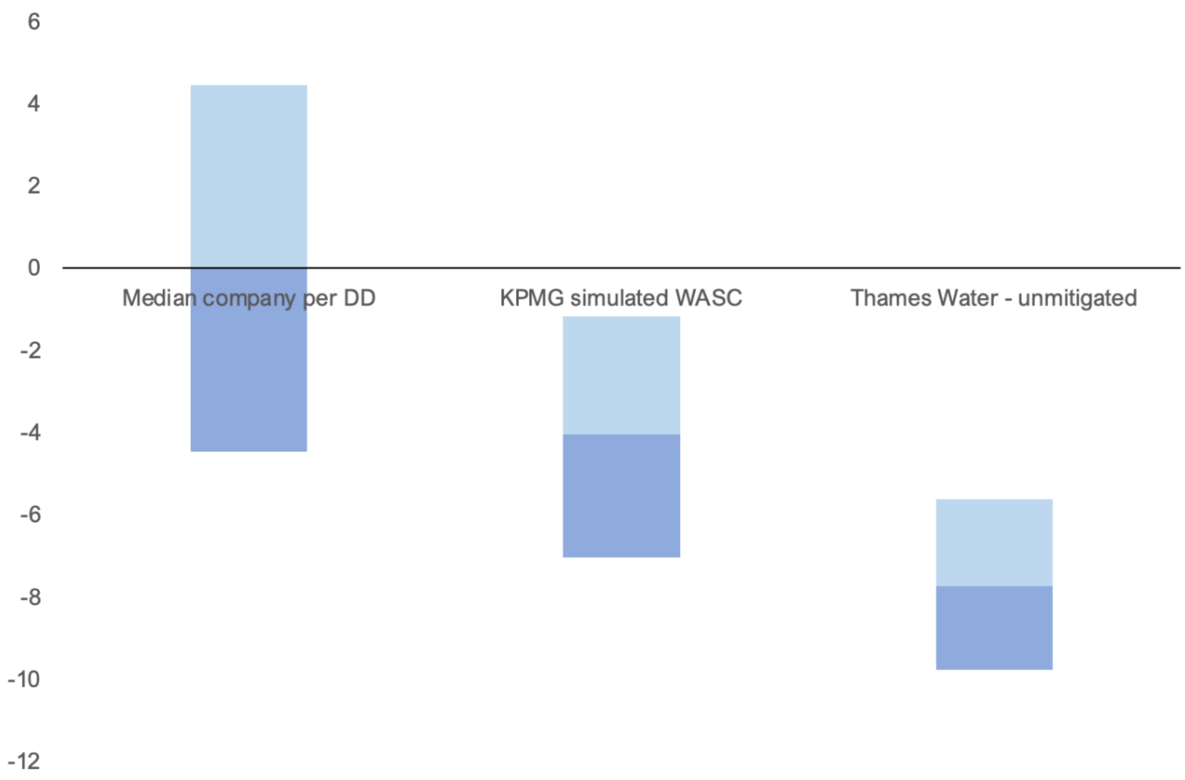
Figure 1: P10-P90 RORE ranges, %, vs allowed return on equity



A well-functioning regulatory regime would create a roughly even mix of prospective out-performers and prospective under-performers at the point when price controls are set. The distribution of expected returns set out above, however, implies that even the best performing companies in the sector will struggle to cover their cost of capital, while the weaker performers in the sector are faced with the prospect of making substantial losses.

Thames Water sits squarely in the second of these categories. Using KPMG's modelling framework, we have sought to produce a separate analysis of our business's expected returns (see Annex 1 for further details). Our RORE range is set out in figure 2 below. The chart identifies an expected under-performance against our allowed return on equity of around 775 basis points of RORE and an 80% confidence interval running from 980 basis points to 560 basis points of potential loss of return.

Figure 2: P10-P90 industry and Thames Water RORE ranges, %, vs allowed return on equity



The key drivers for our weaker outlook include:

- under-funding of our planned 2025-30 expenditure; and
- the prospect of sizeable performance penalties under Ofwat's ODI regime.

We also face a shortfall on our returns due an under-funding of the cost of debt and our 30 basis points QAA penalty.

1.4 Remedies required

It ought to be self-evident that the above picture is not going to be viewed favourably by potential equity investors. In order to be able to implement our turnaround plan, we are going need to see meaningful changes at both industry level and within our company-specific price control arrangements.

We set out in this chapter what we think those changes ought to entail.

At industry level, Ofwat needs to:

- provide additional funding in base cost allowances, especially for companies that are proposing a step up in capital maintenance activity;
- take a less demanding, and more realistic, view of the work that companies can reasonably do within base expenditure allowances, and accept the knock-on consequences this has for the required level of enhancement expenditure;

- reduce reliance on poorly specified, poorly calibrated enhancement cost models, and place more weight instead on actual commercial cost data and bottom-up engineering studies;
- increase the allowed return on RCV from 3.66% to 4.6%;
- provide for realistic glidepaths from the current industry median level of performance towards achievable end-of-period targets; and
- recognise that even the leading companies in the sector are currently looking at net ODI penalties, when a well-functioning regulatory regime would create a balanced mix of expected out-performers and expected under-performers.

For Thames Water specifically, as a company in turnaround, Ofwat also needs to contain the downside losses that potential new equity investors can suffer as a prerequisite for equity injection.

We provide further details of our proposed approach in the rest of this chapter.

2 REVENUE

2.1 Totex allowance

Ofwat's proposed totex allowance makes provision for £5.1 billion less expenditure than we identified in our business plan submission and represents £7.3bn less than our plan including the updates provided in this draft determination response.

We do not agree with Ofwat's assessment of our costs, for the reasons set out in TMS-DD-037 and TMS-DD-038. In summary, after taking account of the cost of delivering new obligations and new work that we have identified since compiling our October 2023 plan, we are seeking allowances worth £20.7 billion over five years in our core plan, with £23.7billion included gated schemes and delivery mechanism. We set out our costs in TMS-DD-036 and the accompany data tables inTMS-DD-002.

2.2 Gated allowances

Approximately £4bn of our proposed allowance is currently conditional upon us satisfying Ofwat that we will be spending money on the right things.

We recognise the merits in principle of a gated process. However, we are concerned that the ongoing dialogue that Ofwat wishes to have with multiple companies over expenditures totalling several billion pounds could inadvertently become unduly burdensome and slow down delivery. The gated approval process after PR24 needs to build on our broadly positive experiences with our gated allowances during the current regulatory period and be slick and quick so we do not unduly hold up delivery of schemes, especially schemes that are required to meet statutory requirements. The process and responsibilities of each party also need to be simple to understand from the outset, so that investors see a realistic route to funding additional investment.

We do not agree with Ofwat's proposal to provide in 2025-30 revenues only for a development cost allowance for our gated SEMD and raw water deterioration schemes worth 6% of forecast project costs, with the remaining balance of allowed costs being held over to an end-of-period RCV adjustment. We also do not agree with Ofwat's proposal that the logged up RCV adjustment should contain no allowance for the time value of money.

The first of these proposals places unnecessary strain on our cashflow at a time when we are already looking at a financing requirement of unprecedented scale. The second is arbitrarily punitive and violates the long-standing principle that companies should be reimbursed for the financing costs they incur when they use investor capital to finance investments ahead of reimbursement by future customers.

We request that Ofwat allows the 6% development cost in the final determination but applies the same in period funding principle used by the delivery mechanism. The in period adjustment, will enable us to unlock funding in the next year when it is required, which would mitigate the issues outlined above, and reduces pressure on the financing requirement.

2.3 PAYG rates

We have no substantive disagreement with Ofwat over the methodology that should be used when calibrating our PAYG rates. We agree with Ofwat that PR24 PAYG rates should reflect the mix of operating and capital expenditures within our final totex allowance and that this necessitates that the rates in Ofwat's draft determination will need be updated to reflect Ofwat's final decision on costs.

If Ofwat accepts our proposed costs, the PAYG rates would be as set out in table 1 below.

Table 1: Proposed PAYG rates

	Natural PAYG rates (2025-30 average)
Water network	37.3%
Water resources	37.5%
Wastewater network	25.7%
Bioresources	47.0%

2.4 PR14, PR19 reconciliations

We accept Ofwat's end-of-period revenue and RCV adjustments with only minor modifications. Our updated estimates of the required adjustment amounts can be found in TMS-DD-002.

2.5 RCV run-off

There is no substantive disagreement over the rate at which our RCV should run-off over the 2025-30 regulatory period.

Our proposed run-off rates, in line with our updated assessments of the 'natural' rates of run-off by price control, are set out in table 2.

Table 2: Proposed RCV run-off rates

	Proposed run-off rates
Water network	4.1%
Water resources	3.3%
Wastewater network	4.5%
Bioresources	4.9%

2.6 Allowed return

We are clear in our view that Ofwat has set the allowed return on the RCV at the wrong level.

The allowed return on equity of 4.8% real (equivalent to approximately 6.8% nominal) sits implausibly close to the prevailing cost of water company debt and, hence, cannot possibly be considered adequate reward for the cost, performance and reputational risks that investors take on when they choose to invest in water companies as shareholders.

Ofwat's allowance for the cost of debt is also out of line with the evidence from recent debt issues in the sector and needs, as a minimum, to be updated to reflect the latest information on debt costs contained within companies' 2024 Annual Performance reports.

In TMS-DD-040 we explain why Ofwat needs to provide in its final determination for an industry-level return of 4.6% per annum (in real CPIH terms).

2.7 Retail margin

We accept Ofwat's proposed retail margin of 1.2%.

2.8 Tax

We will not be in a tax-paying position prior to 2030. Our 2025-30 price controls will therefore contain zero allowance for corporation tax payments.

We note that Ofwat has signalled in its draft determination that it intends to log up a £96.15m deduction from any tax allowances that will be factored into our revenues at future reviews. The deduction relates to the value of losses surrendered by the appointed business to other group companies during the 2020-25 regulatory period.

We disagree with Ofwat's policy in this area. In previous regulatory periods, customers have benefited from the transfer of tax losses from group companies to the appointed business. In Thames Water's case, we can identify that the appointed business, which includes TWUF from PR19 onwards, obtained benefit from a total of £1,704m of tax relief transferred into the regulated business by associated companies between 2010 and 2024, while surrendering losses worth a total of £822m.

There is an inherent inconsistency in a policy that provides for customers to benefit from intra-group arrangements in some years but seeks to neutralise the same arrangements in other years when the effects of previous transfers are reversed.

We therefore request that Ofwat makes it clear in its final determination that it is not proposing to make a de facto deduction from future revenues.

2.9 Revenue profiling

Ofwat's draft determination contained an unexpected profile for bills. Specifically, Ofwat deliberately provided for revenues to sit below costs in 2025/26 so that the bill increases that PR24 requires could be implemented over two years rather in one go from 1 April 2025.

We have been extremely conscious of affordability for customers throughout the PR24 process, and continue to support customers who might be in need of help paying for their bills through a range of assistance measures. We need, however, for the under-funding that has occurred during the 2020-25 regulatory period to come to an end as soon as possible and for Ofwat to avoid unnecessary placing pressure on our financeability. Any funding gap that Ofwat imposes on us in year 1 of the new price control period will directly increase the size of the equity injection that we require and make it harder for us to restore our investment-grade credit rating. Such impediments may, in turn, slow down our investment programme, contrary to the interests of our customers.

We therefore request that the calculated step up in our revenue is implemented in full from 2025/26.

3 PERFORMANCE COMMITMENTS

Our proposed changes to our performance commitment levels are set out in TMS-DD-039. We are seeking material changes to PCLs on PCLs :

- water supply interruptions;
- external sewer flooding;
- Internal sewer flooding;
- serious pollution incidents;
- total pollution incidents;
- per capita consumption (PCC);
- leakage

4 RISK

Our broader proposals as regards the allocation of risk between company and customers are as follows.

4.1 ODI rates

Our proposed changes to Ofwat's proposed ODI rates are detailed in TMS-DD-039. We are requesting:

- an across-the-board tuning down of ODI rates to make rewards and penalties more proportionate;
- a change in the methodology for calculating the values of the C-MeX, D-MeX and BR-MeX penalties and rewards;
- specific adjustments to the PCC and external sewer flooding ODIs; and
- the introduction of caps and collars on all ODIs.

4.2 Retail price cap indexation

We welcome Ofwat's decision to provide an ex ante allowance for retail cost inflation. However, we disagree with Ofwat's decision not to provide for some form of in-period indexation. Ofwat's approach of setting a fixed price cap profile for a five-year period is an anomaly in UK regulation. The industry's experience between during the current regulatory period demonstrate clearly that there is a material underlying exposure to inflation risk and, hence, the prospect of non-trivial loss or gain in returns. This, in our view, points very clearly to the need for the kind of in-period adjustment that Ofwat and regulators apply uniformly to all other regulated businesses.

Ofwat could provide in its retail price control framework for an ex post true-up mechanism, similar to the ex post true-up for wholesale input price inflation. However, we would also be content with basic CPIH indexation, given its comparative simplicity and ease of implementation at this late stage of the price review process.

4.3 Cost sharing rates

We welcome Ofwat's introduction of cost sharing for the bioresources price control.
We are also generally supportive of Ofwat's tuning down of cost incentive rates in places where there is the greatest uncertainty around future cost projections (i.e. enhancements, large projects, IED costs and business rates).

We do not agree with Ofwat's proposal to give asymmetric sharing rates to companies that have scored badly in the PR24 quality and ambition assessment. Differentiation of the sharing of under- and out-performance is a form of financial punishment (alongside Ofwat's RORE deduction) towards companies that submit business plans which are honest and realistic. Ofwat has presented no reason to think that the incentive to spend or not spend each marginal pound of potential expenditure should differ across companies. Nor has Ofwat explained why the marginal incentive should differ depending on whether a company happens to be in a net under-spend position or a net over-spend position, possibly for reasons that are wholly outside of its control.

As such, we request a symmetrical cost sharing rate across base expenditure.

We also request that Ofwat looks again at the way it has approached business rates. Ofwat provides in its draft determination for a 10:90 sharing rate. It then uses the relatively low exposure that companies have to variations in costs to justify a very significant ex ante cut versus requested allowances across the sector. We do not object to Ofwat's sharing rate per se, but we do consider that it needs to be paired with a realistic, central view forecast of future costs. In Thames Water's case, that entails increasing our allowance by £236m. We also think that the proposed 10:90 true-up needs to be applied annually so as to mitigate the adverse effects that any inadvertent underfunding has on our cashflows and to smooth bill impacts for consumers.

4.4 Other uncertainty mechanisms

Outside of the simple cost sharing rules, Ofwat provides for:

- an expanded RPE true-up mechanism;
- a new Notified Item in the bioresources price control to deal with possible future restrictions on landbank use;
- a new delayed delivery cashflow mechanism (DDCM); and
- a storm overflow uncertainty mechanism.

We have a number of difficulties with these proposals, as set out under the headings below. We also have some additional observations about per- and polyfluroalkyl substances (PFAS).

RPE true-up mechanisms

Our comments on the RPE true-up are set out in TMS-DD-037. While we are pleased with Ofwat's decision to expand the PR19 labour-only true-up to include energy and materials costs, we think that Ofwat ought to have gone further and provided for a more comprehensive ex post adjustment mechanism. We also question some of Ofwat's choices of weights and indices.

Use of landbanks for sludge disposal

We think the landbank Notified Item has been defined too narrowly. The draft determination wording focuses on new or changed legal requirements, but the risk we face in this area relates primarily to the interpretation of existing requirements or indeed changes to what is considered to be publicly acceptable rather than brand new legislation. We propose that Ofwat implements an adjustment mechanism that would allow us to unlock additional funding for any increase in bioresources costs in the event that disposal of treated sewage sludge to agricultural land is no longer practically possible. We request that Ofwat rewords its notified item so that it covers changes in law and its interpretation, guidance, and other factors that restrict the application to agricultural land of fertiliser derived from sludge.

Changes in guidance or requirements affecting landbank availability will likely have a material impact on the business, outside the prudent control of management. There is clear evidence that London, due to its high population density, produces higher volumes of sewer sludge. In addition to this, the transport costs for Thames to dispose of its sludge are already higher than other water and sewerage companies, given the lack of proximity to the disposal areas. Should these disposal areas be further reduced in number and/or located further from London, it follows that transport costs for disposal will be even higher.

Furthermore, a reduction in suitable agricultural outlets for biosolids will not necessarily happen as a single event at the point of legal or regulatory change, rather it is likely that the market participants will react in advance. For instance, it is quite possible that farmers may not take on new contracts from water companies in anticipation. This hiatus in sludge disposal options will create associated costs independent of legal change and our ability to access funds.

Given the uncertainty surrounding the detail of any change in law, policy or practice around sludge, we have not provided for any increased costs in this Draft Determination response. However, we consider that the risk of material change during this charging period should be recognised and therefore propose the introduction of a Notified Item or similar adjustment mechanism would be appropriate. Further, we consider the 10% materiality threshold to be too high and could lead to material costs being incurred without Thames Water having the ability to recover them within period. We would therefore welcome a discussion with Ofwat about the design of any adjustment mechanism to deal with this uncertainty, including any licence modifications necessary to provide for the flexibility/bespoke lowering of thresholds for this specific item.

Delayed Delivery Cashflow Mechanism (DDCM)

We are not persuaded by the case that Ofwat has made for the introduction of its proposed DDCM. Slow delivery by a company of its capital programme will normally affect ODIs and/or PCDs. In our case, Ofwat is also putting in place an over-arching delivery mechanism with enhanced reporting and monitoring requirements. It is not therefore clear that Ofwat needs to further complicate the regulatory framework by adding yet another scheme to its toolkit. We consider that we already have a very strong incentive to deliver our programme of planned works as quickly as we can for customers and that the additional benefit that the DDCM provides is outweighed by its complexity and the negative impact it would have on our financeability.

Storm Overflows

We agree with Ofwat that there should be a route to additional funding if we identify that additional storm overflow schemes are required to meet our obligations under the Urban Waste Water Treatment Directive or the Storm Overflow Discharge Reduction Plan.

We think that the uncertainty mechanism that Ofwat proposes should be drawn more broadly. Specifically, we request that there is a clear process by which we can receive additional allowances for new requirements that have to be delivered before 2030, or a new post 2030 requirement that requires additional expenditure in AMP8, or there is an acceptance that new work will be factored into the PR29 process and does not have to be delivered until AMP9.

This would recognise that changes in our legal obligations sit outside of our control and would give our investors confidence that any additional costs that government chooses to place on the industry will ultimately flow directly through into customer bills.

Per- and polyfluoroalkyl substances (PFAS)

We note that the draft determination does not allow for the possibility that the Drinking Water Inspectorate and/or the Environment Agency could impose new requirements on PFAS. Such requirements could significantly impact our required 2025-30 expenditures. Given the uncertain and evolving nature of our PFAS-related responsibilities, we have not provided for any increase in costs in this draft determination response. We consider, however, that it would be appropriate to introduce an uncertainty mechanism, possibly in the form of Notified Item, in respect of any additional costs incurred that are reasonably attributable to any new or amended regulatory or legal requirements/guidance in relation to the assessment, monitoring and reporting, mitigation or removal of PFAS in/from water supply systems

Although we continue to engage with the DWI and stakeholders on ways to address concerns regarding PFAS and comply with our existing obligations, this is an evolving area in which knowledge of the issues and any subsequent regulation will continue to develop. We are not able to predict if or when new requirements will be implemented, although we consider it likely that the DWI (or another authority) will introduce further PFAS-related schemes in the near to long-term future (i.e. before 2030). Such schemes may require significant investment to implement, particularly if they require a more stringent monitoring/reporting regime (than that which exists currently) or requirements to take action to reduce or remove PFAS from our water supply systems.

We encourage Ofwat to work with the sector to ensure that any PFAS-related costs are appropriately reflected in its Final Determination.

4.5 PCDs

Ofwat's new PCDs are an important factor influencing the risk that companies face within their investment programmes. The requirement that companies deliver specific projects ("outputs") in the way that they said they would and according to the timetable specified in business plans constitutes a sharp about-turn from the framework that Ofwat used in PR14 and PR19, when the focus of regulation was on delivering outcomes for customers irrespective of the method of spending.

We set out in TMS-DD-044 how we think Ofwat's proposed PCDs could be improved by:

- removing PCDs from all schemes where we have statutory obligations;
- Improving the specification of certain of our PCDs;
- matching PCD dates more closely to our planned profiles of activity; and
- reducing the size of delay penalties.

4.6 Aggregate sharing mechanisms

Ofwat's PR24 incentives for performance and costs culminate with two aggregate out- and under-performance sharing mechanisms. There is an aggregate sharing mechanism for costs through which under- and over-spending beyond a RORE threshold of +/- 200 bps will be shared 50:50. This will operate alongside a separate aggregate sharing mechanism for ODI payments through which out- and under-performance in excess of 300 bps of RORE will similarly be shared 50:50 between companies and customers (or 10:90 beyond a RORE threshold of +/- 500 bps)

We accept the logic of Ofwat's proposals in this area. But we do not think they go far enough. The principle behind the aggregate sharing mechanism should be that companies and customers alike have a degree of protection against extreme downside and upside risks. In our view, this requires that the protections should kick in well before a company either loses the entirety of its RORE (on the downside) or approaches double-digit RORE (on the upside).

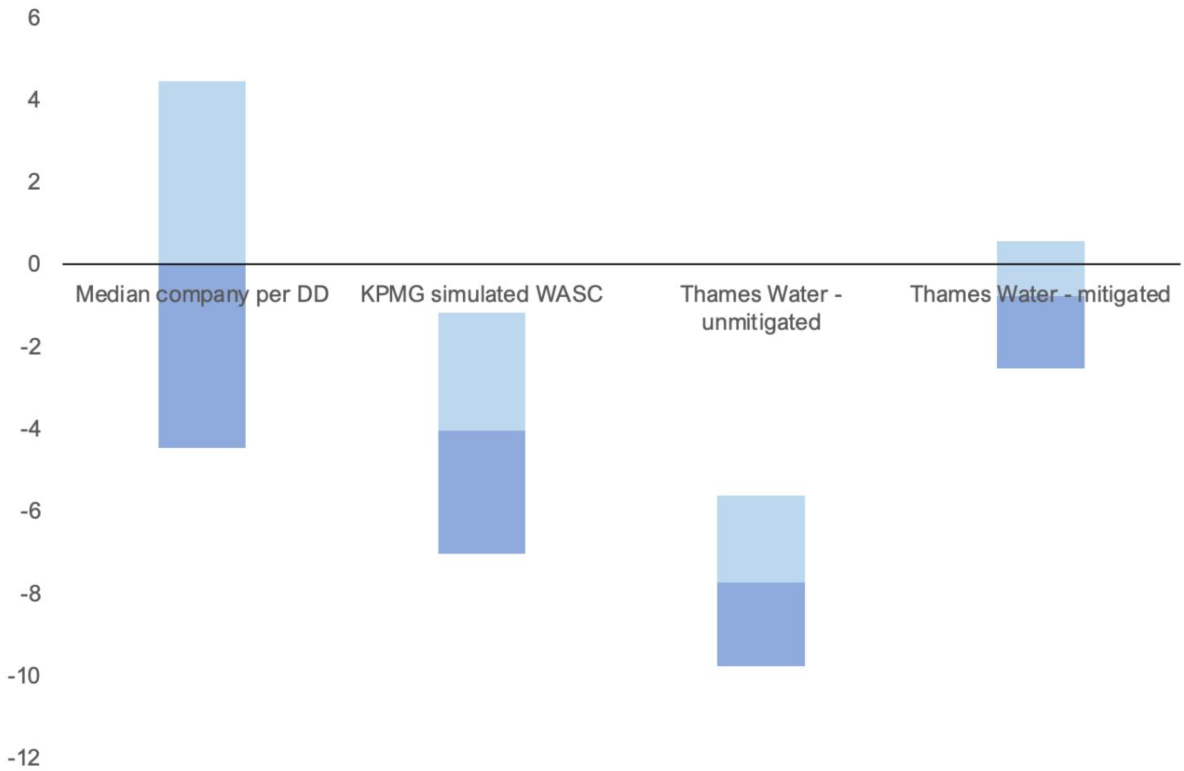
Ofwat's proposed calibrations do not have this quality. The creation of separate 300 bps and 200 bps corridors for performance and costs amount to a potential 500 bps of exposure for investors before sharing kicks in (NB: not including financing under- and out-performance). This means that an operational under-performer/over-spender could lose more than the 4.80% return factored upfront into its price controls. Conversely, an operational over-performer/under-spender could add a total of 5 percentage points to its RORE, more than doubling returns.

We propose that Ofwat should provide in its final determination for greater containment of upside and downside risk in which sharing of out- and under-performance begins much earlier. We set out further thoughts on calibration in section 6 below.

5 MITIGATED RORE RANGE

Our assessment of the potential RORE range that emerges after applying all of the above proposed adjustments to revenues, performance commitments and risk allocation is set out in figure 3 below.

Figure 3: P10-P90 industry and Thames Water RORE ranges



Compared to the first and the second columns in the chart, the mitigated RORE range in the fourth column centres much closer to zero, shows a symmetrical balance between possible under- and out-performance, and more clearly contains potential upsides and downsides within more manageable bounds.

The expected level of return for investors is, however, still some way below the allowed cost of capital. And there remains a downside skew. This stems from our relatively poor starting level of performance going onto the 2025-30 period and the inherent asymmetry that there is some of the risks that we face.

Ofwat's unspoken view appears to be that potential equity investors will be willing to inject new capital into our business even in the face of RORE under-performance and asymmetry in risk. The implicit assumption must be that the consequences of future shortfalls in profits can be transferred in full to existing investors to bear, without affecting the marginal returns to new equity investment.

This is not an assumption that Ofwat has been able to justify with market soundings or other evidence. It therefore constitutes a major leap of faith on Ofwat's part. For the avoidance of doubt, the consequences of Ofwat getting this wrong are likely to be very severe in that not, in fact, having the ability to secure the required equity investment will leave us unable to finance our business plan. In our case, this will require us to constrain our enhancement programme significantly, putting at risk our ability to comply with future statutory obligations.

As such, we think that it is necessary for Ofwat to provide for a further adjustment to risk allocation for companies that fall into Ofwat's new "turnaround regime".

We describe these bespoke arrangements in section 6.

6 TURNAROUND REGIME

In its draft determination Ofwat seeks to establish a “turnaround oversight regime” for companies which present Ofwat with “significant concerns about their performance in-the-round". As currently described, this new regime would focus primarily on additional monitoring and reporting, and additional supervision by Ofwat.

We accept the need for enhanced oversight, and we set out in TMS-DD-036 our thinking on how the new monitoring arrangements can best work. But we also consider that our current financial position, and the paramount criticality of our efforts to attract new equity capital, requires Ofwat to make more fundamental changes to our regulatory regime on a temporary basis (i.e. until such time as we are able to stabilise our finances and demonstrate to stakeholders that we have made progress on our operational performance).

We therefore propose that there should be a more far-reaching, more comprehensive “turnaround regime”.

A key feature of this regime would be that there should be a tuning down of the losses and rewards that new investors face as a result of both over-/under-spending and ODI penalties/ rewards. Our specific suggestions in this regard have four parts.

- First, we think that it is wrong that Ofwat requires companies that are in turnaround to meet Ofwat’s view of efficient base expenditure from day 1 of the new price control. We consider that it is more appropriate to allow such companies the time that they need to make the changes that are needed within their businesses to meet revealed regulatory benchmarks. We therefore think that it would be preferable for Ofwat to provide in its turnaround regime for a glidepath over a five-year period. This glidepath would start from a company’s projected year 1 costs and reach the estimated efficient level of expenditure only at year 5;

- Second, there are places in the draft determination where Ofwat proposes to disallow enhancement spend for schemes in our plan that Ofwat considers are not yet fully justified, full developed or adequately costed. Rather than reject this planned expenditure outright and provide us with no route to funding until PR29, it would be better for Ofwat to put the schemes into its gated process so that we can continue our dialogue with Ofwat beyond the timelines of PR24.

- Third, while operating under Ofwat’s enhanced supervision, we think that the thresholds on Ofwat’s two new aggregate sharing mechanisms should be set at +/- 100 basis points each, and that the enhanced sharing rate beyond that the thresholds should be set at 20:80 for company and customers respectively.

  We envisage that the necessary sharing would be applied on an annual basis, and we would like to discuss with Ofwat whether it might be feasible to implement any required true-ups to our ODIs within period. This would mean that the sharing mechanism would contain the impact that under-/out-performance can have on our cashflows, as well as our RORE.

- Finally, in addition to the above changes, we think that there should be opportunity to revisit our PR24 price controls in a more fundamental way if it is clear that we are encountering significant financial distress. We would like to discuss with Ofwat how this would work in practice, but we envisage a process in which we would have the ability to trigger an interim review, setting out why we consider we are in significant financial distress, and Ofwat would, should it agree, be able to issue an interim determination which would be appealable to the CMA. We would welcome the opportunity to discuss the wording and mechanics of such a reopener with Ofwat.

We recognise that these proposals constitute a major change to the regulatory regime that we operate under. But we think they follow naturally from Ofwat's recognition that we need to be regulated in a non-standard way while in turnaround mode. In particular, the enhanced monitoring, reporting and supervision that we will be subject to means that conventional financial incentives can be given less weight than is the case in normal times (but still produce clear financial consequences for our decision-making at the margin). This, in turn, creates room to present new investors with less uncertainty than they would otherwise be the case, supporting our efforts to raise new equity and debt.

For the avoidance of doubt, the turnaround regime – in its entirety – would remain in place for as long as is necessary to accelerate the step change that we want to make in our operational performance. Once the turnaround regime is successfully wound down, we would switch back to the standard industry sharing schemes.

7 FINANCEABILITY

In the limited time that we have had to prepare our response to Ofwat's draft determination, we have only been to undertake a high-level assessment of the financeability of our business plan and accompanying regulatory framework.

We observe first of all that Ofwat's draft determination is not financeable on a notional basis. The notional company exhibits an extremely weak financial profile, as set out in table 3 below, due to Ofwat's miscalibration of cost allowances and performance targets. Both of the key debt metrics that Ofwat refers to will be well below the thresholds that Ofwat has targeted in its draft determination. And the imbalance between risk and reward, more generally, makes it very difficult to see why either debt investors or equity investors would elect to make new capital available to the notional firm.

Table 3: Notional financeability

	Costs / performance	Equity injection	Assumed dividend yield	Average AICR	Average FFO/net debt
Ofwat DD	As per DD	£941.6m	2%	1.69x	9.6%
Our assessment	As per our plan	£941.6m	2%	0.38x	2.8%

Note: the ratios in the first row of the table are taken from Ofwat's published financial model (including delivery mechanism totex).

We then assess the financeability of the plan that we are putting forward in this response.

We note, before doing so, that we disagree with a number of the steps in Ofwat's financeability testing, for the reasons set out in Annex 2. In particular, we disagree with the way in which Ofwat provides for reductions in dividends and equity injections to seamlessly and effortlessly 'fix' problematic debt metrics without even a basic check on what might be called 'equity financeability' or the 'investability' of Ofwat's PR24 from the point of view of shareholders.

Our assessment of notional financeability therefore proceeds in two distinct parts.

We first recognise that the industry's forthcoming programme of investment will require both new debt finance and new equity finance We quantify what the mix of financing for the notional company will need to be and we check that the notional company's credit metrics would remain compatible with a Baa1/BBB+ rating.

We note that there is some uncertainty at the time of writing about where the limit on the notional company's ability to borrow will be. In a recent sector ratings note[1], Moody's indicated that it may respond to Ofwat's draft determination, as it did in 2018, by downgrading its assessment of the regulatory environment and tightening its guideline credit metrics. We assume for the time being that Ofwat will take the steps that are needed to persuade Moody's and the other rating agencies that such action is not justified, and therefore we continue to test

[1] "Ofwat's Draft Determination increases sector risk" published 14 August 2024

against current threshold values. However, it may be necessary to alter this assessment at some point in the future.

Based on current rating agency guidance, the notional company, with a 55% starting gearing, operating under our proposed regulatory framework, would face a constraint on its ability to borrow in year 2 of the five-year period and would need to raise just under £4 billion of equity in order to stabilise its credit metrics. The results of our financial modelling are shown in table 4 below. The average AICR is 1.75x and the average FFO/net debt is 9.8%, broadly in line with Ofwat's draft determination modelling. Both these metrics are compatible with the targeted rating.

Table 4: Notional financeability

	Costs / performance	Equity injection	Assumed dividend yield	Average AICR	Average FFO/net debt
Ofwat DD	As per DD	£941.6m	2%	1.70x	9.6%
Our assessment	As per our plan	£3,981.7m	4%	1.75x	9.8%

The second stage in the testing of financeability must entail assessing whether there can be a reasonable degree of assurance that the notional firm will be able to raise the required amount of equity capital.

The report that Water UK commissioned from Oxera identifies that multiple factors will play into equity investors' assessment of the sector's investibility. This makes it difficult to collapse the 'equity financeability' test into a single metric. However, we consider that the attributes that our proposed amendments to the regulatory framework have, including:

- the overall balance and containment of risk;
- the provision of a return that is in line with the cost of capital; and
- the inclusion in our modelling of a 4% dividend yield,

provide a reasonable degree of confidence that the required equity will be forthcoming.

As a consequence, we consider that the financial profile shown in table 5 above is one which will enable notional company to finance its activities.

8 THAMES WATER ACTUAL FINANCEABILITY/INVESTIBILITY

Thames Water is clearly in a different position from the notional company. As at 31 March 2024, our debt-to-RCV ratio was 80.6%, forecast to rise to 86.6% next March, both significantly above Ofwat's notional gearing of 55%. And as a result of the financial challenges that we have faced since PR19, we are almost certainty going to be in a position at the end of PR24 where there will be a need to raise equity not just to finance new investment, but also to fund some degree of expected ongoing financial under-performance (see section 5).

Ofwat's statutory duties include the duty to protect the interest of customers and the duty to secure that appointees are able to finance their functions. These duties require Ofwat to consider how our real-world financing challenges are going to play out and, in particular, to assess whether its final determination gives the real-life Thames Water a genuine chance of securing the new equity capital.

In parallel with our work to understand Ofwat's draft determination, we have been developing our company business plan, setting out our best analysis of what we should do between year 5 of AMP7 and the end of AMP8 (this is known as our 2025 Integrated Business Plan, or 'IBP25'). Our IBP25 includes some areas of activity not covered by Ofwat's PR24 price control, for example in relation to our non-appointed business or where we accept that customers already funded work in AMP7. But most of our IBP25 covers areas relevant for PR24.

Our latest best estimates of some of our planned areas of activity have increased beyond the levels we set in our October 2023 business plan and the update we provided to Ofwat in April 2024. Where our cost estimates have changed, we have included them in this draft determination response, we have explained why, and been clear that Ofwat should consider them as further updates to our plan.

In contrast to Ofwat's assessment of company financeability, which focuses solely on a hypothetical notionally geared and efficient company, we have conducted a real-world analysis of the financeability/investibility of our AMP8 business plan using our IBP25 numbers (AMP8-IBP25). We have considered the financeability/investibility or our 'core' plan, but, we have also considered the financeability/investibility of our full plan, which would see the £3 billion spend that sits within uncertainty mechanisms such as the 'delivery mechanism' and the 'large-gated scheme mechanism' fully unlocked. This is important as it enables us to assure the financeability of a fully compliant AMP8 plan.

We have considered the financeability of AMP8-IBP25 using Ofwat's draft determination and also on the basis of a final determination in which Ofwat has listened to our representations and implemented them in full. We have also considered the financeability of AMP8-IBP25 on the basis that we should achieve financial resilience, as measured by credit ratings consistent with Baa2/BBB+ and gearing of no more than 80% by the end of AMP8. Having regard to Ofwat's provisional decision on our interim dividend payment, we have assumed no dividend yield before 2030.

Our analysis has been conducted using by the expert judgement of our advisers in relation to market capacity and on the conditions new equity would be looking for in order to invest in

Thames Water; this judgement being calibrated on the basis of market knowledge and recent relevant transactions.

This analysis shows that AMP8-IBP25 is not financeable on the basis of Ofwat's draft determinations. Thames Water would not be an investible proposition on the basis of AMP8-IBP25 and Ofwat's draft determination and would not be able to attract the equity needed to finance the plan.

The analysis shows that our fully compliant plan would be financeable on the basis of an Ofwat final determination that included the changes we seek in this draft determination response, including a WACC of 4.6%. On the basis of such a determination, the analysis suggests we could raise £3.3 billion of new equity in the market, and deliver reasonable total market returns over a reasonable holding period.

We have set out in TMS-DD-040 our arguments in favour of a sector-wide WACC of 4.6%, in particular taking account of recent relevant data points in the market. However, as a sensitivity we looked at whether our AMP8-IBP25 plan was financeable on the basis of a 4.25% WACC, which was in line with the sector-wide WACC we suggested would be appropriate in our October 2023 PR24 submission. Other things being equal, with this WACC only our core plan would be financeable; the spend included in gated processes, which includes much statutory compliance driven spend, would not be financeable as we would not be able to raise sufficient equity on this basis.

Our board is therefore able to assure the financeability of our fully compliant plan only on the basis of a final determination that incorporates the representations set out in this document, including a WACC of 4.6%.

It is important to note that this conclusion is sensitive to some external factors. We have assumed in our analysis that our credit ratings and the approach of the credit ratings agencies remain unchanged. It is possible that ratings agency activity could increase the amount of equity we need, pushing down returns and compromising our ability to attract equity on the basis we have set out above.

We have also assumed that Ofwat does not implement any further regulation of gearing. To the extent that Ofwat does introduce further regulation, for example to cap gearing, this would also increase the amount of equity we need, pushing down returns and compromising our ability to attract equity on the basis we have set out above.

It is clearly also possible that Ofwat does not implement all the changes we have sought in this draft determination response, and this would also materially impact investibility and therefore the financeability of our plan.

9 FINANCIAL RESILIENCE

We share Ofwat's view that any recapitalisation of the company during the next few months must put the business back on a sound and stable financial footing. We gave formal undertakings to Ofwat setting out the steps that we intend to take to restore compliance with Condition P26 of our licence. These undertakings form the core of our financial resilience plan.

We have stress-tested the financial resilience of our target actual capital structure using the various downsides stipulated by Ofwat in Appendix 10 of the Final Methodology for PR24

Ofwat downside 1: totex increase

Ofwat downside 2: ODI increase

Ofwat downside 3: 2% inflation increase

Ofwat downside 4: initial deflation then recovery

Ofwat downside 5: high inflation

Ofwat downside 6: increase in bad debt

Ofwat downside 7: cost of debt increase

Ofwat downside 8: higher penalties

In the first instance, we may be able to absorb the financial impact of downside shocks by borrowing more money than our plan currently provides for. We assess our capacity to borrow by examining whether the actual company can maintain a […] rating for Class A debt and a […] rating assigned to the Moody's Corporate Family Rating ("CFR"). In particular, this requires that we stay within the thresholds below:

Moody's AICR: >1.3x for CFR

S&P's FFO/Net debt: >6% for Class A debt

In some cases, our capacity to absorb financial shocks through additional borrowing may become exhausted and we may have to take other mitigating actions. These are not assumed but would include: interventions to manage cashflows and/or interest costs; iDOKs; and, in extremis, further equity injections.

The results of our stress testing of the base case modelling are summarised in tables below. They do not note any breach of specified thresholds and indicate a high level of financial resilience for our plan.

Totex underperformance (10% of totex) over 5 years

	2025-26	2026-27	2027-28	2028-29	2029-30
Gearing	72.82%	75.76%	78.34%	80.19%	81.89%
Interest cover	2.54	2.40	2.62	2.00	1.78
Adjusted cash interest cover	1.64	1.42	1.60	1.32	1.25
FFO/net debt	7.13%	7.18%	7.34%	6.13%	5.93%
Class A PMICR	2.07	2.00	1.50	1.50	1.46

ODI underperformance payment (3% RoRE) in one year

	2025-26	2026-27	2027-28	2028-29	2029-30
Gearing	71.48%	72.74%	74.65%	75.26%	75.45%
Interest cover	2.81	2.57	2.43	2.40	2.20
Adjusted cash interest cover	1.88	1.63	1.38	1.60	1.53
FFO/net debt	8.17%	8.20%	6.99%	7.51%	7.50%
Class A PMICR	2.11	2.27	1.37	1.75	1.84

Inflation 2% below the base case in the business plan in each year of the price review

	2025-26	2026-27	2027-28	2028-29	2029-30
Gearing	72.26%	74.03%	75.68%	76.63%	77.52%
Interest cover	2.78	2.55	2.92	2.31	2.08
Adjusted cash interest cover	1.90	1.66	1.91	1.59	1.50
FFO/net debt	8.81%	9.09%	9.42%	8.31%	8.11%
Class A PMICR	2.05	2.22	1.80	1.80	1.73

Deflation of -1% for 2 years, followed by a return to the long term inflation target

	2025-26	2026-27	2027-28	2028-29	2029-30
Gearing	72.82%	75.76%	78.34%	80.19%	81.89%
Interest cover	2.54	2.40	2.62	2.00	1.78
Adjusted cash interest cover	1.64	1.42	1.60	1.32	1.25
FFO/net debt	7.13%	7.18%	7.34%	6.13%	5.93%
Class A PMICR	2.07	2.00	1.50	1.50	1.46

10% spike in inflation with a 2% increase in wedge between RPI and CPIH, followed by two years at 5% and a 1% increase in wedge.

	2025-26	2026-27	2027-28	2028-29	2029-30
Gearing	69.28%	71.29%	72.21%	73.15%	73.44%
Interest cover	2.92	2.56	2.89	2.49	2.32
Adjusted cash interest cover	1.73	1.51	1.73	1.62	1.59
FFO/net debt	4.75%	5.04%	6.38%	7.11%	7.78%
Class A PMICR	2.33	2.34	1.95	1.97	1.92

Increase in the level of bad debt (20%) over current bad debt levels.

	2025-26	2026-27	2027-28	2028-29	2029-30
Gearing	71.48%	72.79%	74.29%	75.00%	75.19%
Interest cover	2.81	2.37	2.74	2.40	2.22
Adjusted cash interest cover	1.88	1.44	1.68	1.60	1.54
FFO/net debt	8.17%	7.56%	7.98%	7.53%	7.54%
Class A PMICR	2.11	2.24	1.61	1.72	1.85

Debt refinanced as it matures, with new debt financed at 2% above the forward projections.

	2025-26	2026-27	2027-28	2028-29	2029-30
Gearing	71.48%	73.06%	74.57%	75.77%	77.11%
Interest cover	2.81	2.15	2.26	1.54	1.24

Adjusted cash interest cover	1.88	1.45	1.56	1.21	1.09
FFO/net debt	8.17%	7.73%	7.92%	6.31%	5.79%
Class A PMICR	2.11	2.13	1.65	1.47	1.31

Financial penalty – equivalent to 6% of one year of Appointee turnover

	2025-26	2026-27	2027-28	2028-29	2029-30
Gearing	71.62%	73.83%	74.82%	75.13%	75.32%
Interest cover	2.32	2.57	2.94	2.40	2.21
Adjusted cash interest cover	1.44	1.63	1.86	1.60	1.54
FFO/net debt	6.50%	8.08%	8.51%	7.52%	7.52%
Class A PMICR	2.04	1.74	1.87	1.90	1.84

10 FINANCIAL RESILIENCE: ADDITIONAL PROTECTIONS

Ofwat indicates in the draft determination that it is considering licence modifications and/or other measures which would restrict a company from paying dividends if its gearing exceeds 70%. This comes on the back of a separate set of financial resilience licence modifications that came into effect in 2023.

Meeting Ofwat's proposed new threshold would require us to increase the amount of equity that we obtain from new investors. In the alternative, we would have to be clear with incoming investors that they could not expect to receive dividends in the near and medium term. We think that both of these steps would be disproportionate in the current circumstances that we face. Our priority right now is to obtain capital to support our programme of investment, and we see a danger that Ofwat's interventions will make an already difficult challenge that much harder.

We have said in our responses to previous consultation exercises that we do not think that financial resilience, or lack thereof, can be assessed by looking at one specific financial measure. Our view is that Ofwat needs to look instead holistically at a wide range of factors, including the structural features built into a firm's borrowing arrangements, liquidity, the support provided by equity investors, the quality of risk management and risk mitigation measures, and the quality of company management. We made these points to Ofwat in the past when its attention was focused on credit rating as a supposedly one-stop measure of resilience. We make the same points again now that Ofwat is switching its attention to gearing level.

We would expect Ofwat to consult fully before moving forward with any of the ideas that it outlines. Pending such consultation, we request that Ofwat takes proper account of the effect that any additional restrictions on gearing and/or dividends will have on our investibility, and factors our unique circumstances into its further thinking in this area.

11 EQUITY LISTING

We do not have any specific comments on Ofwat's proposal to provide cost allowances to companies that seek a stock market listing. We would be concerned, however, if Ofwat is signalling with its proposals that has a preference for a particular ownership structure and/or that it will regulate listed and unlisted companies in different ways in the future.

Ofwat has previously assessed that concentrating ownership in the hands of a small number of engaged equity investors can have advantages in terms of accountability, governance and investor understanding relative to a structure in which shareholdings are spread across a more diverse investor base. Ofwat should give such benefits at least as much weight as the factors that it identifies in its draft determination.

12 DIVIDEND POLICY

In the Company's Annual Performance Report 2022/23, the Board noted that modifications to paragraph 30 of Condition P of its instrument of appointment ('Condition P30') came into effect on 17 May 2023. It is standard practice for the Thames Water Board to review all key polices, including the Company's dividend policy, on a regular basis. The Board stated that, although it was of the view that the Company's dividend policy already had regard to the modified Condition P30 requirements, it would review the wording of the dividend policy during the course of 2023/24 to ensure alignment.

Consistent with that commitment, the Board reviewed the Company's dividend policy ahead of publishing its 2024 Annual Report and Accounts ("ARA") and Annual Performance Report ("APR"). The Board and the Audit, Risk and Reporting Committee (a sub-committee of the Board) maintained its belief that the Company's previous dividend policy had full regard to Ofwat's requirements, but considered that a small number of minor amendments would be beneficial to further clarify alignment with Ofwat's licence modifications and the accompanying guidance (IN 23/04). The Company's updated dividend policy, which was approved at a meeting of the Board on 12 June 2024 and has effect from that date, is set out in our APR.

We received a provisional decision from Ofwat finding on us in breach of our licence in respect of the board's decision to an interim dividend in October last year. We have made strong representations on this and await Ofwat's final decision. Ofwat has also asked for information in relation to our payment of a second interim dividend in March and we are yet to hear from Ofwat how it is thinking about this.

Notwithstanding that the Company is now in 'cash lock-up' following recent ratings actions (and therefore cannot declare or pay dividends without Ofwat's prior consent) the Board will continue to keep its dividend policy under review as we move into, and through AMP8. As part of any future dividend policy review, the Board will need to consider the outcome of steps that are currently underway to raise substantial equity investment into the business. Whilst the Board does not anticipate that any external distributions to shareholders will be made during the period to 2030, we do anticipate that equity providers will expect to see a pathway in the medium term to earn a reasonable rate of return of any investment that may be forthcoming.

13 EXECUTIVE PAY

Context of Performance-Related Executive Pay at Thames Water

Our remuneration framework is designed to offer an appropriate mix of fixed and performance related pay which, as a total remuneration package, attracts, retains and motivates talented senior leaders to deliver great outcomes for our customers, shareholders and other stakeholders. At the same time, the total remuneration package is designed to offer a balance between incentivising appropriate risk-taking with careful stewardship. Our total remuneration package means that a significant portion of the maximum opportunity for any Executive Director is at risk if key performance targets are not met. The design of the remuneration package means that the majority of the total remuneration opportunity is dependent upon performance and delivered over a short- to medium-term horizon.

Thames Water employs two Executive Directors, the Chief Executive Officer and the Chief Financial Officer. They are subject to the Company's Executive Directors' Remuneration Policy. This was provided to Ofwat as part of our APR submission in July 2024.

In 2023 we actively engaged with Ofwat in discussing our approach to Performance-Related Executive Pay. Not only is the sector as a whole under intense scrutiny over executive remuneration, we understand the extreme focus placed on Thames Water given ongoing performance concerns. We are firmly of the view we need to reflect the needs of all our customers, regulators, stakeholders and colleagues in our approach to variable pay, and as such launched a new incentive programme for the financial year 2024, the Performance-Related Pay Plan (PRPP).

Performance-Related Pay Plan

The main aims of the Performance-Related Pay Plan are to:

- align with our key remuneration principles (as set out in our Directors' Remuneration Policy)
- support retention and motivation
- create and maintain a clear and demonstrable link between pay and performance
- be neutral to AMP boundaries
- balance customer, environment and financial resilience KPIs
- align with shareholder value creation over the longer-term.

The measures included in the PRPP are directly relevant to our customers, stakeholders, shareholders and colleagues and are categorised as:

- Customer (worth 35%)
- Environment (worth 35%)
- Financial Resilience (worth 30%).

As can be seen from the above, 70% of the PRPP is aligned to customer and environmental outcomes.

Targets against each measure are set so that PRPP appropriately rewards:

- Delivery against the Business Plan
- Delivery against the Turnaround Plan
- Year-on-year performance improvement

- Progress towards Ofwat's performance expectations.

We understand Ofwat's expectations that companies will set stretching targets when designing any performance-related pay plan. Through the 2023 consultation process Ofwat recognised each company would need to consider what is stretching in the context of their own company and the metrics being used. For Thames Water, we believe it is critical our measures and targets support the delivery of our turnaround plan and are clearly linked to the approved business plan. It is through that plan that sustainable performance improvement will be delivered for our customers and the environment. Whilst we recognise that Thames Water's performance continues to fall short of the expectations of our Board, Executive Teams, customers and stakeholders, our turnaround plan is starting to yield positive results driven by management effort and enterprise. For example, in 2023/24 our water quality CRI outturn improved markedly after investment at key sites including Hampton and Coppermills, and leakage (whilst falling short of our regulatory target) is now at its lowest ever level. As we accelerate delivery of our Turnaround Plan it is essential that we can continue to motivate, incentivise and retain a senior team capable of delivering both our stretching turnaround plan and our AMP8 plans. In order to do this, we need to be able to reward improvements having regard to our overall rate of change.

As such, the PRPP is designed to enable the Company to recognise and reward performance which colleagues can directly contribute to and influence, with the Remuneration Committee retaining final discretion to ensure any out-turn reflects the Company's performance in the round.

The PRPP comprises two elements: an in-year award opportunity (the 'base award') designed to reflect colleagues' contribution to short term delivery – including the delivery of our in year turnaround plan targets; and a deferred award opportunity, the value of which is linked to the extent to which that contribution results in improved performance outcomes longer-term.

The deferred element of the PRPP has purposefully been aligned to our three-year Turnaround Plan so that its rewards colleagues for sustained performance improvement plans required to meet our customers' and stakeholders' expectations. At the end of the two-year deferral period, the Remuneration Committee will assess performance against the following key turnaround plan outcomes:

- Pollutions
- Leakage
- Water Quality
- Customer Complaints
- Bad Debt.

In addition, the Remuneration Committee will assess the overall health and safety performance of the company 'in the round' based on a recommendation from the Health and Safety Committee. The Remuneration Committee believes this is the most appropriate way to reflect performance in a complex area rather than a simple Long-Term Injury Frequency rate or other such arbitrary measure

The out-turn of the deferred award can be increased or decreased (between 0.75x and 1.25x) dependent on performance. The Remuneration Committee retains absolute discretion to determine the final payment.

The Executive Directors' can be awarded a maximum of 240% of base pay if all measures within the PRPP exceed target. This was reduced from a maximum of 320% in the previous scheme.

Malus and Clawback

Malus and clawback clauses are included within our Directors' Remuneration Policy and the PRPP Plan rules. These have been rigorously tested with external legal advisors so that they are enforceable. The Remuneration Committee can instigate the withholding of a future award or the repayment of a previous award, in part or in full, and against both the short-term (in-year) and mid-term (deferred) awards. The Remuneration Committee has previously instigated this clause (in 2021).

Remuneration Committee discretion

In deciding whether any PRPP payment should be made, the Committee takes into consideration a range of important perspectives including (but not limited to):

- performance against the PRPP measure scorecard
- performance against specific outcomes, including in-year outcomes and year-on-year improvements
- performance against regulatory performance commitments, and
- the need to reward delivery of, and attract and retain highly talented colleagues to execute, a complex and challenging turnaround plan that is critical to our ability to deliver for customers, communities and the environment.

The Committee's final decision-making is also underpinned by the need to meet Ofwat's requirement that variable pay reflects performance in the round.

By taking this approach, the Remuneration Committee seeks to ensure it does not simply take the formulaic outcome of the PRPP in determining the award of any Executive Director variable pay. As an example, for the performance year 2023/24, the Committee made the decision to exercise downward discretion against the outcome of the PRPP, reducing the out-turn of the PRPP by 10 percentage points. In making this decision, the Committee gave particular consideration to the fact that, whilst the Environmental measures in the PRPP scorecard were all at or above target, this did not translate through to outcomes, specifically the increased number of pollutions events and the static performance against category 1 and 2 pollutions.

Remuneration Governance

Whilst we are not a listed company, we voluntarily abide by the 2018 UK Corporate Governance Code and make full disclosures on all remuneration matters in our Directors' Remuneration Report which is published within our Annual Report and Accounts. We will also abide by the 2024 UK Corporate Governance Code once that comes into effect in January 2025.

In line with Ofwat's Board leadership, transparency and governance principles, Thames Water is and continues to be transparent in reporting of different aspects of executive pay. Each year we publish a Directors' Remuneration Report, which provides an explanation of the company's executive pay policy and how the criteria for awarding short and long-term performance related elements are substantially linked to stretching delivery for customers and the environment.

We were also pleased to note that in its assessment of how performance related pay awarded to water company executives during 2022/23 was aligned to delivery for customers and the environment, and to overall company performance, Thames Water was one of four companies (out of 16) called out for achieving or exceeding 80% alignment with Ofwat's expectations regarding how both annual and long-term pay incentives are substantially linked to stretching delivery for customers and the environment.

Alignment with the Broader Workforce

The Remuneration Committee is conscious of the criticality of aligning executive performance-related pay to the performance-related pay arrangements that are in place across Thames Water. This is core to securing engagement, fairness and transparency of reward. The executive directors of Thames Water are held to account for the same bonus measures as the leadership population (c. 800 colleagues), the only difference being that 100% of their bonus is based on company performance with no individual performance element.

Annex 1: Risk Modelling

Purpose

The modelling that we reference in the main body of this document has helped us to understand:

- our expected level of return under Ofwat's draft determination;
- the extent of our exposures to further upside and downside movement from this starting level of return; and
- the overall balance of risk that there is in Ofwat's proposals.

Inputs and assumptions

Along with a group of other companies, we asked KPMG to develop the basic modelling capability that would enable us to produce this analysis. We also asked KPMG to provide us with estimates of RORE ranges for the average company in the sector.

The key assumptions that KPMG makes in its work are detailed in TMS-DD-051.

KPMG's input assumptions differ from Ofwat's modelling of risk in several important respects.

- Ofwat's modelling of risk in relies on sector PR14 performance data as a proxy for PR24 risk exposure. KPMG's risk modelling uses sector PR19 performance data.
- Ofwat considers totex risk as a single block. KPMG separates base and enhancement costs for risk analysis.
- Ofwat focuses on variation in retail costs to estimate risk in the retail price control. KPMG considers retail net profit risk.
- Ofwat calculates C-MeX risk on the maximum and minimum penalty possible with P50 set to nil. KPMG simulates C-MeX risk based on reweighted historical scores.
- Ofwat puts each P50 ODI setting at no out- or under-performance and uses historical data to calibrate the P10 and P90. KPMG for the most part simulates each ODI based on a baseline of average AMP7 performance multiplied by business plan forecasts by PCL and using historical data to calibrate the P10 and P90.
- Ofwat considers inflation and new debt risk under its financing risk category. KPMG considers, inflation, new debt and embedded debt risk under its financing risk category.

Modelling of Thames Water's RORE ranges

We have used KPMG's modelling framework when analysing our company-specific risks and expected return.

Our company-specific analysis adds the following company-specific inputs:

- we anchor the analysis of RORE to the Thames Water RCV and Thames Water's regulatory equity;
- we provide for forecasts of future expenditure, future financing costs and future performance in line with the projections in our business plan;

- we factor in our company-specific cost sharing rates, ODIs and PCDs.

We continue to use KPMG's underlying sector-wide risk/probability distributions – i.e. we do not provide for a bespoke, company-specific level of potential year-to-year variation in costs or performance around our central case forecasts.

Initial results

Our simulated estimates of central case ("P50") returns are shown in the table overleaf. The table also identifies the lower bound ("P10") and upper bound ("P90") of an 80% confidence interval around this central case.

Table A1: Unmitigated RORE ranges

	P10	P50	P90
Totex	-4.78%	-2.38%	-0.71%
Retail	-2.18%	-0.62%	0.46%
DPC	-0.06%	0.00%	0.00%
ODIs and MeX	-7.61%	-4.72%	-3.08%
Financing	-1.80%	-0.34%	0.87%
Revenue	-0.05%	-0.03%	0.00%
QAA penalty	-0.30%	-0.30%	-0.30%
Mitigations (ASM)	3.07%	1.18%	0.00%
Total	-9.77%	-7.74%	-5.62%

The P50 estimate of expected returns is lower than KPMG's P50 estimate for the average water and sewerage company. This principally reflects:

- an expected overspend against Ofwat's proposed totex and retail cost allowances;
- expected under-performance against Ofwat's performance targets;
- our position that Ofwat's allowed return will under-remunerate both the cost of the industry's embedded debt and the cost of new debt.

Our P10 and P90 estimates are also positioned lower than KPMG's bounds for the same reasons. However, our P10-P90 confidence interval is narrower than KPMG's range. This reflects our expectation that our over-spending and under-performance will push us beyond the thresholds for Ofwat's aggregate sharing mechanisms and activate Ofwat's enhanced sharing rates. The aggregate sharing mechanisms also drive the modest skew that there is in the shape of the confidence interval.

Mitigations

We identify in sections 2-6 of this document a series of remedies for what is otherwise going to be an unfinanceable and investible draft determination.

After factoring all of these mitigations into the model, the RORE ranges are as set out in table A2.

Table A2: Mitigated RORE ranges

	P10	P50	P90
Totex	-1.31%	-0.40%	0.43%
Retail	-0.69%	0.00%	0.34%
DPC	-0.06%	0.00%	0.00%
ODIs and MeX	-1.36%	-0.45%	0.20%
Financing	-0.81%	0.00%	0.75%
Revenue	-0.05%	-0.03%	0.00%
Total	-2.54%	-0.78%	0.56%

A comparison of tables A1 and A2 shows that our proposed corrections to Ofwat’s draft determination eliminate expected retail and financing under-performance. There remains under-performance against our proposed totex allowances and proposed performance targets worth the equivalent of 78 bps of RORE

The P10-P90 confidence interval is narrower than KPMG’s range for the average water and sewerage company. This reflects our proposals for lower ODI rates, ODI caps and collars, and more expansive ex post true-up mechanisms for RPEs, business rates and retail cost inflation.

The P10-P90 confidence interval also identifies that there is slightly more downside than upside risk. This is due to the asymmetry that we see in penalty-only ODIs and our PCDs, as well as the basic asymmetry in KPMG’s view of sector-wide cost risk.

Annex 2: Financeability

Ofwat's PR24 approach to assessing financeability is much more simplistic than both the approach it has taken in previous reviews and the approach taken by other regulators, including by the CMA in its PR19 decision:

- Ofwat first assumes that all companies in the sector will spend exactly in line with Ofwat's totex allowances and perform exactly in line with Ofwat's performance commitments;
- Ofwat then models the financial ratios that a notionally efficient company will exhibit if it starts the 2025-30 regulatory period with a notional debt-to-RCV ratio of 55%;
- if Ofwat observes that interest cover and other debt metrics are likely to move beyond the thresholds that rating agencies have identified companies are required to maintain as part of a Baa1/BBB+ credit rating, Ofwat assumes company ratios can be improved by constraining dividends to an annual yield of 2%. If rating metrics are still too weak at this point, Ofwat assumes that shareholders inject new equity into balance sheets in whatever amount is required to bring ratios to an acceptable level.

In our opinion, all of the steps in this analytical framework are problematic and cause Ofwat to fall well short of a proper, rounded assessment of companies' ability to finance their activities.

We showed first of all in section 7 that the draft determination leaves all companies in the sector looking at likely overspends and ODI penalties. We considered the impact of this expected downside on our key financial ratios in table 4 above. We therefore do not consider that Ofwat's draft determination begins from an accurate characterisation of the notional company's financial position.

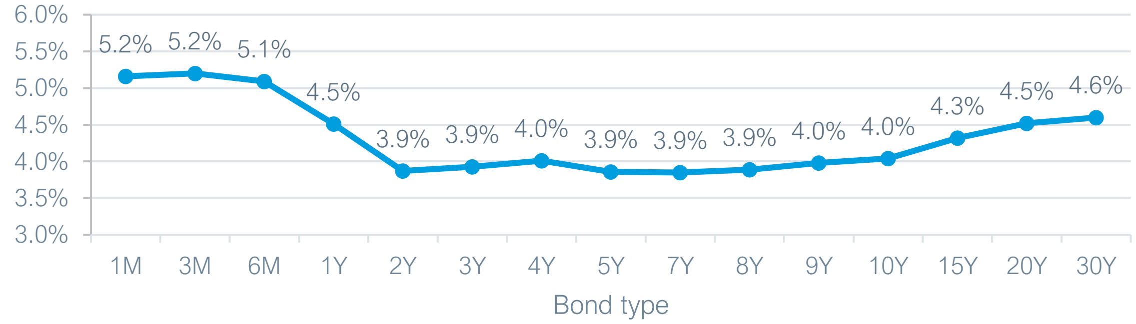
Ofwat's notional starting gearing of 55% is in any case a hypothetical level of gearing that no real-life shareholder-owned water and sewerage company has currently. Ofwat has not explained why it is entitled to use an artificially low debt-to-RCV ratio in its modelling or how a notional company could have costlessly reduced gearing by 5 percentage points from Ofwat's PR19 60% gearing assumption. Ofwat's arguments to the contrary in the draft determination risk & return appendix are unconvincing, in that Ofwat focuses on a number of recent positives for actual industry gearing ratios (e.g. inflation) but ignores completely the upward pressures that have come from over-spending and miscalibrated performance targets. As evidence of this, we note that the real-life shareholder-owned water and sewerage companies that started the 2020-25 regulatory period with gearing close to Ofwat's assumed 60% debt-to-RCV ratio have all seen gearing increase in the last four years.

The 2% dividend yield constraint is contrived and harms the attractiveness of our industry to investors that are seeking regular income from a low-risk utility business. Investors entering the water sector do so with a long-term investment horizon. In AMP8, they will be doing so in an increasingly competitive international context, during a time of macroeconomic uncertainty and increasing operational risk, and when most of the sector is failing to earn its base return. If we fail to attract investor support, the detrimental impact on customers and the environment will be very significant.

Ofwat's choice of a 2% dividend yield is not only not backed by robust evidence, but also puts investment into our business at significant risk:

- By setting an annual dividend yield close to inflation, the real cash return received each year will be zero. While our shareholders have historically supported our business by taking no dividends out of it (including for the last 7 years), maintaining this position while securing investment for our business into the future is not credible.
- A 2% dividend yield is significantly below benchmarks – including all short- and long-term bond yields (see figure below). It is also significantly below both the current bank rate (5%), Bank of England market implied path bank rate (3.2% by 2026[2]) and average of HM Treasury independent forecasts (3.23% by 2028[3]).

Figure 2: Short- and long-term bond yields



Source: Financial Times Markets Data as of 29th July 2024

A 2% dividend yield equates to a 29.4% payout ratio, based on Ofwat's draft determination allowance for the return on equity, which is significantly lower than comparators.By way of comparison the dividend yield of the FTSE-100 is currently 3.5%.[4]

By far the biggest concern with Ofwat's financeability assessment, however, is the assumption that equity providers will always step in to provide however much new equity capital Ofwat's modelling says is needed to stabilise credit metrics. For the avoidance of doubt, we do not object to the notion that equity will have a part to play in financing the industry's upcoming programme. But, at the same time, equity cannot be treated as a 'magic wand' fix that will solve any and every financial challenge that a company can ever be facing. Any financeability assessment needs to be 'in-the-round' and take account of all risks and understand where those risks will materialise financially.

The key thing that is missing from the draft determination, therefore, is an assessment of whether new equity investment can realistically be factored into the PR24 financing mix and on what terms. We call this kind of assessment an 'equity financeability' or 'investability' test. Such a test ought to consider, as a minimum:

- the risk that shareholders are being asked to bear;
- the base level of return on offer;
- the expected internal rate of return (IRR);

[2] Bank of England (2024). *Monetary Policy Report – February 2024.* Available here.
[3] HM Treasury (2024). *Forecasts for the UK economy: a comparison of independent forecasts.* Available here.
[4] Source: FactSet. Simple average of FTSE-100 company dividend yield, as at 16 August 2024.

- the extent to which this return translates into actual cash dividend payments during the 2025-30 regulatory period;
- the conditionality attached to these dividend payments;
- the possible need for repeat injections, including in the 2030-35 and subsequent regulatory periods; and
- any and all other factors that will weigh in investors' minds as they contemplate whether or not to put money into the water industry in preference to investment opportunities elsewhere.

Our assessment is that had Ofwat properly tested investibility prior to issuing its draft determination it would have identified that significant obstacles to new equity raises across the industry as a whole. These obstacles include: an imbalance in risk and return; an IRR that sits below the allowed return;[5] the basic unattractiveness of a 2% dividend yield; the uncertainty that Ofwat's rules for dividends insert into investors' minds as to whether dividends will ever actually be paid; and Ofwat's sudden and unexpected warning that companies with gearing in excess of 70% will be prohibited from making distributions, despite having complied will all regulatory obligations up until this point.

Ofwat needs to correct for the absence of a formal 'equity financeability test' prior to constructing its final determination. There needs to be a dedicated section in the final determination that lays out the deal that equity investors are being offered and justifies why investors will positively choose to accept Ofwat's terms. There should also be external assurance of Ofwat's views, so that the assessment of sector 'investibility' is grounded in real-world market testing rather than regulatory assertion.

[5] The lower IRR during the 2020-25 regulatory period is a consequence of: a change in modelled working capital requirements; and expected CPIH inflation of less than 2% per annum over five years.

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