1. REGULATORY UPDATE

This briefing note covers the financial issues raised within the Ofwat Aide Memoire to Customer Challenge Group (CCGs), along with the NWL responses. It does not address any of the issues raised in the Ofwat April consultation “Putting the Sector in Balance”.

All of the NWL responses will be included in our business plan, so this paper is for information for the CCG to use in their report to Ofwat.

2. OFWAT FINANCIAL ISSUES AND NWL RESPONSES

2.1 Background – the Ofwat Aide Memoire in relation to financial issues

https://www.ofwat.gov.uk/publication/aide-memoire-customer-challenge-groups/

Ofwat description of the Aide Memoire: In this note we provide CCGs with an “aide memoire” of the following information:

1. The role of CCGs at the 2019 price review (PR19) as explained in the May 2016 Customer Engagement Policy Statement and Expectations for PR19 (the “Customer Engagement Policy Statement”);
2. How we will take account of CCG independent assurance reports at the 2019 Price Review (PR19); and
3. The sections of Delivering Water 2020: Our final methodology for the 2019 price review (the “Final Methodology”) that are most relevant to CCGs.

2.2 Financial items covered in Aide Memoire Annex 1 – subject areas from 8b to 13

Extracts from Ofwat’s Aide Memoire Annex 1 are shown in italics
8b. Corporate and financial structures (Customer evidence needed)

We have introduced a new IAP test to require assurance from company Boards that their business plan will enable customers’ trust and confidence through high levels of transparency and engagement with customers on issues such as its corporate and financial structures.

NWL Evidence

NWL has involved customers in designing and creating ‘Our Finances Explained’, a report that sets out:

- What the money from customer bills delivers.
- What our capex plan includes.
- Minimising the impact on customer bills.
- Borrowings and interest.
- Tax.
- Shareholder dividends and returns.
- Company Ownership Structure.

https://www.nwl.co.uk/your-home/our-finances-explained.aspx

Customers told us that these were the areas they wanted to see explained, in plain English and with visual representation.

Our report has been shared widely with customers.

10. Securing cost efficiency - need for investment (CCGs to comment and customer evidence needed)

In relation to cost adjustment claims: Where appropriate, is there evidence – assured by the customer challenge group (CCG) – that customers support the project?

Best option for customers:

- *Does the proposal deliver outcomes that reflect customers' priorities, identified through customer engagement? Is there CCG assurance that the Company has engaged with customers on the project and this engagement been taken account of?*
- *Is there persuasive evidence that the proposed solution represents the best value for customers in the long-term, including evidence from customer engagement?*

NWL Evidence

NWL has not made any cost adjustment claims in its May submission. The models Ofwat published are for base modelled totex and exclude enhancements. As such, NWL has not needed to submit the discretionary enhancement schemes as cost adjustments.

We have addressed the customer engagement requirements in full for all discretionary enhancement schemes, and this has been fully shared with the CCG.

11. Financeability (Customer evidence needed)

We will look for evidence of customer support where companies take steps to address financeability constraints.

NWL Evidence

NWL has not made any changes to customer bills to address financeability constraints. Our financial ratios remain within investment grade limits, even after applying the stress tests set out by Ofwat.

12. Bill profiles (Customer evidence needed)

Companies should take into account customers' views on the profile of bills over time, which will enable companies to understand customers' implicit views on the impact of their PAYG and RCV Run-Off choices on bills, both in the short and long-term.

We acknowledge feedback from respondents to the consultation and we do not expect companies to directly ask their customers about their PAYG and RCV Run-Off rates.

NWL Evidence

Both our PAYG rate and run-off rates have been set using the natural rates. They apply a fair balance between current and future customers, using the same approach as for PR14 and in a way that does not defer or advance costs such as depreciation.

We have not altered our PAYG or Run-Off Rates to address financeability constraints.

Finally, we intend to make a significant price reduction in year one of the five year period, with smoothed bills from years two to five. The significant year one reductions are important as they represent returning to customers the efficiencies made over 2015-20. From that point onwards, we have smoothed the bills as customers have told us they prefer smoothed bills over volatile ones, see Appendix 1 attached.

We have carried out the smoothing in a net present value neutral way, so there is no gain to the Company or customers.

13. Accounting for past delivery (Customer evidence needed)

When testing how well the Company has provided evidence for its proposed reconciliations for the 2015-20 period and how well it has followed the PR14 reconciliation rulebook methodology ….we would expect to see…. evidence of customers' support, and the strength of that support, for its proposed adjustments to the 2020-25 price controls.

NWL Evidence

All our PR14 reconciliation adjustments are in-line with the PR14 reconciliation rulebook. We have used the Ofwat models for the calculations and have assured our projections to the end of 2020.

We have made an adjustment for a share of the profits for a major long-term water trading contract we made in 2015. We have followed the Ofwat guidance and model on this in full. We have demonstrated how the benefits of the trade have been shared with customers.

The incentive for this contract is included in price limits in 2020/21. It is fully off-set by reductions due to the inclusion of the trading income in the price control and the one-off reduction in the revenue allowance in 2020/21 for totex efficiency. Indeed, we have proposed it as a one-off adjustment for precisely this reason, to ensure minimum bill volatility. The incentive is a one-off adjustment in 2020/21, so bills from 2021/22 onwards are unaffected.

We have carried out customer research which confirmed that customers, on average supported a 50:50 sharing mechanism for gains and losses. This matches the Ofwat methodology, so confirms customer support for our approach. See Appendix 2 attached.

**CERI JONES
Assets & Assurance Director**

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