Representations: Executive Summary

Document Reference: J001

This document contains a summary of UUW’s representation on the draft determinations of the slow track and significant scrutiny water companies, and provides signposting to our representation documents.

United Utilities Water Limited

Draft determinations of the slow track and significant scrutiny water companies

We welcome the opportunity to respond to Ofwat's draft determinations, published on 18 July 2019. Whilst these determinations did not include a determination for United Utilities Water (UUW), there are many new issues arising (such as Ofwat's updated WACC assessment, revisions to its cost assessment models, and changes to company performance targets and incentive rates), which also invite comments from fast track companies.

We note that Ofwat's publications have addressed some of the comments made in response to our fast track draft determination. But many others are outstanding, and relate to company specific issues one would not expect to have been raised within the slow track DDs. Therefore, **these representations should be considered in conjunction with our fast track DD responses**. We have sought, were possible, to recognise where Ofwat has resolved issues raised out our fast track DD response.

Outcomes (Document J002)

- We note the positive move to apply an improved performance glidepath for supply interruptions. We consider, as set out in our fast track DD response, that an improved glidepath should be allowed for internal sewer flooding, particularly in recognition of the challenge to UU of delivering such dramatic improvements from historic levels.
- We are concerned about further ratcheting up of performance expectations and changes to incentive rates, resulting in a further stretch in expected performance penalties of c.0.2% of RoRE over AMP7, giving rise to a RoRE range for ODIs of -2.9% to +0.6%. We note that this is in addition to Ofwat's reduction in the WACC and question whether this provides the right balance of risk and return in AMP7.
- Some of the changes to incentive rates result from reviewing again our customer research and making company-specific judgements. We do not consider that these changes are supported by our customer research, nor are they consistent with fast-track status.
- Some of the changes to performance targets for asset health measures are not deliverable without a substantially increased investment programme, which would be incompatible with affordability objectives. In particular, we consider that our proposed mains repair target is already lower than the level which Ofwat defines as good, and therefore should be accepted. In addition, the sewer collapse target needs to be adjusted to reflect our revised estimates, which were changed following clarification of the common definition for the measure.
- We also raise concerns over C-MeX, supported by evidence from Frontier Economics, regarding the proposed design of the measure. In particular there is a need to double the sample size and to discontinue the use of the Net Promoter Score, which will improve confidence in the result.
- We note that issues raised in our response to the fast track DDs (fast track DD response document D002) remain outstanding, including our representation on the following outcomes: Systems Thinking, Keeping our reservoirs resilient, Treatment works compliance, Enhancing natural capital for customers, and Recycling biosolids.

Cost assessment (document J003)

- Special cost factors:
    - We note that Ofwat has now accepted (at least in part) reservoir claims for Dwr Cymru and Hafren Dyfrdwy, and we also note that these claims are almost identical in substance to our reservoir claim (also see fast track DD response D003b).
    - We also expect Ofwat to take account of our Diversions cost adjustment claim (from our fast track DD response document D003d), in recognition that its implicit cost assessment for gross diversions costs is insufficient to account for our projected level of diversions activity
    - We also expect Ofwat to reconsider the updated evidence we put forward on our Drainage and M&PR claims set out in response to our fast track DD (documents D003a and D003c respectively).
- Income Offset – we welcome Ofwat's revised proposed approach, in recognition of this issue.
- Diversions:
    - We welcome Ofwat's recognition that contributions from NRSWA and HS2 related diversions should be dealt with outside of the revenue control.
    - However, that alone does not address our primary concern with diversions as raised in our fast track DD response, which is that Ofwat's assessed (implicit) cost for diversions was significantly less that the assumed income provided by the company. We raised a new cost adjustment factor (document D003d), which we expect that Ofwat will still need to consider for the Final Determination.
- Base cost assessment for Bioresources - we do not believe that applying a separate catch-up efficiency challenge or radically changing the modelling approach is appropriate nor required. Instead, Ofwat should adjust the percentage of Wholesale Wastewater expenditure allocated to Bioresources based on each company forecast, consistent with its approach to Water Resources
- Enhancement costs – we welcome Ofwat's change in approach, to include opex within enhancement assessments, which means that the lead model now appears to recognise costs relating to UUW's lead programme.
- Frontier shift – we welcome Ofwat's recognition of a lower net frontier shift, resulting from an assumed relative price effect of wage inflation. We do not support Ofwat's consideration of applying an *ex post* adjustment based on observed manufacturing wages – the impending impact of Brexit is unclear, and there is a risk of a material disconnect in future between trends in wage inflation manufacturing and the water sector.
- WINEP cost adjustment mechanism – we better understand Ofwat's approach to one or two sided cost adjustment mechanisms. We have identified one specific instance where we have a reasonable expectation that a significant (£78.3m of totex) scheme that is currently "red" will become "green" when EA's confirms requirements in, which is after Ofwat's publication of Final Determinations. We propose that a two way mechanism is in place for this scheme alone, in recognition of its likely change in status. We have also suggested a number of additional customer protections to support the acceptability of this proposal. This is set out in document J003a.

- Retail cost assessment - we note that Ofwat's revised models result in a reduction in cost assessment for UUW of £37m, which seems an unduly large change. We propose that Ofwat should revert to its previous approach of using nominal average bills when modelling future retail costs.
- Additionally we set out our analysis of a number of model errors and discrepancies which we have identified in the wholesale cost assessment models used by Ofwat and which are capable of correction prior to final determination.

Risk & Return (document J004)

- We note the reduction in WACC from 2.4% to 2.19% (RPI stripped, appointee level), which compares with 3.75% at PR14 and 5.1% at PR09.
- We disagree with the approach of using latest market data to inform a WACC that would be even lower, given the current significant amount of political and economic uncertainty, including the uncertainty on Brexit and re-nationalisation risk - predominantly in the water sector - but also in reaction to more risky global dynamics with rising US-China trade tensions and concerns over a global economic slowdown. This has resulted in a flight to "safe-haven" assets such as gold, and resulted in relatively large moves in rates and other metrics over a short period of time. There is no reason to expect that this will persist over the next five years or so, as such recent movements in the short term do not imply a fundamental change in the underlying economics.
- We have tested the impact of Ofwat's July WACC on the credit rating of the notional company using our fast track Draft Determination (with appropriate adjustments to dividend yield in line with resulting changes to the assumed cost of equity):
    - Our business plan and our fast track draft determination (based on 2.4% WACC RPI-stripped) would imply ratings of Baa1 / BBB+ for the notional company.
    - The WACC assumed in the July DD's (2.19% RPI-stripped) would imply ratings of Baa2 / BBB for the notional company
    - Ofwat's indication of an even lower WACC based on latest market data (1.83% RPI-stripped) would imply ratings of Baa3 / BBB for the notional company
- The financeability of the actual company (and actual ratings) depends on many assumptions that Ofwat may make at the Final Determination – not just its assumption for the WACC. However, as not all necessary information has been made available to us (for example, a populated financial model), we are unable to reliably estimate the amount of overall revenue that the draft determinations now imply UUW could expect to be allowed during AMP7, nor the likely level of revenue in prospective final determination. This uncertainty significantly restricts our ability to come to any view about the adequacy or otherwise of the revenue allowance and it is the overall revenue outcome that determines financeability and financial resilience for the actual company.
- If the final determination assumes, in addition to Ofwat's proposed slow track DD WACC:
    - Recognition of our representations on cost assessment (including cost adjustment claims);
    - Recognition of our representation on PAYG and "fast cash" advancement, including our proposals (in our fast track DD response) to accelerate transition of CPIH, by advancing RCV run-off;

    - Higher resultant revenue allowances, such that customer bill levels (overall level and profile) are consistent with our September 2018 business plan; and
    - Amelioration of our more significant ex post revenue risks, in particular to further reduce the detrimental impact of Ofwat's proposed internal sewer flooding ODI;

  then the board is likely to judge that the final determination will enable the company to be financeable and financially resilient on both an actual and notional company basis.

- However, given that we cannot predict Ofwat's judgement on the various issues set out above (and detailed in our representations), it is impossible at this stage to arrive at any definitive conclusion regarding the financeability of Ofwat's proposed change to the WACC as it affects the actual company.
- We believe that there is now a more pressing need for Ofwat to accept our proposal for greater CPIH transition. In our fast track DD response we set out that it would be both feasible and desirable (given further bill reductions), and that moving towards full CPIH transition was also supported by customers. In light of the ongoing uncertainty in UUW's final allowed revenues in AMP7, and Ofwat's proposed reduction in the WACC, it is now evident that there is an additional need for our CPIH transition proposal to be accepted in order to ensure the financeability and financial resilience of the final determination.

Past delivery (document J005)

- We are concerned that Ofwat's revised SIM methodology is out of line with the clear expectations of the majority of companies, as demonstrated in their business plan submissions and that this could have broader consequences for the degree of confidence that companies have in the application of future incentive mechanisms. We propose that Ofwat either reverts to the previously established basis for calculating SIM incentives or otherwise removes outliers which tend to distort the overall outcome for other companies.
- Separately, we provide feedback on the treatment of indexation for residential retail outcome delivery incentives and in particular propose that Ofwat recognises that in the specific case of UU's Customer Experience Programme ODI the Ofwat "Revenue Adjustment" model incorrectly applies RPI inflation to ODI penalties.

Delivering customer value in large projects (document J006)

- We welcome the ongoing support and engagement with Ofwat on the development of our direct procurement for the Manchester & Pennines Resilience project.
- We highlight the need to work constructively to ensure that there is further clarity on timetables, approval gateways, licence amendments and formalisation of existing draft guidance in order to continue to make satisfactory progress on DPC activity.
- We set out that it is essential that at the final determination the Board has confidence that the risks the project is targeting will be adequately accommodated and addressed in the PR19 final determination, that this remains the case regardless of the means of financing and procurement and that, in the event that a DPC project is ultimately delivered in house that the company is able to efficiently and effectively finance the project.

- In this context we do not support Ofwat's proposal to include the scheme as a notified item in the event of "DPC-exit", which would result in the interim determination (IDoK) process being used to amend the company's cost assessment and instead propose alternative mechanisms which are more closely aligned to the WINEP uncertainty mechanism embedded in draft determinations.
- We also reiterate the risk that IFRS16 could have for the application of the DPC procurement mechanism and suggest that this should be separately identified and acknowledged by Ofwat.

Strategic regional water resource solutions (document J007)

- We are very concerned by Ofwat's draft determinations in this area:
    - Ofwat has only allowed half of company specific costs, and then disallowed cost sharing of cost over-runs. This is more punitive than making no assumption at all, and expecting the company to entirely fund this investment as an additional (unrecognised) overspend, and relying on general totex cost sharing rules.
    - Ofwat has shared the company specific costs of UUW and Severn Trent between the two companies, despite these costs being entirely company specific, and also giving rise to competition concerns. Given that UUW's costs were higher than those of Severn Trent, Ofwat has (in effect) allowed Severn Trent to make RCV additions in respect of UUW specific investments. This approach is unacceptable.
- This adds up to a highly punitive delivery proposition for UUW, which (in our assessment) carries a significant level of delivery risk and uses an unacceptable approach to cost sharing of company specific investments with other parties. Ofwat's overall approach to this strategic supply does not feel conducive to securing company support for such schemes in future.

Regulating Developer services (Document J008)

- We have provided a completed version of Ofwat's requested data table and provided supporting commentary.
- We support Ofwat's changes in respect of the treatment of the income-offset, and to its revised assumptions for the developer services incentive mechanism.
- As also set out in out representations on cost assessment, for Diversions:
    - We support Ofwat's proposal that contributions from NRSWA and HS2 related diversions should be dealt with outside of the revenue control, and accept the related licence change.
    - However, that alone does not address our primary concern with diversions raised in our DD response, which is that Ofwat assessment (implicit) cost for diversions was significantly less that the assumed income provided by the company – we raised a new special cost factor (in our fast track DD response document D003d), which we expect that Ofwat will still need to consider for the Final Determination.