Representations: Past delivery & SIM

Document Reference: D005

This document contains our representations on the application of SIM and of our customer experience outcome delivery incentive. We will be updating and resubmitting our PR14 reconciliation tables and models in July 2019.

The document also provides feedback and recommendations on the proposed PR19 reconciliation models for revenue forecasting and bioresources forecasting accuracy.

United Utilities Water Limited

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1. AMP6 SIM reconciliation

Concerning reconciliation of the Service Incentive Mechanism (SIM), in the United Utilities Draft Determination document, Ofwat states that:

"*We will publish the reconciliation for all companies alongside draft determinations for slow-track and significant scrutiny companies in July*."[1]

Ofwat also states it is publishing models for each of the PR14 reconciliations, and for the overall RCV and revenue adjustments on their website. However, Ofwat has not at this stage provided a model for calculating the SIM reconciliation.

Given that the reconciliations and supporting model will be released in July, we are unable to make specific comments on Ofwat's proposed SIM reconciliation as part of Draft Determination representations and will **therefore comment when Ofwat publishes its reconciliation for all companies in July 2019**. We expect Ofwat will consider carefully any comments we do make at that time.

The methodology for reconciling AMP6 Service Incentive Mechanism performance should, nevertheless, be clear. SIM is a continuation of the incentive first introduced in AMP5. At PR14 a methodology for reconciling SIM rewards and penalties was established and subsequent to this Ofwat has published a number of changes to the method of calculating individual company SIM scores. However, no changes to calculation of final SIM rewards/penalties has been published and therefore Ofwat has not signalled any change in policy on calculating SIM reward/penalties since PR14.

We have been using the methodology established at PR14 over the last four years to help understand the scale of SIM reward and penalty. The incentives under SIM has been one of the key factors in driving management focus on improving customer service in AMP6. A review of other water companies' September business plan submissions shows that all water companies have applied a near identical understanding of the reward/penalty methodology[2].

At PR14 the SIM reconciliation approach used for a company with a SIM score which is above industry average, but less than one full standard deviation above average is:

$$SIM\ reward = \frac{(\bar{x}_{Company} - \bar{x}_{Ind})}{\sigma_{Ind}} \cdot Household\ retail\ revenue \cdot 6\%$$

Where:

$\bar{x}_{Company}$ = annual average combined SIM score for the company

$\bar{x}_{Ind}$ = annual average combined SIM score for the industry

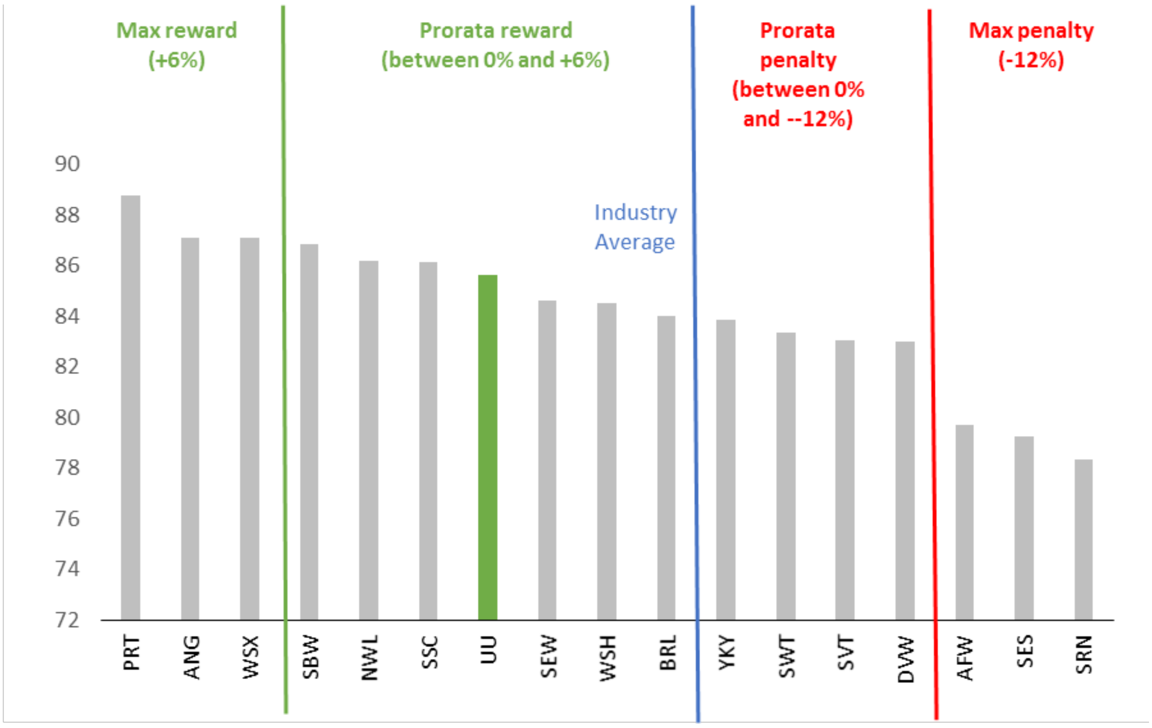
σ_{Ind} = standard deviation associated with $\bar{x}_{Ind}$

[1] United Utilities Draft Determination, Section 4.3
[2] We reviewed all companies' table R10 submissions, including forecast revenue adjustments reported on line 9.

Household retail revenue = revised household retail allowed revenues for 2019/20 * 5

We used this methodology in forecasting UU reward/penalty reconciliation values included in our AMP6 Reconciliation Early Submission in July 2018, and in our PR19 Business Plan submission in September 2018.

Figure 1: Estimated 4 year average SIM performance by company and associated reward/penalty categories



For our early submission we developed an assessment of SIM performance for the first four years of AMP6 for both ourselves and other companies and have based our proposed reward on our understanding of the established SIM methodology, first used as part of PR14 SIM reconciliations. In particular we have:

- Calculated our actual performance using the component parts of both the quantitative and qualitative (rounded) elements of the SIM utilising actual and forecast performance.
- Utilised 3 years of actual information as reported in APR table 3D of the Annual Performance Report for other companies' actual performance.
- Estimated 2018-19 performance for other companies based on past performance trends.
- Maintained Bournemouth Water as a separate entity for the purposes of calculating industry average SIM performance.
- Calculated the resulting SIM scores as being the average of all four years for each company, deriving the industry average SIM score and standard deviation in the process.
- Calculated UU's performance relative to the average SIM score and then ranked all companies according to their standard deviation from the average.
- Applied penalty and reward deadbands alongside caps and collars (consistent with the approach adopted at PR14), with deadbands set at ±0.2 standard deviation and the cap/collar set at ±1.0 standard deviation
- Scaled rewards and penalties for companies that lie between the average and cap/collar on a pro rata basis.

- Used a maximum reward rate of 6% and a maximum penalty rate 12% of Residential Retail revenues.
- Used forecast UU Residential Retail revenues for 2019/20 to scale rewards.

In our PR19 Business Plan submission we forecast that UU's four year average SIM score would be 85.17, the industry average would be 84.03, with a standard deviation of 3.19. This generates a £11m reward (2017/18 FYA) for United Utilities.

We have updated our latest forecasts using latest information on UU and industry average performance. We now anticipate that UU's reward under SIM will be c.£16m, following our best ever SIM score in 2018/19.

We will update our assessment as part of our July 2019 submission on 2018/19 performance.

In summary, we propose that Ofwat:

- **Recognise that we may comment on proposed SIM reconciliation models when released in July.**
- **Continue to apply the methodology first established at PR14 for calculating the rewards and penalties due to companies under SIM.**

2. ODI: R-A2 Customer Experience Programme

As part of the UU Draft Determination Ofwat applied intervention "UUW.PD.A2a", which acted to increase the penalty applied through "R-A2 Customer Experience Programme ODI" from £3.709m to £4.738m in 2012/13 prices.

We agree with Ofwat's assessment that UU should return £4.738m to customers via the Customer Experience Programme ODI. However we believe that the Revenue Adjustments model is incorrectly applying RPI inflation to the penalty value of retail measures. Therefore, as part of our PR19 Business Plan submission, we deflated inputs into the model to correct for this.

We would appreciate guidance on the most appropriate way of correcting for undue inflationary uplifts to retail revenues in the Revenue Adjustments model. We recognise that this is a complex area, and would continue to welcome the opportunity to discuss the question of inflation on retail ODIs directly with Ofwat in order to ensure no errors are made. If we receive additional guidance we will reflect this in our July 2019 PR14 reconciliation update.

Basis of the adjustment

The Customer Experience Programme ODI is part of the Residential Retail price control. As set out in the UU PR14 Final Determination the ODI is designed to return to customers an element of any unused funding received by UU.

"*Under the cost to serve methodology the company will recover the forecast depreciation on the customer experience programme expenditure based on the projected spend in its retail household business plan. This ODI protects customers by returning half of any funding for this scheme (via payments for depreciation) back to customers if the outturn costs of the programme are lower than allowed for in the company's price limit… This ODI also penalises the company for not fully delivering the customer experience programme by 31 March 2019*"[3]

[3] PR19 Final price control determination notice: company-specific appendix – United Utilities; p.205

Our proposal was to return £4.738m (nominal prices), based upon £2.900m of relative depreciation because the outturn costs of the programme are lower than allowed for in price limits and £1.838m for removal of the Customer Relationship Management system (CRM) from the programme.

In the draft determination Ofwat accepted this value but have applied the value in 2012/13 prices rather than in nominal/outturn prices.

Appropriate inflation index for retail ODI

In total £17.8m was allowed in UU Residential Retail price control limits for additional depreciation associated with the Customer Experience Programme. As retail price controls are not linked to RPI the amount received from customers over AMP6 will equal £17.8m on a nominal basis.

The purpose of the ODI is to return unused elements of funding for discretionary enhancement investment. The calculation of returns to customers under the ODI should therefore, be subject to the same inflationary uplifts as the original depreciation allowance, i.e. zero uplift. However the design of the Revenue Adjustments model automatically applies RPI inflation to all ODI rewards/penalties. There does not appear to be a mechanism within the model to prevent inflation being applied.

Left uncorrected the application of RPI inflation to this residential retail ODI will result in excess return to customers. As an extreme example, if we had delivered none of the Customer Experience Programme then the full £17.8m of the original revenue allowance would correctly be returned to customers. However using the current Revenue Adjustment model, RPI will automatically be applied to this value, resulting in a penalty of £20.5m, which is £2.7m more than we received in revenues to support the Customer Experience Programme investment.

Approach applied by UU as part of PR19 Business Plan submissions

As part of our PR19 Business Plan submission we deflated the £4.738m penalty (outturn) to £3.709m (2012/13 prices). This was done to resolve the issue of inflationary uplifts embedded in the Revenue Adjustments and Financial Models. The effect of this was to ensure revenue returned to customers via the Customer Experience ODI equalled £4.738m (outturn).

This adjustment was set out in our 2018 PR14 reconciliation submission within Section 2.1 outcome delivery incentive (ODI) mechanisms, on page 29 Household retail assumptions and method.

The calculation showing how we converted the nominal penalty to a 12/13 prices input to App 27 was set out on a worksheet (called 'retail adjustment factors') that we added to our submitted revenue feeder model.

If this approach to correcting for undue inflationary uplifts in the Revenue Adjustments model is not preferred we would appreciate guidance on the most appropriate mechanism to correct for this inappropriate adjustment.

In summary, we propose that Ofwat:

- **Recognise that the Revenue Adjustment model is incorrectly applying RPI inflation to Customer Experience Programme ODI penalties.**
- **Provide guidance on how to appropriately adjust inputs into the Reconciliation model so as to prevent undue inflation of Residential Retail ODI rewards/penalties.**

3. Impact of variations in developer revenues on Ofwat's overall wholesale revenue controls

Developer incomes can have a significant and unwarranted impact on the current and proposed operation of the overall wholesale controls (which include developer revenues). We don't believe that volatility in developer revenues should by necessity (as they do currently) act to cause volatility in customer bills and company financeability, for example, it is possible that:

- a significant reduction in developer revenues could lead to an increase in domestic customer bills.
- a significant increase in developer revenues increase could lead to a decline in customer bills and hence a reduction in reported income (with resulting impacts on financial ratios).

We recognise that Ofwat's actions to introduce a developer services incentive mechanism, and its amendments to the proposed Revenue Forecasting Incentive (RFI) mechanism may (in part) counteract these effects. However, remains true that such a "single till" approach will lead to corresponding impacts between developer income and income from main wholesale and retail charges.

We propose that Ofwat give further consideration to operating these revenue controls (between developer revenues and other revenues) more independently, such that:

- annual charges are subject only to RFI adjustments resulting from the company's main charges (i.e. not adjusted due to variations in "price control" developer revenues); and
- variations in developer revenues are trued up at the next price control, along with the (as planned) developer services volume correction.

Such an approach would enable the overall revenue cap to remain intact, but in a way that avoids unnecessary bill volatility for customers.

In summary, we propose that Ofwat:

- **Operate revenue controls for developer contributions independently of other revenues to avoid undue in period bill volatility.**

4. PR19 bioresources forecasting accuracy incentive model

The draft bio resources 'In Period Revenue Correction' model has an input for Modified Average Revenue (MAR). To complete the model companies will need to calculate MAR (using the formula notified in section 2.4 of the Draft Determination letter) and input this value into the model. There is a risk that in so doing companies develop different interpretations as to the workings of the MAR calculation. We believe it would be better for companies to enter the inputs for calculating MAR into the model, and that the model then applies a standardised calculation of MAR.

We have also observed that the draft bio resources 'In Period Revenue Correction' model incorrectly adds - rather than subtracts - the revenue variance from year t-2 when calculating the adjusted allowed revenues for year t. This means that if companies over-recover in year t-2, the model allows additional revenues in year t. We believe that the correct approach is that revenue variances should be subtracted in the event of revenue over recovery in past years.

In summary, we propose that Ofwat:

- **Enhance the PR19 bioresources forecasting accuracy incentive model so that it calculates MAR directly, rather than relying on each company to make an assessment.**
- **Correct an error in calculating 'In Period Revenue Corrections'.**