

UUWR_26

PR24 Draft Determination: UUW Representation

Area of representation: Cost and PCD - Business rates

August 2024

This document outlines the need to adjust the level of the expenditure allowances for business rates proposed by Ofwat in the draft determination.

Reference to PR24 draft determination: Expenditure allowance section 2.3.1

1. Key points

- **The draft determination risks materially underestimating UW's business rates expenditure in AMP8:** The allowance proposed by Ofwat in the draft determination is significantly understated, given the known increases in business rates liabilities in AMP8. These increases are predominantly following a rise in the regulatory return and the significant AMP8 wastewater enhancement programme.
- **Changes to cost sharing mechanism do not sufficiently mitigate the risk:** Although changes to the cost sharing rates are helpful in providing mitigation against the value of increases being wrong, this does not mitigate against not factoring in known increases. A failure to recognise the substantial increase in the required expenditure allowance would still leave the business exposed to an almost certain loss and reduce financial headroom through a not insignificant impact on gearing calculations.
- **An in-AMP annual true up would be one option to minimise cashflow impacts:** In the event Ofwat continues to believe it is appropriate to set AMP8 business rate expenditure forecasts based on 2022-23 outturn values, we consider that it should provide an in-AMP annual true-up mechanism for business rate expenditure. This will minimise the impact of inaccurate cost forecasts on company cashflow during the AMP8 period. We consider that this in-AMP true-up could be structured in a similar way to ODI incentives within AMP7, with a two-year lag to allow updated values to be reflected in customer bills.

2. UW's PR24 proposal

In our October 2023 submission we highlighted that as a result of two business rates revaluations there are above-inflation cost increases of around £150m (Main chapter document, Chapter 8.5.2, page 218). In addition, we also noted that it would not be appropriate to use historical business rates liabilities as a basis to forecast future business rates liabilities, identifying the introduction of new reporting requirements being one of the reasons why rates liabilities will increase in AMP8 (October 2023 business plan document *UW46 - Cost assessment proposal*, section 3.3.3, page 38).

We carried out extensive work to model our business rates costs for AMP8. This included thoroughly reviewing our existing assessments, gathering external data, working with external advisers and liaising with the Valuation Office Agency (VOA). The forecasts we modelled are a balanced estimate of what we believe our business rates liability to be in AMP8 and still retain a significant degree of downside risk to the company.

As per data table CW10 we estimated total AMP8 business rates costs for water of £362.1m.

However, following receipt of the draft determination, which set out expected increases in the regulatory return (3.29% to 3.72%) and the revenue allowances for AMP8, we have modelled an increase in our central list liabilities for the water business of an additional £42.1m to £404.2m. This is because the central list liabilities are based on the pre-tax return of the water business.

As per data table CWW10 we estimated total AMP8 business rates costs for wastewater of £202.5m.

In addition, there has also been a slight adjustment to the wastewater liabilities to reflect updates in a number of assumptions, including the impact of changes to the AMP8 wastewater enhancement programme. Hence, we have modelled an overall reduction in wastewater liabilities of £2.2m to £200.3m

Set out in Table 1 below are the revised figures we are incorporating in our revised tables CW10 & CWW10:

Table 1: Business Rates per UW final plan

| 2022/23 price (£m) | 2025-26 | 2026-27 | 2027-28 | 2028-29 | 2029-30 | Total |
|--------------------|-------------|--------------|--------------|--------------|--------------|--------------|
| Water | 49.9 | 83.2 | 83.0 | 83.1 | 105.0 | 404.2 |
| Wastewater | 30.5 | 39.5 | 40.7 | 42.1 | 47.5 | 200.3 |
| | 80.4 | 122.7 | 123.7 | 125.2 | 152.4 | 604.5 |

Source: CW10 & CWW10

3. Draft determination position

In the draft determination Ofwat has based the business rates allowances on the rateable values set at the 2023 revaluation and the 2023-24 multiplier set by central government. Ofwat point out that it has not reflected the revaluations due in 2026 and 2029 in its allowances, nor increased business rates due to changes in the wastewater asset stock in the period 2025-30 (PR24 draft determination: expenditure allowance section 2.3.1). However, both of these factors that Ofwat has discounted - alongside other items similarly not considered - will certainly drive-up business rates liabilities over AMP8.

The expenditure allowance that Ofwat has set out at the draft determination is set out in Table 2 below:

Table 2: Ofwat's expenditure allowance

| 2022/23 price (£m) | 2025-26 | 2026-27 | 2027-28 | 2028-29 | 2029-30 | Total |
|--------------------|-------------|-------------|-------------|-------------|-------------|------------|
| Water | 50.2 | 50.2 | 50.2 | 50.2 | 50.2 | 251 |
| Wastewater | 29.6 | 29.6 | 29.6 | 29.6 | 29.6 | 148 |
| | 79.8 | 79.8 | 79.8 | 79.8 | 79.8 | 399 |

Source: Ofwat draft determination

4. Issues and implications

Table 3 below shows the extent to which we believe the Ofwat allowance for business rates is understated:

Table 3: Comparable expenditure between UW and Ofwat's draft determination for business rates

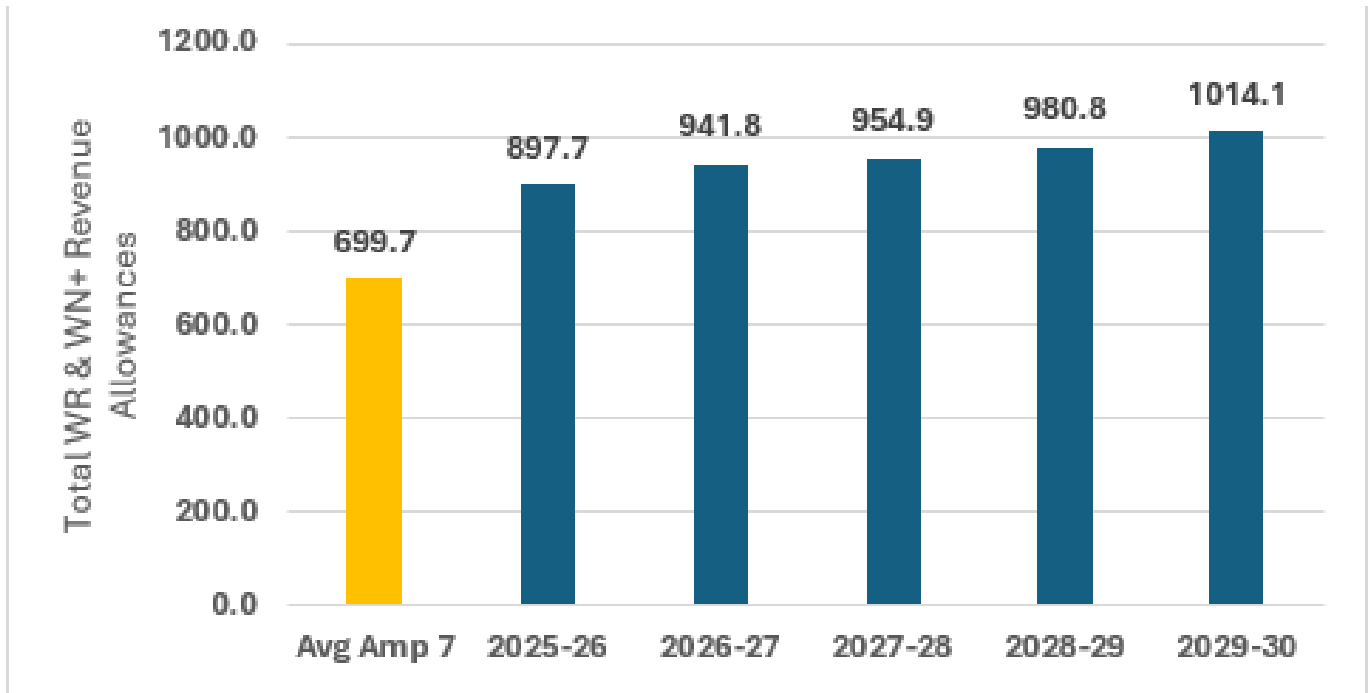
| 2022/23 price (£m) | 2025-26 | 2026-27 | 2027-28 | 2028-29 | 2029-30 | Total |
|--|-------------|--------------|--------------|--------------|--------------|---------------|
| Ofwat DD (Water and Wastewater) | 79.8 | 79.8 | 79.8 | 79.8 | 79.8 | 399 |
| UW revised plan (Water and Wastewater) | 80.3 | 122.7 | 123.7 | 125.2 | 152.6 | 604.5 |
| | -0.5 | -42.9 | -43.9 | -45.4 | -72.8 | -205.5 |

Source: Ofwat draft determination, CW10 & CWW10

Following extensive work reviewing our business rates liabilities and future investment plans we have modelled business rates liabilities for the forthcoming AMP. These are significantly higher than the expenditure allowance Ofwat has proposed in the draft determination. There is no doubt that there is a high degree of uncertainty around business rates over the next AMP as we will see two business rates revaluations (2026 and 2029) and the introduction of new reporting requirements, increasing the number of assets brought into assessment and making it more difficult for ratepayers to challenge assessments with the Valuation Office Agency (VOA).

However, despite this uncertainty there is a lot of information and data available to us that allows us to reliably estimate a large proportion of these liabilities. On the water costs, these are predominantly based on the pre-tax return the water business is expected to generate and is referenced to regulatory return rates and allowed revenues set out during the price review process. The 2023 revaluation that Ofwat has used to create its expenditure allowance for AMP8 is based on the regulatory return of 2.96% from PR19 and the associated allowed revenues this produced. However, the vast majority of the AMP8 water liabilities will be based on the PR24 draft determination which has published a much higher regulatory return of 3.72%, resulting in much higher allowed revenues. This is illustrated by Figure 1 below detailing increases in revenue allowances:

Figure 1: Increase in revenue allowances by year



Source: UUW analysis of PR19 final determination & PR24 draft determination

Using the recently published allowed revenues alongside inflation data our revised plan reliably estimates a large proportion of the water central list liabilities at the next two revaluations dates. The overall Rateable Values are expected to increase as follows:

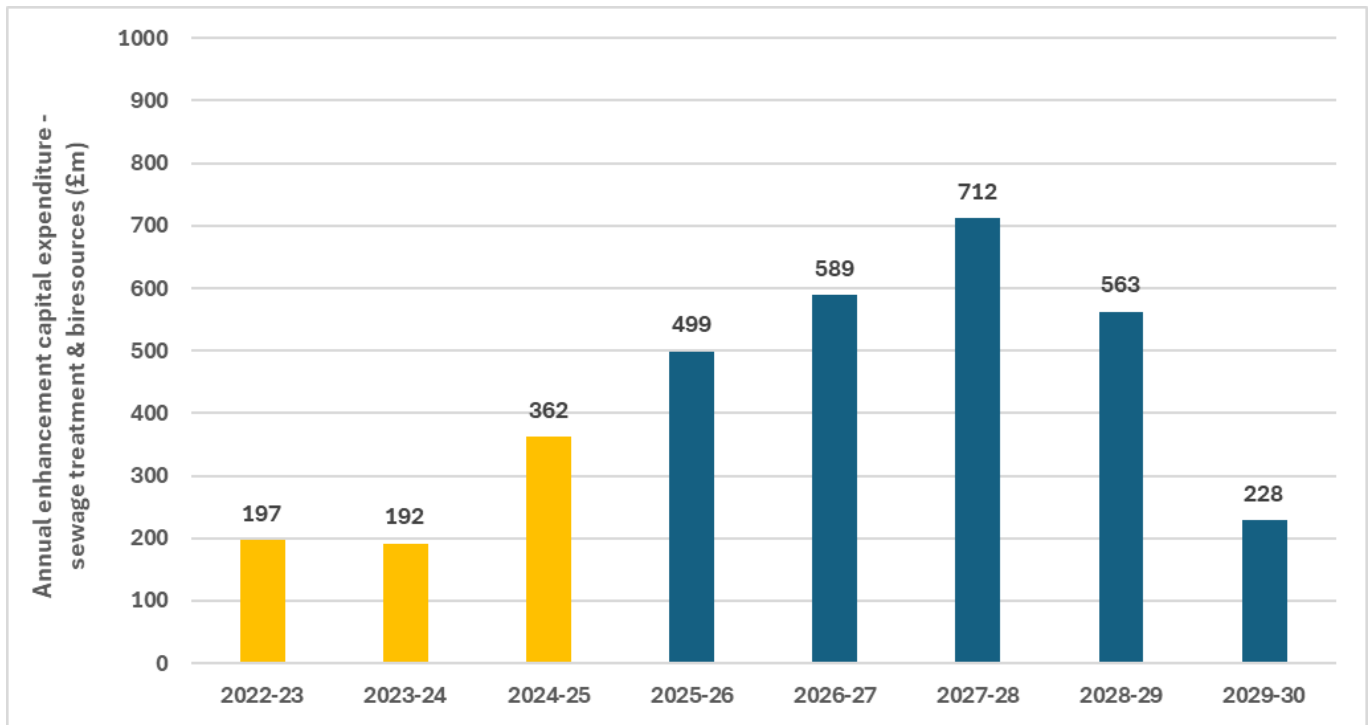
Table 4: Rateable value increases by revaluation date

| Revaluation Date | Central List Rateable value (Outturn prices £m) |
|------------------|---|
| 2023 | 98.5 |
| 2026 | 175.9 |
| 2029 | 237.6 |

Source: UUW analysis of CW10

On wastewater costs, these liabilities are predominantly based on replacement cost of assets. Therefore, our plan has referenced construction output price index data to model the growth in the wastewater liabilities. With this data indicating increases of 18.9% and 10.3% at the 2026 and 2029 revaluation dates respectively. In addition, based on in depth analysis of our significant wastewater enhancement programme up to the end of AMP8 (see Figure 2 below), it is clear that the level of this expenditure will increase very substantially over this period. Utilising this data we have reliably estimated how we expect our wastewater business rates liabilities to grow up to the end of AMP8. At which point we estimate that the annual business rates costs associated with this enhancement will be £12.7m per year.

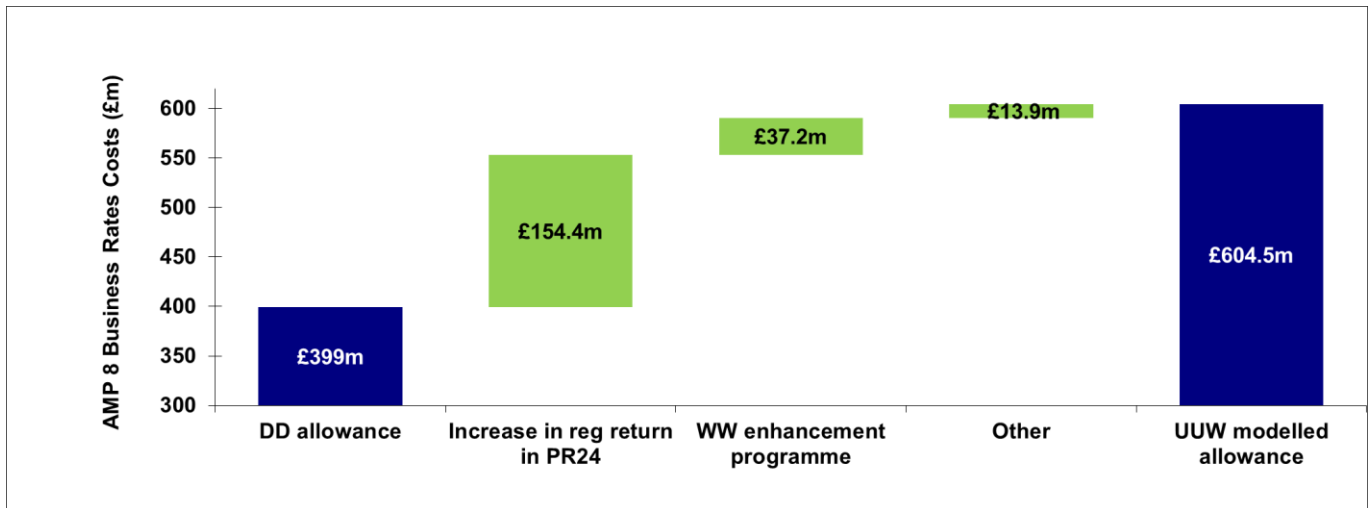
Figure 2: Sewage treatment and bioresources enhancement capital expenditure



Source: CWW1

In summary, Figure 3 below sets out and quantifies the key factors driving the variance between the draft determination allowance and our modelled approach:

Figure 3: Bridge between DD allowance and UW modelled allowance



Source: UW analysis of Ofwat draft determination and UW modelled allowance for CW10 & CWW10

Increase in regulatory return in PR24: This impacts the water central list liabilities. Following the publication of the DD we have obtained published data such as revenue allowances, PAYG, RCV run-off and RCV, as well as inflation data. This data was applied to the valuation calculation that the VOA has used at previous revaluations and has confirmed it is expecting to use at the 2026 & 2029 revaluations to model the increase in liabilities.

WW enhancement programme: Wastewater liabilities are effectively based on replacement costs. We have used details of our wastewater enhancement programme to model the AMP8 wastewater liabilities considering the scale and nature of investment alongside the extent and timing it will attract assessment for business rates.

Other: This includes the impact of increases in construction costs, impacting wastewater liabilities as well as other factors such as changes in business rates multipliers and changes in the way under working allowances are calculated.

When modelling these costs, we have utilised existing mechanisms for calculating business rates liabilities and have adopted an evidence based approach to our forecasts where possible. There are a number of factors that could drive up our costs well beyond what we have modelled. However, we have not factored such increases as they cannot be reliably quantified or evidenced. Hence, there is a significant amount of downside risk factored into our revised plan. An example of this is we have not modelled increases to reflect that we have a new government that has indicated the need to increase tax revenues. At the same time, they have also signalled that they will provide business rates relief to specific sectors such as retail. For government to achieve this objective we could feasibly see business rates liabilities in our sector increase well beyond what we have modelled.

Also, whilst modelling these costs we have always taken a very balanced approach in the assumptions that we have used. Again, this means there is a significant amount of downside risk factored into the revised plan. For example, on water we have assumed that when the VOA are estimating our central list valuation, they will continue to adopt the more favourable asset split approach rather than returning to using the cost of capital approach that they have followed historically.

On wastewater, our plan has applied a reduction to costs of approximately £5m per year to reflect our expectation of winning an ongoing appeal we have lodged with the VOA challenging the methodology they adopt in calculating our under working allowances on wastewater assessments.

In addition, in both our water and wastewater plans we have modelled that the business rates multipliers will be adjusted downwards by 4.4% at the revaluation dates, reducing overall planned liabilities.

These assumptions have a high degree of uncertainty risk. However as set out above, we have adopted an evidenced based approach to our forecasts where possible.

Based on the thorough analysis we have undertaken; we believe that we are likely to under-perform the proposed draft determination cost allowance by over £200m. However, based on a worst-case scenario this under performance could feasibly be in excess of £300m, should a number of factors change from our assumptions stated above.

Given the above, we are clear that Ofwat's approach as set out in the draft determination is inappropriate and not reasonable. Based on a realistic forecast of £200m under performance (given the evidence presented in this case relating to the fundamental difference between 2023-24 and AMP8), even with the 90:10 cost sharing mechanism we expect to face a shortfall of £20m. We will also need to finance the gap between Ofwat's forecast and actual liabilities within AMP8. We judge that this will result in a circa one percent impact on RCV gearing, which will have consequential impacts for headroom on our credit rating metrics throughout the AMP. This financing concerns has recently been supported by Moody's:

*"...energy costs and business rates, which will be subject to ex-post inflation adjustments and enhanced cost sharing. However, initial cost allowances may not reflect current cost expectations and any true-up will only be applied at the end of the AMP8 period. This means that companies will have to fund any interim increase in costs, which would weaken in-period financial metrics."*¹

Finally, we note the potential for such a large retrospective cost sharing arrangement to create inter-generational unfairness as AMP8 business rate costs will be recovered in future AMPs from customers who may not have utilised the service in the years these costs were incurred.

While we support Ofwat's proposed 90:10 cost sharing rate, we are clear that this cannot be thought to compensate for an inappropriate forecast. The factors discussed in this representation demonstrate that there is overwhelming evidence to suggest that Ofwat's roll forward of 2023-24 business rates is wholly inappropriate

¹ https://www.moody.com/research/Thames-Water-Utilities-Ltd-Update-following-downgrade-to-Ba2-negative-Credit-Opinion--PBC_1415589

given the clear step-up in activity between AMP7 and AMP8. As we have demonstrated, this step-up in activity has clear and appreciable impacts on business rate liabilities. We consider that it is highly inappropriate to expect companies to absorb costs that have been reasonably incurred in the proper carrying out of their functions.

In summary, even though Ofwat has taken this same approach in the past, as we go into the next AMP there are multiple factors that strongly indicate that rates liabilities will rise significantly, coupled with a number of other risks and uncertainty around business rates that we have not had at previous price reviews.

5. Approach for final determination

In order to resolve these issues, we believe Ofwat should provide an allowance in line with UW modelling, not an allowance based on the historical 2023-24 position. Hence in our response to the draft determination we are proposing a total expenditure allowance for water and wastewater business rates costs of £604.5m.

We believe Ofwat's decision to change the sharing mechanism from 75:25 to 90:10 is a positive step and one we are supportive of. In the extremely unlikely event of there being significant outperformance of the allowance, customers are provided with a high degree of protection through this mechanism. Likewise, companies are protected from adverse changes away from the baseline. However, the introduction of more comprehensive cost sharing arrangements does not obviate the need to make a reasonable assessment of the base case. As set out above, we believe that we have a prudent and well evidenced approach in this regard.

In the event Ofwat continues to believe it is appropriate to set AMP8 business rate expenditure forecasts based on 2022-23 outturn values, we consider that it should provide an in-AMP annual true-up mechanism for business rate expenditure. This will minimise the impact of inaccurate cost forecasts on company cashflow during the AMP8 period. We consider that this in-AMP true-up could be structured in a similar way to ODI incentives within AMP7, with a two-year lag to allow updated values to be reflected in customer bills.