United Utilities Group PLC
3 October 2014

UNITED UTILITIES RESPONSE TO DRAFT DETERMINATION

As scheduled, United Utilities Water PLC has submitted its representations in response to the draft determination (DD), covering the 2015-20 period, published by Ofwat on 29 August 2014. Ofwat is expected to publish final determinations on 12 December 2014.

Our response addresses the gap between Ofwat's totex assessment and the business plan revision we submitted on 27 June 2014. It benefits from further detailed discussions over this period with Ofwat, the Customer Challenge Group and other stakeholders.

Performance and efficiency improvements

United Utilities has delivered significant performance improvements across the 2010-15 regulatory period. We are one of the most improved companies on customer satisfaction, our serviceability and environmental performance places us amongst the leaders in our sector, and we are delivering our ambitious cost saving targets.

In providing our response to the DD we have reflected our aim to continue to provide the best service to customers, at the lowest sustainable cost and in a responsible manner whilst delivering value for shareholders. In light of this, we have challenged our efficiency plans further and set, where practical, more stretching targets beyond those contained in our original business plan submission. Our revised plan would result in average household bills falling by 4.1% in real terms over the 2015-20 period, compared with a 2.3% reduction in our June plan.

Plan expenditure (totex)

In August, Ofwat announced that it would reflect part of our proposed totex exclusions as an adjustment to its baseline in the DD. This included partial acceptance of totex adjustments in respect of projects at our Davyhulme wastewater treatment works and for Bathing Water and Biodiversity drivers, worth £156 million and was reflected in the DD.

The remaining totex gap between our June business plan submission and the DD was around £1 billion, comprising just under £800 million for wastewater and just over £200 million for water. Our response to the DD reflects adjustments to our business plan which reduce planned totex by around £370 million.

This includes reduced activity of around £90 million primarily associated with 2020-25 early start projects under the National Environment Programme (NEP5) and trunk mains resilience activity. The remaining proposed reduction of around £280 million relates to cost efficiencies which bring our overall proposed wholesale totex, for the 2015-20 period, down to £5.52 billion from £5.89 billion in June.

Revised totex exclusions supported by evidence and assurance

Following the plan revisions set out above, we are now proposing that Ofwat allows £628 million of totex, in addition to the aforementioned £156 million already included in the DD. This comprises the following items:

Water
- £143 million for the major Thirlmere project to address supply and demand issues in West Cumbria, which will arise from the revocation of our abstraction licence at Ennerdale Water. This is driven by the Habitats Directive, to protect a declining population of endangered freshwater mussels. Proposed costs for the project have been independently assessed as upper quartile efficiency. The amount sought is £72 million lower than in the June plan, following an independent assessment of the implicit allowance already provided for within Ofwat's totex models.

Wastewater
- £191 million of NEP5 wastewater projects, which are driven by environmental legislation, such as the Water Framework Directive, after removing early start activity and adjusting costs to a level consistent with Ofwat's upper quartile efficiency challenge;
- £188 million of wastewater base totex adjustments to reflect the particular characteristics of the North West region (outlined in detail with our June business plan), not captured in Ofwat's totex modelling; and
- £106 million relating to specific large integrated schemes, driven by legislation and customer demand, and other activity, after reductions to account for implicit allowances and the upper quartile efficiency challenge.

In the DD, Ofwat asked the company to provide further evidence and assurance to support its claim for additional costs above Ofwat's assessed totex baseline. We have provided Ofwat with a comprehensive response comprising further independent evidence and information to support our proposed model exclusions and the quantum of our revised cost proposals. We have responded specifically to all of the areas where Ofwat indicated we had not provided sufficient evidence. This information covers need, cost benefit analysis and robust support for our costs, as required, on a project-by-project basis. Supported by third party assurance, we have also provided our assessment of the implicit allowances contained within Ofwat's totex models.

Pay-as-you-go (PAYG)

We have adjusted the wholesale business PAYG ratio in light of our revised proposed totex and have increased this overall ratio by 2% to 56%.

The PAYG ratio for the water service is 65%, an increase of 2%, and the PAYG ratio for the wastewater service is now 50%, an increase of 3%. The ratio is lower for the wastewater service reflecting the significant enhancement requirements in this area, largely driven by new environmental obligations.

Household Retail

Reflecting the impact of the extreme levels of deprivation in the North West on our costs, we sought an adjustment to the household retail average cost to serve of around £19 million per annum. We are pleased that Ofwat has accepted this claim, although the DD represents a significant cost challenge for this area of our business. Our DD response addresses aspects of Ofwat’s average cost to serve calculation and its assumption not to allow any inflationary cost increases. We have also provided further evidence to Ofwat to support our cost proposals.

Non-household retail

Having already separated our household and non-household retail businesses, we believe our costs are accurately represented. Ofwat has applied an additional efficiency assumption to our cost base and our DD response proposes that, in a competitive environment, our charges need to be cost reflective. We believe that the company should have greater flexibility in setting customer charges to help ensure that it can recover its costs and earn the allowed margin through the default tariffs. Given the uncertainty relating to the market fully opening to competition, we have also proposed that an annual re-assessment is undertaken to enable any cost and margin implications to be periodically reviewed.

Return on capital

Our revised proposals are based on the weighted average cost of capital (WACC) provided by Ofwat in its risk and reward guidance and assumed in the DD in August. This is a real, vanilla WACC of 3.7% for our wholesale business, plus retail margin. We believe it is important that this level of WACC is maintained to support the financeability of our plan.

Outcome delivery incentives (ODIs)

In our June plan, we revised our ODI package so that it was more symmetric, having both rewards as well as penalties, along with better alignment of financial returns to the value delivered to customers. This followed further engagement with the Customer Challenge Group and reflected customers’ priorities and willingness to pay. In the DD, Ofwat amended certain ODI targets and reward/penalty ranges, compared with our June plan, and we have considered these changes in formulating our response.

There are nine ODIs which relate to the water service and cover performance in areas such as reliability of supply, water quality, leakage and river quality improvements. We propose that the total reward incentive is retained at around £100 million, with a total penalty risk of around £190 million (similar to our June plan), based on potential outcomes covering 80% of the probability range. In particular, we believe that the parameters relating to the water quality ODI in the DD need to be changed to provide a suitable incentive mechanism to reflect the regional differences in the North West.

There are nine ODIs which relate to the wastewater service and cover performance in areas such as sewer flooding, bathing waters, private sewers and sludge disposal. We now propose that the total reward incentive is reduced to around £60 million (from around £100 million in our June plan), with an increase in the total penalty risk to around £250 million (from around £190 million in our June plan), based on potential outcomes covering 80% of the probability range. In particular, we believe that the parameters relating to the sewer flooding ODI in the DD need to be changed to provide a suitable incentive mechanism to reflect our regional differences and deliver a performance level in line with customer preferences.

Recognising customers' preference for bill predictability and stability, we plan to make any performance adjustments relating to our ODIs at the end of the 2015-20 regulatory period.

Adjustments relating to the 2010-15 period

In the DD, Ofwat largely accepted our proposed adjustments (relating to areas such as the opex incentive allowance and the revenue correction mechanism) and allowed £123 million. We are seeking amendments to a small number of relatively minor specific issues.

Next steps

We will continue to engage with Ofwat and our other regulators and stakeholders between now and publication of final determinations on 12 December 2014.

United Utilities contacts

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