UUWR_71

PR24 Draft Determination: UUW Representation

Area of representation: Balance of Risk and Return and Financeability - Consultation responses

August 2024

This document is UUW responses to Ofwat's Draft determination action response summary as set in PR24-draft-determination-company-representation-proforma, RP1 tab

Reference to draft determination documents:
PR24 draft determinations: Aligning risk and return
PR24 draft determinations: Accounting for past delivery
PR24 draft determinations: Ofwat comments on cost of debt report submitted by Water UK
PR24-draft-determination-company-representation-proforma, RP1 tab

United Utilities

Water for the North West

1. UUW response to RP1 proforma

1.1 Do you agree with the proposed cost of equity? If not please indicate where you provide evidence in support of your response.

We welcome the increase in draft determination WACC and cost of equity compared to the 'early view' WACC and cost of equity. However, the draft determination WACC and cost of equity remains too low to secure sector investability, as investors will simply choose to deploy their funds to other investments that offer a better return for a commensurate or lower risk.

Frontier Economics has updated their view on an appropriate cost of capital for the water sector, which when restated at 55% gearing, is a point estimate of 4.19% for appointee WACC and 5.65% for appointee cost of equity. These numbers are significantly higher than the draft determination 3.72% and 4.80% respectively.

Whilst we agree with Ofwat's move to select a point estimate towards the top end of the cost of equity range, the problem that we see, however, is that Ofwat has not, in fact, aimed up in the way that it has intended. Having opted for the lowest admissible risk-free rate, the lowest admissible TMR and the lowest admissible beta, Ofwat's aiming up tends to act as a correction for parameter misestimation rather than deliver a heightened attractiveness into returns.

To correct this parameter misestimation, the risk-free rate should be based on a basket of proxies to avoid too much weight being placed on one specific proxy that diverges from other market evidence, the TMR should be increased at a time of higher interest rates just as it was reduced when interest rates were moving lower, beta should be increased by including Pennon data and putting more weight on shorter dated beta estimates that now exclude unusually volatile periods. On top of this, hybrid bond cross checks support retaining a point estimate at the top of this higher range.

This topic and the supporting evidence are discussed in more detail in UUWR_70 Balance of Risk and Return and Financeability, section 1 and the accompanying our supporting DD representation document *UUWR_72 Cost of Capital*.

1.2 Do you agree with the proposed cost of debt? If not please indicate where you provide evidence in support of your response.

We continue to view the cost of debt proposed in the Draft Determination WACC as not fully representing the costs that efficient water companies face in raising debt finance.

Whilst we welcome the removal of the 15 basis point outperformance adjustment from the cost of new debt, this does not go far enough as the composite A/BBB corporate index used by Ofwat is significantly unachievable even for best in class companies with ratings stronger than the notional company. We strongly advocate that the underlying index used to assess the cost of new debt, the debt indexation mechanism and embedded debt cross checks should be changed to be the iBoxx GBP Utilities 10yr+ index as this is more representative of sector costs, with future index changes monitored in the run up to the final determination to determine whether an additional uplift is required. Efficient companies with credit ratings stronger than the notional company assumption should be able to consistently fund in line with or even outperform the underlying index.

The cost of embedded debt should be updated to include all known sector issuance up to Q3 2024 along with a realistic projection of aggregate debt issuance in the sector up until 31 March 2025 (for both refinancing and to finance RCV growth) based on 2024 debt rates experienced across the sector as a whole. We expected this to lead to an increase in the cost of embedded debt.

In addition, whilst we welcome the increase in transaction and liquidity costs to 15 basis points at the draft determination, we consider the 6-7 basis points for cost of carry to be too low and should be doubled to 12-14 basis points as companies need to hold at least 12 months liquidity as a minimum as opposed to the 6 months currently used.

The proportion of embedded to new debt should reflect expected spend under gated mechanisms to ensure this is not understated in practice

This topic and the supporting evidence are discussed in more detail in UUWR_70 Balance of Risk and Return and Financeability, section 1.

1.3 Do you agree with the proposed notional gearing? If not please indicate where you provide evidence in support of your response.

We continue to disagree with the reduction in notional gearing from 60% at PR19 to 55% at PR24. We continue to believe that this diverges from the actual gearing of almost all companies in the sector and also diverges from regulatory treatment in other high investment sectors such as Ofgem RIIO-ED2, CAA H7 and Ofgem RIIO-3 (GD) SSMD.

Our main concern is that the 55% gearing assumption results in notional company financial ratios that are more comfortably placed than that which almost all companies in the sector could reasonably achieve. Because of this 55% gearing assumption the notional company financeability testing no longer represents a reasonable test that an efficient water company is financeable. This topic and the supporting evidence are discussed in more detail in UUWR_70 Balance of Risk and Return and Financeability, section 3.

1.4 Do you agree that the additional complexity of adopting a model similar to the one produced by KPMG and the increased data burden to populate the model is not warranted?

We do not support the adoption of a model similar to the one produced by KPMG. Whilst we support the principles and policy decisions behind the KPMG model, we agree that the additional complexity of the specific KPMG model makes it unsuitable for use in practice. As highlighted in the PR24 draft determination document "Ofwat comments on cost of debt report submitted by Water UK" we agree that most of the more material differences between the results of the KPMG model and the Ofwat model concerned policy and/or are proposed as changes to the Ofwat model.

1.5 Do you agree that index linked cross checks should be used as a cross check for the upper limit of our allowance to avoid significant inefficiencies that customers should not be required to pay for?

We do not agree that the current cross checks to trailing averages of the composite iBoxx A/BBB 10+ index should be used as a cross check for the upper limit of Ofwat's allowance to avoid significant inefficiencies that customers should not be required to pay for. As demonstrated in UUWR_70 Balance of Risk and Return and Financeability, section 1, over the past year or more funding in line with this index has become significantly unachievable, even for best in class companies with ratings stronger than the notional company. Therefore, we can no longer support this index being used as a cross check.

If the index used for any cross check were to be changed to the iBoxx GBP utilities 10yr+ index, which is more representative of sector debt issuance costs, then we would likely be able to support the use of this cross check.

1.6 Do you agree that we should adjust the cost of debt model to accrete the principal debt balance of indexed linked embedded debt over the 2025-30 period?

We agree that the cost of debt model should be adjusted to accrete the principal debt balance of index linked embedded debt over the 2025-2030 period.

1.7 Do you agree that we should adjust the cost of debt model to allow bespoke effective interest rates to be entered for indexed-linked debt instruments not issued at par value and have varying principal debt balance?

We agree that the cost of debt model should be adjusted to allow bespoke effective interest rates to be entered for index-linked instruments not issued at par value and have varying principal debt balance.

1.8 Do you agree with the introduction of a cost aggregate sharing mechanism? If not please indicate where you provide evidence in support of your response?

Draft determination position

Ofwat has introduced "an aggregate sharing mechanism (ASM) for wholesale costs to protect customers against exceptional outperformance, and to support continued investment in the event of material underperformance. The ASM will share 50% of excess returns, or penalties beyond a trigger threshold of 200 basis points of regulated equity (calculated over the five years of the price control) between companies and customers"[1].

Issues and implications

There are two issues with how the aggregate sharing mechanism has been presented in the draft determination (DD) that Ofwat should look to address for its final determinations (FD); the proposed threshold at which the mechanism is triggered is too high and Ofwat appears to have placed an overreliance on this type of mechanism as a backstop to obviate the need for setting appropriate ex-ante allowances when assessing the balance of risk and return.

Firstly, the threshold at which the mechanism is triggered has been set at a level in the DD that in practice is unlikely to achieve its stated aim of "supporting continued investment". A 200bps threshold, post-sharing, would constitute a considerable (cash) overspend by companies, particularly on investment areas that may be subject to enhanced sharing rates; where through reconciliation, customers pay for a greater proportion of overspends. For areas with enhanced sharing, the overspend required by UUW to trigger the mechanism could be more than £2.6bn of pre-sharing underperformance (assuming a 25:25 sharing rate), a level at which the short-term financeability of the company would clearly come under significant pressure. Whilst customers may ultimately remunerate companies for a greater share of these additional costs in the subsequent period, companies must still finance these additional investments in the short run and so a trigger of 200bps is at such a level that Ofwat's desired impact of incentivising companies to carry on investing is not one that would materialise. The reality of such a circumstance is that companies would instead be seeking immediate remuneration through an IDoK, thereby making the ASM ineffective for the purposes of achieving its stated intention while the trigger threshold set at 200bps of regulated equity.

Secondly, Ofwat appears to have introduced a number of enhanced cost sharing arrangements and aggregate sharing mechanisms as a backstop to obviate the need for setting appropriate ex-ante allowances when assessing the balance of risk and return. As all assessments of (RoRE) risk are made after accounting for the various regulatory reconciliation mechanisms, the range on totex, and therefore the wider risk exposure faced by equity, is supressed. The reality is that the avoidance of setting appropriate ex-ante cost allowances and having an overreliance on ex-post sharing mechanisms (particularly for business rates) will burden companies with short-term cashflow and financeability issues that could only be solved by equity. For where this is the case, this additional risk and burden is clearly not factored into the assessment of the balance of risk and return when setting the allowed cost of equity.

[1] PR24 draft determinations: Aligning risk and return appendix - Ofwat, page 10

Approach for final determination
Whilst we are not opposed to the introduction of such a mechanism in the final determination, Ofwat should not place excessive reliance on the introduction of an ex-post correction mechanism (as well as other mechanisms such as enhanced cost sharing rates) to obviate the need to set appropriate ex-ante cost allowances. However, for the Final Determination Ofwat should lower the threshold at which the mechanism is triggered, ensuring that it is set at an effective level. We would note that the current threshold is almost double that which Ofwat itself determines is a P10 likely outcome for totex, a level at which companies would never expect to achieve save for some catastrophic event, and at which point the additional sharing is unlikely to be of any real relief to the financial pressures it will be facing in the period.

The only justification for not making appropriate up-front allowances is where there is uncertainty in the need, and therefore the possibility that no additional costs will be required, as is the case for our proposed Bioresources Notified Item. For all other instances, Ofwat should be making appropriate ex-ante allowances and where material gaps remain, Ofwat should also recognise the additional short-term risk that it is requiring to be borne by equity in setting cost allowances at a level that is clearly too low and not reflected in the allowed cost of equity.

1.9 Do you agree with the proposed 'Delayed Delivery Cashflow Mechanism'? If not please indicate where you provide evidence in support of your response?

Draft determination position
Ofwat is *" proposing to introduce a sector wide Delayed Delivery Cashflow Mechanism (DDCM). The DDCM would claw-back a proportion of revenue associated with unspent wholesale expenditure allowances through an adjustment to allowed revenues later in the period if companies are behind in their delivery. This would allow customer bills to more fairly reflect the actual delivery profile.*

The DDCM would be purely a cash-flow mechanism affecting revenue, intended to operate as a customer 'fairness' mechanism. There is no 'penalty' element to the mechanism. Price control deliverables already incentivise timely delivery and cost sharing arrangements already incentivise cost efficiency. The DDCM would not alter expenditure allowances or cost sharing incentives, and any revenue foregone would automatically be reinstated through reconciliations in PR29 if companies subsequently catch up their enhancement programmes. Companies would remain funded to meet their legal obligations, whilst providing customers with a reduction to their bills before the end of the period where companies are materially underspent"[2].

Approach for final determination
We support the proposed introduction of the DDCM to adjust customer revenues more immediately in instances where companies are not delivering against their cost allowances. Whilst we agree with the stated desire and that the adjustments would be purely a cashflow mechanisms, our ability to review all aspects of the calculations and process steps in the time allowed has been limited. Therefore, we recommend that Ofwat engages with companies further on the technicalities of this change in approach as part of the APR25 consultation, to ensure that any wider impact to tables (e.g. table 4C) and/or process for the blind year reconciliation and in-period adjustment is rectified in advance of the APR.

[2] PR24 draft determinations: Aligning risk and return - Ofwat, *page 28*

1.10 We seek companies' views on our proposed approach to apply the RCV midnight adjustments on 31 March 2025 as opposed to 1 April 2025?

Draft determination position

In PR24-draft-determinations-Accounting-for-past-delivery[3], Ofwat has proposed to amend the timing of the RCV midnight adjustment to 31 March rather than applying the adjustment to the opening balances on 1 April as it has done previously.

Issues and implications

We agree that the timing of the adjustment can be undertaken without having any detrimental impact to customers and further, we believe that the existing feeder model can accommodate the change with only minor edits to terminology. We anticipate that the underlying calculations for how adjustments are made within the RCV feeder model can remain unchanged and the impact on PR24 and the mechanics of the financial model should be nil, as the model uses the opening balance – and therefore the timing of the adjustment is irrelevant. The proposed approach therefore should only result in a change to how Ofwat publishes the RCV update in advance of the APR and how companies subsequently report performance for 2024-25 - (customer) revenues will be unaffected. We anticipate that Ofwat will include within the published RCV for 2024-25 the PR24 final determination assumptions for the reconciliation adjustments that will subsequently be trued up as part of the blind year reconciliation.

Approach for final determination

We support the proposed change to the timing of the RCV midnight adjustment to make the adjustment on 31 March, rather than 1 April. Whilst we believe that the change can be achieved with relative ease and without any detrimental impact to customers, our ability to review all aspects of the calculations and process steps in the time allowed has been limited. Therefore, we recommend that Ofwat engages with companies further on the technicalities of this change in approach as part of the APR25 consultation, to ensure that any wider impact to tables (e.g. table 4C) and/or process for the blind year reconciliation is rectified in advance of the APR.

1.11 Do you agree with the proposed approach to profiling revenue? If not please provide evidence in support of your response?

UUW's PR24 proposal

We engaged with customers to understand their preferences for bill phasing and customer groups told us that they prefer stable bills, with predictable incremental adjustments in charges, rather than large upfront or deferred bill changes. UUW's proposed approach of spreading investment, and recovering revenues on a gradual but continual basis over multiple AMPs is supported by the majority of customers. Therefore, for our business plan submission(s), we did not undertake any reprofiling of revenues to adjust for those calculated by the (natural) building blocks.

As noted in our query on 22 August and documented in UUW95 (page 9) the "*approach to profiling the current in-period ODIs revenue adjustment appears to limit the opportunity for companies to smooth the impact on customer bills*". Therefore, to limit the impact on customer revenues, we entered "*all remaining AMP7 ODI revenue adjustments into the 'PR19 ODI revenue adjustment' inputs, thereby enabling the impacts to be smoothed over five years in the financial model and for setting revenues…. We believe that this is the most effective and least intrusive way to alleviate the issue raised and can be accommodated within the current modelling approach*".

In assuring the financeability of our plan (as set out in UUW09, 9.6.4), we noted that we intended to utilise the additional reconciliation revenues to ensure that our plan was financeable, whilst achieving our target ratings of A3/BBB+ on an actual company basis (noting that the notional company would continue to assess financeability prior to these adjustments). We also highlighted that rating agencies' approach to assessing credit metrics can

[3] https://www.ofwat.gov.uk/wp-content/uploads/2024/07/PR24-draft-determinations-Accounting-for-past-delivery.pdf, page 30

adjust for any revenue reprofiling (as well as any revenue advancements) and therefore, the company would need to achieve the target ratios on the underlying revenues, prior to any adjustments. As any plan must therefore be financeable absent such adjustments, reprofiling is often not a lever that can be utilised to address any financeability issues in any particular year(s).

Draft determination position

Ofwat has reprofiled the allowed revenues within the UUW PR24 financial model, noting that "*Wholesale revenue reprofiled in NPV neutral way to profile bills broadly in line with the companies business plan bill profile*", as shown below in Table 1.

Table 1: Impact of re-profiling of allowed revenues (2022-23 prices)

	31 Mar 26	31 Mar 27	31 Mar 28	31 Mar 29	31 Mar 30
Re-profiled allowed revenue - active - real (total)	1,766.340	1,845.423	2,008.800	2,095.130	2,148.441
Revenue requirement excl. tax charge - real (total)	1,894.524	1,935.598	1,963.999	1,997.746	2,049.051
Impact of re-profiling of allowed revenue - real (total)	**(128.184)**	**(90.175)**	**44.801**	**97.383**	**99.391**

Source: UUW analysis using 'NWT PR24 financial model v21s TEMPLATE'

In populating the revenue feeder model, Ofwat has included "*inputs for in-period PC payments (year4, 2023-24) and apply in 2025-26 in full and include inputs in-period PC payments (year 5, 2024-25) and apply in 2026-27 in full.*" This results in a front-end loading of reconciliation revenues for use in the financial model, rather than a smooth profile as proposed (thereby necessitating further reprofiling adjustments to be made), as shown in Table 2.

Table 2: PR19 reconciliation total revenue adjustment (2022-23 prices)

	31-Mar-26	31-Mar-27	31-Mar-28	31-Mar-29	31-Mar-30
Post financeability adjustments eligible for tax uplift - real (total)	**70.993**	**72.063**	17.730	17.730	17.730
Post financeability adjustments not eligible for tax uplift - real (total)	43.092	43.092	43.092	43.092	43.092
Residential retail revenue adjustment - real	**24.116**	**19.755**	3.213	3.213	3.213
Total revenue adjustment	**138.201**	**134.910**	**64.035**	**64.035**	**64.035**

Source: PR24-DD-Revenue-adjustments-model-United-Utilities

Ofwat has separately stated in IN 24/02 (page 6) that " *any revenue adjustments that flow from the ODI payments can be applied across the full five years of the next price control period. Our policy, as set out in our PR24 final methodology, is that any past performance revenue adjustments can be applied either in the first year or spread over a number of years in the new price control period (preserving the net present value of the payments due). Companies can, in their representations propose how these revenue adjustments should be applied across the five-year period provided they can show this is consistent with customer preferences for bill profiling.*"

Issues and implications

Whilst we do not have any issue with the resulting revenue profile from a customer point of view (as it is aligned to revenues in our plan, which customers support), there is an issue with how Ofwat has achieved the profile, as it risks (we presume, unintentionally) harming the financeability of the actual company. Because Ofwat has not adopted our proposed approach to profiling the reconciliation adjustments of AMP7 ODIs, the underlying revenues are not smooth without any reprofiling. Ofwat has instead undertaken revenue reprofiling within the financial model to ensure that bills are appropriately profiled, moving revenues from the start of the AMP to the end. Whilst the resulting revenues might superficially appear the same, the consequence of the difference in

approach is that rating's agencies will unwind reprofiling adjustments from the financial model in its calculation of financial metrics, causing a significant downturn in financial ratios towards the end of the AMP. This is important as it is at the end of the AMP when the actual company experiences the most pressure, because of the proportion of new (more expensive) debt exceeds the assumption within the allowed cost of debt.

Table 3: Impact on AICR (Ofwat) due to changes in revenue profiling

	31 Mar 26	31 Mar 27	31 Mar 28	31 Mar 29	31 Mar 30
AICR (Ofwat) - excl reprofiling	1.69	1.66	1.63	1.63	1.67
AICR (Ofwat) - incl reprofiling	1.26	1.37	1.76	1.91	1.96
Difference	**0.43**	**0.28**	**- 0.13**	**- 0.28**	**- 0.29**

Source: UUW analysis using 'NWT PR24 financial model v21s TEMPLATE.xlsx'

Approach for final determination
We propose that Ofwat profiles the adjustments for AMP7 ODIs and customer measures of experience in line with our submission proposal, applying the adjustments equally across the five years in line with IN 24/02, so that resulting revenues are smoothed, rather than seeking to correct for the variances later, within the financial model. This will ensure that revenues for customers are smoothed, and key credit metrics are unharmed in AMP8.

1.12 We welcome views on our proposal to not apply the gearing outperformance sharing mechanism (GOSM) as part of the PR19 reconciliation process or for the 2025-30 period.

Draft determination position
Ofwat has proposed " on balance, not to apply the GOSM mechanism as part of the PR19 reconciliation process or for the 2025-30 period"[4].

Issues and implications
Whilst we understand Ofwat's desire to remove this mechanism, and so are not looking to challenge this proposal, we would highlight that this amounts to making retrospective policy changes to the PR19 Final Determination which, more generally, we consider must only occur in exceptional and well justified circumstances.

Approach for final determination
We note the proposal to not apply the GOSM as part of the PR19 reconciliation process.

1.13 We welcome companies' views on our proposal to amend the cost sharing rate for 2024-25.

Issues and implications
Whilst we understand Ofwat's desire to adjust these cost sharing rates, and so are not looking to challenge this proposal, we would highlight that this amounts to making retrospective policy changes to the PR19 Final Determination which, more generally, we consider must only occur in exceptional and well justified circumstances.

Approach for final determination
We note the proposal to amend cost sharing rates for some companies for 2024/25.

[4] PR24-draft-determinations-Accounting-for-past-delivery.pdf (ofwat.gov.uk) (p31

1.14 Proposal to cap cost sharing rates for 2024-25.

Issues and implications

Whilst we understand Ofwat's desire to adjust these cost sharing rates, and so are not looking to challenge this proposal, we would highlight that this amounts to making retrospective policy changes to the PR19 Final Determination which, more generally, we consider must only occur in exceptional and well justified circumstances.

Approach for final determination

We note the proposal to cap cost sharing rates for some companies for 2024/25.

1.15 Do you agree with our overall approach to the assessment of the balance of risk and return? If not please indicate where you provide evidence in support of your response?

UUW's PR24 proposal

In our October 2023 business plan, we presented a largely symmetrical RoRE range, which was aligned to Ofwat's PR24 methodology ranges with the exceptions being totex and financing risks.

- For totex risk, we noted that there was "*an inherently asymmetric risk. It is much more likely that we will encounter unforeseen additional costs over AMP8, than opportunities to deliver additional efficiencies above and beyond those in our plan. The plan we need to deliver is significant in size and requires new capabilities. We are attempting to our largest ever programme, at a faster pace, and at efficient cost. There is inevitably a risk that in order to deliver such a programme, costs may be higher than forecast in order to deliver projects on time and to the standard customers expect. With other water companies facing the same environmental and social pressure to deliver significant investment over AMP8, we're expecting one of our key pinch points to be around availability of equipment and materials. We have already began engaging with suppliers on some materials, but it is clear that scarcity of materials and key equipment will be one of our main challenges*" (UUW82, page 53).
- For financing risk, one of the main causal factors of the negative skew was caused by the proportion of new debt within the allowed cost of debt calculation being significantly below that which we faced in practice due to the significant increase in investment requirements in AMP8. As the cost of new debt is higher than the cost of embedded debt, this resulted in a more negative skew to reflect the underperformance in aggregate expected.

Draft determination position

In 'PR24 draft determinations: Aligning risk and return appendix', Ofwat set out its view of the RoRE ranges of its draft determinations for each company and the reasoning behind each of the component ranges. Although many companies argued that there was more downside risk inherent within the methodology and their plans, Ofwat has presented a much more symmetrical range albeit around a higher base return, reflecting the increase to the allowed cost of equity in the draft determination (4.80%) and the QAA reward for UUW (+5bps). Most notably it proposed that whilst there may be a downward skew in 'operational' risk components (cost and outcomes) this was offset by an upward skew on financing (for the median company). It also recognised the risk of price control deliverables (PCDs) on the RoRE, which had been excluded in the original assessments required of companies in their submissions, proposing a range with a slight positive skew for UUW. Because Ofwat's approach was to calculate percentages for each component and then apply these to the regulated equity for each company, the monetary ranges for Ofwat's draft determination are much smaller than that proposed by UUW and other companies as Ofwat has made significant reductions to allowed totex.

Issues and implications

Although there have been positive (yet insufficient) adjustments to calculating the allowed cost of equity since the PR24 final methodology, we do not agree with Ofwat's view that the balance of risk faced by equity in the draft determinations is commensurate with an allowed (real) return of 4.80%. Not only do we think that risk ranges for some components have been understated, but Ofwat has made several significant interventions to

company business plans that will result in additional downside risk to be managed for a company to simply earn the base allowed return, with very little potential for upside and a significant risk of earning a return below the cost of equity if the additional these risks materialise.

Approach for final determination
Risk and return principles dictate that the allowed cost of equity must appropriately remunerate investors for the risk it bears. Asking investors to bear more risk is not an unreasonable ask (if that is what is desired and who is best placed to manage the risk), but it must be reflected in the rate of return that is on offer. If the return is set too low in relation to the level of risk borne, a rational investor will have no incentive to invest as less risky alternative investments will be available for the same level of return. Our view is that the net impact of the methodology and interventions made by Ofwat in its draft determination result in a significant increase and downward skew to the risks faced by investors. However, as is apparent from Ofwat's view of the RoRE range being symmetrical (indeed slightly positive) these additional risks have clearly not been reflected in the calibrations of the draft determination allowed cost of equity. This means that the draft determination cost of equity is not a reasonable level of return to remunerate investors for the actual risks faced (i.e. it is not a 'fair bet'). To attract investors to the sector, companies must be able to offer a level of return commensurate to the risk faced and the draft determination, as a package, has not struck the right balance between risk and return.

We provide a more thorough assessment of Ofwat's overall approach to assessing the balance of risk and return within the commentary for ADD18 in our DD representation document 'UUWR_93 _Data table commentary'.

1.16 Do you agree with the approach taken to PAYG and RCV run-off? If not please indicate where you provide evidence in support of your response?

UUW's PR24 proposal
Our business plan utilised the natural rates for both PAYG and RCV run-off in determining revenue allowances for AMP8. Whilst rates exceeded Ofwat's guidance thresholds for Water Network plus and Bioresources, we provided evidence in support of our proposed run-off rates in "UUW71_RCV_Run_off_Rate". For both the pre and post 2025 RCVs, in each year we utilised a single rate for each price control, rather than differentiating between existing and new assets RCVs.

Draft determination position
In its determination, Ofwat noted that "*We have also made an adjustment to RCV run-off rates for United Utilities. The company set RCV run-off rates for the bioresources control at 10.25% on average. This is significantly higher than other companies in the sector and our guidance for upper limits. The average RCV run-off rate equates to an average remaining life for assets within this control of less than ten years and means that circa 42% of the RCV existing at 31 March 2025 would be recovered in period. As such we have reduced the RCV run-off rates for the bioresources control to our upper limit of 8%. However, to ensure that United Utilities remains financeable over the price control period, we have offset the potential reduction in revenue by increasing RCV run-off rates for the wastewater network plus control. The net effect of these adjustments on total and wastewater revenue is zero over the period*"[5].

It also "*set PAYG rates for draft determinations as operating costs as a proportion of totex for all companies*"[6], which was in line with the approach that we took in our submission, using the 'Opex capex split model' to correct for differences in cost allowances.

Issues and implications
As Ofwat has retained our proposed approaches to PAYG and we expect that the issues concerning the reduced revenues from not updating the RCV run-off rates to account for the differences in totex allowances to be

[5] PR24 draft determinations: Aligning risk and return appendix - Ofwat, page 46

[6] PR24 draft determinations: Aligning risk and return appendix - Ofwat, page 31

addressed through cost assessment (see section 1.20), we do not believe that there are any further material issues or implications from Ofwat's approach at the draft determination.

Approach for final determination
Ofwat should continue to set PAYG rates as operating costs as a proportion of totex for all companies and use the 'Opex capex split model' to correct for differences in cost allowances. We do not challenge Ofwat's intervention to cap Bioresources' RCV run-off rates at the 8% threshold if it continues to reallocate the revenues to Wastewater Network plus, so that the net effect of these adjustments on total and wastewater revenue is zero over the period. As we note in section 1.20, we expect that any issues caused to the misalignment between the proposed run-off rates and the natural rates derived from the cost allowances will be minimised by Ofwat making appropriate allowances for the key cost areas.

1.17 Do you agree with the approach taken to the calculation of tax? If not please indicate where you provide evidence in support of your response?

We agree with the approach taken in relation to the calculation of tax, with the exception of the calculation of deferred tax. We noted in our October 2023 submission "*that the calculation of temporary differences arising in year within the financial model does not account for either any tax loss arising in the year or the utilisation of any losses carried forward in offsetting the current year taxable profit. The result is that deferred tax is misstated leading to total effective tax rates (current tax + deferred tax/ PBT) that are significantly different from the headline rate of corporation tax*" (UUW95 section 1.6, page 6). The consequence of this error is relatively minor and it should only impact where any stated profit after tax is used in any calculations, the most noticeable of these is reported dividend cover ratios in RR16.17.

1.18 Do you consider further steps should be taken to mitigate the impacts on customer bills (for example through further intervention on RCV run-off or the allocation of revenue reconciliation adjustments to RCV)? If you have a proposal, please set this out.

UUW's PR24 proposal
UUW did not undertake any additional steps to mitigate the impact on customer bills. The affordability and acceptability testing of our proposed plan for a £520 average bill by 2030 found that "*78 per cent of household customers find the plan to be acceptable (14 per cent unacceptable); 75 per cent of non-household customers find the plan to be acceptable (21 per cent unacceptable); 88 per cent of future bill payers find the plan to be acceptable (13 per cent unacceptable); and 69 per cent of vulnerable customers find the plan to be acceptable (25 per cent unacceptable)*" (UUW03, page 58). In addition to our business plan and set out in UUW21 (table 13), we also tested the acceptability of higher bill impacts, achieving 75% acceptance for a proposed bill increase of £546 by 2030.

We recognised the additional pressures that this placed on those that may struggle to afford their bills and so a "*robust £525m affordability package was developed and scale of support was tested with customers. Customer supported an uplift to the cross-subsidy for PR24 and this enhanced programme of support will enable an additional 590,000 households to benefit and broaden support for lower middle income homes that cannot access social tariff discounts*" (UUW03, page 59).

We did not seek to advance revenues from beyond AMP8 but note that several companies did propose higher PAYG and/or RCV run-off rates to assist with the financeability of their business plans. In some instances, this advancement of revenues resulted in significant additional pressure on customer bills in AMP8.

We applied revenue and RCV adjustments from PR19 reconciliations in line with the prescribed approach set out in the PR19 Reconciliation Rulebook. In assuring the financeability of our plan (as set out in UUW09, 9.6.4), we noted that we intended to utilise the additional reconciliation revenues to ensure that our plan was financeable,

whilst achieving our target ratings of A3/BBB+ on an actual company basis (noting that the notional company would continue to assess financeability prior to these adjustments).

Draft determination position
Ofwat did not make any intervention to limit UUWs proposed RCV run-off revenues (noting the reallocation between Bioresources and Wastewater Network+ was neutral) or PAYG rates for its Draft Determination to mitigate the impacts on customer bills. It did reduce the RCV run-off rates for eight companies below the natural rate where it believed that there was sufficient headroom in the financeability assessment and also removed any PAYG advancements companies had proposed to "*set PAYG rates for draft determinations as operating costs as a proportion of totex for all companies*"[7].

Ofwat has applied PR19 reconciliation adjustments in line with the approach it set out in the Reconciliation Rulebook, applying adjustments to revenues and the RCV respectively.

Issues and implications
We do not support the proposal for revenue reconciliation adjustments to instead be allocated to the RCV. As set out in UUW09, our Board assured the financeability of the business plan on the basis that these revenues were available to be used to assist with financeability during AMP8. If Ofwat was to intervene and allocate these to the RCV, it would be contrary to that which our Board has previously assured and the Determination that we accepted in PR19. Furthermore, company Boards and shareholders have made investment decisions during AMP7 on the presumption of how reconciliations would be made having been set out in the PR19 Reconciliation Rulebook, and changing the policy approach from what has been set would reduce confidence in the regulatory framework. Given that the number of adjustment mechanisms are increasing further in AMP8, confidence that these will be applied as intended is important.

Approach for final determination
Ofwat should continue to use the natural RCV run-off (and PAYG) rates proposed in our plan (or updated PAYG to reflect any differences in the opex/capex split of Ofwat's cost allowances) and allocate reconciliation adjustments between revenues and the RCV in line with the approach set out in Ofwat's PR19 reconciliation rulebook. It should not seek to reduce AMP8 revenues to mitigate the impact on customer bills where companies provide sufficient evidence of their proposed rates and should recognise that customer affordability issues are also best addressed through targeted interventions and support and not simply reducing the overall average bill.

1.19 Do you agree with the interventions to RCV run-off rates to assist affordability for customers? If not, please indicate where you provide evidence in support of your response.

UUW's PR24 proposal
UUW did not undertake any additional steps to mitigate the impact on customer bills. The affordability and acceptability testing of our proposed plan for a £520 average bill by 2030 found that "*78 per cent of household customers find the plan to be acceptable (14 per cent unacceptable); 75 per cent of non-household customers find the plan to be acceptable (21 per cent unacceptable); 88 per cent of future bill payers find the plan to be acceptable (13 per cent unacceptable); and 69 per cent of vulnerable customers find the plan to be acceptable (25 per cent unacceptable)*" (UUW03, page 58). In addition to our business plan and set out in UUW21 (table 13), we also tested the acceptability of higher bill impacts, achieving 75% acceptance for a proposed bill increase of £546 by 2030.

We recognised the additional pressures that this placed on those that may struggle to afford their bills and so a "*robust £525m affordability package was developed and scale of support was tested with customers. Customer supported an uplift to the cross-subsidy for PR24 and this enhanced programme of support will enable an additional 590,000 households to benefit and broaden support for lower middle income homes that cannot access social tariff discounts*" (UUW03, page 59).

[7] PR24 draft determinations: Aligning risk and return appendix - Ofwat, page 31

Draft determination position

Whilst Ofwat did not make any intervention to limit UUWs proposed RCV run-off (noting the reallocation between Bioresources and Wastewater Network+ was neutral) for its Draft Determination to mitigate the impacts on customer bills, we note that it did reduce the RCV run-off rates for eight companies where it believed that there was sufficient headroom in the financeability assessment.

Issues and implications

Although we are supportive of aiding customers that are struggling to pay their bills, we do not consider that Ofwat should take further steps in relation to UUW to mitigate the impact on average customer bills by looking to reduce allowed revenues. There are several reasons we do not believe it is appropriate.

- Firstly, UUW is already offering a sector leading level of customer support through our Water Sure, Back on track and Help to Pay schemes, with Ofwat recognising in its QAA that we have proposed "sector leading level of ambition on affordability"8 and reducing revenues even further will actually prevent, not help, us from offering this ambitious level of support. UUW's business plan also proposed £200m of shareholder contributions towards customer support schemes – the highest of any company and more than the two "Outstanding" companies put together.
- Secondly, there is insufficient headroom in key credit metrics to ensure that companies can remain financeable with the DD allowed return. Whilst it may, in some instances, appear that the notional company has sufficient headroom to support reduced revenues in AMP8 (ignoring our first two reasons why it is not appropriate), the reality is that actual companies are going to find it more difficult to accommodate. Although Ofwat does claim not to concern itself with the actual company financeability, at a time when the sector is needing to strengthen, not weaken, its balance sheet position, reducing revenues and making the sector less appealing to new investors will ultimately lead to a much worse outcome for customers in the long run if sufficient, low-cost capital is not willing to invest in the sector.
- Thirdly, customer bills are expected to be increasing for at least the next 25 years in real terms. Therefore, the deferral of revenues from AMP8 will simply cause even greater affordability pressures for future bill paying customers and cause intergenerational inequality.
- Finally, we believe that customer affordability issues are best dealt with through targeted affordability support programmes and not through the restriction or deferral of total allowed revenues, particularly given long term investment requirements are likely to lead to further bill increases in future AMPs.

We note that companies appear to have taken different approaches to deriving their run-off rates, with some, like UUW deriving it bottom-up based on the underlying assets, whereas others have based their rates on historical inferences and/or previous determinations. We do not think it is appropriate to artificially adjust run-off rates for those companies that derive their rates bottom up. However, it may be more appropriate to adjust those companies that have less linkages between their proposed rates and the underlying assets and therefore Ofwat may still consider that there is sufficient leeway to reduce allowed revenues without harming the financeability of the company.

Approach for final determination

Ofwat should continue to use the natural RCV run-off (and PAYG) rates proposed in our plan (or updated PAYG to reflect any differences in the opex/capex split of Ofwat's cost allowances). It should not seek to reduce AMP8 revenues to mitigate the impact on customer bills where companies provide sufficient evidence of their proposed rates and should recognise that customer affordability issues are also best addressed through targeted interventions and support and not simply reducing the overall average bill. Given UUW's sector leading approach to supporting customers with affordability issues, adjustments are not justified in UUW's case.

[8] PR24 draft determinations: United Utilities - Quality and ambition assessment appendix - Ofwathttps://www.ofwat.gov.uk/wp-content/uploads/2024/07/PR24-draft-determinations-United-Utilities-Quality-and-ambition-assessment-appendix.pdf, page 2

1.20 Do you agree that we should not amended RCV run-off rates for post 2025 RCV as a result of any changes to totex allowances for enhancement. If you consider that RCV run-off rates for post-2025 RCV are no longer appropriate for the mix of investment in draft determinations, please indicate where you have provided evidence to support updated RCV run-off rates.

UUW's PR24 proposal

Our business plan utilised the natural rates for both PAYG and RCV run-off in determining revenue allowances for AMP8. Whilst rates exceeded Ofwat's guidance thresholds for Water Network plus and Bioresources, we provided evidence in support of our proposed run-off rates in "UUW71_RCV_Run_off_Rate". We utilised a single rate in each price control for both the pre and post 2025 RCVs in each year, rather than differentiating between existing and new assets.

Draft determination position

Ofwat has retained company business plan RCV run-off rates as the start point for its assessment, despite there being significant cuts to totex allowances, which in some cases, would likely have a material impact on the natural RCV run-off rate.

Issues and implications

Where companies, such as UUW, have calculated their RCV run-off rates through a bottom-up approach (by using the asset lives and commissioning assumptions for each of its proposed schemes and assets) to new investment and calculating the annual (current cost) depreciation of each asset as a proportion of the RCV, changes to totex allowances should naturally result in a change to the underlying RCV run-off rate, particularly where the cuts to totex are on investment areas that are typified by assets at either extreme of the typical asset life i.e. those where very short or very long lived assets are employed, such as monitoring or infrastructure. Therefore, using the original company proposed rate in the face of material totex gaps will likely over or understate the actual natural run-off rate required to remunerate the underlying assets' depreciation over their theoretical asset life for the revised totex allowance (and resulting RCVs). This is a similar issue to what Ofwat faces for PAYG rates, but in this instance it already (correctly) actively adjusts company inputs to calculate revised opex and capex inputs for use in the financial model when companies have material gaps in their totex allowances.

For UUW, the vast majority of Ofwat's cuts to allowed totex for the DD have been made to areas of enhancements that are typified by (long-lived) infrastructure. These enhancements areas characteristically have average asset lives of 100+ years, and so the resulting natural run-off rates would be far below the aggregate RCV run-off rate for the price control. This means, that by excluding this allowance (and therefore underlying depreciation) from the calculations, the natural RCV run-off rate absent this investment should be higher than what we proposed in our plans.

The example in Table 4 below simplifies the impact of not making an adjustment to the run-off rate when the cost allowances differ from those assumed within the business plan. In the example, as is with the case for UUW, the main area of challenge on cost allowances occurs within long-lived assets.

Table 4: Simplified example showing the impact of reduced cost allowances on the natural rate of RCV run-off

	Ave Asset life (years) [A]	Company totex (£m) [B]	Annual depreciation (£m) [B/A]	Ofwat totex (£m)	Adjusted annual depreciation (£m)
Enhancement A	10	40.00	4.00	40.00	4.00
Enhancement B	40	5.00	0.13	1.00	0.03
Enhancement C	140	250.00	1.79	100.00	0.71
Enhancement D	24	80.00	3.33	60.00	2.50
Enhancement E	60	100.00	1.67	100.00	1.67
Enhancement F	30	25.00	0.83	25.00	0.83
Total		500.00	11.74	326.00	9.74
Natural run-off rate required			**2.35%**		**2.99%**

Source: UUW analysis

Whilst the difference in percentages might appear small, because of the size of the respective RCVs they would be applied to, and the growth many companies are seeing in AMP8 (particularly in wastewater network plus) these small differences in run-off rates can lead to significant differences in revenue requirements that are not being reflected in the allowances by continuing to use the company proposed rates.

We have estimated the impact on revenues that the approach in the Draft Determination has resulted in compared to our business plan assumptions for totex (and therefore RCV), as shown below in Table 5. Because much of the challenge in cost assessment has been on areas categorised by long-lived infrastructure, UUWs run-off rates for the Draft Determination are understated, particularly in Wastewater Network plus. Bioresources experienced a much more observable change to the natural rate due to the relatively smaller RCV and larger challenge on enhancement expenditure as a proportion of this.

Table 5: Impact of reduced totex allowances on natural run-off rates (business plan vs draft determination)

	31 Mar 26	31 Mar 27	31 Mar 28	31 Mar 29	31 Mar 30
WR combined RCV - run-off rate (natural)	2.53%	2.60%	2.66%	2.67%	2.71%
Increase/(decrease) from business plan	(0.04%)	(0.09%)	(0.08%)	(0.02%)	(0.00%)
WN combined RCV - run-off rate (natural)	5.07%	5.05%	5.03%	5.09%	5.27%
Increase/(decrease) from business plan	0.01%	0.04%	0.06%	0.08%	0.09%
WwN combined RCV - run-off rate (natural)	3.50%	3.46%	3.38%	3.28%	3.31%
Increase/(decrease) from business plan	0.04%	0.13%	0.18%	0.20%	0.17%
Bio combined RCV - run-off rate (natural)	12.45%	12.46%	11.72%	11.60%	11.72%
Increase/(decrease) from business plan	0.52%	1.48%	1.98%	2.33%	2.52%

Source: UUW analysis

The difference in resulting revenues of these revised percentages is twofold; the reduced revenues from the additional run-off that should be modelled and an opposing variance in the allowed return (as the RCV is larger than it would be ceteris paribus). We have modelled the impacts of both factors when assessing the difference between revenues in the business plan and the draft determination. Both scenarios use the early view of the WACC (3.23%) for consistency, but the allowed return is a much smaller proportion of the under/(over) recovery

of revenues caused by the difference in run-off rates. We estimate that the total additional revenue requirement that is not included in the draft determination for UUW (because of the artificially low rates) to be approximately £110m over AMP8 (2022-23 prices), split between allowed return and run-off as set out below in Table 6.

Table 6: Impact of reduced totex allowances on revenue allowances (business plan vs draft determination)

Under/(over) recovery	31 Mar 26	31 Mar 27	31 Mar 28	31 Mar 29	31 Mar 30
WR combined RCV - run-off (revenue)	(0.3)	(0.7)	(0.5)	(0.1)	0.0
WR combined RCV - allowed return	0.0	0.0	0.0	0.1	0.1
WN combined RCV - run-off (revenue)	0.5	1.5	2.3	3.1	3.4
WN combined RCV - allowed return	(0.0)	(0.0)	(0.1)	(0.2)	(0.3)
WwN combined RCV - run-off (revenue)	3.6	11.7	17.2	19.0	16.1
WwN combined RCV - allowed return	(0.1)	(0.3)	(0.8)	(1.3)	(1.9)
Bio combined RCV - run-off (revenue)	2.7	7.7	10.1	11.4	11.2
Bio combined RCV - allowed return	(0.0)	(0.2)	(0.5)	(0.8)	(1.2)
Total revenue under/(over) recovery	**6.4**	**19.6**	**27.7**	**31.1**	**27.5**

Source: UUW analysis

Whilst this is a material reduction in allowed revenues from what would be the natural rate, we note that the difference is primarily driven by the large difference between Ofwat and UUW on the assessment of efficient cost for the WINEP CSO programme in AMP8; with Wastewater Network plus having the most material difference between revenues, and on Bioresources enhancement expenditure. We expect that the additional evidence provided in our response to the draft determination for all areas of cost assessment will enable Ofwat to reduce these and the other gaps in its totex allowance for the final determination.

Approach for final determination

We anticipate, having accounted for the additional evidence and representations to the draft determination, that Ofwat will make proper cost allowances such that the difference between the run-off rate proposed by the company and the natural rate implied by the totex allowance will be largely immaterial, thereby making any further adjustment to the RCV run-off rates unnecessary. To the extent that there remains a material gap between the company plan and the totex allowance for the final determination, there will be a material gap in allowed revenues as a result and Ofwat may need to consider adjusting rates to ensure that companies remain financeable.

1.21 Request if the company would like its QAA reward as revenue (as opposed to an adjustment to RCV).

UUW's PR24 proposal

UUW did not include a forecast of the QAA reward in its business plan proposal, nothing that this would be determined by Ofwat in the draft determinations.

Draft determination position

QAA rewards were not included in the draft determinations for UUW.

Approach for final determination

We are willing to accept the QAA reward as an addition to the RCV rather than receiving it as a revenue adjustment for AMP8.

1.22 Do you agree with the overall approach taken in our assessment of financeability? If not please indicate where you provide evidence in support of your response.

Whilst we understand that there are many aspects of the draft determination financeability assessment that are reasonable and justified in principle, we do have concerns that the notional company financeability assessment may not actually provide comfort that efficient companies in the sector are, in fact, financeable.

Headroom against financial ratios has been set too 'close to the wire'. Moody's has already flagged that unless there are changes at the final determination that its assessment of water company business risk has increased, primarily through a likely downgrade of its assessment of the 'stability and predictability of the regulatory regime', and that required financial ratio thresholds will tighten. Other rating agencies may well make similar changes following the final determination. Additional headroom is also required as the gross interest impact on financial ratios has not been reflected.

Further, the notional company financial ratio output is unlikely to be achievable in the real world. Gating mechanisms result in significant levels of spend being excluded from the assessment. The 55% gearing assumption excludes realistic debt and interest costs that almost all companies in the sector will face. Asymmetrical expected performance and insufficient cost allowances that are only partially compensated by sharing mechanisms means that notional company financial ratio output is unlikely to be achieved in practice.

Further, the ratings treatment of our large PR19 DPC project, the Haweswater Aqueduct Resilience Programme, has the potential to weaken our financial resilience which would need to be mitigated by raising additional equity, and this would need to be compensated by an additional equity return to be earned by United Utilities.

These points are covered in more in the DD representation document UUWR_70 Balance of Risk and Return and Financeability, section 3.

1.23 Do you agree that we need to consider further actions to mitigate the impacts on customers of poor financial resilience, for example the proposals on gearing? If not please indicate where you provide evidence in support of your response.

We are pleased that Ofwat remains firmly focussed on the financial resilience of companies in the sector for the long-term. This objective very much aligns with UUW's approach over many years and is supported by Ofwat's assessment '*PR24 draft determinations: United Utilities - Quality and ambition assessment appendix' that UUW met its minimum expectations on financial resilience.*

We agree that gearing is a key metric supporting the risk profile of a company, particularly with regards to financial resilience, and we consequently include RCV gearing as a KPI within our annual reporting. We also agree that higher gearing amplifies both upside and downside performance and that a threshold of around 70% is reasonable at which companies should consider potentially restricting dividends. This aligns to our current & proposed AMP8 dividend policy as stated in section 9.3.5:

"*Where gearing rises above the upper bound of 70% then the Board would give explicit consideration to whether it should restrict the base dividend in order to lower gearing and explain its decision. In the event that the Board approved a base dividend which left gearing above 70% then it would explain to stakeholders what the company's forward looking plan was to manage gearing back to within the normal range.*"

As such, provided it is not too restrictive, we support Ofwat's proposal to signal more firmly in its dividend guidance that a gearing level of 70% is an upper limit beyond which it would expect dividend yields to be restricted in the 2025-30 period.

We welcomed Ofwat's licence changes in 2023 which expanded the factors which require consideration by companies when paying dividends and noted its alignment to our current dividend's policy. However, we question

whether enforcement through further licence changes is actually required to solve the identified issues. Increased transparency and disclosure about company dividend policies is acting effectively to ensure that companies and their boards are accountable to customers and other stakeholders for their decisions and the long term impact this can have on the company. This could be enhanced through additional Ofwat guidance. In our view, this may obviate the need for formalisation through the relatively blunt instrument of further licence enforcement.

We also believe consistency of licences throughout the sector help ensure a level playing field and temporarily changing individual company licences for specific circumstance would create inconsistency throughout the sector as well as an administrative burden.

It is clear that external events, out of control of companies, can occur which impact gearing (for example due to high or low inflation). As such, we believe there should remain some flexibility for companies to appropriately manage dividend policy with reference to gearing. With record sector investment levels proposed for AMP8, and likely to continue in AMP9 and beyond, it is important to continue to attract equity investment for the sector. The potential to introduce punitive downward adjustment to RCVs for PR29 could reduce the attractiveness of the sector, adversely impacting equity investability, which could ultimately increase the required cost of equity for the sector. Such costs would likely be borne by customers over time.

In terms of underlying measure of gearing, we believe Debt:RCV (or Debt:Regulatory Asset Base (RAB) in other regulated utility sectors) is the main, commonly presented and widely understood, industry measure. As such, we have a strong preference to remain with the current debt/RCV metric presentation.

1.24 Do you agree with the proposal to provide funding for the net efficient costs of a company raising equity through a new stock market listing? If not please indicate where you provide evidence in support of your response.

As UUW is a wholly owned subsidiary of a listed company we do not have a view on this question.