United Utilities response to Ofwat's consultation on the PR14 reconciliation rulebook

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1 INTRODUCTION

United Utilities welcomes the opportunity to respond to Ofwat's consultation on the PR14 reconciliation rulebook. We support the goal that customers and their representatives, investors, companies, regulators and other stakeholders should have more clarity about the application of regulatory incentives from the start of the current regulatory period.

United Utilities has sought to provide a comprehensive response and we hope that these observations provide a useful contribution towards the development of the rulebook ahead of publication of a final set of rules in July. At the outset we seek to highlight three key issues:

- The final decision on whether or not to adjust company RCVs for incorrect specification of the CIS model at PR14 is for Ofwat to make. However, if it is minded to make an adjustment then it is important for Ofwat to emphasise the special circumstances surrounding this case and to explain that other elements of the PR14 price determination should not be revisited. We have set out why we believe this would be in the best interest of customers and other industry stakeholders (see section 6.1 below);

- We disagree with the proposed approach to the treatment of ODI taxation. We believe that the proposal is materially inconsistent with both companies' final determinations and the expressed preferences of customers (see section 2.3 below);

- Ofwat's approach to the consolidation of ODI rewards and penalties is not consistent with the proposals set out in our business plan and embodied in the final determination. We therefore expect that Ofwat will recognise the bespoke package of rewards and incentives which was included in the final determination and provide the necessary scope for these to operate as designed. (see section 2.4 below);

We have also provided feedback following a detailed review of the indicative incentive model spreadsheets. We highlight a small number of issues related to the construction of the detailed incentive models and the guidance provided to companies.

We would be pleased to meet you to discuss further the detail of our response at your earliest convenience. If there are any questions you would wish to raise, or if further detail is required, then please do let us know.

2 OUTCOME DELIVERY INCENTIVES

2.1 Indexation (consultation section A2.2)

Ofwat proposed approach: Use actual average year RPI to inflate PR14 values to PR19

We agree with the proposed approach of using actual year average RPI to determine indexation changes to Outcome Delivery Incentives for end of period ODIs.

2.2 Time value of money (consultation section A2.3)

Ofwat proposed approach: Do not adjust for time value of money

We agree with the proposed approach of not adjusting the values of incentives to account for the year in which they are incurred. We consider that this approach would be simple and clear and therefore easy to communicate to customers. The alternative would involve potentially complex adjustments

with comparatively modest impacts.

2.3 Taxation (consultation section A2.4)

Ofwat proposed approach: Allow taxation on ODI rewards and penalties as part of PR19 review

We do not agree that Option 2 ("providing a tax allowance for all ODIs") is the most appropriate approach. This is because the drawbacks which are acknowledged significantly outweigh the potential benefits.

We believe that this proposal is substantially different to the approach set out in both the draft and final determinations. For example, page 94 of Final price control determination notice: policy chapter A2 – outcomes[1], states:

"*The [ODI] cap will operate post-tax and will be calculated at the end of the control period. In the operation of the cap, rewards and penalties will be factored by 80% to make them post tax.*"

This makes no reference to any uplift for tax and the only reasonable conclusion that can be drawn is that ODI penalties and rewards would be applied on a post-tax basis; the adjustment for tax was only applicable to the calculation of the RORE cap and the only rationale for applying such an adjustment was that ODI penalties and rewards were being applied post tax. Given these statements in the final determination, we are concerned that implementing a pre-tax approach now would be inconsistent with the basis on which the company accepted the terms of the final determination.

We also believe that the proposed approach conflicts with the guidance on determining ODI penalties and rewards set out in the final PR14 methodology. Page 1 of the final PR14 methodology document: Appendix 1: Integrating the calibration of outcome delivery and cost performance incentives states[2]:

"*ODIs should be based on WTP with appropriate adjustments – which should include adjustments necessary to take account of the impact of cost performance incentives, so that when considered together the incentives provide appropriate protection for the interests of consumers and appropriate incentives for companies*".

In accordance with this guidance document, cost beneficial ODI targets were developed based on a comparison of the customer willingness to pay against the totex impact of the incremental expenditure, with neither of these calculations taking into account tax impacts on the totex or ODI penalties/rewards.

The proposal also appears to break the link and calibration between the ODI penalties and totex interventions which was used as the basis for developing the performance targets in our business plans and agreeing these targets with our CCG. The different approach now outlined in Ofwat's consultation has not been reviewed or approved by customers or the CCG and therefore cannot be considered to be consistent with the views they have expressed. Also, and as recognised by Ofwat on page 20 of the current consultation on the PR14 reconciliation rulebook[3], providing a tax adjustment would reduce the link to customer willingness to pay.

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[1] http://www.ofwat.gov.uk/pricereview/pr14/det_pr20141212outcomes.pdf

[2] http://www.ofwat.gov.uk/pricereview/pr14/pap_pos201307finalapproachapp1.pdf

[3] http://www.ofwat.gov.uk/content?id=c4d2a58d-d2ff-11e4-a8b0-2fd112cac76f

It is inappropriate to consider the ODI rewards or penalties in isolation of the totex impacts, and we consider that it is important to look at the outcome and totex incentives as a package. For example the reward calculations were designed, calibrated and then recalibrated following company menu choices such that the level of the ODI reward would incentivise companies to cost beneficially improve customer service, by offsetting the totex penalties, which would be associated with the incremental expenditure required to deliver this improved performance level. Therefore when taken together the net impact of the ODI and totex incentives would be broadly neutral and as such would not result in any net additional revenues, forecast profits or tax allowances. This means that accounting for the tax impacts of the ODI without accommodating the tax impacts of the totex would be inconsistent and inappropriate. It could not have been foreseen by UUW either when accepting the final determination or making its menu choice.

The proposal presents a risk of perverse incentives. ODIs and totex interventions were designed to be set to incentivise appropriate behaviours (i.e. to incentivise companies to invest where cost beneficial and not to invest where this was not the case). Following the publication of the final determinations companies were required to recalibrate their ODIs to reflect the revised cost sharing ratios generated through companies menu choices. This recalibration had - in the vast majority of cases - a comparatively minor impact upon the ODI incentives, but was required to ensure that the balance between totex and ODI incentives was maintained. The revision in incentive rates which would be generated by adopting Option 2 would change the balance between ODI and totex incentives by an order of magnitude more than the impacts of the menu choice revisions and could incentivise companies to invest to improve performance (or avoid deterioration in performance) where this was not cost beneficial.

Finally, the proposed approach would also be inconsistent with the RORE impacts determined through Table A20 and published by Ofwat in the final determinations. The approach therefore has the impact of invalidating this assessment of company risk/rewards, and impacting the evidence based on industry cost of capital and financeability.

As such we can see significant disadvantages of revising the approach at this late stage, with no real benefits. We therefore recommend the adoption of Option 4: "adjust ODIs rewards and penalties in PR19 to offset tax adjustment". This would mean that the value of rewards and penalties continued to be aligned to the approach adopted throughout the PR14 process.

We recognise that this option is a more complex approach to implement. However, given the central importance of ODIs to the current and future price determinations we believe the additional complexity is proportionate, manageable and justified.

One option for simplifying the calculation of the adjustments to the RCV element of ODI rewards and penalties could be to base all adjustments on the effective tax rates reflected in the PR14 financial model runs for each company. It would appear reasonable to apply the weighted average of the annual effective current tax rate used in calculating allowed revenues for each company at the time of the price review. The annual value for each company was reported as part of each company's Ofwat Financial Model run, in the "Tax Reconciliation" report, line 38. The weighted annual average could then be applied as a discount to RCV based rewards and penalties before adjusting company RCVs at the end of the period.

We believe this approach is relatively simple to implement, enables the strength of tax adjustments for RCV penalties/rewards to be established upfront, and is broadly equitable for customers and other

stakeholders. However we recognise this is only one of a range of possible approaches to making such an adjustment, and we would be happy to discuss alternatives to implementing RCV tax adjustments with Ofwat further.

2.4 Aggregate cap and collar (consultation section A2.5)

Ofwat proposed approach: Do not adjust ODI rewards and penalties for taxation comparison with cap

We support the approach to calculating the aggregate cap and collar that was set out within "Final price control determination notice: policy chapter A2 – outcomes" and are happy that for the purposes of determining the cap, netting off between years should be allowed, but that netting off between rewards and penalties, should not.

Based upon our response to section A2.4 above, we do not however, support the proposal that Option 1 is the best approach. Under this option, the 80% factor to rewards and penalties would not be applied in determining the ODI cap. We recommend that option 2 is adopted to ensure consistency with the approach set out within policy chapter A2 and with our recommendation on taxation in the above section.

In the consultation Ofwat states that the policy intent of this approach is the same as the final determination, but acknowledges that the approach would depart in some of the detail. We agree that in respect of the derivation of the cap the impact would be the same, but consider that the application of the approach to taxation on individual and non capped aggregate ODI penalties and rewards, would depart markedly from the policy intent articulated throughout the development of the price review methodology and within both the draft and final determinations.

We have also observed that the current outcome delivery incentive reconciliation spreadsheet, calculates the net sum of the revenue and the RCV ODI penalties/rewards separately. This produces two single net impacts upon RCV and revenue respectively. This calculation appears to be on the basis that most companies' individual ODIs will either impact upon revenue or on RCV, but not both.

This is not the case for UUW as set out in the final determination, whereby penalties and rewards associated with ODIs can impact upon either revenue or RCV depending upon whether the net position of all ODIs in total results in a penalty or a reward. That is, if the sum of all individual ODIs results in a net reward, then the net reward is applied to the RCV. If the sum of all individual ODIs results in a penalty, then the net penalty is applied as a revenue adjustment. (Appendix A of this response incorporates a worked example of the application of this mechanism.)

This was the approach which was agreed with the CCG and was developed on the basis that, whilst preferring bill stability overall, customers typically prefer to see increases in bills phased in gradually (as embodied in the RCV-based approach to an overall reward) and decreases in bills phased in sooner (as embodied in the revenue-adjustment approach to an overall penalty.) This was an approach which, in UUW's case, was applied across all ODIs on a global basis. This approach is different from that adopted by many other companies, whereby rewards might be applied to revenues – and therefore be reflected by a short term increase in bills – and whereby penalties might be applied to the RCV – and therefore customer bills would only reflect the benefit of this over the very long term.

It is important to note that the statements of how this mechanism was designed to apply were explicitly set out in our business plan submissions and Ofwat made no adjustments or offered subsequent clarification on how these proposals would be applied prior to this point. Accordingly, the final determination was accepted by the company on the basis that the application of rewards and

penalties would be as set out above, and as described in the final and draft determinations.

We therefore expect that Ofwat will recognise the bespoke package of rewards and incentives which was included in the final determination and provide the necessary scope for these to operate as designed. We do not believe it would be appropriate for Ofwat to overwrite the position proposed and confirmed in our business plan and final determination, and as supported by the CCG, given that there has been no reference to such a change being proposed in either the draft or final determinations.

2.5 Scheme ODIs (consultation section A2.6)

Ofwat proposed approach: We set out principles that will apply to the assessment of major scheme ODIs in PR19

We recognise that the options presented are incremental and support the recommended Option 2.

All options confirm the basic final determination requirements that companies should report annually and that Ofwat would review the delivery of schemes at PR19 against evidence provided. We agree that the additional step in Option 2 "Ofwat sets principles that will apply to the assessment of major schemes" is beneficial.

We also agree that the two final steps proposed through options 4 and 5, "Ofwat undertakes a full review of major scheme ODIs and mandates companies to publish specific information" and "Ofwat undertakes an interim review in 2017-18 to review the delivery of a number of major schemes" are unnecessary and would involve a disproportionately large additional burden of work, given the very limited benefit.

We also recognise that the additional step discussed in option 3 should not be necessary. Companies should be able to take ownership of their documentation and publications and there is a potential risk that detailed publication of current plans and assumptions could artificially constrain innovation in delivering the outcomes for customers.

As such we would support the recommended Option 2: Ofwat setting principles that will apply to the assessment of major scheme ODIs.

2.6 Asset health ODIs (consultation section A2.7)

Ofwat proposed approach: Require companies to publish further details for asset health measures where these are not included in PR14 final determinations

We support the proposal that companies should publish further information on the operation of their asset health ODI indices including details of the supporting formulae.

We also recognise that the final determinations would take precedence over any additional information that we were to publish should there be any conflict.

3 WHOLESALE TOTEX

3.1 Definition of totex for menu sharing (consultation section A3.2.1)

Ofwat proposed approach: Exclude items not included in the menu baseline such as third party costs, pension deficit recovery and transition costs

We broadly support the revised definition of totex for menu sharing, but seek clarification on three elements of the proposed adjustments.

We assume the proposed removal of pension cash contributions is intended to relate solely to cash contributions for pension deficit recovery, and not to cash contributions for current service. This definition of menu totex would align with the approach adopted in setting the menu baseline in companies final determinations.

We would welcome greater definition of the proposed removal of costs associated with fines, investigations, and compensation claims. We recognise it would not be appropriate for the cost of regulatory fines, or associated investigations, to be shared with customers. However there are instances where it may well be appropriate for such costs to form part of the menu. This can be particularly true in instances where customers derive material benefit from company action in defending unmerited third party compensation claims.

We would also welcome greater definition of the proposed legacy depreciation adjustment, perhaps including a worked example. We agree that recharges between price controls resulting from the "principle use" approach to allocating historic cost depreciation should not drive a net variance in company observed performance against the totex menu baseline; however we are not clear as to how these adjustments should best be made in practise.

3.2 Indexation (consultation section A3.2.2)

Ofwat proposed approach: Deflate future year total expenditure using actual RPI for comparison for PR14 allowance

The proposal to deflate future year totex by year average RPI before comparison with final determination baseline totex appears consistent with our understanding of the totex mechanism at the time the company accepted the final determination. On this basis, we support this approach.

3.3 Allocation of totex out and under performance to revenue and RCV (consultation section A3.2.3)

Ofwat proposed approach: Allocate out- and underperformance using weighted average PR14 PAYG rate, with companies providing robust evidence for changes that are in customers' interests.

On balance we support the proposed approach, noting that at the time of the final determination the question of how to allocate future rewards/penalties between revenues and RCV had not been explicitly addressed.

In common with a number of other companies we adjusted the annual PAYG rates within our business plan submissions to help smooth annual movements in customers' bills. We therefore recognise that each annual PAYG rate may not be an appropriate value for allocation of totex performance between revenues and RCVs. The use of the five year weighted average values appears a reasonable approach to both simplifying management of the totex mechanism, and avoiding unintended incentives on company investment profiles, and as such we support this approach.

We also support the inclusion of some flexibility into the methodology by allowing companies to propose an alternative PAYG rate where it is demonstrably in customers' interests. Our assumption is that any adjustment would be for companies (rather than regulators) to propose, having sought the views of customers.

3.4 Time value of money (consultation section A3.2.4)

Ofwat proposed approach: Adjust for time of money for customer sharing of out-/underperformance

The proposal to adjust for the time value of money appears consistent with our understanding of the totex mechanism at the time the company accepted the final determination and is consistent with the

core principles of menu regulation. On this basis, we support this approach.

3.5 Taxation (consultation section A3.2.5)

Ofwat proposed approach: Include a taxation adjustment for RCV changes only

On balance we believe that the preferred approach of making a tax adjustment for RCV changes only is not in the best interest of customers or the long term integrity of menu regulation. Instead we believe that Option 2 "Do not include a tax adjustment for the customer share of totex out/under-performance in PR19" represents the best approach to adjusting for tax under the totex mechanism.

By applying an asymmetric approach to tax adjustments between revenue and RCV adjustments the incentives the totex mechanism places on companies is compromised. The totex mechanism is one of the most powerful regulatory incentive mechanisms deployed by Ofwat, and as such it is to be expected that companies will respond strongly to all of the incentives inherent within the mechanism. Tax adjustments in most cases adjust marginal allowed revenues by c.20%. This is a very material proportion of the total value of rewards/penalties due under the totex mechanism. If revenue based adjustments are subject to a different tax treatment than RCV adjustments companies will observe a material bias in the totex incentive package and are likely to respond to this. Any action companies take to respond to unintended incentives, rather than pursuing core efficiency, is by its nature likely to be to the detriment of customers.

We recognise that option 2 "Do not include a tax adjustment for the customer share of totex out/under-performance in PR19" is a more complex approach to implement. However, given the strength of the totex mechanism and its central importance to the current and future price determinations, we believe that this complexity is reasonable and proportionate in order to protect the integrity of the totex mechanism's incentives.

In section 2.3 we set out an example of how RCV adjustments could be adjusted for tax effects as part of price determinations in 2019. We believe this approach is relatively simple to implement, enables the strength of tax adjustments to be established upfront, and is broadly equitable for customers and other stakeholders. However we recognise this is only one of a range of possible approaches to making such an adjustment, and we would be happy to discuss alternatives to implementing RCV tax adjustments with Ofwat further.

4 WHOLESALE WRFIM

4.1 In period ODIs (consultation section A3.3.1)

Ofwat proposed approach: Exclude revenue changes from in-period ODIs from WRFIM reconciliation

As UUW does not have in-period ODIs we provide no comment on this element of the consultation.

4.2 Taxation (consultation section A3.3.2)

Ofwat proposed approach: Do not include taxation adjustment in PR19

As the proposed approach is in line with our preferred approach to the treatment of tax for ODIs and totex we support the option to not include a taxation adjustment in PR19.

4.3 Blind year (consultation section A3.3.3)

Ofwat proposed approach: make an adjustment in PR19 for the blind year based on forecast outturns

We support the proposed approach.

4.4 PR14 reconciliation rulebook: WRFIM

We believe that the rulebook would benefit substantially through the provision of more clarity

regarding the application of the revenue caps.

If a company under-recovers revenue in year 1 it is not clear whether it is intended that tariffs set in year 3 should be set in a way that they would be allowed to over recover the year 3 revenue cap, i.e. to make up for the short fall in year 1.

Any changes in policy regarding the surface water drainage refund policy and the period of time over which refunds are provided could, in the year of introduction, affect the ability to set charges in a way that meets the revenue cap. It would therefore seem reasonable that companies are allowed to reflect such changes in later years in order to recover the allowed revenue over the five year period.

However this may result in a company over recovering the revenue cap in a later year to make up for a short fall in an earlier year. It would be helpful to specifically clarify that this approach is acceptable and considered compliant with Condition B of the Instrument of Appointment.

Further clarity is also needed on the source of the information to be used for allowed revenues in 2012/13 prices. Revenues in 2012/13 prices are published in the final determination documentation – Table A6.2, but using these numbers and inflating by the appropriate RPI provides a different number in outturn prices than that set out for 2015/16 in the covering letter. We consider that it is important to explain the approach taken to RPI conversion (between average and November-November) in order to ensure that the company sets tariffs with a view to recovering an amount which is consistent with Ofwat's view of the calculation.

5 WATER TRADING INCENTIVES

5.1 Export incentive (consultation section A3.4.1)

Ofwat proposed approach: Payment at PR19 of 50% of the full discounted economic profit for the forecast life of the export capped at 100% of the economic profit for the years the export operates in 2015-20

The proposal to make a payment equal to 50% of the fully discounted economic profit of a trade appears consistent with our understanding of the water trading incentive at the time the company accepted the final determination. As such we support this approach, albeit with a modified cap.

The proposal to cap the value of the incentive at the next price determination is sensible given the uncertainty that exists around projections of future profitability. However we believe that the proposed cap of 100% of the economic profit in the period 2015-20 is likely to be unduly constraining and complex to operate. Instead we recommend that the cap be set at 1% of the exporter's water service turnover.

The current proposed capping mechanism is likely to significantly delay companies receiving benefits from trades implemented late in the 2015-20 period, and might therefore reduce incentives to pursue such trades. It is also likely to delay full resolution of incentives for all exporters for some years to come, introducing continuing complexity in the regulatory regime, even where the scale of a trade may be relatively trivial in nature. Whilst we recognise the need to protect customers where the future profitability of a trade is both uncertain and material, we see significant benefits in simplifying the proposed approach to capping.

We propose that the cap be set in the same way as the proposed import incentive cap, scaled up to recognise the increased strength of the export incentive, thus implying a cap set at 1% of the exporter's water service turnover. This approach will protect customers from future material

uncertainty, whilst simultaneously ensuring that companies are less sensitive to the year in which a trade is initiated and means that trades that are relatively trivial in size can be fully resolved at the next price review, reducing future complexity.

5.2 Import incentive (consultation section A3.4.2)

Ofwat proposed approach: Qualifying imports will benefit from an import incentive of 5% of the costs of water imported subject to an incentive cap of 0.1% of importers water activity turnover.

The proposal to make a payment equal to 5% of the costs of a trade appears consistent with our understanding of the water trading incentive at the time the company accepted the final determination. As such we support this approach.

5.3 Inflation, time value of money and taxation (consultation section A3.4.2)

Ofwat proposed approach: Adjust for inflation to the base year of PR19, adjust for time value of money and provide a tax allowance.

The proposals to adjust for inflation using year average RPIs, adjust for the time value of money, and to provide for tax allowances all appear consistent with our understanding of the water trading incentive at the time the company accepted the final determination. As such we support this approach.

6 PR09 RECONCILIATION

6.1 Indexation in the CIS RCV (consultation section A4.2)

Ofwat proposed approach: Adjust PR19 opening RCV for amount remaining in the RCV due to the use of different indexation assumptions. This would result in a reduction in the overall industry RCV from 2020.

The final decision on whether or not to adjust company RCVs for incorrect specification of the CIS model at PR14 is for Ofwat to make. As the regulatory treatment is common to all companies, it is important that if any adjustment is to be made, it is done explicitly and applied on a consistent basis to each company. We therefore welcome the opportunity to comment on this matter.

We firmly believe that an adjustment would not be appropriate if the RCV in question had either 1) been efficiently incurred (ie: investment made in the interests of providing efficient service to customers, based on the information available to the company at the time of committing the investment) or 2) had arisen through the expected operation of established regulatory methodologies.

In this case it appears that the element of the RCV in question would not normally have been expected to accrue as a result of the established regulatory methodologies in place at the time. Given this, the decision on whether or not to now make an adjustment for it should be made based on broader criteria reflecting the way in which the RCV was attributed to companies in the first place and whether an adjustment now adjusting for the relevant amount is 1) in customers' interests and 2) in accordance with Ofwat's duties and the principles of better regulation.

We believe that this perspective is similar to the approach set out by Ofwat in its consultation. It is also clear that a similar view was taken by the Competition Commission in its review of the Northern Ireland Electricity determination:

"*The regulatory 'contract' is that, on the one hand, firms should have the confidence to invest and plan for the future on the understanding that the regulator will not revisit the rules of a regulatory agreement after the event… we find that revisiting the terms of previously set price control should be considered very carefully because it might otherwise undermine the regulatory 'contract' under which*

firms in regulated industries operate, and therefore their confidence to act in a way which would reap longer-term benefits for consumers."

(extract from the Competition Commission's "Northern Ireland Electricity Limited price determination", Section 15)

On this basis we believe it is important to be clear about why the approach that Ofwat adopted at the draft determination - and which underpinned the final determination - can now be changed without undermining the regulatory 'contract' as described by the Competition Commission above.

Importantly, if the reason for the change in approach was merely that Ofwat had reassessed its methodology and, based on further reasoning, it had decided to take an alternative view about two equally correct approaches, then making the change might trigger concern that this could be in conflict with the principles of better regulation. Specifically, it would give rise to concerns that the change of approach did not demonstrate consistency over time. It could also raise the question of whether there were other aspects of the determination which could subsequently be open to reinterpretation or a revised evaluation.

Based on our conversations with Ofwat, we do not believe that these concerns need arise in this particular instance. This is because we understand that the reasons underpinning the change are more substantial than merely electing to take a different view. In fact, the change is driven by a recognition that the approach adopted in arriving at the draft determination was not in line with the original expectations of how the CIS adjustment would work. Having evaluated the magnitude of this impact, Ofwat subsequently decided that the implications were too significant to ignore and, therefore, has subsequently recalculated the adjustment in a corrected calculation which more accurately reflects the original expectations of how the CIS adjustment mechanism would work. Evidence in support of this interpretation can be found, for example, in the representations that UUW made in relation to the CIS model in its December 2013 business plan *"S-TC003-Wholesale Wastewater Table Commentary"* and, we understand, in the representations made by other companies at various times.

We recognise the magnitude of the RCV adjustment set out in '*260315- 2009 Price Review CIS reconciliation.xlsx*'. In deciding whether or not to make such an adjustment, we consider that Ofwat should ensure that it is able to answer "no" to each of the following questions:

- **Would the proposed adjustment de-recognise RCV which was either efficiently incurred or which had arisen through the expected operation of established regulatory methodologies?**

  Ofwat has previously made significant commitments to continued recognition of efficiently incurred RCV and these have carried great weight with the investment community. It is important for future confidence in the industry that Ofwat honours such commitments. This is because if investors were to believe that this adjustment breached this commitment, then there would be the potential for detriment to current and future customers to be greater than the matter that Ofwat is seeking to correct. [4]

[4] For example, Ofwat's proposal affects approximately £1.2bn of industry RCV (2012/13 prices). But if this adjustment reduced investor confidence and therefore increased the cost of financing then even a modest 0.25% increase in the industry cost of capital for a period of 10 years would more than wipe-out long-term customer benefits of reduced RCVs, on an NPV basis. Additionally, short term customer bills would be significantly detrimented, with company revenue requirements increasing by a net £330m over the years 2020-2025.

- **Would the proposed adjustment be retrospective in nature, or set a precedent for other adjustments which might be retrospective?**

  It is clearly stated in the consultation that any adjustment to the RCV would be applied as part of a future price determination and would not seek to reopen revenue requirements for 2015-20. We welcome this and believe it is important that the AMP6 determination is kept whole. However, it is also important to assess whether or not this change is timely. In particular, it is important to consider how far back in time the revisiting of past judgements can reasonably be made, even if in this case the proposal to reset RCVs has been made sufficiently quickly. Without such an assessment, there may be concerns that other aspects of the final determination might be subject to subsequent adjustment in the future.

- **Would application of the adjustment conflict with the principles of better regulation published by DBIS?**

  Ofwat has already indicated that this is a key consideration, which we welcome.

Net value retained in AMP6

As stated above, the identified issue with RCV indexation is similar to that raised in our representations on the CIS in December 2013 "*S-TC003-Wholesale Wastewater Table Commentary".* Our view is that this was not the only error in the CIS model at PR14. In fact, we consider that the model contained two errors which, in the case of UUW at least, were partially offsetting: 1) indexation was incorrectly applied in calculating the 2015 midnight adjustment to the RCV and CIS revenue rewards and 2) penalties were also incorrectly assessed. Ofwat is now proposing to adjust for the former, but has not recognised the latter.

We believe that the approach to application of rewards and penalties (ie: item 2 above) served to incorrectly reduce UUW's allowed revenues by £69m.

Because Ofwat is proposing to allow companies to retain the benefit of the increased RCV for the period of AMP6, we are not inclined to further pursue the issue of the CIS model's incorrect calculation of rewards/penalties. However, we do wish to record that our view is that, in UUW's case, the benefit associated with retaining the increased RCV during AMP6 (as described by Ofwat in its consultation) has already been substantially offset by the reduction in revenues attributable to the incorrect calculation of rewards/penalties. In addition we highlighted a number of further errors and omissions within the price review process which mean that overall we will not have received any undue benefit from the approach that Ofwat is proposing to take in respect of the midnight adjustment to RCV.

6.2 Blind year (consultation section A4.3)

Ofwat proposed approach: Include a materiality threshold for the blind year adjustment.

We agree that Option 2 is the most appropriate approach, as this would only result in adjustments being made where there is a material impact on customers.

We support the proposed materiality thresholds and the basis of the derivation of these thresholds.

We note the basis of the calculation used in the supplied spreadsheets, which calculates materiality independently four times: water, wastewater, RCV and revenue. Given the complex interaction

between legacy RCV adjustments, revenue adjustments, and final inflation indices, we recommend that the specific circumstances of each company be considered when determining the interaction of materiality tests.

6.3 COPI updates for the CIS model (consultation section A4.4)

Ofwat proposed approach: Adjust for COPI when accurate data becomes available (for example, in 2016)

The current proposal to adjust for COPI when a full and final series becomes available appears consistent with our understanding of the approach to AMP5 legacy adjustment true-ups at the time the company accepted the final determination. On this basis we support this approach.

However as there is considerable uncertainty as to the nature and timescale for the provision of future COPI series we believe this issue may need to be revisited as and when further information is provided by BIS and/or the ONS. This issue may require further consultation between Ofwat and companies if future COPI series are not well aligned to the series released by BIS during AMP5.

6.4 PR09 reconciliation adjustments in the PR19 review (consultation section A4.5)

Ofwat proposed approach: indexation undertaken based on actual RPI, time value adjustments will be made only for all adjustments to take account of the difference between the timing in the adjustment, tax adjustments will be applied.

The proposals to adjust for RPI, the time value of money, and taxation appear consistent with our understanding of the approach to AMP5 legacy adjustment true-ups at the time the final determination was accepted by the company. On this basis we support this approach.

7 HOUSEHOLD RETAIL

7.1 Reconciliation of household retail control (consultation section A5.2)

Ofwat proposed approach: Include a wash-up between allowed and outturn revenues in PR19

We support the proposed approach.

7.2 Time value of money (consultation section A5.3)

Ofwat proposed approach: financing cost adjustments should only be made if differences are material.

We do not support this approach as it is inconsistent with the application of time value adjustments to other revenue and cost incentive measures contained within the rule book. UUW considers that it would be more appropriate to treat household retail on the same basis as all other areas and that the rule book should make a firm commitment to this.

7.3 Taxation (consultation section A5.4)

Ofwat proposed approach: Do not adjust for taxation

As the proposed approach is in line with our preferred approach to the treatment of tax for WRFIM we support the proposal to not include a tax adjustment.

7.4 PR14 reconciliation rulebook: household retail

We observe that neither the rulebook nor associated spreadsheets appear to anticipate that a company may have subsidised tariffs that do not rebalance onto other customers.

UUW introduced a social tariff in 2015/16. This tariff was supported by our customers on the condition that the company funded part of it. Therefore in setting our tariffs for 2015/16 we have not rebalanced

the full impact onto other customers. An adjustment could be made to the spreadsheet to take account of this or we could provide supporting documentation. Clarification of the Ofwat preferred approach should be included in the rulebook.

8 OTHER ISSUES

8.1 Land sales (consultation section A6.1)

Ofwat proposed approach: Continue PR94 approach, deduct 50% of the net proceeds of qualifying land sales from the RCV.

We support the proposal to continue with the well established methodology for land sale adjustments.

8.2 Gain sharing mechanisms (consultation section A6.2)

Ofwat proposed approach: it is companies responsibility to ensure that gain sharing mechanisms do not cause issues with the operation of other mechanisms in the reconciliation rulebook.

As UUW does not have an in period gain sharing mechanism we provide no comment on this element of the consultation.

9 ACCOMPANYING SPREADSHEETS

9.1 Review of accompanying spreadsheets

We have reviewed the accompanying spreadsheets and our observations on these are included in table 1 below.

Table 1: Summary of observations on the spreadsheets accompanying Ofwat's PR14 reconciliation rulebook consultation documents

Model	Observation	Location of observation in model	Proposal
Totex menu reconciliation	Calculation of the totex adjustment appears to reference actual totex before considering totex exclusions and inclusions. As a result it appears that expenditure excluded from the totex menu contributes to the calculation of future revenue and RCV adjustments.	Worksheet 'Calcs', rows 102 and 103	Apply totex exclusions and inclusions to actual totex before calculating under/(over) performance.
Totex menu reconciliation	Calculation of financing effects includes a half year uplift, in recognition of payment mid-year. Whilst a legitimate approach to calculating financing effects it differs from the approach used within the WRFIM, which considers full years.	Worksheet 'Calcs', rows 110 and 111	Recommend consistent approach to calculating financing effects across all reconciliation tools. As the WRFIM calculation is defined in companies' final determinations recommend that the totex financing effect calculation is aligned to the approach adopted for the WRFIM.
Totex menu reconciliation	The model calculates total totex menu rewards/(penalties) for the period, and then profiles evenly over the period. However these rewards/(penalties) are then subject to financing effects, resulting in an artificial financial adjustment disassociated with the time at which out/(under) performance occurred.	Worksheet 'Calcs', rows 96 and 97	Recommend that total period totex menu rewards/(penalties) are associated with the years in which company out/(under) performance occurred.

Model	Observation	Location of observation in model	Proposal
WRFIM reconciliation	The model is applying Revenue Variances, Penalties and RCM Blind Year Adjustments with a 2 year lag, however this does not appear consistent with existing Licence Conditions. Previous statements suggested that the WRFIM would apply revenue corrections at the next price review.	Worksheets 'WRFIM - Water', and 'WRFIM - waste'	Recognise that where companies' licences prevent them from adjusting price controls in period the valuation of the "Adjusted Allowed Revenue" (line 26) should not include the impact of the "AMP5 RCM blind year adjustment" (line 20), or the "AMP6 forecasting incentive adjustment including over / under recovery true up" (line 24). Instead the calculation of the "Total reward / (penalty) at the end of AMP6" (line 54) should capture all wholesale revenue variances.
WRFIM reconciliation	Revenues in 2012/13 prices are published in the final determination main document in Table A6.2, however if these are used and inflated by reconciliation model RPI, this produces a different figure in outturn prices compared to the revenue in 2014/15 prices communicated in the final determination covering letter when inflated to outturn prices. To comply with Condition B the figure from the covering letter (quoted in 2014/15 prices) is used to set charges. The difference between the two methods appears to be due to the difference between Average year RPI and Nov RPI.	Worksheets 'WRFIM - Water', and 'WRFIM - waste'	Further clarity is required regarding the source of information to be used for Allowed Revenues, including how the calculations reconcile with values included in companies' final determination covering letters and condition B of companies' licences.
WRFIM reconciliation	Potential incorrect application of indexation in formula for "RFIM adjustment - to be applied after two year lag".	Worksheets 'WRFIM - Water', and 'WRFIM - waste', row 39	It appears the formula should inflate variances by RPI for year (t-1) x RPI for year (t), however the formula actually uses compounded RPI for year (t-1) x compounded RPI for year (t).

Model	Observation	Location of observation in model	Proposal
Water trading	Current model set-up implies the appointed business cost of capital of 3.75% should be used in calculations, however as incentive applies entirely to the wholesale price control should probably use 3.6% WACC	Worksheet 'Export incentive', cell F16; Worksheet 'Import incentive' cell F56	Alter real cost of capital from 3.75% to 3.6% for non-enhanced companies
Water trading	Current model set-up requires all costs and revenues to be entered on a "real" basis, however it is not specified how "real" values should be calculated.	Worksheet 'Export incentive'; Worksheet 'Import incentive'	Specify that "real" inputs should be stated in 2012/13 year average RPI, consistent with Totex and ODI incentive models.
Water trading	Model requests that all import costs are entered on a "real" basis, however the "RPI adjustment" element of the model then applies an adjustment factor as if the inputs are on a nominal basis	Worksheet 'import incentives', rows 47 - 52, and row 63	Remove the "RPI adjustment" elements of the calculation
Water trading	Current model requires forecast export costs to be inclusive of a return on capital, however does not specify how this return on capital should be calculated.	Worksheet 'Export incentive', rows 26 and 67	Provide guidance on the basis for the inclusive return on capital within input water export costs, in particular dealing with assumed cost of capital post 2020.
Water trading	Current model includes an option to input costs associated with export trades for 2014-15, but then excludes 2014-15 costs from the calculation of the export incentive.	Worksheet 'Export incentive' column J	Provide guidance on when it is appropriate to include pre AMP5 costs in the assessed costs for a water trade.
Water trading	The model recalculates import incentive rewards into PR19 base year prices, but does not do so for export incentives.	Worksheet 'Import incentive', rows 60 to 68	Recommend a consistent approach to quoted price base within the water trading model. Either restate export incentives in PR19 base year prices, or remove the base year revaluation calculation from the import model.

Model	Observation	Location of observation in model	Proposal
Water trading	The model carries a maximum of 25 years of future costs and revenues, however asset lives and contracts associated with exports may exceed 25 years.	Worksheet 'Export incentive'	Include functionality within model to extend export trade lives beyond 25 years.
Water trading	The "time value of model" adjustment factors use different base years, with the export incentive calculated to 2015-16 and the import incentive based in 2014-15	Worksheet 'Export incentive', row 19; Worksheet 'Import incentive', row 58	Use a consistent base year for calculating the time value of money effects. Recommend aligning to totex financing approach (noting recommendation for adjustments to totex approach set out above).
2009 price review legacy blind year	The "Total adjustment due to financing costs Revenue" calculation is based upon the value being greater than zero, rather than not equalling zero. This means that only positive adjustments are displayed.	Worksheet 'calcs water' and 'calcs – wastewater', row 37	Calculate "Total adjustment due to financing costs Revenue" based upon both +ve and -ve values.
2010 price review legacy blind year	No observed adjustment made within the model for variances in outturn land sales.	N/A	Recommend variances in land sales be included in the calculation of blind year RCV adjustments.
ODI reconciliation	See section 2.4		
Household retail reconciliation	See section 7.4		
2009 Price Review CIS reconciliation	No observations		

Model	Observation	Location of observation in model	Proposal
Revised CIS model with alternative RCV calculation	No observations		

APPENDIX A – APPLICATION OF ODI PENALTIES AND REWARDS

This appendix reproduces the content of UUW's Annex 4 query sent to Ofwat on 12 January 2015; seeking confirmation that no interventions had been made to the application of penalties and rewards to revenues or RCV as proposed in our business plan.

In Annex 4 of the UUW Final Determination ("Outcomes, performance commitments and ODIs"), the following is stated in respect of the application and form of rewards and penalties:

Timing and frequency of rewards/penalties
This delivery incentive will be applied at the next price determination for the performance year 2015-16 – 2019-20. A cumulative net penalty or reward for all the financial measures within a price control will be calculated. For performance in the year 2019-20 United Utilities will make an estimate of the cumulative net penalty or reward for all the financial measures. Any difference from the estimate will be dealt with through an adjustment in AMP8.

Form of reward/penalty
Where a cumulative net penalty is calculated, this will be applied as a revenue adjustment to ensure customers are fully compensated for any underperformance. Where a cumulative net reward is calculated, this will be applied as an upward adjustment to the RCV, to minimise the short-term impact on customer bills.

This appears consistent with the approach we proposed in our business plan, and reiterated most recently in our representations submission (e.g.: Section 1.3, page 4 of REP06 Outcome Delivery Incentives.) We have not identified any interventions to this approach.

On this basis, we would expect the calculation process for the cumulative net penalty or reward for each price control would be as proposed in our business plan and set out in the two examples below (where penalties are negative numbers and rewards are positive numbers.)

EXAMPLE 1:

	AMP6 Yr 1	AMP6 Yr 2	AMP6 Yr 3	AMP6 Yr 4	AMP6 Yr 5	Total AMP6
ODI 1	-20	-20	-20	-20	-20	-100
ODI 2	-30	-30	-30	-30	-30	-150
ODI 3	40	40	40	40	40	200
Total	**-10**	**-10**	**-10**	**-10**	**-10**	**-50**

Result and Application: AMP7 revenue penalty of £50m

EXAMPLE 2:

	AMP6 Yr 1	AMP6 Yr 2	AMP6 Yr 3	AMP6 Yr 4	AMP6 Yr 5	Total AMP6
ODI 1	20	20	20	20	20	100
ODI 2	30	30	30	30	30	150
ODI 3	-40	-40	-40	-40	-40	-200
Total	**10**	**10**	**10**	**10**	**10**	**50**

Result and Application: AMP7 RCV adjustment of +£50m