

December 2019

# PR19 final determinations

**United Utilities – Aligning risk and return  
final decisions**

## PR19 final determinations: United Utilities – Aligning risk and return final decisions

In our [draft determinations](#) we published the ‘Aligning risk and return actions and interventions’, the ‘Securing long-term resilience actions and interventions’ and the ‘Securing confidence and assurance actions and interventions’ document for each company. This set out the required and advised actions in our initial assessment of plans, a summary of the company’s response to the action, our assessment of the company’s response, and any further interventions we made as part of the draft determination.

This document sets out the decisions we are making for the final determination in response to representations received from companies on our draft determinations and changes for the final determination that are not resulting from representations received. We set out our response to thematic representations and representations from other stakeholders within the ‘Aligning risk and return technical appendix’ and the ‘Allowed return on capital technical appendix’. Our ‘Allowed revenue appendix’ for the company is published alongside this document. These documents are intended to be fully consistent. In the event of any inconsistency, the other documents listed above take precedence over this document.

Table 1 below sets out the action/intervention reference, our assessment and rationale for the draft determination, a summary of the company representation, our assessment and rationale for the final determination and our decisions for the final determination.

Table 2 sets out any further decisions that are not resulting from an action and/or representation which we are making as part of the final determination.

Each action has a unique reference. The prefix ‘Uuw’ denotes the company United Utilities. The central acronym references the test area where the action has been identified, please see the ‘Glossary’ for a key to these acronyms. Actions whose numbers are preceded with an ‘A’ denote required actions and actions whose numbers are preceded with a ‘B’ denote advised actions. Draft determination interventions not resulting from an initial assessment of plans action are preceded with a ‘C’ and new interventions for the final determination not related to a previous action are preceded with a ‘D.’ For all other documents related to the United Utilities draft determination, please see the [final determinations webpage](#).

**Table 1: United Utilities – Representations in response to the draft determination**

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
Risk and return	Uuw.RR.A1	For the assessment of notional financeability, the proposed dividend yield for the notional company exceeds the real cost of equity on a blended CPIH:RPI basis. The company should revise the dividend yield (and associated dividend growth) for the notional company to reflect the real CPIH:RPI blended cost of equity of 4.52%. The company should reconsider the level of the PAYG adjustment and provide more	No intervention required.  United Utilities has complied with the action. We accept the evidence provided in relation to the financeability constraint and apply the revised PAYG adjustment proposed by United Utilities in our draft determination. We accept the RCV run off rates proposed by United Utilities and apply these in our draft determination.	Representation made.  The company makes a representation in relation to notional dividends yields, setting out that the policy should recognise that assumed rates of dividend growth persist across price control periods. United Utilities states that the dividend yield assumption should include an amount relating to growth over the period of time in which we have been applying a ‘base yield plus real growth’ approach to notional dividends	Change for the final determination.  We do not accept the company proposal. We discuss how we determine an appropriate base dividend yield in the ‘Aligning risk and return technical appendix’ and the circumstances in which we may vary the dividend yield.	RCV growth for United Utilities’ final determination is less than 10%. Therefore consistent with our policy approach set out in ‘Aligning risk and return technical appendix’ we apply our notional dividend yield to 3.00% (from 3.16% in the fast track draft determination) and apply a dividend growth of 1.18% (1.36% in the fast track determination).

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		evidence to justify its choice of RCV run-off rates.				
Risk and return	UUW.RR.C1	United Utilities' approach to PAYG rates is to recover in each year an amount equivalent to operating costs. The Ofwat view of totex has a different profile of operating and capital expenditure. Using the company's PAYG rates would result in PAYG revenue not being consistent with the approach stated in the business plan.	We are intervening to amend the PAYG rates across all wholesale controls to reflect the mix of operating and capital expenditure in our view of efficient costs in the draft determination. The changes maintain the company's stated approach for PAYG of recovering operating costs.	<p>Representation made.</p> <p>The company states that following representations made to cost adjustments, Ofwat should calculate the natural PAYG rate with the correct view of opex and capex and maintain the 1.8% uplift applied in the draft determination.</p> <p>Further to this, United Utilities states if Ofwat makes amendments to the overall income statement revenues in the final determination, it is in customer interests that PAYG revenues should be limited to ensure bill impacts do not exceed those in the September plan.</p>	<p>Change for the final determination.</p> <p>A number of companies and stakeholders have made similar representations in relation to the proportion of operating expenditure in cost allowances and the determination of PAYG rates.</p> <p>We set out our response to thematic representations in the 'Aligning risk and return technical appendix'.</p>	<p>Taking account of company representations, we have revised our approach to the calculation of the mix of operating and capital expenditure following our totex interventions.</p> <p>In order to calculate the mix of operating and capital expenditure we follow the approach set out in 'Securing cost efficiency technical appendix'.</p> <p>We set out the specific interventions we make for United Utilities in relation to notional financeability in the 'United Utilities final determination' document.</p>
Risk and return	UUW.RR.C2	In our draft determination summary, we note that the RoRE risk ranges shown in Table 5.1 and Figure 5.1 reflect our interventions and, in particular, that we have included the RoRE risk ranges for ODIs shown in Table 2.3 of the summary document.	The company should provide an updated view of RoRE risk ranges at P10/P90 confidence levels in light of our draft determination. For this purpose, the company should apply its view on the interactions between individual ODI risks in arriving at an overall risk range for ODIs. Calculations should be carried out using the App26 rows on the F-Inputs tab of the draft determination financial model, with values read off the model dashboard. The company's updated view should be provided in its response to the draft determination.	<p>Representation made.</p> <p>United Utilities provides updated views on RoRE risk ranges in its representation on the draft determinations.</p>	Change for the final determination.	See UUW.RR.D4.
Risk and return	N/A	N/A	N/A	Representation made.	Change for the final determination.	We set out in section 4.2.2 of 'United Utilities final determination summary' that we

Test area	Actions/intervention reference	Action	Our intervention for the draft determination	Summary of company representation	Our assessment and rationale for the final determination	Final interventions in the final determination
				<p>In its representation, United Utilities sets out that an adjustment is required to RCV run-off rates for the water resources and water network control as a result of the intervention to the allocation of opening RCV between the two controls in the draft determination.</p> <p>The company requests that we amend RCV run-off rates for the two controls if we do not accept the representation it makes in relation to the allocation of opening RCV.</p>		accept the revised approach which allocates 15% of RCV to Water Resources versus 14% in its original business plan. As such we consider a technical adjustment is not required.
Risk and return	N/A	N/A	N/A	<p>Representation made.</p> <p>United Utilities makes a further representation for an adjustment to RCV run-off rates for RCV inflated by RPI to deliver the effect of a full transition to CPIH. The company proposes to transition up to a level capped by the bills set out in its original business plan. United Utilities provides evidence that the bill profile resulting from full transition is supported by customer preferences.</p>	<p>Change for the final determination.</p> <p>We accept the company proposal. The company proposes to transition up to a level capped by the bills set out in its original business plan. United Utilities provides sufficient and convincing evidence that the bill profile resulting from full transition is supported by customer preferences.</p>	We accept United Utilities' representation that its proposal for a full transition to CPIH is supported by customer preferences. We increase RCV run-off rates by 1% to give the effect of a full transition to CPIH. Following this we consider our determination to be financeable on a notional basis and remove the increase to PAYG rates applied in the draft determination for notional financeability.
Securing confidence and assurance	UUW.CA.A2	<p>On dividend policy the company should confirm that it is committed to adopt the expectations on dividends for 2020-25 as set out in 'Putting the sector in balance' to include clear Board commitment to signal changes to stakeholders.</p> <p>Please provide an update on the steps you are taking to fully meet the expectations as set out in our 'Putting the sector in balance' position statement.</p>	No intervention required.	<p>Representation made.</p> <p>In its response to the draft determination and subsequent query response the company has provided some additional information to that previously provided. The company confirms that its dividend payments will take account of the company's overall delivery for customers, which will be based on performance targets embedded in the final determination, including all outcome delivery incentives, cost and financial targets reflected therein. The company details the specific obligations and commitments to customers that will</p>	<p>Change for the final determination.</p> <p>We have updated our assessment of the reasonable base dividend for water companies in 2020-25 as set out in the 'Aligning risk and return technical appendix'.</p>	We expect United Utilities to be transparent when explaining its dividend policy and reporting on dividends paid over 2020-25, to demonstrate how it has delivered on the commitments in relation to its dividend policy and to ensure it meets the expectations we set out in 'Putting the sector in balance' as updated in 'Aligning risk and return technical appendix'.

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				be considered. It confirms that dividends may be increased or lowered from the base depending on the actual performance of the company and explains how performance delivery will impact on dividends paid.		
Securing confidence and assurance	UUW.CA.A3	<p>On executive pay the company should confirm it is committed to adopt the expectations on performance related pay for 2020-25 as set out in 'Putting the sector in balance' to include:</p> <p>Commitment to report how changes, including the underlying reasons, are signalled to customers.</p> <p>Commitment to publish the executive pay policy for 2020-25 once it has been finalised.</p> <p>Please provide an update on the steps you are taking to fully meet the expectations as set out in our 'Putting the sector in balance' position statement.</p>	<p>No intervention required.</p> <p>There remain a number of details to be finalised, for example the exact structure and weightings of the annual bonus scheme, approval of the long term incentive plan.</p> <p>We expect the company and its remuneration committee to ensure executives continue to have stretching targets linked to performance delivery for customers. We expect the company to be transparent about further updates to the development of its policy that will apply in 2020-25.</p>	<p>No representation made.</p> <p>The company has provided no additional information in its response to its own draft determination or in its response to the slow track and significant security draft determinations.</p>	<p>Change for the final determination.</p> <p>United Utilities states that it is committed to meet the expectations set out in our 'Putting the sector in balance: position statement'. Based on our calculations, the overall percentage of alignment of incentives to customers falls short of the 60% we highlighted as evidence of good practice amongst the companies we regulate in our document, 'PR19 draft determinations: Aligning risk and return technical appendix'. Our calculation is based on RoRE performance for 2015-19 but the company could exceed 60% on a forward basis depending on outturn performance. We therefore consider that there is scope for the company to improve this position.</p>	<p>We expect United Utilities to be transparent when explaining and reporting the application of its performance related executive pay policy over 2020-25, to demonstrate how it exhibits a substantial alignment to the delivery of service for customers and meets the expectations we set out in 'Putting the sector in balance' as updated in 'Aligning risk and return technical appendix'.</p>

**Table 2: United Utilities – Changes to the draft determination that are not in response to an action or representation**

Test area	Actions/intervention reference	Our assessment and rationale for the final determination decision	Decisions for the final determination
Allowed return on capital	UUW.RR.D1	<p>We have revised our assessment of the allowed return drawing on market data up at 30 September 2019 and taking account of revisions to our approach following our assessment of representations.</p> <p>We have revised our assessment of the required retail margin deduction down from 0.11% to 0.04%, reflecting our view that the double-counted component of return in the household retail margin has reduced since PR14.</p> <p>We set out the basis for the allowed return on capital in our 'Allowed return on capital technical appendix'.</p>	<p>The sector allowed return on capital for the appointee price controls in our final determinations is 2.96% – CPIH deflated (1.96% – RPI deflated), 23 basis points lower than in the draft determination.</p> <p>The sector allowed return on capital for the wholesale price controls in our final determinations is 2.92% – CPIH deflated (1.92% – RPI deflated), 16 basis points lower than in the draft determination.</p>
Gearing outperformance sharing mechanism	UUW.RR.D2	<p>In our final determinations, we have amended our gearing outperformance sharing mechanism to contain a glidepath. We explain this in the final determination 'Aligning risk and return technical appendix'.</p>	<p>We have changed the trigger from a fixed trigger of 70% in the draft determination to a glide path which will start at 74% for the year 2020-21 and will reduce by 1% each year, ending at 70% for the year 2024-25 in the final determination.</p>
Financeability	UUW.RR.D3	<p>We consider that United Utilities final determination is financeable based on the allowed revenues which include a reasonable allowed return on capital. The final determination is sufficient to ensure it will be in a position to deliver its obligations and commitments to customers.</p>	<p>We discuss our assessment of financeability in the 'United Utilities final determination' and the basis on which we consider United Utilities final determination to be financeable on the basis of the notional capital structure.</p>
Return on Regulatory Equity (RoRE) - Financial Risk Assessment	UUW.RR.D4	<p>We have revised our approach to assessing RoRE risk ranges for five of the risk areas set out in the PR19 methodology to take account of changes we have made in our final determinations to address concerns raised by companies on the overall level of stretch in our draft determinations, and evidence on past performance that we have observed in the sector.</p> <p>Our approaches are set out in the 'Aligning risk and return technical appendix' and the risk ranges for United Utilities are set out in the 'United Utilities final determination'.</p> <p>Taking account of changes in our final determination, the RoRE risk ranges at P10 and P90 confidence limits in our final determinations are, in most cases, more symmetrical than the risk ranges represented by companies. Our view of risk ranges also indicates more scope for outperforming companies to earn higher returns, but also for underperforming companies to receive lower returns.</p>	<p>The final determination risk range reflects the following interventions that we make for all companies:</p> <ul style="list-style-type: none"> <li>• The totex range is our assessment of the plausible range based on evidence of the historic sector performance and taking account of the company's cost sharing rates that apply in its final determination.</li> <li>• The financing cost risk range is based on our assessment of the range for a notional water company including both embedded and new debt.</li> <li>• The ODI risk range has been determined under our Outcomes Framework.</li> <li>• The C-MeX risk range is calculated as 12% upside and 12% downside of residential retail revenue, reflecting the cap and collar limits for this incentive.</li> <li>• The D-Mex risk range is calculated as 6% upside and 12% downside of developer services revenue, reflecting the cap and collar limits for this incentive.</li> </ul>
Financial Risk Assessment – Uncertainty Mechanisms	UUW.RR.D4	<p>We are including a PR24 reconciliation mechanism for business rates in our final determination for United Utilities along with all other companies because:</p>	<p>In each case, the cost variance to the company's PR19 cost allowance will be subject to a 75 (customer share):25 (company share) symmetrical sharing rate in the totex reconciliation at PR24. This means that the company will still be incentivised to manage costs efficiently, whilst</p>

Test area	Actions/intervention reference	Our assessment and rationale for the final determination decision	Decisions for the final determination
		<ul style="list-style-type: none"> <li>• There is uncertainty about business rates costs because the Valuation Office Agency (VOA) will be carrying out revaluation exercises during 2020-25, and increases (or decreases) in cost levels could be material.</li> <li>• Companies can only exercise limited control over cost levels by engaging with the VOA and, possibly, by considering the business rate implications of asset development choices.</li> </ul> <p>We are also including a PR24 reconciliation mechanism for Environment Agency abstraction licence costs in our final determination for United Utilities along with all other companies serving England because:</p> <ul style="list-style-type: none"> <li>• The Environment Agency expects to consult on changes to its basis for setting abstraction licence fees during 2020 meaning that there is material uncertainty about company cost levels in 2020-25.</li> <li>• Companies can only exercise limited control over cost levels by engaging with the consultation process and providing accurate information when required for licence fee setting purposes.</li> </ul>	<p>receiving appropriate protection against material cost increases. Conversely, customers will receive a benefit if outturn costs are lower than the allowance levels we have set. Details will be set out in the PR19 Reconciliation Rulebook.</p>

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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