Section 12A and 13 proposed modifications to Condition B -Consultation by Ofwat August 2023

United Utilities
Water for the North West

United Utilities response – October 2023

Introduction

UUW welcomes the opportunity to comment on Ofwat's consultation under sections 12A and 13 of the Water Industry Act 1991 on proposed modifications to Condition B: Charges.

We support the proposed modifications to include new excluded charges.

We do, however, wish to raise a number of additional points that we believe Ofwat should consider as it progresses its work in this area. In particular, it is our view that the proposed modifications are insufficiently wide. The modifications should also include a change to sub-paragraph 2A of Condition B to extend the period within which non-section 185 diversions are excluded from the price control.

The proposed text for additional excluded charges appears to cover all of the principal developer services activity we would expect to be excluded from the price controls.

We would support the creation of a RAG4 supplementary appendix to provide additional clarity to be confident of a consistent approach being taken by all companies.

We welcome the additional clarification provided in the proposals confirming that the provision of supplies for non-domestic purposes section 55 would also be covered as part of the excluded charges for new water connections.

Within the proposals the intention to allow the exclusion of non-section 185 diversions to lapse is set out. In relation to non-section 185 diversions we do not agree that they should be within the revenue control. We raised this point in our response to the draft proposed excluded charges in May 2023 (see Appendix A), in September 2023 in our response to the consultation on the Revenue Forecasting Incentive (RFI) for the period 2025-2030 (see Appendix B) and more recently as part of the PR24 submission (see Section 5 of supplementary document *UUW54 – Developer services business plan.*)

We feel the points made in our response to the draft proposed excluded charges in May 2023 have not been sufficiently addressed in this consultation.

We suggest the current exclusion of non-section 185 diversions be extended until 31 March 2030 for the following reasons:

- Non-section 185 diversions are not part of the day to day operation of the company, they are bespoke third party projects and are inherently difficult to predict both in terms of cost and timing with the potential to create significant disruption to customer bills if included in the price control
- Including non-section 185 diversions in the price control creates additional wholesale price control complexity by introducing in period volatility that will be adjusted by and end of period mechanism, details of which are yet to be published
- A natural mechanism is already available by keeping non-section 185 diversions outside of the price control.

Non-section 185 diversions

At PR19 we made significant representations to ensure non-section 185 diversions were kept outside of the price control due to the significant unpredictability of these third party projects. They

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are not part of the day-to-day operation of the company and have the potential to create significant disruption to customer bills if included in the price control. Ofwat agreed to this in PR19.

The draft PR24 methodology[1] proposed to "maintain the same regulatory approach at PR24", acknowledging that non-section 185 expenditure is "relatively uncertain, meaning that actual expenditure could be significantly different from forecast" and highlighting that the "risk was magnified in the 2020-25 period because of the large forecast increase in non-section 185 diversions expenditure because of High Speed 2" (HS2).

On 2 October we included within our PR24 submission an estimate of costs relating to Phase 2b of HS2, in excess of £150m. On 4 October 2023 the Government announced the cancellation of HS2 Phase 2b between Birmingham and Manchester and outlined plans to create Network North. Whilst the specific HS2 project may no longer materials, the new proposals include plans to reinvest the savings from cancelling that part of the HS2 project in hundreds of transport projects. We consider it reasonable to assume that there will still be a large number of infrastructure projects, including infrastructure schemes from the likes of National Highways and Network Rail that will influence our spend across the period 2025-30. Given this we consider the potential scale of large infrastructure projects for the period 2025-30 may well be significantly greater than 2020-25 and also even less predictable than was previously the case. Therefore given that the risk and uncertainty are greater at PR24 we would expect non-section 185 diversions to remain outside the price control for the period 2025-30.

In the final methodology for PR24 Ofwat set out a decision that non-section 185 diversions (water and wastewater) would be within price controls for 2025-2030 as part of third party services. This was a significant and unexplained change of the approach described in the draft PR24 methodology. Details of the third party end of period reconciliation mechanism and how this will work is yet to be published.

It is not possible to judge whether such a mechanism would serve as an effective mitigant, as no further details have been published. However given that it is an end of period reconciliation this would not alleviate year on year bill volatility for customers.

It is not clear how the third party reconciliation mechanism will adjust for third party revenue if the price control third party elements have already been dealt with in period. Consequently, this makes it difficult for us to be confident that the approach taken will be adequate for the purposes of managing non-section 185 charges during the period 2025-30.

Given this, we consider inclusion within the control is inappropriate as companies will likely incorrectly estimate the level of activity, be penalised for that estimate and create unnecessary bill volatility for customers. This means that if there are significant increases or decreases in non-section 185 activity across subsequent years customer bills would increase or decrease significantly in any given year dependent on any previous increase or decrease in non-section 185 activity.

In the consultation document on proposed modifications to Condition B, Ofwat noted that removing water site-specific developer services out of the revenue control had benefits including "it should improve water bill predictability for end users because unexpected year-on-year changes in water

[1] Page 24-25 https://www.ofwat.gov.uk/wp-content/uploads/2022/07/Appendix-9-Setting-expenditure-allowances-1.pdf

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site-specific developer services revenue would no longer lead to changes in water customer bills."[2] In our view, the considerations apply, to a greater extent, for non-section 185 charges and we therefore consider that non-section 185 diversions should also be outside of the revenue control.

Therefore, we consider the proposed modifications to be insufficiently wide. The modifications should also include a change to sub-paragraph 2A of Condition B to extend the period within which non-section 185 diversions are excluded from the price control. We suggest that the exclusion of non-section 185 diversions from the revenue control should be extended until 31 March 2030.

To be clear, we do not see this issue an impediment to supporting the overall licence changes proposed in this consultation. It will still be possible to make the change that we are suggesting (for the current exclusion of non-section 185 diversions be extended until 31 March 2030) at a later date. We expect this would be after we have received further details of Ofwat's proposal for a third party reconciliation mechanism, and considered whether or not that provides adequate mitigation for the risk of material ex-post changes in non-section 185 diversions.

Other considerations in relation to developer services excluded charges

It is important to ensure that costs recovered through developer services are equivalent for both the appointed entity and competing organisations. Without this equivalence the associated competition and therefore the market would be less efficient and reduce the benefits for customers. Conversely ensuring an equally efficient operator could compete is obviously necessary, and to support this the incumbent cannot be cross subsidised from the control. These excluded costs should include all equivalent costs covering use of shared services such as finance or HR, administrative costs, construction activities, margin and any other costs related to delivering the services set out within the proposed draft wording.

The proposed additions to Condition B appear, at a high level, to support this. However there are a number of activities for which the proposed text may not provide sufficient clarity to be confident of a consistent approach being taken by all companies. We would support the creation of a RAG4 supplementary appendix to provide clarity. We provided detail on the elements that could benefit from additional clarification in May 2023 in our response to the draft proposed wording for excluded charges.

13 October 2023

[2] Page 7 https://www.ofwat.gov.uk/wp-content/uploads/2023/08/Licence-modification-consultation-notice-changes-to-the-Excluded-Charges-definition-in-Condition-B.pdf

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APPENDIX A

PR24 Developer Services – Draft excluded charges

United Utilities response – 26 May 2023

United Utilities
Water for the North West

Thank you for this opportunity to provide initial thoughts on the draft excluded charges that could be added to Condition B. Overall the proposed text appears to cover all of the principal developer services activity we would expect to be excluded from the price controls.

Within the proposals the intention to allow the exclusion of non-section 185 diversions to lapse is set out. We suggest that the exclusion be extended for non-section 185 diversions until 31 March 2030. The provision of non-section 185 diversions is not part of the day to day operation of the company with the level of activity completely dependent on third parties. This approach has the potential to create significant disruption dependent on an unknown level of activity. Given this, inclusion within the control is inappropriate as companies will likely incorrectly estimate the level of activity and be penalised for that estimate.

The provision of supplies for non-domestic purposes s55 is not mentioned specifically in relation to the exclusion. However, we would assume that any reinforcement work would form part of the activity included within the control while the non-domestic supply connection would be excluded. Clarity on this position may be beneficial.

It is important to ensure that costs recovered through developer services are equivalent for both the appointed entity and competing organisations. Without this equivalence the associated competition and therefore the market would be less efficient and reduce the benefits for customers. Conversely ensuring an equally efficient operator could compete is obviously necessary, and to support this the incumbent cannot be cross subsidised from the control. These excluded costs should include all equivalent costs covering use of shared services such as finance or HR, administrative costs, construction activities, margin and any other costs related to delivering the services set out within the proposed draft wording. The proposed additions to Condition B appear, at a high level, to support this. However there are a number of activities for which the proposed text may not provide sufficient clarity to be confident of a consistent approach being taken by all companies. We would support the creation of a RAG4 supplementary appendix to provide clarity. This should include consideration of the following:

- **Engagement with the planning process.** We would suggest that engagement with the planning process be included within the price controls, and not be excluded. This activity includes work on strategic plans to help understand and guide long term resource requirement, including statutory engagement into the planning process.

- **Engagement with developers, SLP and NAVs.** There are a number of activities undertaken to support the operation of both developer services and non-developer services related incumbent activity, such as water resource planning. We believe that this engagement does not clearly sit either within or fully excluded from the controls.

- **Provision of NAV services.** Activities relating to the provision of services to NAVs do not necessarily align with other developer services activities. For example when meters are installed on the connection to a development being supplied by a NAV the cost of that meter are not charged to the NAV, this cost should be within the control, or recharged from developer services to the control. This does not align to meters being installed in other circumstances.

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- **Provision of common carriage.** The notes suggest that developer services activity relating to common carriage provision S66B-C and s117A-D (s66d and s117e agreements) should be considered excluded from a price control. Having clarification of this position set out within RAG4 would be beneficial to ensure consistency. Additional clarity as to which activities are excluded, and which not, from across the process set out within the access code is required. This includes the application and feasibility studies, but given the low levels of activity, and therefore associated experience, further work may be required to define the activities appropriate categorisation.

- **Administration charges.** It would be appropriate to clearly set out the expectation that the site specific developer services activity extends beyond the physical activity to include any costs associated with the provision of that service. This includes administration costs and charges related to that physical developer services activity.

- **Incumbent reporting obligations.** There are obligations that place a heavier burden on the incumbent when carrying out developer services activity than other trading parties. These obligations include those relating to regulatory reporting (RFIs, APR, Price Review, D-MeX). Whilst these costs may not be able to be fully included within the controls we would expect that where practicable they should be.

- **Management of the Lloyd's accreditation scheme.** Clarification should be provided with regard to the management of the Lloyd's accreditation scheme (WIRs) which should be identified as included costs, rather than excluded. Obviously the costs of the incumbent meeting the same obligations, such as training, must be excluded, the operation of the overall scheme should be a responsibility sitting within the control. It would seem perverse if these costs were recovered through this site specific developer services costs.

- **Allocating shared services costs.** Where services are shared such as finance, HR, regulation costs or debt collection, companies should as usual attribute costs across activities based upon an appropriate rational. Allocation guidance can be created to support the application of this attribution, as is the case with retail in RAG2. There would be value in considering the value chain of developer services activity in detail and providing clarity as to the point at which the exclusion applies for each form of activity. Trading parties would be well placed to support in this development, once the overall positions are clear.

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APPENDIX B

Revenue Forecasting Incentive – Consultation by Ofwat July 2023

United Utilities response – September 2023

United Utilities
Water for the North West

Introduction

UUW welcomes the opportunity to comment on Ofwat's consultation on the Revenue Forecasting Incentive (RFI) for the period 2025-2030.

We are supportive of the changes proposed to the RFI including retaining the existing deadband of 2% and having a flat penalty rate set at 3%.

We are supportive of changes to simplify the process, which could be simplified further by considering the following suggested changes:

- removing the end of AMP adjustments and blind year adjustments. Instead adjustments could be applied simply with a 2 year lag
- approve the net ODI rewards/penalties by price control and input directly into the RFI model, rather than applying ODI payments by changing K factors

We seek confirmation that the RFI includes both price control revenue under licence condition B and Direct Procurement for Customer (DPC) revenue under Condition U.

We have concerns in relation to non-section 185 diversions and do not agree that they should be within the revenue control. We raised this point in our response to the draft proposed excluded charges within licence Condition B in May 2023. We suggest the current exclusion of non-section 185 be extended until 31 March 2030 for the following reasons:

- Non-section 185 diversions are not part of the day to day operation of the company, they are bespoke third party projects and are inherently difficult to predict both in terms of cost and timing with the potential to create significant disruption to customer bills if included in the price control
- Including non-section 185 diversions in price control creates additional wholesale price control complexity by introducing in period volatility that will be adjusted by and end of period mechanism, details of which are yet to be published
- A natural mechanism is already available by keeping non-section 185 diversions outside of the price control

We have responded in more detail to each of the questions set out in the consultation below.

1. Do you agree that the RFI should apply to revenue that sits within the relevant revenue controls (noting that, as such, site-specific developer services revenue would be treated differently for English and Welsh companies)?

We only agree that the RFI should apply to revenue that sits within the relevant revenue controls given our assumption that non-section 185 diversions should be outside of the controls.

We consider the relevant revenue controls to be price control revenue allowed under licence condition C and DPC revenue allowed under licence condition U.

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However we do not agree that non-section 185 diversions should be part of the water or wastewater revenue control.

At PR19 we made significant representation to ensure non-section 185 diversions were kept outside of the price control due to the significant unpredictability of these third party projects. They are not part of the day-to-day operation of the company and have the potential to create significant disruption to customer bills if included in the price control. Ofwat agreed to this in PR19.

The draft PR24 methodology[1] proposed to "maintain the same regulatory approach at PR24", acknowledging that non-section 185 expenditure is "relatively uncertain, meaning that actual expenditure could be significantly different from forecast" and highlighting that the "risk was magnified in the 2020-25 period because of the large forecast increase in non-section 185 diversions expenditure because of High Speed 2" (HS2). The potential scale of HS2 for the period 2025-30 is significantly greater than 2020-25. Therefore given that the risk is greater at PR24 we would expect non-section 185 diversions to remain outside the price control for the period 2025-30.

In the final methodology for PR24 Ofwat set out their decision that non-section 185 diversions (water and wastewater) would be within price controls for 2025-2030 as part of third party services, a significant and unexplained reversal of the approach described in the draft PR24 Methodology. Details of the third party end of period reconciliation mechanism and how this will work is yet to be published.

It is not possible to judge whether such a mechanism would serve as an effective mitigant, as no further details have been published. However given that it is an end of period reconciliation this would not alleviate year on year bill volatility for customers.

It is not clear how the third party reconciliation mechanism will adjust for third party revenue if the price control third party elements have already been dealt with in period. Consequently, this makes it difficult for us to be confident that the approach taken will be adequate for the purposes of managing non-section 185 charges during the period 2025-30.

Given this, inclusion within the control is inappropriate as companies will likely incorrectly estimate the level of activity, be penalised for that estimate and create unnecessary bill volatility for customers. This means that if there are significant increases or decreases in non-section 185 activity across subsequent years customer bills would increase or decrease significantly in any given year dependent on any previous increase or decrease in non-section 185 activity.

In its recent section 12A consultation on Condition B, Ofwat noted that removing water site-specific developer services out of the revenue control had benefits including "it should improve water bill predictability for end users because unexpected year-on-year changes in water site-specific developer services revenue would no longer lead to changes in water customer bills." In our view, the considerations apply, to a greater extent, for non-section 185 charges and we therefore consider that non-section 185 diversions should also be outside of the revenue control.

We suggest that the exclusion of non-section 185 diversions from the revenue control should be extended until 31 March 2030.

2. Do you agree with our proposal that the existing deadband set at +/- 2% should be retained and to apply a penalty at a flat rate of 3% for the RFI for the 2025-2030 period?

[1] Page 24-25 https://www.ofwat.gov.uk/wp-content/uploads/2022/07/Appendix-9-Setting-expenditure-allowances-1.pdf

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We agree with the proposal to retain the deadband at the existing +/-2% level.

We agree with the proposal to apply a flat penalty rate of 3% on actual revenues that fall outside of the deadband. The application of a flat penalty rate will reduce the complexity of the mechanism.

3. Do you have views on whether arrangements to smooth revenue profiles could be improved, noting that any such improvements would need to only be available for significant adjustments, allow for advance notification to Ofwat, justify benefits to customers and ensure that there is a way to hold companies to account for delivering what they have proposed?

On balance we agree that there is not a requirement to introduce a formal mechanism to assist with smooth revenue profiles.

We consider that there is suitable scope within the existing RFI mechanism to allow companies to base the penalty calculation on the level of revenue on which prices were set and highlight any adjustments made within the RFI commentary.

A further way to simplify the process and smooth revenue profiles would be to consider removing the end of AMP adjustments and blind year adjustments. Instead, adjustments could be applied simply with a 2 year lag. For example an adjustment for 2023/24 would be applied in 2025/26 and so on. This would be much simpler than the current approach.

4. Do you have any comments on whether we should apply outcome delivery incentive payments through the RFI formula for the 2025-2030 period and any views on how this should be done?

In relation to outcome delivery incentive payments we consider that it would be much cleaner if Ofwat did not apply these by changing K factors. Instead Ofwat could approve the net ODI rewards/penalties by price control. These could be input directly into the RFI model which would then inflate these to outturn prices and apply to the charging year in much the same way as the RFI adjustments and RFI penalties.

To facilitate this it would probably require the inclusion of some additional functionality in the RFI model to defer ODI rewards. Deferrals are currently done in the in-period adjustments model. We consider that incorporating a change in the RFI model would make it easier to communicate what the impact is of ODI rewards on charges. The current process is more complicated, e.g. to derive the impact of ODI rewards on charges involves looking at the change in K between one in period determination and the next.

5. Given the intended scope of the RFI at PR24 set out in this consultation, do you have any views on whether detailed changes are required to the RFI formula for the 2025-2030 period or whether the PR24 rulebook would need to be different from the PR19 rulebook in relation to the RFI?

We do not consider that detailed changes are required to the RFI formula for the 2025-30 period.

We do not consider that the PR24 rulebook would need to be significantly different from the PR19 rulebook but for clarity and transparency the rulebook should be updated to confirm the revenue controls that the RFI affects. We expect this to include revenues relating to Direct Procurement for Customer (DPC).

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The draft PR24 methodology[2] confirmed that revenues relating to DPC Competitively Appointed Providers (CAP) would be included in the Revenue Forecasting Incentive. This confirmation was absent from the Final Methodology.

We seek confirmation that DPC CAP revenues will be included within the Revenue Forecasting Incentive mechanism. This issue was discussed between Ofwat and UUW in the preparation of the Allowed Revenue Direction for HARP, and Ofwat noted in its letter of 6 December 2021 that the determination of an appropriate revenue forecasting reconciliation mechanism for DPC Allowed Revenue would be addressed as part of PR24.

12 September 2023

[2] See Appendix 5 – Direct procurement for customers, page 5, bullet 3

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