UUW response to draft PR19 methodology

We welcome the opportunity to comment on Ofwat's draft methodology. In general, we agree that it sets out clear expectations for companies wishing to be judged as "exceptional" at PR19 and we observe that it seeks to establish a very challenging benchmark performance for individual companies.

We are actively engaged with the Water 2020 process and remain very supportive of Ofwat's overall direction of travel - to improve the legitimacy of the sector in the eyes of customers, to increase customer engagement and participation in the services and plans delivered by companies, and to better harness the power of markets and innovation to ensure that companies are providing customers with better and more resilient services at a lower price.

We particularly welcome many of the developments in the household retail price control, especially the recognition of key drivers (such as bill size and deprivation) when assessing efficient retail costs. We welcome customer-focused developments in outcomes, such as the development of C-MeX and D-MeX, and specific outcomes for affordability and vulnerability.

Whilst we believe that in many areas the draft methodology successfully addresses Ofwat's ambitions for the sector, we highlight a few key areas where we suggest that Ofwat considers modifying its approach. These are in relation to:

- Overall expected target performance levels
- Overall balance of risk and returns
- Estimation of the cost of equity
- Comparability of data used in comparative assessments
- Incentivising direct procurement for customers
- C-MeX design
- Further feedback on financial model and data tables

Overall expected target performance levels
Ofwat sets out clear expectations for what it considers to represent stretching performance commitments on what matters most to customers and the environment. This typically involves delivery in 2021 of a forecast upper quartile 2025 level of industry performance across all measures.

We have no doubt that such a level of performance would be very stretching, and would provide great service to customers. However, no company is currently performing consistently at industry upper quartile in all areas – i.e. on costs for each price control as well as on performance levels for every outcome individually. Therefore it appears that a notionally efficient company (as implied by the performance expectations set out in the draft methodology) is already considerably beyond the industry frontier to such an extent that it likely represents an unachievable position. This is further amplified by the expected rate at which companies progress towards this level of performance, i.e. from the first year of the next period. It is particularly the case for leakage, for which it would be virtually impossible to achieve a substantial reduction in a single year for a measure that is based on a three year rolling average.

We feel that customers' interests would be better served by taking a more balanced view as to what level of stretching performance companies can achieve in the round, across all areas of cost and performance. Given the different local and legacy circumstances which apply to different companies, it is unrealistic to expect that every company has an equal chance of achieving performance at the proposed upper quartile level, on the same timescale and whilst simultaneously achieving upper quartile cost levels. The reality is that the efficient costs of achieving the proposed upper quartile performance levels will differ between companies, as will the degree of customer support for investment to achieve such a level.

Overall balance of risk and returns

We agree that our plan should represent a reasonable balance of risk and returns. Ofwat asserts that the overall balance of risk and returns remains symmetric around the “base case” of the notionally efficient company - i.e. the level which meets Ofwat’s minimum performance expectations in all areas of cost and performance.

As set out above, a notionally efficient company is already beyond the frontier of the industry, so it is difficult to see how the symmetry in expected RoRE ranges (as set out in section 10 of the draft methodology and illustrated by figure 10.1) could be achieved. This is further supported by Ofwat’s expectation that an average performing company should expect to receive net penalties, which means it is difficult to see how a P10 and P90 performance range could result in a symmetric RoRE range around the assumed cost of equity.

We have engaged with Ernst & Young (EY) to produce the report “Balancing Risk & Reward at PR19” to investigate this issue in more detail and have provided it to Ofwat alongside our response to the draft methodology. In summary, EY concludes that in setting any determination Ofwat should satisfy itself that the overall risk and reward package should be balanced such that a notionally efficient company expects to be able to achieve a return on equity equal to the rate of return which equity investors in a notionally efficient company would require.

Estimation of the cost of equity

We recognise that requirements for overall returns (including the cost of debt) are lower now than they have been historically. However, we do not agree that the total market return has decreased to the extent suggested by PWC's report for Ofwat.

The total market return proposed in the draft methodology appears too low, with too much weight placed on a 'lower for longer' interest rate scenario which we feel has not been robustly evidenced. There is insufficient regard to the uncertainty and skew associated with this scenario. In addition, we feel that too much weight has been placed on the market to asset ratio and the dividend discount model - this evidence is difficult to interpret and lacks robustness. The analysis also appears to give insufficient regard to longer term data and the underlying stability of long term rates of return as well as the associated inverse relationship between the risk free rate and the market risk premium which is well documented in many academic papers.

In summary, we encourage Ofwat to consider a more holistic range of views on the total market return for PR19 to ensure that the sector remains able to attract and retain finance on the best value for money terms and in the best long term interests of customers. We have commissioned further work from EY to review the evidence base in this regard and have also provided a copy of this report (“The cost of equity at PR19”) alongside our response to the draft methodology.

Comparability of data used in comparative assessments

We agree that company targets should be stretching and that comparisons between companies should play a significant part in setting targets. However, we consider that there should be much greater recognition that local circumstances outside of management control are likely to mean that equally efficient and effective companies may deliver varying levels of performance. For example, environmental differences (such as rainfall) between companies affect the level of performance that companies are able to deliver for an equivalently stretching level of effort and cost.

In relation to the four common measures with common targets, Ofwat states that "there are no strong reasons why we should not expect companies to achieve the same level of performance". We do not agree this is appropriate for sewer flooding given the significant influence of external factors such as regional variations in rainfall. The number of internal and external sewer flooding incidents is a reflection of sewer condition, operating and maintenance regimes and, crucially, levels of rainfall. In the North West we have industry leading performance in terms of sewer blockages, collapses and pollution incidents which demonstrates our robust approach to the management of our sewer infrastructure. However, the high levels of rainfall in our region mean that we have higher than average incidences of sewer flooding. We recognise that sewer flooding is unacceptable for the customers affected, and we will set stretching targets for AMP7. However, we strongly believe that it is not appropriate to set common targets for measures where there are regional variations in such an influential external factor. Instead, such regional variations should inform what targets companies are able to achieve for an equivalently stretching level of performance and cost.

Expecting companies to meet a frontier level of performance where this is currently being achieved by a company in a favourable operating environment may drive companies towards a balance of bills and service performance which does not reflect customer priorities or their long term interests.

We fully recognise that the onus is on us to provide compelling evidence in our business plan which demonstrates that the costs and performance targets proposed are stretching within the context of the environment in which we operate. We expect that Ofwat will be open to reviewing such evidence fairly and objectively, and will not rely on simplistic or merely prima facie comparisons between companies in forming its judgements on what constitutes stretching performance.

We also strongly believe that Ofwat should recognise that comparisons are invalid if there are inconsistencies in measurement. We consider that there are several areas where this requires further investigation and standardisation before Ofwat could reasonably rely upon measures as being comparable. One case in point is measurement of sewer flooding. We believe that our more comprehensive procedures for establishing the full extent of sewer flooding, which involve a thorough check of neighbouring properties, protects customers but distorts comparisons with other companies as these checks of neighbouring properties identify a significant proportion of the overall flooding incidents. In view of the potential impact on comparisons, we suggest that all companies should report the number of incidents which they identify, separate from those notified by customers. This information should be readily available, so it should not involve any additional costs. If this shows significant differences between companies, then we consider that these differences should be taken into account when making comparisons and when setting any targets which are based on comparative performance.

Incentivising direct procurement for customers

We agree with Ofwat that direct procurement for customers (DPC) has the potential to unlock additional efficiencies in the delivery of large projects, for the benefit of customers. We also welcome the opportunity for incumbents to have a potential role in the operation of directly procured assets. We further believe that greater customer benefit could be achieved if incumbents are able to have greater participation in a DPC process than Ofwat now envisages.

If efficiency in procurement is required, then it is unclear what advantages are gained by excluding the incumbent from the process. At worst it could result in a higher cost outcome for customers. If transparency in the procurement process is desired, then there are a number of alternatives that could be considered, none of which are presented in the draft methodology. It is therefore unclear why Ofwat has felt compelled to adopt this position, without consultation.

We are concerned that Ofwat appears to have concluded, without presenting the evidence, that a third party solution would always offer customers better value for money than could be achieved by the incumbent. We are concerned that the methodology contemplates that, in the event of a failed direct procurement process, an incumbent's allowed costs would be subject to a downwards adjustment to meet a lower expected level of costs; this appears to indicate that the approach being taken towards direct procurement is not open even to the possibility that the incumbent company may be best placed to offer value to customers for a project which is subject to DPC. In this way, there is a risk that the proposed approach to DPC is less focussed on achieving value for money for customers, but rather on excluding incumbents from delivery of medium to large schemes in their area of appointment.

We observe that the overall regulatory model proposed for DPC seems to be more focussed on an enforcement process which presumes that a third party is best placed to provide a particular service and then seeks to penalise the incumbent in the event that this is not successfully applied. The apparent reliance on a penalty-only incentive appears incongruent with the more balanced approach to incentives that Ofwat has been progressing towards in recent years.

We have been supportive of the development of a DPC process to this point, but believe that a more balanced regulatory approach is needed, particularly in taking the first steps towards commissioning projects through this method. There is scope for the DPC process to have a more balanced approach towards reward and penalty incentives. Where there is scope for a potential sharing of benefits between company and customer, this would provide a real incentive for companies to obtain the best price for a service through a DPC process.

We may have two projects which could potentially be "in scope" for DPC at PR19. At present, both of these possibilities are yet to be finalised (see details below) and therefore we cannot yet be certain of their suitability for DPC:

1. Resilience of supplies from the Haweswater Aqueduct - a component of the preferred solution (following customer engagement) may include a single large infrastructure investment (e.g. a large water treatment works) which may be a suitable candidate for DPC. We would expect such a project to be completed over AMP7 and AMP8.
2. Water trading - we may be in a position to make initial proposals for a significant transfer of water for use in the South East of England. Whilst elements of such a project could be suitable for DPC, it seems likely that the main elements of investment will take place after AMP7.

C-MeX design

Whilst we endorse the aims and objectives of C-MeX, our response to the draft methodology raises a number of suggestions for how it should be implemented:-

- <u>Survey weightings</u>: We believe that customer complaints should continue to carry a weighting of no less than the current 25% within C-MeX. Customers and industry stakeholders place great emphasis on complaint volumes as a measure of quality customer service. The proposal not to include complaints in the calculation of a C-MeX financial reward/penalty risks incidences of companies with high relative complaint volumes simultaneously receiving high financial rewards for customer service. This would seem to risk undermining the legitimacy of the measure in the eyes of many customers and stakeholders.

  We also suggest that the non-contacting customer survey should carry a weighting closer to 25% within the new C-MeX financial incentive calculation. The introduction of a new measure for non-contacting customers is a positive move, but the industry should be careful initially in applying very strong financial incentives to it as we have limited collective understanding of how much influence company actions will have on it, and whether the new survey will drive unintended activity.

- Sample sizes: We believe that the proposed sample sizes are simply too small to identify statistically significant variations between companies, and further do not agree that this issue could be resolved by adding up results from two unrelated surveys. Current best practice in customer survey design does not support this solution. We strongly encourage Ofwat to seek independent academic advice from experts in customer survey design to identify appropriate survey designs and sample sizes.

- Survey channels: We endorse the introduction of online surveys into the survey mix. We encourage Ofwat to go further and seek to match survey channel with the customer's original contact channel, such that a customer that contacts a company by voice is surveyed by telephone, whereas a customer that initiates contact on a digital channel has a digital survey.

Further feedback on financial model and data tables
We have raised any issues we've identified so far with the financial model and the data tables along with our main response. However, we will make much more use of the financial model and the data tables over the coming months, in preparation to make our submission next September. We therefore recommend that Ofwat maintains a communication channel with companies, to receive feedback on any further issues identified in the coming months.

3. Addressing affordability and vulnerability	Q1	Do you agree with our proposal to use the five principles of customer engagement; customer support; effectiveness; efficiency and accessibility to assess how a company is addressing affordability in their business plan?	Strongly Agree	Yes, we support Ofwat's proposed three aspects and five principles for assessing affordability. We agree that considering affordability for all customers, now and in the future, as well as those most in need, is a sensible approach.
3. Addressing affordability and vulnerability	Q2	Do you agree with our proposal to use information and measures, including possible common measures, to assess how a company performs against the five principles in addressing affordability in their business plan?	**Agree**	**Yes, we support Ofwat's proposal to use information and measures to assess company performance on affordability.** **Using common measures has merit, particularly once a fuller understanding of such common measures has been developed across the industry. We are keen to work with Ofwat and the industry to further develop this common understanding.** **The proposed measures included in table App4 mark a good starting point, although we believe some work will be required on developing more robust and insightful measures before comparison of performance on common measures begins. A wider consideration of companies' operating environment and bespoke performance commitments should also form part of Ofwat's assessment of business plans.**
3. Addressing affordability and vulnerability	Q3	Do you agree with our proposed option for requiring companies to propose bespoke performance commitments for addressing vulnerability in their business plan?	Strongly Agree	Yes, we support Ofwat's proposal for companies to propose bespoke performance commitments to address vulnerability. As Ofwat acknowledges, there are challenges in developing meaningful and robust cross-industry measures of vulnerability outcomes. A series of bespoke measures is most likely to result in commitments that address local needs and drive the right outcomes for customers in vulnerable circumstances.

3. Addressing affordability and vulnerability	Q4	Do you agree with our proposed option for using measures in our assessment of companies' approaches to addressing vulnerability in their business plan?	**Agree**	**Yes, we support Ofwat's proposed option for using measures to assess the company's approach to vulnerability; however quantitative measures can only ever form a subset of the evidence needed to understand companies' effectiveness in supporting customers in vulnerable circumstances. If a common set of definitions can be developed then the specific measures in table App4 may help understand the relative scale of companies' vulnerability schemes, but are unlikely to reveal how effective those schemes are at supporting customers or how local differences in need are being addressed. As set out in Ofwat's "Vulnerability Focus Report" support for those in vulnerable circumstances needs to be tailored to local conditions to ensure it is effective, therefore we believe substantial weight should be placed on independent bodies' assessment of companies' affordability plans, including but not limited to the views of CCGs.** **One option for enabling more frequent qualitative reviews of companies' support for vulnerable customers is to ask companies to publish an annual report on the support they offer. United Utilities will publish just such a report on the work we have undertaken next September.**
3. Affordability and vulnerability	Q1	What do you think about our proposed options for requiring companies to propose bespoke performance commitments for addressing vulnerability?	**Strongly Agree**	Yes, we support Ofwat's proposal for companies to propose bespoke performance commitments to address vulnerability. As Ofwat acknowledge there are challenges in developing meaningful and robust cross industry measures of vulnerability outcomes. A series of bespoke measures is most likely to results in commitments that address local needs and drive the right outcomes for customers in vulnerable circumstances.
4. Delivering outcomes for customers	Q1	Do you agree with our proposals for common and bespoke performance commitments?	**Agree**	**Yes, we broadly support Ofwat's proposed approach to common and bespoke performance commitments.**
4. Delivering outcomes for customers	Q1a	Do you agree with the common PCs (1 - 14)?	**Agree**	Yes, we generally support Ofwat's proposed list of common performance commitments. However, without detailed reporting methodologies which are thoroughly applied and assured, "consistency" may be somewhat illusory. It is our firm view that, for all indicators, any comparisons of performance will need to take into account that companies are not all collecting information in a consistent way. The recent Water UK / UKWIR work has resolved some issues on some of the measures. However, there will continue to be significant differences in approaches to reporting. Furthermore, setting targets for the new water quality measure will be problematic. There is very little cross-industry information for this measure so back-casting will be an issue. This is a measure where performance is likely to fluctuate considerably from one year to the next as it is very dependent on the parameter that has failed and there is also an inspector assessment which has an element of subjectivity. Therefore for AMP7 we propose that if there is to be a financial incentive on water quality performance it should be for companies to propose an appropriate measure and target. It may be appropriate to switch to a common measure in AMP8 when experience with the new measure will show how appropriate targets can be set. For the outages asset health measure, we consider that unplanned outages as a result of asset failure would be a better measure of asset health. This would exclude outages due to issues which are not asset related e.g. electricity supply failure.

4. Delivering outcomes for customers	Q1b	Do you agree with our approach to asset health outcomes?	**Agree**	**Yes, we support Ofwat's proposal that there should be some common measures and a list from which companies can select. In reviewing companies' targets, we believe that the most important objective is that companies achieve stability over time, as that will be the key indicator of whether an individual company is maintaining the health of its assets. Comparisons with other companies should not be given as significant weight due to different approaches to measurement, and because targeting improvement is not appropriate unless it can be justified by the potential improvements to service performance.** **An example of differing approaches to measurement is recording of sewer collapses. We use an approach based on 10% sewer deformation or 25% cross-sectional loss but we understand that other companies use different approaches.** **Another factor in making comparisons is the extent of proactive work on the network, e.g. increased leak detection work or sewer inspection will lead to increases in recorded mains bursts and sewer collapses. It is important that companies should not have incentives to avoid increasing this activity.** **As noted in response to Q1a, we consider that outages related to asset failure would be a better measure than all outages.**
4. Delivering outcomes for customers	Q1c	Do you agree with our approach to bespoke PCs including areas that bespoke PCs should cover?	**Agree**	Yes, we support Ofwat's approach to bespoke performance commitments.

4. Delivering outcomes for customers	Q2	Do you agree with our proposals on setting performance commitment levels?	**Neither agree nor disagree- N/A**	**We understand the challenge that Ofwat is setting for companies. We agree that company targets should be stretching and that comparisons between companies should play a significant part in setting targets. However, we consider that there should be much greater recognition that local circumstances outside of management control are likely to mean that equally efficient and effective companies may deliver varying levels of performance. For example, environmental differences (such as rainfall) between companies affect the level of performance that companies are able to deliver for an equivalently stretching level of effort and cost.** **In addition, customer priorities should be taken into account - it is unlikely that the benefit perceived by customers will justify the cost of aiming to achieve upper quartile performance in all areas. This is particularly true where achieving such high performance levels in a compressed time frame would also lead to these costs being incurred over a very short period of time in order to counter factors which are outside of management control.** **Expecting all companies to meet a frontier of performance where this is being achieved by a company in a favourable operating environment will not be in customers' long-term interests, as it will lead to a balance between bills and service performance which does not reflect customer priorities.** **We fully recognise that the onus is on us to provide compelling evidence in our business plan which demonstrates that the costs and performance targets proposed are stretching within the context of the environment in which we operate. We expect that Ofwat will be open to reviewing such evidence fairly and objectively, and will not rely on simplistic or merely prima facie comparisons between companies in forming its judgements on what constitutes stretching performance.** **We also strongly believe that Ofwat should recognise that comparisons are invalid if there are inconsistencies in measurement. We consider that there are several areas where this requires further investigation and standardisation before Ofwat could reasonably rely upon measures as being comparable. One case in point is measurement of sewer flooding. We believe that our more comprehensive procedures for establishing the full extent of sewer flooding, which involve a thorough check of neighbouring properties, protects customers but distorts comparisons with other companies as these checks of neighbouring properties identify a significant proportion of the overall flooding incidents. In view of the potential impact on comparisons, we suggest that all companies should report the number of incidents which they identify, separate from those notified by customers. This information should be readily available, so it should not involve any additional costs. If this shows significant differences between companies, then we consider that these differences should be taken into account when making comparisons and when setting any targets which are based on comparative performance.** **Alternatively, if the extent of company-identified reporting of incidents by other companies is not recorded, then we suggest that an adjustment be made to any comparative targets for United Utilities to reflect our level of company-identified incidents.**

4. Delivering outcomes for customers	Q2a	Do you agree with our proposals to setting bespoke performance commitment levels?	**Agree**	In general, we support Ofwat's proposals on bespoke performance commitments. However, we note that our comments in response to question 2 above and 2b below also apply to setting targets for bespoke performance commitments. In addition, we have some concern that too little attention may be given to local customer priorities, relative to comparisons over time and with other companies. In some areas, setting improvement levels based on comparisons, where customers are currently satisfied with the service, may lead to additional costs which will ultimately be reflected in higher bills. This would not be in line with customer priorities.
4. Delivering outcomes for customers	Q2b	Do you agree with our proposals to setting common performance commitment levels?	**Neither agree nor disagree-N/A**	**As noted in our response to Q2, performance comparisons have a part to play but targets should also reflect customer priorities and differences in the environment in which we operate, which affect the economics of delivering improved services.** **In addition, although there have been efforts to standardise measurement, we consider that there will still be differences between companies' approach to measurement and these differences should be taken into account in setting targets. This applies particularly to sewer flooding (also noted in our response to Q2), where we consider that our approach to ensuring that all incidents are recorded leads to higher reported numbers than other companies.** **In relation to the four common measures with common targets, Ofwat states that "there are no strong reasons why we should not expect companies to achieve the same level of performance". We do not agree this is appropriate for sewer flooding given the significant influence of external factors such as regional variations in rainfall. The number of internal and external sewer flooding incidents is a reflection of sewer condition, operating and maintenance regimes and, crucially, levels of rainfall. In the North West we have industry leading performance in terms of sewer blockages, collapses and pollution incidents which demonstrates our robust approach to the management of our sewer infrastructure. However, the high levels of rainfall in our region mean that we have higher than average incidences of sewer flooding. We recognise that sewer flooding is unacceptable for the customers affected, and we will set stretching targets for AMP7. However, we strongly believe that it is not appropriate to set common targets for measures where there are regional variations in such an influential external factor. Instead, such regional variations should inform what targets companies are able to achieve for an equivalently stretching level of performance and cost.**

4. Delivering outcomes for customers	Q2c	Do you agree with our proposals to setting leakage performance commitment levels?	**Neither agree nor disagree- N/A**	We agree that leakage targets should encourage further reductions in leakage and should take into account the wider considerations referred to in the consultation. We expect to include some reduction in leakage in our plans to reflect the priority which customers give to this issue. However, targets do need to take into the supply-demand balance position in a company's area. Too much emphasis on comparative targets could have an impact on bills beyond what customers would support. This is further amplified by the expected rate at which companies progress towards this level of performance, i.e. from the first year of the next period. It would be virtually impossible to achieve a substantial reduction in a single year for a measure that is based on a three year rolling average. We welcome a statement that targets may be modified where there is convincing evidence that larger leakage reductions would not be beneficial to customers. Comparisons should also recognise that there is still more work to be done on ensuring that leakage estimates are comparable. Work on common definitions has addressed some of the issues on differences of leakage measurement but significant differences remain. This applies particularly to trunk mains leakage and per capita consumption. A large proportion of the differences in per capita consumption estimates is probably due to variations in approaches to measurement rather than real differences in consumption. PCC estimates have a significant impact on the leakage calculation. This potential impact limits the extent to which comparisons between companies can be used for setting leakage targets.
4. Delivering outcomes for customers	Q3	Do you agree with our proposals for strengthening outcome delivery incentives?	**Agree**	**Yes, we agree with Ofwat's intentions for strengthening outcome delivery incentives. However, it is important that incentive rates should continue to reflect the value which customers place on changes in service. Companies should build in potential service improvements into their plan based on customer consultation, and this may limit the scope for further improvement. These constraints may mean that it is inappropriate to aim for a predetermined target in terms of how much return is at stake in ODIs.** **We also note some issues with some of the individual proposals in response to the following questions.**
4. Delivering outcomes for customers	Q3a	Do you agree with our proposals to increase the strength of ODIs by increasing the impact ODIs have on reputation, the greater use of in-period ODIs, linking ODIs to revenue rather than RCV and having a greater onus on financial ODIs?	**Agree**	Yes, we agree with Ofwat's proposals in these areas: **Reputational** - at PR14 many reputational ODIs were simply "non-financial" rather than being truly reputational in their impact, so we agree with Ofwat's proposals to strengthen the impact of such measures. **In-period ODIs, and revenue rather than RCV linked** - we agree that in-period ODIs linked to revenue are more in customers' interests. We also welcome Ofwat's recognition that this requires some flexibility to smooth the impact on customer bills. **Focus on financial ODIs** - we agree that it is preferable for ODIs to be financial rather than reputational. However, we also recognise the value of reputational ODIs when they are appropriately set.

4. Delivering outcomes for customers	Q3b	Do you agree with our proposals on enhanced rewards and penalties?	**Neither agree nor disagree- N/A**	**We agree with Ofwat's rationale for enhanced rewards and penalties as that is what happens in competitive markets. However the water industry is not a fully competitive market, with companies free to provide services in any area. Service standards are not uniformly achievable in all areas of the country, and in all specific company operating environments. Setting enhanced rewards and penalties for comparative performance can only be justified when performance is truly comparable.** **The challenge for Ofwat is to be confident that performance targets are set in a way that is comparable, and provides all companies with a level playing field from which to perform and outperform targets. We agree with Ofwat's aim to recognise performance that is pushing at the boundary of what is achievable - however, only examining performance on a simplistic basis (which does not recognise difference in operating environments) harms the potential benefit to customers, as those companies in more favourable operating environments will more likely be observed as pushing against those boundaries. With appropriate adjustments to ensure comparability of measurement, it should be possible for all companies to have equal opportunities to establish industry benchmark performance, to the benefit of all customers.** **Water industry performance is also very externally dependent, especially on the weather, which can have very large regional variations in its impact on performance. We agree that companies should be incentivised to perform well in adverse circumstances, and agree that poorly targeted exclusions should not excuse poor response to extreme weather conditions (e.g. during a flooding incident). However, such an external event should not be a sole reason for a company to suffer enhanced penalties.** **Exclusions should be avoided where gains and losses from factors outside a company's control can be expected to average out over a five year period. However, if removal of exclusions risks large windfall gains or losses then we consider that exclusions should continue to be applied, in order that the incentive properties of ODIs are not masked by fluctuations due to external factors. It is also questionable whether such factors are likely to average out over a five year period, as it seems more likely that there will be greater downside risk (e.g. from extreme weather impacts) than upside.**
4. Delivering outcomes for customers	Q3c	Do you agree with our proposal to remove the RoRE cap?	**Agree**	We agree that an arbitrary cap on rewards and penalties may stifle innovation. However, the role of the regulator in investigating company performance that varies by a significant amount from expectations, should not be removed. Whilst it is appropriate for Ofwat to incentivise performance, it also has an important role in protecting customers from the extremes of company performance when it is undue - either to ensure that extreme poor performance is remedied when it was within the company's control, or to restrict undue profiteering from targets which (for an individual company's circumstances) were unduly easy to meet and outperform. Removal of the RoRE cap places a lot of weight upon the reliability and accuracy of Ofwat's comparative assessments. In many cases, Ofwat's PR14 approache did not result in a level playing field for all companies to equally achieve rewards through outperformance, and it remains to be seen whether PR19 comparisons will better account for differences between companies.

UUW response to draft PR19 methodology

4. Delivering outcomes for customers	Q4	Do you agree with our proposed Customer Measure of Experience (C-MeX)?	**Agree**	**We endorse the objectives of the new C-MeX, and in particular believe the introduction of a wide ranging customer experience survey of customers that have not contacted the company is likely to prove an effective additional incentive for companies to push themselves further. We believe that using a refined version of the current CCWater customer satisfaction survey on customer experience should be used to measure non-contacting customers' experience. Expanding on an existing survey in this way has many benefits including to help avoid "survey fatigue" with customers. It seems preferable to have one well resourced survey which is well understood and promoted rather than a number of different surveys of different quality, all of which will show some degree of inconsistency but only some of which will impact on rewards and penalties.** **We support the introduction of online surveys into the survey mix. We encourage Ofwat to go further and seek to match survey channel with original contact channel, such that a customer that contacts a company by voice is surveyed on the telephone, whereas a customer that initiates contact on a digital channel has a digital survey.** **We also agree with the move to a one year incentive, benchmarking against upper quartile UKCSI, and moving away from measuring unwanted contacts.** **We do have a number of areas of concern with regards to the preferred option for incentive design, these are set out in detail in our response to question Q4a.**
4. Delivering outcomes for customers	Q4a	Do you agree with our proposed methodology for the C-Mex surveys, as set out in table 4.2 of Appendix 2?	**Strongly Disagree**	Whilst we endorse the aims and objectives of C-MeX we have substantial concern with regards to the preferred detailed option for incentive design:- **1. Complaints**: We believe Customer Complaints should carry a weighting of no less than the current 25% within C-MeX. Customers and industry stakeholders place great emphasis on complaint volumes as a measure of quality customer service. For example customer complaint volumes are frequently used in the national press as a way of judging general industry performance trends and ranking of companies. The proposal not to include complaints in the calculation of a C-MeX financial reward/penalty risks incidences of companies with high relative complaint volumes simultaneously receiving high financial rewards for customer service. For example in 2016/17 a WaSC achieved industry leading results on the qualitative element of SIM but also reported a below industry average quantitative score. Under the current C-MeX proposals that company would receive a large in-period financial reward whilst simultaneously reporting relatively high levels of complaints. Such an event would risk undermining the legitimacy of the measure in the eyes of many customers and stakeholders. We agree that in the past we have some indications of companies reducing contact channel availability to try and reduce unwanted contact numbers; however the removal of unwanted contacts as a measure will be effective in resolving this issue. In the last year UU has substantially reduced complaints at the same time as increasing contact centre opening hours and digital channel availability, demonstrating that good service availability and low complaints volumes are not mutually exclusive. **2. New customer experience measure**: We suggest that the non-contacting customer survey should carry a weighting closer to 25% within the new C-MeX financial incentive calculation. The introduction of a new measure for non-contacting customers is a positive move, but it is currently unclear how companies will respond to the new incentive. The industry should be careful initially in applying very strong financial incentives to it as we have limited collective understanding of how much influence company actions will have on it, and

				whether the new survey will drive unintended activity. There is a risk of undue company windfalls/penalties if too much weight is placed on the new survey, a lower weighting within C-MeX will help address these risks whilst still ensuring companies have an incentive to act. **3. Sample sizes**: We have substantial concerns with regards to the new survey designs. We believe that the proposed sample sizes are simply too small to identify statistically significant variations between companies. We don't believe that this issue is in any way resolved by adding up results from two unrelated surveys, as we believe current best practice in customer survey design would not support this solution. We strongly encourage Ofwat to seek independent academic advice from experts in the field of customer survey design to identify appropriate survey designs and sample sizes. With significant financial incentives at stake we have deep concerns that the proposed survey designs could not command appropriate levels of confidence from companies or stakeholders should customer advocacy groups be unconvinced by the scale of future company rewards. Increasing the sample size will increase costs only by a small amount compared with the potential size of rewards. Given the importance of good customer service, companies should be prepared to provide additional funding to Ofwat to cover this, so it should not be seen as an unreasonable burden. **4. Survey channels:** We endorse the introduction of online surveys into the survey mix. We encourage Ofwat to go further and seek to match survey channel with original contact channel, such that a customer that contacts a company by voice is surveyed on the telephone, whereas a customer that initiates contact on a digital channel has a digital survey. **5. Data protection considerations**: New consumer data protection legislation is coming into force. On a first view we believe all customer details passed by companies to Ofwat for survey purposes would require explicit informed consent on behalf of the customer. As an industry we need to consider how such a change may influence future customer service surveys and what, if any, options there may be to resolve such issues.
4. Delivering outcomes for customers	Q4b	Do you agree with the C-Mex contact survey focusing on customer satisfaction with both contact handling and resolution?	**Neither agree nor disagree-N/A**	**We understand the desire to focus on customers' satisfaction of both contact handling and resolution. The move towards such an approach has advantages in ensuring that the full customer experience is understood and measured. We encourage Ofwat to carefully consider developing a robust, clear, and enforceable definition for 'contact resolution' to underpin such a change.**
4. Delivering outcomes for customers	Q5	Do you agree with our proposed Developer Measure of Experience (D-MeX)?	**Agree**	We agree that there should be a measure of developer customer satisfaction. It will be important that the outcome of the measure is not targeted on developer income (and hence impacting directly on charges to developers), as developers could then feel incentivised to rate companies poorly, in the expectation that this could lead to lower prices in the future.
4. Delivering outcomes for customers	Q5a	Do you agree with our proposed approach to implementing D-MeX, in particular by conducting a satisfaction survey amongst past developer services customer contacts?	**Neither agree nor disagree-N/A**	**The proposed survey measure will be new, with limited time for development and testing before implementation. Therefore we propose that for AMP7 the D-MeX measure should also include performance on the Water UK measures. These have been tested and are already driving improved performance. We suggest a 50:50 split between the survey and the existing measures.** **We would welcome the opportunity to contribute to the design of the new survey, including issues such as questions to be included and appropriate sample sizes. Issues to discuss include:** **• For some of the smaller companies, 25% sampling may not give statistically significant results, whereas it may be too large a sample for large companies.** **• Whether there should be separate measures for water and wastewater**

				• What is included in developer services, is it just dealing with new connections or all dealings with companies, e.g. including land sales.
5. Securing long-term resilience	Q1	Do you agree with our resilience planning principles?	Strongly Agree	Yes, we strongly support Ofwat's eight resilience planning principles.
5. Securing long-term resilience	Q2	Do you agree with our approach to assessing resilience in the initial assessment of plans?	Agree	**We agree with Ofwat's approach to assessing resilience in the initial assessment of plans. In particular, we agree with both the depth and breadth of Ofwat's assessment, i.e.** **- that resilience is a company-wide issue, of operational resilience, financial resilience and corporate resilience. We are particularly pleased to see greater prominence placed on financial resilience, and we are keen to understand more about how Ofwat intends to assess the financial resilience of companies with highly geared financing structures, relative to conventionally geared companies such as UU.** **- that resilience risk assessments should be innovative and sophisticated. We have been concerned by proposals from other parties to take overly simplistic approaches to assessing and measuring resilience (particularly when this has focused solely on system redundancy), which would tend to incentivise expensive infrastructure outcomes, which may not always be in the best interest of customers.**
6. Targeted controls, markets and innovation: wholesale controls	Q1	Do you agree with our proposals for the form of control for network plus water and network plus wastewater set out in the 'Wholesale controls' chapter and appendix 7, 'Wholesale revenue incentives'?	Agree	We agree in most part with Ofwat's proposals in these areas. We support Ofwat's proposals for a volume adjustment to developer services revenue, and for any variations to be adjusted for at the following price control period, as this will help to smooth impacts on customer bills. However, we continue to be of the view that wholesale price controls should not represent a total which includes developer services revenue - whilst the proposed volume adjustment will represent a significant improvement on the current arrangements, it is not clear whether this will be based on customer numbers or volume of water supplied. If it is the former, then this would not provide a mechanism to account for developments to support very large industrial customers (as some have experienced with major nuclear energy developments, such as Hinkley Point). We therefore recommend that the volume adjustment represents an expected volume of water required to supply the development, rather than customer numbers, or alternatively that industrial supplies are converted into an equivalent number of domestic supplies.
6. Targeted controls, markets and innovation: wholesale controls	Q2	Do you agree with our proposals for the form of control for water resources as set out in the 'Wholesale controls' chapter and appendix 5, 'Water resources control'?	Agree	**Yes, we agree with Ofwat's proposals for the form of control for water resources.**

UUW response to draft PR19 methodology

6. Targeted controls, markets and innovation: wholesale controls	Q3	Do you agree with our proposals for access pricing for English water companies set out in the 'Wholesale controls' chapter and appendix 5, 'Water resources control'?	**Neither agree nor disagree- N/A**	We have no objection (in principle) to providing access prices as part of our business plan, however we note the risk of inconsistency between companies unless there is a clear prescribed methodology, i.e. not simply to state that companies' access prices are set consistent with competition law. We note that Ofwat has stated that "the detailed design of access pricing are outside the scope of the methodology" and we await the content of its Autumn discussion paper on wholesale market architecture. We urge Ofwat that this paper sets out proposed detailed design criteria for access pricing (along with the consequences for not adhering to them), and that it is not simply a high level discussion document.
6. Targeted controls, markets and innovation: wholesale controls	Q4	Do you agree with the proposals for company bid assessment frameworks set out in appendix 9, 'Company bid assessment frameworks: the principles'?	**Agree**	**We agree with Ofwat's outline proposal to introduce a bid assessment framework, in particular the need to align this with the principles of non-discrimination, equal treatment, transparency and proportionality as well as procurement best practice. We do however have some concerns and points to raise in response to the proposal in Appendix 9:** **• We agree with the aim of avoiding 'undue regulatory burden' and we would add to this the need to ensure unnecessary administration is avoided to ensure the process is as lean and efficient as it can be so as not to deter third party bidders;** **• We would welcome further information as to the potential for regulation in this area coming out of Section 12 of the Water Act 2014 as and when available;** **• We agree with the best practice recommendation around a separate procurement team overseeing the bidding process and believe this will support the underlying objective of the bidding framework;** **• We believe the principle around complaints and challenges to the outcome of any bid process would benefit from further dialogue and discussion. The use of an independent third party to arbitrate complaints is a concern and if we are entering into a written agreement we would propose consideration of normal legal recourse through the courts for breach of contract be considered. If a third party were to be appointed we believe there would need to be some regulation and control over their appointment, qualifications and an avenue for appeal against their decision to be made available;** **• We would welcome further detail and explanation about the proposed 'open' nature of bidding rather than a 'time limited bidding window'. An open process will require greater administration, resource and resulting cost to facilitate and it is unclear at this stage how such a process would operate in practice. If something such as a Dynamic Purchasing System is envisaged, as is available under the Utilities Contracts Regulations 2016, the potential costs of setting up and running this could be significant considering the potential IT infrastructure and systems which may be needed as well as the resource needed to facilitate the same.**

6. Targeted controls, markets and innovation: wholesale controls	Q5	Do you agree with our proposals for the form of control for bioresources as set out in the 'Wholesale controls' chapter and appendix 6, 'Bioresources control'?	**Agree**	We agree with much of Ofwat's proposals for the bioresources control. We would raise three issues in particular: - we very much support the requirement that sludge TDS is measured at the boundary, to avoid the risk of companies benefiting from approximate values derived by calculation. However, it is not clear how Ofwat plans to protect customers in the event that a company is unable to comply with that requirement. - regarding the overall limit on revenue, we note a particular issue with meeting phosphorus limits under the Water Framework Directive during AMP7. Broadly, there are two competing solutions: (a) chemical dosing (higher opex, lower capex) which will increase the volume of sludge, and (b) biological treatment (higher capex) which results in a lower sludge yield. It is possible that setting a cap on the overall level of sludge could result in inefficient outcomes for customers, in the event that forecast sludge volumes (effectively) pre-empts one of those solutions, and hence precludes consideration of the other. We believe that companies should be able to make representations to make adjustments to the cap where it is demonstrably in the interests of customers for that issue alone. - we note that sludge transport is frequently quoted as a cost driver for bioresources. Whilst it is a significant cost of company sludge operations, we would note two reasons why Ofwat should not use transport distances as a cost driver: (a) some companies are able to sell sludge, due to the excess of demand for manures over supply - this creates headroom for companies to transport over greater distances in order to maximise opportunities for sludge sales, (b) distance travelled is (in part) under company control, as companies negotiate arrangements with local landowners, and (c) distances travelled only represents normal operations - in circumstances where restrictions apply (e.g. due to weather or foot and mouth disease) company distances travelled can vary dramatically, due to local land availability. For these reasons, we believe that availability of arable land (as indicated by the ALOWANCE tool provided by ADAS) is a more reliable predictor of the costs companies incur in transporting sludge to disposal.
7. Targeted controls, markets and innovation: direct procurement for customers	Q1	Do you agree with our draft guidance that appointees should focus on projects likely to deliver the greatest customer value for DPC at PR19? (We ask that appointees provide a list and description of which projects, based on our guidance, they consider would be in scope at PR19.)	**Neither agree nor disagree-N/A**	**We agree with Ofwat that direct procurement for customers (DPC) has the potential to unlock additional efficiencies in the delivery of large projects, for the benefit of customers. We also welcome the opportunity for incumbents to have a potential role in the operation of directly procured assets. We further believe that greater customer benefit could be achieved if incumbents are able to have greater participation in a DPC process than Ofwat now envisages.** **If efficiency in procurement is required, then it is unclear what advantages are gained by excluding the incumbent from the process. At worst it could result in a higher cost outcome for customers. If transparency in the procurement process is desired, then there are a number of alternatives that could be considered, none of which are presented in the draft methodology. It is therefore unclear why Ofwat has felt compelled to adopt this position, without consultation.** **We are concerned that Ofwat appears to have concluded, without presenting the evidence, that a third party solution would always offer customers better value for money than could be achieved by the incumbent. We are concerned that the methodology contemplates that, in the event of a failed direct procurement process, an incumbent's allowed costs would be subject to a downwards adjustment to meet a lower expected level of costs; this appears to indicate that the approach being**

				taken towards direct procurement is not open even to the possibility that the incumbent company may be best placed to offer value to customers for a project which is subject to DPC. In this way, there is a risk that the proposed approach to DPC is less focussed on achieving value for money for customers, but rather on excluding incumbents from delivery of medium to large schemes in their area of appointment. We believe that a fully transparent approach to tendering all DPC works to any party that should be interested in such a procurement would deliver best outcomes for customers. This would of course be delivered in line with OJEU procurement rules which themselves would not rule out an incumbent bidding for all or part of any DPC in an appropriate capacity. We are also unsure as to the accounting treatment of a DPC, and in particular whether under IFRS16 (which is due for implementation in 2019/20) this will result in the requirement to account for the full value of a DPC arrangement as an asset in the incumbent's statutory accounts, regardless of who owns the asset. How IFRS 16 would impact DPC would need to be judged on a case by case basis - one of the key determinants of whether there is a lease that would need to be captured on the balance sheet is whether or not we would have the right to control an identified asset for a period of time in exchange for consideration. We would be deemed to have the right to control the asset, and would therefore need to account for a lease on the balance sheet, if (a) we have the right to substantially all the economic benefit, ad (b) we have the right to direct the use of the asset - both of these seem likely to apply to many projects eligible for DPC. Given that DPC is likely to disproportionately apply to larger companies, this could create an unintended difference in financeability between small and large companies. We believe that the accounting implications of DPC require some further investigation with the industry and accounting advisors. We may have two projects which could potentially be "in scope" for DPC at PR19. At present, both of these possibilities are yet to be finalised (see details below) and therefore we cannot yet be certain of their suitability for DPC: 1. Resilience of supplies from the Haweswater Aqueduct (HA) - following inspection of the HA for the first time (which was enabled by the earlier West-East link main, completed in 2012), we now better understand the resilience risks associated with the HA, which is UU's single largest supply. Options are being developed, and we will engage with customers to better understand the value they place on a reduction in resilience risk, which will inform our preferred solution. a component of the preferred solution (following customer engagement) may include a single large infrastructure investment (e.g. a large water treatment works) which may be a suitable candidate for DPC. We would expect such a project to be completed over AMP7 and AMP8. 2. Water trading - we may be in a position to make initial proposals for a significant transfer of water for use in the South East of England. Whilst elements of such a project could be suitable for DPC, it seems likely that the main elements of investment will take place after AMP7.

7. Targeted controls, markets and innovation: direct procurement for customers	Q2	What are your views on the type of tender model (ie an early or late tender model) appointees should use? Do you have any views on whether or not we need to specify a tender model companies should use?	**Neither agree nor disagree- N/A**	We do not think that Ofwat should specify a particular tender model, as this will likely be case dependent. We consider that Ofwat should seek for companies to justify that their particular approach was the most appropriate, and in the interest of customers. It is also likely to be the case that specifying a tender model in advance would reduce the number and scope of projects which could reasonably be subject to a DPC.
7. Targeted controls, markets and innovation: direct procurement for customers	Q3	What are your views on the overall commercial and regulatory model, including our draft procurement and contract principles set out in appendix 10, 'Direct procurement for customers'?	**Neither agree nor disagree- N/A**	**We support some aspects of Ofwat's proposed approach, but ot all. We support Ofwat's proposal to add pre-construction and procurement costs to its assumed totex for PR19. We also note that there will inevitably be additional ongoing contract management costs associated with managing services which have been subject to DPC, which should also be recognised in assumed totex at future price controls. We observe that the overall regulatory model proposed for DPC seems to be more focussed on an enforcement process which presumes that a third party is best placed to provide a particular service and then seeks to penalise the incumbent in the event that this is not successfully applied. The apparent reliance on a penalty-only incentive appears incongruent with the more balanced approach to incentives that Ofwat has been progressing towards in recent years. We have been supportive of the development of a DPC process to this point, but believe that a more balanced regulatory approach is needed, particularly in taking the first steps towards commissioning projects through this method. There is scope for the DPC process to have a more balanced approach towards reward and penalty incentives. Where there is scope for a potential sharing of benefits between company and customer, this would provide a real incentive for companies to obtain the best price for a service through a DPC process. If this is Ofwat's intention, then we suggest that the incentive framework around DPC is made clearer in the final methodology.**
8. Targeted controls, markets and innovation: retail controls	Q1	Do you agree with using a weighted average revenue control, where appropriate control, taking account of different costs by customer type for the residential retail price controls for English and Welsh water companies?	**Strongly Agree**	We agree with the use of a weighted average revenue control. This approach is understood across companies and allows the control to dynamically adapt to changes in customer numbers over the period.
8. Targeted controls, markets and innovation: retail controls	Q2	Do you agree with using an average revenue control for business retail price controls for Welsh companies not subject to competition?	**Agree**	**Yes, we support this proposal**

8. Targeted controls, markets and innovation: retail controls	Q3	Do you support price controls for business retail activities for English water companies that have not exited the business retail market?	**Strongly Agree**	Yes, we support this proposal
8. Targeted controls, markets and innovation: retail controls	Q4	Do you support price controls for water service customers of Welsh companies using more than 50 megalitres a year?	**Agree**	**Yes, we support this proposal**
8. Targeted controls, markets and innovation: retail controls	Q5	Do you support a three year price control for residential retail activities and business retail activities?	**Agree**	We agree with the proposal for three year retail price controls. The retail environment is by its nature more dynamic, and less dependent on long term capital investment than wholesale business models. A three year control will better enable the industry to adapt to new information, such as emerging evidence from business retail markets, or the emergence of new digital capabilities. There is considerable uncertainty about the potential timing and execution of moves to open up the retail market for domestic customers to competition. Experience from opening the non household market shows that this is a potentially costly exercise to implement and will result in significant costs which will need to be recovered. It may be that a 3 year price control for retail could help ensure those costs are recognised for retail after the three years, however that may not allow for additional costs in wholesale. We suggest that any such costs are dealt with under a separate mechanism, to ensure that they are separately identified and recoverable from customers in a way that provides certainty to companies and investors, whilst not delaying market developments. Finally, if the price control is on a different basis and different timetable then it needs to be subject to a separate appeal process; it will no longer be possible to look at wholesale and retail price controls in the round.

9. Securing cost efficiency	Q1	Do you agree with our overall approach to cost assessment?	**Agree**	**We have actively supported Ofwat's developments in cost assessment since PR14. We have four particular comments on the proposals: 1. the assumption of "frontier" costs should be distinguished from the performance of individual companies in a particular totex model (or suite of models). Econometric models will always contain imperfections in their assessment (given complex differences in the operating environments between companies), which means that the "frontier company" on any particular model should not been viewed synonymously with the "industry frontier level of cost". It is normal to assess industry frontier by (for example) reference to an upper quartile position of companies on a particular model, or a more or less stringent position depending on the reliability of the suite of models being used. It is essential that Ofwat takes a reasonable approach to setting the efficiency frontier, which recognises the limitations of any particular models. 2. the use of company plans as a secondary check on model assessments of the industry frontier may not necessarily reveal any additional reliable information. Since Ofwat has moved away from menus, and has committed to allowing assessed costs (i.e. not capping company costs at its plan costs, if they are lower), then this incentivises companies to understate costs to maximise value from the cost sharing incentive. However if all companies equally react to this incentive, then all companies will be benchmarked at a lower level of totex. This is equivalent to a "prisoner's dilemma", whereby a company would only benefit from the incentive if it is the only one responding to it, and (conversely) the industry benefits most by all acting contrary to the incentive. We do not consider that such an approach is an effective way to reveal real opportunities for company costs, and tends to undermine the effective ex-post incentive on companies to reduce costs to the long term benefit of customers. 3. For services which, in future, may be increasingly provided by 3rd parties (e.g. for bioresources), it should be recognised in the cost assessment that the totex cost paid to an external provider will include non-totex costs (such as the 3rd party's return on capital, taxation etc.) Unless the cost assessment process makes recognition for these costs, a company with a lot of third party provision of bioresources will appear inefficient compared to a company that has not participated in the market. This may also act as a barrier to competition. We suggest that Ofwat makes additional allowance in the Bioresources totex assessment for contract costs that contribute to non-totex costs of any third party service providers. 4. Ofwat's proposed approach to cost assessment appears does not yet appear to acknowledge two pertinent changes in accounting, namely (a) the IFRS16 leasing standard due to be adopted in 2019/20, which will crystallise (as totex) many existing leases, creating a discontinuity between past and future costs between companies which is driven by accounting practice, not by company performance, and (b) "principal use" accounting which will tend to allocate costs and assets between services in ways that could create unintended cost differences between companies when viewed at the level of each price control. This might lead Ofwat to judge that a company is more or less efficient, due (in part) to principal use accounting, rather than actual cost performance.**

9. Securing cost efficiency	Q2	Do you agree with our proposed cost sharing incentive? We welcome thoughts on the calibration of the incentive.	**Disagree**	We do not have any particular concerns over the cost sharing incentive in of itself, but we do not fully support Ofwat's intended use of company responses to this mechanism to inform its cost assessments at the final determination, as set out in our response to Q1 above. The use of company plans as a secondary check on model assessments of the industry frontier may not necessarily reveal any additional reliable information. Since Ofwat has moved away from menus, and has committed to allowing assessed costs (i.e. not capping company costs at its plan costs, if they are lower), then this incentivised companies to understate costs to maximise value from the cost sharing incentive. However if all companies equally react to this incentive, then all companies will be benchmarked at a lower level of totex. This is equivalent to a "prisoner's dilemma", whereby a company would only benefit from the incentive if it is the only one responding to it, and (conversely) the industry benefits most by all acting contrary to the incentive. We do not consider that such an approach is an effective way to reveal real opportunities for company costs, and tends to undermine the effective ex-post incentive mechanism on companies to reduce costs to the long term benefit of customers.
9. Securing cost efficiency	Q3	Do you agree with our proposals to funding unconfirmed environmental requirements? Which of the two options do you consider is more appropriate, and why?	**Disagree**	**Whilst we recognise the overall rationale for this change, we are concerned that United Utilities will end up being penalised for Ofwat's perception of the actions of other companies. Contrary to Ofwat's claims of the industryt in the draft methodology, UU has not under delivered on outputs or costs associated with the Water Framework Directive during AMP6 (our current estimate is for costs to be within 5% of those assumed at PR14), and therefore webelieve that, if Ofwat has concerns about company behaviour, then this should be a company specific response based on the performance on individual companies rather than a blanket approach that applies to all.** **Of Ofwat's specific proposals, we would be more supportive of the second approach, whereby value based on the unit cost of outputs is passed back to customers in the event of non-delivery.**

9. Securing cost efficiency	Q4	Do you agree with our approach to cost adjustment and our proposed approach to make the process more symmetric?	**Agree**	We consider there is merit in this approach where there are factors which vary between companies which cannot be adequately reflected in a cost model, i.e. those which (preferably) would be factors included within a totex model, but which may not be included as a factor for whatever reason. An example of this from PR14 would be our base totex special cost factor (SCF) claims. At PR14 a number of other special factors represented company specific environmental programmes, or "large projects" whereby the past was not a good predictor of future cost. This applies to many of the SCF claims we made at PR14, such as the Thirlmere Link, Davyhulme, and Oldham. For these types of adjustments, it is unlikely that a symmetric adjustment would be appropriate. We also consider that there needs to be clarification of the special cost factor process in the event that Ofwat does not publish cost models prior to special factor submission in May. Absent model publication, there are a number of factors which drive company costs for which it is unclear whether or not they will be represented in Ofwat's final models. If they are adequately included in the models, then a special factor claim would not be required. If they are not, however, then a special factor claim will be a necessary part of the process of establishing an efficient level of totex. Publication of the totex models would provide clarity on this point and significantly reduce the potential number and scope of special factor claims. However, if the models are not published then companies can only provide special factor claims on the basis of tentative assumptions about whether they are required. This would necessitate a twin track approach to the classification of special factors (a) those special factors which are independent of the form of any cost model (e.g. related to large projects), and (b) those factors which may or may not be reflected in Ofwat's final models (including new quality investment, regional wages, economies of scale, urbanisation etc.) Regarding water trading, at present, the cost assessment process makes no specific consideration of the development costs for significant water trades (which may take place over a long timeframe), and therefore they would be at the company's expense. That is despite it not being a core function of that business, as it does not support the delivery of water to its own customers. We suggest that the development of significant water trades could be better supported by (for example) removing the triviality threshold, and any assumption of implicit allowances, for special factor claims related to future water trades.

9. Securing cost efficiency	Q5	Do you agree with our proposed approach for assessing retail (residential and business) costs at PR19?	**Strongly Agree**	**We strongly support the proposed approach to assessing residential retail costs. Efforts to move to an econometric model approach to cost assessment represents a substantial improvement on the approach applied at PR14. The identified potential cost drivers make operational sense, and reflect the types of adjustments that were made at the previous price review. These key drivers are the same as those identified by Economic Insight when they considered options for household retail cost assessment (published on the "Market place for Ideas"). We are keen to work with Ofwat and other companies to develop stable predictive cost models that work for customers and the industry as a whole.** **As set out in our work with Reckon on the role of deprivation and arrears risk in household retail cost assessment (published on the "Market place for Ideas") it is important to recognise the dependency on the nature of factors used to represent differences in costs, in particular differences in deprivation. Evidence strongly supports that bad debt is not linearly related to the level of deprivation, more that it is the prevalence of extreme deprivation that drives differences in bad debt. If Ofwat's retail cost model only represents difference in average deprivation (or some equivalent measure) then this will not fully represent differences in company costs.** **We also support the use of bill size, but note that this should be represented as an "average revenue per customer" using the same customer count that is used in the model for customer numbers. If not, then this inconsistency would inappropriately assess costs for companies with different levels of dual and single service customers.** **We fully recognise the need for companies to demonstrate that they are applying best in class debt management techniques, including taking evidence from beyond the water sector about both differing performance levels and circumstances.** **We suggest when adjusting for legacy retail depreciation (as set out in Appendix 12 - section 5) the reduction for legacy depreciation in company totex allowances should be the implicit pre 2015 depreciation allowance experienced by the efficient company, this will ensure that only efficiently incurred post April 2015 costs are allowed for whilst preserving the full RCV protection for pre April 2015 investments.**
9. Securing cost efficiency	Q6	Do you agree with our preferred approach not to index the retail controls to a measure of general inflation, and, if appropriate, deal with input price pressure as part of our totex allowance?	**Agree**	Yes, the proposal to deal with input price pressures as part of an overall totex allowance seems reasonable. We agree with Ofwat's observation that the majority of retail costs are not region specific and as Ofwat are proposing to set cost allowances at an 'efficient' company level we believe that the most appropriate approach to applying any additional cost pressure allowance is on a symmetric industry-wide basis, uplifting all companies' cost allowance by the observed allowance for the efficient company.

9. Securing cost efficiency	Q7	Do you agree with our proposals for the transition programme?	**Disagree**	**We do not entirely concur with Ofwat's representation that its totex and outcomes approach have removed the link between costs and outputs. At PR14, we were required by Ofwat to remove AMP7 transition spend from our NEP5 programme for the delivery of WFD outputs that were required in 2021. As such we would expect that a transition programme would be available for specific quality outputs that are required for delivery very early in AMP7, and hence will require early investment towards the end of AMP6 - we currently estimate this to be c.£21m.** **Ofwat's proposals also do not allow for large, long term schemes, where cost and delivery of outcomes may occur in different AMP periods. For example, our work on the resilience of supplies from the Haweswater Aqueduct has resulted in some addition early work being delivered during AMP6 (notably to provide an appropriate solution for one tunnel section which has been identified for priority action). Given that this is part of a wider long term programme to address the resilience of those supplies, we believe that this "early start" work should be treated as transitional investment.**
10. Aligning risk and return	Q1	Do you agree with our proposed approach to setting the cost of equity, based on the best estimate of expected returns in the 2020-25 period?	**Strongly Disagree**	We recognise that requirements for overall returns (including the cost of debt) are lower now than they have been historically. However, we do not agree that the total market return has decreased to the extent suggested by PWC's report for Ofwat. This position is supported by the attached document "The cost of equity at PR19" prepared for UU by Ernst and Young. The total market return proposed in the draft methodology appears too low, with too much weight placed on a 'lower for longer' interest rate scenario which we feel has not been robustly evidenced. There is insufficient regard to the uncertainty and skew associated with this scenario. In addition, we feel that too much weight has been placed on the market to asset ratio and the dividend discount model - this evidence is difficult to interpret and lacks robustness. The analysis also appears to give insufficient regard to longer term data and the underlying stability of long term rates of return as well as the associated inverse relationship between the risk free rate and the market risk premium which is well documented in many academic papers. Additionally, we beieve that the analysis presented as part of the methodology consultation is not robust. It ignores significant volatility in market returns over short time periods and the lack of robustness in the short term estimates these numbers rely on (with swings in returns over just the last few years from 0.2 to over 30% pa) as well as completely different results from even small variations in the time periods. The analysis appears to confuse different inflation assumptions leading to historical estimates with lower inflation being combined with higher inflation assumptions going forward leading to a larger adjustment from nominal to real conversion than embedded in the underlying historical data. Numerically, in order to derive the cost of equity estimates quoted at the lower end, one has to assume a negative risk free rate of as much as -1.6%, which is not a reasonable assumption. The analysis also suggests that any recent data (notwithstanding the arguments above) can be readily projected going forward without any supporting evidence to say that this is a reasonable assumption. In summary, we encourage Ofwat to consider a more holistic range of views on the total market return for PR19 to ensure that the sector remains able to attract and retain finance on the best value for money terms and in the best long term interests of customers.

10. Aligning risk and return	Q2	Do you agree with our approach to indexing the cost of new debt?	**Agree**	Yes, overall we agree with Ofwat's approach. However, we believe that the cost of future debt set at PR19 should be set with reference to forward rates as opposed to a simple average of the index in the 12 months leading up to the final determinations. If the initial rate doesn't take into account market derived expected changes in rates it is likely to lead to larger variances to the outturn cost of future debt per the debt indexation mechanism and therefore larger year by year impacts on companies' financial results and ratios. Whilst any variance between the cost of future debt set at PR19 and the outturn cost of future debt per the debt indexation mechanism would be 'trued up' at the end of the period and therefore variances are just a timing issue, these should be minimised where possible. Additionally, we note that limited information has been provided on Ofwat's proposed end of period adjustment in relation to the cost of future debt indexation mechanism. The example calculation included in the methodology consultation would imply that the end of period adjustment for the full five years of AMP7 would not be available for calculation until after 31 March 2025 and therefore would be too late to be adjusted as part of PR24, only being available to be fed into prices from FY27 onwards . Whilst our preference remains for flexibility to be given for companies to either apply an in-period or end of period adjustment, where an end of period adjustment is mandatory it would be our preference that as full an adjustment is made as early and as fully as is feasible to minimise the timing differences between the higher/lower cost of debt experienced and the recovery/pass-back through revenues, which in turn would minimise impacts on companies' financial results and ratios.
10. Aligning risk and return	Q3	Do you agree with our proposal to index price controls to CPIH (subject to its redesignation as a national statistic before we publish our final methodology)?	**Strongly Agree**	Yes, we agree with Ofwat's approach and have embraced Ofwat's planned transition to CPIH by being the first utility to issue CPI linked debt (being the most closely available match to CPIH at this point) and whilst the availability of such debt is limited this is an area of ongoing focus for UU. However, we note that the move to CPIH has a number of consequences. For example, Ofwat intends to apply an ongoing efficiency target to wholesale costs at PR19. Historically, such adjustments have been made relative to RPI. When applying such adjustments relative to CPIH, it should be recognised that the lower value of CPIH relative to RPI means that Ofwat should expect a lower level of productivity gains relative to the economy than those previously measured by reference to RPI.
10. Aligning risk and return	Q4	Do you agree with our approach to setting tax allowances at PR19, including the proposed true up mechanism?	**Strongly Agree**	**Yes, we agree with Ofwat's approach to setting tax allowances and we support Ofwat's preferred option for the proposed true-up mechanism.**

10. Aligning risk and return	Q4a	Should the true up mechanism be limited to change in corporate tax rates and capital tax allowances or should we extend that true-up mechanism so we can also make adjustments for other changes in tax legislation or accounting regulations which have a material impact on the amount of tax companies are liable to pay?	Strongly Agree	We believe that Ofwat's proposed option represents the right initial approach to a tax true-up mechanism for PR19. The proposed approach strikes the right balance between ensuring that risks and rewards associated with key areas of change outside of the companies control are shared on a fair and transparent basis whilst at the same time avoiding placing an undue compliance burden on either Ofwat or the companies. Companies should retain incentives to act efficiently.
10. Aligning risk and return	Q5	Do you agree with the set of scenarios for RoRE analysis we have prescribed, the guidance we propose and to use our financial model to provide the suite of prescribed scenarios?	Strongly Disagree	**We agree that our plan should represent a reasonable balance of risk and returns. Ofwat asserts that the overall balance of risk and returns remains symmetric around the "base case" of the notionally efficient company - i.e. the level which meets Ofwat's minimum performance expectations in all areas of cost and performance. We have no doubt that such a level of performance would be very stretching, and would provide great service to customers. However, no company is currently performing consistently at industry upper quartile in all areas – i.e. on costs for each price control as well as on performance levels for every outcome individually. Therefore it appears that a notionally efficient company (as implied by the performance expectations set out in the draft methodology) is already considerably beyond the industry frontier to such an extent that it likely represents an unachievable position.** **Given that Ofwat's expectations for a notionally efficient company are (as explained above) already beyond the frontier of the industry, it is difficult to see how the symmetry in expected RoRE ranges (as set out in section 10 of the draft methodology and illustrated by figure 10.1) could be achieved. This is further supported by Ofwat's expectation that an average performing company should expect to receive net penalties, which means it is difficult to see how a P10 and P90 performance range could result in a symmetric RoRE range around the assumed cost of equity.** **We have engaged with Ernst & Young (EY) to produce the report "Balancing Risk & Reward at PR19" to investigate this issue in more detail and have provided it to Ofwat alongside our response to the draft methodology. In summary, EY concludes that in setting any determination Ofwat should satisfy itself that the overall risk and reward package should be balanced such that a notionally efficient company expects to be able to achieve a return on equity equal to the rate of return which equity investors in a notionally efficient company would require.** **Regarding the specific scenarios, whilst they seem reasonable in principle, we also note the wide variation in interpretation of P10 and P90 levels of performance as applied by companies at PR14, and we consider it appropriate for Ofwat to be more prescriptive regarding the approach that companies take at PR19. For example:** **- companies should not use minimum / maximum reward and penalty values for ODIs to represent P10**

				and P90 **- historic company performance could (and should) be taken into account when assessing the likely variation in performance which should inform overall P10 and P90 performance levels.**
11. Aligning risk and return: financeability	Q1	Do you agree with our overall approach to assessing financeability?	**Agree**	Yes, we agree with Ofwat's approach to assessing financeability. However, we note that in setting a 50:50 weighting of A and BBB rated iBoxx indices as a benchmark for the cost of debt assumptions for the future cost of debt, that this would only be consistent with testing financeability for a notional company at the same level (i.e. the cusp of A-/BBB+). If companies were to propose financeability testing at higher/lower rating then the benchmark cost of debt index would need to be adjusted lower/higher.
11. Aligning risk and return: financeability	Q2	Do you agree the calculation of the metrics (as set out in Section 11.5 in the Financeability chapter) that we are proposing to use in our assessment?	**Agree**	Yes, we mostly agree with Ofwat's calculation of the financial metrics, although we believe that the alternative calculations are the more appropriate indicators on which to base the financeability assessment. There are a couple of points of detail where we see some differences: 1. For RCF/Net Debt we believe that IRE should be added back to the numerator as per Moody's methodology. 2. As the model is currently unpopulated it is difficult to fully assess the computational basis of some of the inputs to the financial ratios, and therefore some of these points may already be addressed, but net debt should not include fair values and the calculation of net debt appears to deduct 'retained cash' as opposed to the cash balance. As we complete inputs to the financial model to test it further, we intend to provide further feedback to Ofwat in the event that we would propose any changes.
12. Accounting for past delivery	Q1	Do you agree with our proposed approach for dealing with PR14 reconciliations and SIM? If not, please explain your alternative approach and why this would be in customers' interests.	**Agree**	Yes, we agree with Ofwat's approach to dealing with PR14 reconciliations and SIM performance. We have reviewed the PR19 revenue and RCV adjustment feeder models and noted an error within the "CPIH deflate from 2020 FYE to 2018 FYA" calculation. The calculation is intended to provide the adjustment factor used in converting any revenue/RCV adjustment from a 2012/13 RPI to a 2017/18 CPIH basis, but does so incorrectly. It does not account for the different base years between the RPI and CPIH (i.e. where the index = 100). As the RPI base year is 1987 and the CPIH is based in 2015, simply dividing the CPIH 2018 FYA value (e.g. 104) by the 2020 March RPI value (e.g. 294) then also discounts by the 28 years difference between the index base years. Therefore, the resulting adjustment factor overstates the difference between RPI and CPIH on a comparable basis and results in a different adjustment being made in nominal terms. This can be corrected by adjusting for the differences in the respective base years for the two indices by calculating the adjustment factor based in the same year as has been done in previous regulatory reconciliations.

12. Accounting for past delivery	Q2	Do you agree with our proposed approach for reflecting how well the company is delivering for customers over the 2015-20 period in the initial assessment of business plans? If not, please explain your alternative approach and why this would be in customers' interests.	**Agree**	**Yes, we agree with Ofwat's proposed approach for reflecting how well the company is delivering for customers over the 2015-20 period. However, we question the need for further customer engagement on applying its proposed adjustments to the 2020-25 price control, given that they will result from mechanisms (such as ODIs) which were already initially subject to customer engagement.**
Securing confidence and assurance	Q1	Are the business plan and data requirements clear and sufficiently specified?	**Neither agree nor disagree-N/A**	Overall the table guidance could be improved. Where data is intended to same as other regulatory returns we request that the corresponding table and line be referenced in full and that the line definition should be replicated in the guidance section of each of the PR19 tables. Tables WS18 and WWS18 are intended to be collected in a consistent way and this table would benefit from more detailed line definitions to ensure that companies are reporting in a consistent manner, again where numbers appear in other tables then reference should be included.
13. Securing confidence and assurance	Q1a	Are there any areas we need to look at again?	**Neither agree nor disagree-N/A**	**Appendix 5 Water resource control' states that "The full mechanics of the equalisation payment are outside the scope of the methodology" and "Detailed design questions on access pricing are outside the scope of the methodology". It would be helpful if this was in scope, otherwise we will assume that the table is to be populated based on the table guidance and line definitions provided.**
13. Securing confidence and assurance	Q1b	Is there any data missing, or included but not required?	**Neither agree nor disagree-N/A**	We are not aware of any areas where data is missing. However, as we make more use of the tables over the coming months, in preparation to make our submission next September, we will raise with Ofwat any further issues identified with the tables.
13. Securing confidence and assurance	Q2	Do you agree that our approach to assessing assurance can provide us and stakeholders with confidence in the companies' business plans?	**Strongly Agree**	**Yes, we agree with Ofwat's approach to assessing the quality of a company's assurance. The information regarding expectations for Board assurance is helpful.**

14. The initial assessment of business plans: securing high quality, ambition and innovation	Q1	Do you agree with our proposed approach to the initial assessment of business plans?	**Agree**	Yes, we support Ofwat's overall approach and the nine areas of coverage. We believe it is reasonably clear what Ofwat's expectations are for a company that is judged to have an "exceptional" plan - however we note that there is some substantial uncertainty regarding the boundary between the other categories. It appears that this reflects a measure of how much Ofwat has agreed with a particular company's business plan proposals, in the event that they are not proposing better than future upper quartile performance. The corollary of this is that the business plan assessment could be a reflection of the number of areas in which a company has to provide additional evidence. Unless Ofwat's comparative assessments are sufficiently sophisticated to allow for all environmental differences between companies (that affect both cost and performance levels), this will lead to an uneven playing field whereby some companies will inevitably need to explain differences from Ofwat's expectations more than other companies. We strongly urge Ofwat to recognise this when setting performance expectations, and not be overly simplistic in comparative assessments. Ofwat should recognise the inevitable and natural differences between companies when assessing company business plans, and not rely solely on models and other comparative assessments. We also note that for a company to be stretching in all areas (on every common and bespoke ODI, and on retail and wholesale costs for each price control) is almost certainly not going to be feasible. For the overall assessment of plans, Ofwat should consider what a stretching plan should look like in the round, and accept that it doesn't necessarily need to be a plan that is pushing at industry leading performance in every area individually.
14. The initial assessment of business plans: securing high quality, ambition and innovation	Q1a	In terms of the nine test areas?	**Agree**	**Yes we support Ofwat's overall approach, we are pleased to see the continuity from the PR14 risk based review assessment criteria and recognise the need to adapt this criteria to take account of responsibilities of the industry that are higher profile than five years ago, such as resilience.**
14. The initial assessment of business plans: securing high quality, ambition and innovation	Q1b	In terms of the business plan characteristics we want to see? (high quality, ambition and innovation)	**Agree**	We agree with this in principle, although we question how independent Ofwat will judge these characteristics to be - i.e. will it be possible (in practice) for a company's plan to be considered to be high quality and innovative if it is not judged by Ofwat also to be ambitious?

14. The initial assessment of business plans: securing high quality, ambition and innovation	Q1c	In terms of the business plan categories we propose to assign companies to? (significant scrutiny, slow track, fast track, exceptional)	**Agree**	**We agree with Ofwat's approach to categorising company business plans.** **We believe it is reasonably clear what Ofwat's expectations are for a company that is judged to have an "exceptional" plan – however we note that there is some substantial uncertainty regarding the boundary between the other categories. It appears that this reflects a measure of how much Ofwat has agreed with a particular company's business plan proposals, in the event that they are not proposing better than future upper quartile performance. The corollary of this is that the business plan assessment could be a reflection of the number of areas in which a company has to provide additional evidence. Unless Ofwat's comparative assessments are sufficiently sophisticated to allow for all environmental differences between companies (that affect both cost and performance levels), this will lead to an uneven playing field whereby some companies will inevitably need to explain more differences from Ofwat's expectations more than other companies.** **We urge Ofwat to recognise this when setting performance expectations (and not be overly simplistic in comparative assessments) and also to recognise the inevitable difference between companies when assessing company business plans.**
14. The initial assessment of business plans: securing high quality, ambition and innovation	Q1d	In terms of the financial, procedural and reputational incentives we propose to put in place?	**Agree**	We agree that the financial and reputational incentives that Ofwat proposes appear appropriate. However, we suggest that Ofwat remains somewhat more open to the impact of new information coming to light in the period between business plan submission and final determination. We are not suggesting that companies should have complete freedom to amend plans post submission, free from any consequence, but we do believe that Ofwat should be open to considering new evidence presented by companies after submission of business plans, if it was not known at the time that business plans were submitted.
14. The initial assessment of business plans: securing high quality, ambition and innovation	Q2	Do you agree with our proposed approach to assessing a company's ability to deliver results for customers and the environment from innovation?	**Agree**	**We agree with Ofwat's proposed approach.**
Appendix 14 - the initial assessment of business plans	Q1	Do you agree with the key questions under each of the test areas?	**Agree**	We agree with the questions that Ofwat has proposed.
Appendix 14 - the initial assessment of business plans	Q2	Do you agree with what we will look for in terms of high quality, ambition and innovation under each of the test areas?	**Agree**	**We agree with this in principle, although we question how independent Ofwat will judge these characteristics to be - i.e. will it be possible (in practice) for a company's plan to be considered to be high quality and innovative if it is not judged by Ofwat also to be ambitious?**

Appendix 14 - the initial assessment of business plans	Q3	Do you agree with our high-level approach for scoring business plans into the four categories (significant scrutiny, slow-track, fast-track, exceptional)?	**Agree**	We agree with Ofwat's approach to scoring company business plans. We believe it is reasonably clear what Ofwat's expectations are for a company that is judged to have an "exceptional" plan - however we note that there is some substantial uncertainty regarding the boundary between the other categories. It appears that this reflects a measure of how much Ofwat has agreed with a particular company's business plan proposals, in the event that they are not proposing better than future upper quartile performance. The corollary of this is that the business plan assessment could be a reflection of the number of areas in which a company has to provide additional evidence. Unless Ofwat's comparative assessments are sufficiently sophisticated to allow for all environmental differences between companies (that affect both cost and performance levels), this will lead to an uneven playing field whereby some companies will inevitably need to explain more differences from Ofwat's expectations more than other companies. We urge Ofwat to recognise this when setting performance expectations (and not be overly simplistic in comparative assessments) and also to recognise the inevitable difference between companies when assessing company business plans.
Appendix 14 - the initial assessment of business plans	Q4	Do you agree with our proposed schedule for the initial assessment of business plans?	**Agree**	**We agree with Ofwat's proposed schedule.**