

# Representations: Delivering customer value in large projects

## Document Reference: J006

This document contains UUW's representations on the Ofwat document 'PR19 draft determinations – Delivering customer value in large projects'.

In particular, it sets out a proposed approach to managing uncertainty in the event of a DPC exit, as a preferable alternative to Ofwat's proposal for a Notified Item.

**United Utilities Water Limited**



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## 1. Executive Summary

As part of Ofwat’s initial assessment of business plans in January 2019, Ofwat stated that the assessment of proposed direct procurement for customers (DPC) schemes would continue outside of the fast-track process<sup>1</sup>. As a result, we welcome the opportunity to comment on ‘PR19 draft determinations – Delivering customer value in large projects’ as part of the slow-track draft determination process.

In section 2 of this document, we begin by recognising that Ofwat’s slow-track determination publication is broadly consistent with its assessment of companies’ DPC proposals at IAP.

In Section 3, we then propose a series of key DPC considerations that we believe should be addressed in advance of December’s final determination. These include:

- Section 3.1 - our proposals that review timescales for the deliverables outlined in Ofwat’s draft briefing note are agreed between industry and regulator.
- Section 3.2 - we express our concerns about Ofwat’s proposed uncertainty mechanism (a “Notified Item”) in the event of an exit from the DPC process, and we propose an alternative mechanism that we believe better addresses the uncertainty inherent within the DPC process.
- Section 3.3 - we set out in more detail how we expect the uncertainty mechanism, proposed from section 3.2, would operate in practice, and include how we would provide assurance on costs at different possible stages of DPC exit.
- Section 3.4 - for licence amendments, we consider the value of a consultation period in advance of December’s final determination, and the potential drawbacks to making these changes to different cohorts of companies.
- Section 3.5 - we detail how Ofwat’s assessment of DPC to date appears to correlate with our proposed performance commitments, but reiterate again that we are yet to be afforded the opportunity to represent on these proposals.
- Section 3.6 - finally, we outline concerns about the potential negative impact of IFRS16 on UUW’s ability to implement a DPC approach and the need for Ofwat to recognise this as a potential risk moving forward.

## 2. Ofwat’s determination of our scheme

In Ofwat’s initial assessment of business plans (IAP) in January 2019, United Utilities was assessed to have “carried out a strong DPC assessment with sufficient evidence of convincing decisions to be high quality”<sup>2</sup>.

Further we note Ofwat’s recognition of HM Treasury’s Five Case Model as a suitable method for developing a project business case. As a component of our business plan submission in

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<sup>1</sup> PR19 initial assessment of plans – Overview of company categorisation, page 28.

<sup>2</sup> United Utilities: Test question assessment, page 8.

September 2018, we submitted our preliminary Strategic Outline Case (SOC) for the Manchester and Pennine Resilience scheme. Following Ofwat’s positive reception of our proposal for the scheme, and recognising the guidance laid out within Ofwat’s draft briefing note<sup>3</sup>, we re-submitted our updated SOC on 26<sup>th</sup> April 2019 for Ofwat’s review and provision of its assent, in accordance with the requirements for control point B. This contained an amended timeline, reflecting Ofwat’s control and information points. We are currently awaiting formal acceptance of this document and would welcome confirmation from Ofwat as to when this can be expected.

We recognise the inclusion of Ofwat’s procurement and contract principles, and note that these are unchanged from those published in its PR19 final methodology<sup>4</sup>. We interpret this to mean that these principles will remain unchanged for the final determination. If this is not the case, we would welcome a view of when and how these principles are expected to change.

### 3. Key DPC considerations

Since IAP we have continued to work collaboratively with Ofwat’s DPC team; having a consistent point of liaison has proved invaluable in facilitating the development of our Direct Procurement. We appreciate this input and will continue to work collaboratively towards the success of the DPC as we near final determination and transition into AMP7. To aid in this process, and to give our board confidence of progress within the DPC process, there are some areas where we believe further consultation will be beneficial ahead of Ofwat’s final determination, due 11<sup>th</sup> December 2019.

From a governance perspective, our board will seek confidence that the project and our Strategic Outline Case have been formally approved by Ofwat’s board. Further, we hope to establish a collaborative, time-bound process for review and approval as we progress through Ofwat’s control points.

We propose that a dialogue around licence amendments should take place ahead of final determination, with a view to giving both our board and the market confidence as to when amendments will be made, their form and substance.

Our board will also look for confidence in Ofwat’s choice of uncertainty mechanism, to ensure that there are suitable safeguards in place, for company as well as customers, in the event that delivery of the scheme comes back in-house. **It is essential that the Board has confidence that the risks the project is targeting will be adequately accommodated and addressed in the PR19 final determination, that this remains the case regardless of the means of financing and procurement and that, in the event that a DPC project is ultimately delivered in house that the company is able to efficiently and effectively finance the project.**

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<sup>3</sup> Direct Procurement for Customers – Briefing note on the procurement process for 2020-2025 (draft 25<sup>th</sup> March 2019).

<sup>4</sup> Delivering Water 2020: Our methodology for the 2019 price review, Appendix 9: Direct procurement for customers, pages 10-19.

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For our performance commitments, Ofwat has yet to publish a draft determination of its views regarding these outcomes, in order for us to make final representations ahead of final determination – this is contrast with the remainder of our suite of performance commitments for AMP7.

Finally, we outline the potential negative impact of IFRS16 on UUW’s ability to implement a DPC approach and the need for Ofwat to recognise this as a potential risk moving forward.

We detail our proposals on these topics below, with a view to giving Ofwat, our board and the market confidence in the future of Manchester and Pennines Resilience as a DPC scheme.

### 3.1. Ofwat’s governance of the DPC process

Following distribution of Ofwat’s draft briefing note earlier in March 2019<sup>5</sup>, we have taken care to align our internal delivery timeline with Ofwat’s control points as far as possible, incorporating the specified requirements into our plans for development. Our timeline for procurement will make it challenging to accommodate for significant periods of review and sign-off for submitted deliverables.

We are committed to undertaking a fair and transparent procurement process, and to do so need to allow sufficient time for the preparation of tender documents. In turn, these documents rely on the outputs of surveys and investigations, which inform our requirements within the tender process. Similarly, the length of the delivery timeline is constrained by the need to address the risk to water quality and supply posed by the deterioration of the existing aqueduct. These forces place constraints on our timeline. We have developed what we consider to be a workable plan for delivery; however, this requires a collaborative approach to the review and approval of outputs between United Utilities and Ofwat.

Throughout our continuing liaison with Ofwat’s DPC team, we have developed a working assumption that we will provide Ofwat with elements of our control point submissions ahead of formal submission dates. On the basis that Ofwat we stage the submission of deliverables in advance of formal submission, then we understand that this will allow for a shorter review period of 28 days before final sign-off is agreed. With a view to confirming review timescales, we request confirmation that this approach is acceptable, or in the alternative, that Ofwat provide further detail around its review process at each control point, with a specific focus on maximum review periods to inform our submission planning.

At present we consider that there are two documents which if formalised would give more certainty to our governance arrangements. Firstly, Ofwat’s draft briefing note from March of this year has become essential to our understanding of Ofwat’s position and requirements for review. We would like to see this document finalised and published, so that we may finalise our planning around it. Secondly, our strategic outline case currently awaits formal approval from Ofwat’s board, award of which will be essential to giving our board comfort in the scheme’s acceptance before final determination.

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<sup>5</sup> Direct Procurement for Customers – Briefing note on the procurement process for 2020-2025 (draft 25<sup>th</sup> March 2019).

## 3.2. DPC exit & Ofwat’s proposed uncertainty mechanism

### 3.2.1. Summary

Ofwat proposes two options for the recovery of costs in the event that a scheme is forced to exit the DPC process, with an expressed preference for the first option:

- a) *A Notified Item detailed in a company’s final determination and which could, subject to relevant thresholds, lead to a change in the level of price controls through an interim determination*

United Utilities does not share this view. We consider a notified item to be problematic in three main respects:

- The nature of the uncertainty being accounted for is not typical of other items normally eligible for IDoK;
- IDoKs have specific rules and timetables which create additional uncertainty, and additional inertia to the timetable (despite the need having already been accepted, and the cost being market tested), which could result in unacceptable delays to project delivery; and
- Use of the IDoK mechanism creates the risk that Ofwat rejects the IDoK application, and the company is left treating the additional expenditure as a “totex overspend”.

It also does not appear to adequately address Ofwat’s concern about customer protection – an IDoK would be assessed mid-period, prior to the company incurring significant construction costs. Therefore, there remains a risk that company incurred costs in AMP7 vary from those assumed at the IDoK. However, an *ex-post* true up for actual/projected proportion of the project delivered, based on *ex ante* valuations, as proposed by UUW (i.e. to use the same uncertainty mechanism being applied to WINEP amber schemes) would seem to better protect customers.

Further, use of the IDoK process seems unduly unreliable (and hence is wholly inappropriate) for an agreed project whereby the company has supported and pursued a novel procurement route in the pursuit of delivering better value for customers, and which may pave the way for greater future savings for customers across the industry. We strongly believe that Ofwat’s preferred mechanism for dealing with DPC exit, at least in the case of UUW’s Manchester and Pennines Resilience project, should be a passive and predictable adjustment applied at the following price control.

### 3.2.2. Notified Item / Standard IDoK

Notified items (and relevant changes of circumstance) are intended to account for uncertain circumstances that cannot be sufficiently quantified or defined at the time the final determination is made. In the case of this DPC project, however, much of it can be considered reasonably certain.

Ofwat has accepted the strategic need to address the risk to the Haweswater Aqueduct<sup>6</sup>. We have also submitted an assessed cost for delivery via DPC, along with a timetable for the completion of works<sup>7</sup>; these factors provide definition of the likely shape and cost of the proposed scheme.

The novelty, and thereby the source of uncertainty in assessing the scheme, is only to be found in the application of the direct procurement for customers process. We share Ofwat's view that this process has the potential to unlock value for customers, and stress our commitment to pursuing delivery via this route.

Given the clear importance of the scheme to addressing resilience risk and its centrality to the company's AMP7 proposals, Ofwat's proposal to utilise the IDoK process therefore seems to undermine this degree of confidence that the company can have that the FD will provide appropriate certainty about the enablement of this project. Furthermore, given prior industry experience with IDoKs, it will be interpreted as a somewhat punitive and risky method for the company to have to rely on.

We also consider that the established process by which standard interim determinations are made (with submissions in September and determination December) runs contrary to our need to deliver the scheme in a timely fashion and is likely to act as a significant impediment to delivering the required interventions on time. The IDoK mechanism leads to greater uncertainty due to the need for an IDoK to be actively triggered, giving rise to the risk of significant additional timing delays - this ought to be unnecessary given the up-front support for the project. A more passive (and predictable) process would seem far more appropriate, and provide greater certainty and confidence to the board going into AMP7 that efficiently incurred costs will be recovered.

Our second concern centres on the length of the process required to make, assess and receive a response on an interim determination. Per Ofwat's stated process:

*Interim determination applications must be submitted at least 6 months in advance of the charging year. Interim determinations normally cover the remaining time until the next price review and the new price limits set apply from the start of the next charging year in April.<sup>8</sup>*

We recognise that exit from the DPC process should require consent from Ofwat<sup>9</sup>, but are concerned that the length of this process will deviate attention away from the previously recognised delivery timescales.

Our priority within this project is to ensure a resilient supply of water to customers in the Manchester and Pennines regions, addressing a risk to our single largest source of supply. We

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<sup>6</sup> Ofwat. "PR19 draft determinations: Delivering customer value in large projects" (July 2019), page 6; Ofwat. "PR19 initial assessment of plans: United Utilities company categorisation" (January 2019) page 6.

<sup>7</sup> S5007a – MaPR Preliminary SOC; S5008 – Direct procurement CAP payment calculation.

<sup>8</sup> <https://www.ofwat.gov.uk/regulated-companies/price-review/interim-determinations/>

<sup>9</sup> PR19 draft determinations: Delivering customer value in large projects.

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have designed our delivery timeline in order to best mitigate this risk and protect supply to customers. However, in the event that we are forced to exit DPC, any additional undue process may cause delays to the delivery of the solution via an alternative route. This could potentially be an entire calendar year, given that there is only one window available each year to make connections to the existing infrastructure.

Without confidence that interim determinations can be assessed within significantly shorter timescales (and at any point in the year, regardless of when a prospective DPC exit occurs), we believe that Ofwat's preference for a notified item will compromise the company's ability to deliver the Manchester and Pennines Resilience scheme in line with required timescales.

Finally, we consider that the application of any acceptability threshold assessment (as is the case with an IDoK) introduces uncertainty around the financial outcome of the notified item/interim determination process. Given that the Manchester and Pennines Resilience scheme represents the highest totex value of any single project in AMP7, the risk to the company's financeability is significant. If a prospective IDoK fails to be accepted, the company would bear the burden of 50% of the cost in AMP7 (after cost sharing with customers). This level of uncertainty, in the event of DPC exit, is not acceptable for a project for which the need has already been accepted by Ofwat. We fully recognise that customers must also be protected, however it is important that Ofwat recognise that the DPC process itself is intended to unlock customer value from the market, which would not otherwise be achievable from a company only solution. At any point in the DPC process, the company's costs will have been informed by market participation and hence Ofwat should be able to feel confident that the company's costs are efficient, particularly if exit occurs in the latter stages of the DPC process.

### 3.2.3. Substantial effects IDoK

Ofwat may also consider that this project is significant enough to be eligible for a "substantial effects" IDoK. In this case, we presume that a notified item would not be required. It should also be possible to restrict the claim to this single item – this is not the case in a standard IDoK, whereby all eligible items are considered together. As such, it may also be possible for Ofwat to reach a decision over a shorter timeframe.

However, historic interim determinations, most notably the outcome of Sutton & Easy Surrey's claim in 2009, saw the adoption of a more restrictive standard of assessment (beyond the "20% of turnover" threshold contained in the Licence), leading to rejection of its proposal, which was also upheld at CMA. Whilst this route appears simpler in principle, our board would be very concerned about Ofwat's ability to reach a satisfactory outcome for the company through this process, given the most recent precedent. Again, therefore, we consider that an IDoK based uncertainty mechanism would not be appropriate.

### 3.2.4. United Utilities' position

We recognise that Ofwat must protect the interests of customers. In this case, the customer interest is best served by ensuring that there is cost effective and timely delivery of this essential resilience project.



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Our primary concern is to ensure that there is confidence that the final determination provides sufficient scope and certainty that the identified resilience risks can be financed and delivered on a timely basis.

Our intentions and incentives are therefore well aligned.

However, by providing a very significant review point for in-house costs in the event of a DPC exit through an IDoK mechanism, Ofwat also appears to be reopening the assessment of a project that has already been accepted. This risks harming confidence in the capability to address the risk as well as presenting the likelihood of delays to project delivery. This would be contrary to the interests of the 2.5 million customers affected by the risk that we are seeking to address.

We consider that an appropriate uncertainty mechanism should not be reliant upon non-binding assurances about how a particular mechanism will be applied as might, for example be achieved through a narrow use of an IDoK. Further, in the event of IDoK rejection, Ofwat could not provide any assurances over the outcome of any subsequent appeal to the CMA.

We therefore consider that reliance on the IDoK process, in this instance, represents an unduly punitive approach, particularly considering the open and supportive adoption of the DPC process by U UW throughout the PR19 process. Therefore, and on the basis that our scheme has already been accepted, we look to Ofwat for greater certainty in the mechanism that would be applied in the event of a DPC exit. We consider that it should be clearly incorporated in the FD, giving certainty about the means by which the company can proceed to finance and deliver the project and that that it should be as automatic and passive (without further need for extensive gathering and review of evidence) as possible. This will provide more predictability– and hence greater confidence to the U UW board that it will not be disadvantaged for having pursued a DPC outcome in the first instance.

Practical considerations also suggest that an exit decision should be made expediently. We consider two situations where DPC exit would be assessed prior to CAP award:

- First, should final CAP bids fail to present superior value for money in comparison to a cost projection for in-house delivery, this should constitute sufficient evidence the in-house solution is efficient and fully market tested.
- Secondly, if our assessments indicated that DPC was no longer preferable in advance of tender conclusion, we fully recognise that Ofwat will need to receive appropriate assurance of our assessment to exit. Accordingly, we expect that this would include information regarding our latest view of the “in-house” solution. It may be difficult, immediately, to obtain 3<sup>rd</sup> party assurance (as that would likely require input from companies involved in bidding for the position of CAP) - this would potentially harm our ability to make an appropriately assured IDoK claim. However, we expect that further assessment of costs incurred would necessarily occur after the decision to exit DPC has been confirmed by Ofwat, as this will allow us to engage with these parties in an assurance capacity, during the construction phase.

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We believe that a mechanism akin to that employed for the WINEP in AMP7 would be more suitable to address the uncertainty within the DPC process. As projected costs have been provided for the project, we propose that Ofwat allows an adjustment to cost assessment up to this amount, with recovery to be based on a proportion of completed work. This allows for a continual, review of efficient delivery against the projected total cost.

Given that any DPC exit would likely be considered to be a significant change to the company's AMP7 activities, it seems certain that it would require a formal publication to identify the event, along with expectations for how the issue would then be addressed including the implications for project delivery and financing arrangements. A DPC exit event would certainly be sufficiently significant to be price sensitive, and require publication of a stock exchange announcement for a listed company to explain the circumstances of the DPC exit. Furthermore, there would be a clear need to inform customers and stakeholders more widely about the change and its implications. Beyond the initial announcement it would likely be possible to provide further updates through the annual APR and ODI determination processes.

To be clear, this proposed mechanism would imply zero additional up-front costs assumed at the PR19 determination, but provides a means to (*ex post*) adjust cost assessment to include relevant AMP7 costs, only in the event of a DPC exit. The revenues required to recover those costs would then be adjusted naturally as part of the PR24 price control process, most likely as a “midnight adjustment” to the RCV (as set out in more detail in section 3.3 below).

Further, as the scheme will run into AMP8, it provides a means by which recovery can be reasonably apportioned across each AMP, with any over or under-recovery to be offset in the following AMP period, to minimise the risk of detriment to both customers and to the company. It would also be possible to assure the percentage completion of the scheme each year using independent parties, allowing over/underspend to be identified and cost-sharing mechanisms to work more effectively than under the IDoK process, which only allows for a single *ex ante* forecast of cost at the time of the IDoK assessment.

In the following section (section 3.3) we set this proposal out in more detail, explaining how it would work in practice, and also how we would satisfy Ofwat's likely need for assurance of the assumed cost, in the event of a DPC exit prior to full market testing (i.e. prior to the “FBC”). Table 1 summarises our views of the various options, against our requirements for a suitable uncertainty mechanism.

Table 1 U UW assessment of the various options, against our requirements for a suitable uncertainty mechanism

Criteria	Standard IDoK	Substantial effects IDoK	No specified mechanism	WINEP-style cost adjustment mechanism
Company recovers costs incurred	Yes	Yes	No – standard cost sharing (50%) applies	Yes – s.t. Ofwat accepting proposals in section 3.3
Certainty of outcome	No – IDoK assessment along with all eligible items	No – following precedent set at Sutton & East Surrey case (2009)	Yes	Yes
Impact on delivery timeline	Significant additional process and evidence requirements	Significant additional process	Nil - passive	Nil – process is entirely passive
Supports communication to capital markets	Yes	Yes	Not proactive – sharing rules are published & cost reporting through APR	Yes – need to communicate impact on mechanism, and through publication of in-period ODI determinations

United Utilities and its board will find great benefit in the inclusion of a refined uncertainty mechanism in the final determination. Whichever route Ofwat elects to follow, we suggest that certainty around the outcome of any future assessment is something that should be sought as far in advance as possible, so as to maintain a minimal impact on timescales for delivery of the scheme, and to maintain the confidence of U UW’s board in the capacity of the FD to support delivery of this critical project.

### 3.3. U UW proposed uncertainty mechanism for DPC

For AMP7 ‘amber’ WINEP schemes not included within company business plans, Ofwat has enabled cost allowances to be adjusted should these schemes subsequently be included within WINEP. This underlying principle is consistent with how cost allowances for the Appointee need to be updated in the case of a DPC ‘exit’. Whilst Ofwat has accepted the requirement for this mechanism (for WINEP), the mechanistic approach for the adjustments has not been explicitly stated. There are two key components required to ensure companies are appropriately remunerated:

- An adjustment to account for the change to the efficient totex baseline to prevent all the additional expenditure being treated as an overspend within the totex (sharing) reconciliation mechanism and,
- An adjustment to account for the additional costs incurred (and hence additional revenues required) not recovered in AMP7 for the additional (allowed) expenditure incurred.

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Both of these mechanisms are required in order to reconcile an in-period addition to the programme. In the following sections, we set out how we believe Ofwat could undertake the adjustments for each of these components at PR24, in the event of a DPC ‘exit’. Whilst our comments and examples primarily focuses on the application of the mechanisms and reconciliation relating to the addition of our specific scheme, the same underlying principles are likely to apply to all companies with a DPC scheme within AMP7.

We accept that the PR19 reconciliation mechanisms are still being developed but we believe it is beneficial to voice these requirements now as many of the proposals will apply in other instances and would benefit from a consistent approach from Ofwat. We welcome the opportunity for further discussions in support of developing these mechanisms for use at PR24.

### 3.3.1. Proposed update to Ofwat baseline efficient totex

The first adjustment that is required is to the AMP7 Ofwat efficient baseline totex used within the PR19 totex reconciliation mechanism (‘cost sharing’). In the event of a DPC ‘exit’, this will necessitate the allowed AMP7 expenditure to increase in line with the efficient cost assessed at the time of DPC exit. If Ofwat does not update the baseline to account for this addition, all of the additional expenditure incurred will manifest as an underperformance for the Appointee. This observed underperformance would subsequently be shared with customers using the company specific sharing rate for that price control, resulting in the company only recovering a maximum of 50% of the allowed costs. It is therefore important that Ofwat update the baseline so that cost sharing only reflects actual differences in efficiency and not differences in scope.

With the cost-sharing model for PR19 reconciliations<sup>10</sup> still being in development, the following two issues should be accounted for prior to inclusion within the final model to be used at PR24.

### 3.3.2. Value of the adjustment

Ofwat should increase the totex baseline by the efficient expenditure required for the Appointee to deliver the scheme. We appreciate that the timing of the DPC exit will have a significant impact on the certainty and assurance available to use in calculating this addition and so we believe that depending on when exit occurs, different sources may be appropriate in order to provide Ofwat with the confidence that customers are sufficiently protected. Below we set out what we believe to be the most appropriate source of information to use in adjusting the cost baseline at each different phase of the DPC process. We further expect that this evidence would form part of the DPC exit process. For each of these scenarios, we propose that only costs for the AMP7 are approved within the adjustment and that any future costs are addressed through the subsequent Price Review period.

## SOC to OBC

Between the SOC and OBC, our best cost estimate is that provided as part of our business plan, which was market tested with two separate tunnelling contractors. Therefore Ofwat should be

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<sup>10</sup> <https://www.ofwat.gov.uk/regulated-companies/price-review/2024-price-review/pr19-reconciliation-models/>

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content that the current cost estimate represents the best currently available estimate of the total construction costs of the project.

**Outcome: Utilise current company cost estimate, supported by views of two independent tunnelling contractors**

### OBC to FBC (incl no CAP bids)

Between the OBC and the FBC the Appointee will be required to update its view of the costs required to deliver the scheme through the traditional route against which to assess potential CAP bids. There is no incentive for the Appointee to misrepresent the required expenditure either way as overestimating the costs will mean that it is unlikely to obtain the most efficient bids from the CAPs as part of the DPC process whereas underestimating the costs will set an unobtainable benchmark against which the company would be required to perform. The Appointee will therefore need to seek sufficient 3<sup>rd</sup> party assurance that its own internal estimating is appropriate to satisfy its own requirements and this information would be submitted to Ofwat as part of the evidence in determining the cost adjustment required.

**Outcome: company to provide 3<sup>rd</sup> party assurance of revised Appointee costs (likely to have been required in preparation for OBC)**

### Post FBC - Appointee best option

In the event that the Appointee offers the lowest cost to customers then this cost should be used in making the adjustment to the totex baseline. There would be no need for further assurance or evidence as the cost to customers has been fully market tested cost through the bidding process.

**Outcome: acceptance of Appointee valuation of required expenditure**

### Post FBC - CAP default

In the event where the CAP is unable to continue to deliver the project (ie: default), the Appointee must undertake the remainder of the work and so an adjustment to the baseline would still be required. CAP default is likely an indication that the CAP solution was not feasible and so the adjustment should be for the Appointee valuation of the required to complete, less a percentage for the work already completed by the CAP. Depending on the contractual arrangements there may be some further payments required to the CAP that should also be accounted for within the allowance but this will be on a case-by-case basis.

**Outcome: Appointee valuation of required expenditure less proportion due to work completed by the CAP**

### 3.3.3. Profiling of the adjustment

The second aspect that needs to be considered when making the adjustment to the baseline is how the allowed expenditure will be profiled. This has two important aspects:

- Cost reconciliation variances adjust for the time value of money (often referred to as ‘financing’) within the assessment and therefore the year in which expenditure occurs will impact the final value within the comparison to the baseline and,
- If a scheme spans AMPs then only a proportion should be included within the addition to the baseline with the residual forming part of the AMP8 allowance.

Ofwat could adopt several approaches in making the adjustment namely:

- Flat profile over remainder of AMP7,
- Standard ‘S’ curve approach using the anticipated delivery date,
- AMP7 Business plan totex profile, or
- Project specific profile.

As major interventions tend to constitute ‘lumpy’ expenditure profiles and the information should be readily available (for all companies), **we propose that Ofwat should always seek to profile the adjustment to the baseline in line with the expenditure profile proposed by the company for the scheme added.** For the MaPR scheme, in order to hit the prospective delivery date, we estimate that the AMP7 expenditure profile would be as follows if delivered by the Appointee excluding the amount already assumed as part of AMP7 totex (within the company business plan).

*Table 2 Proposed AMP7 expenditure profile for construction phase (from 2022-23) of MaPR scheme if delivered by the Appointee (2017/18 CPIH FYA prices)*

[✂]

[✂]

The expenditure sought as part of the cost adjustment claim has already been allowed (in part) within AMP7 cost assessment and so is not required to be included within the baseline adjustment. The remainder of the expenditure required to deliver the scheme (AMP8) would then form part of the PR24 business plan and be assessed through a cost adjustment claim for the residual costs to complete.

### 3.3.4. Proposed form of adjustment

Whilst updating the totex baseline is clearly an important requirement for the adjustment mechanism, **it does not (in of itself) correct for the revenue allowances in AMP7.** Having assumed that a CAP would deliver the scheme within our business plan, this means that there is also no associated revenue within the allowance that will be recovered from customers during the period as revenue payments to the CAP are deferred until completion of the sections (revenue payments were scheduled to commence in 2024-24). If the Appointee delivers the scheme then the additional revenues for AMP7 expenditure incurred will need to be factored in. We believe that there are two clear options available to Ofwat:

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- An end of period revenue and RCV adjustment based on a full financial model re run using the revised cost baseline (which would be complex to operate); or
- An end of period (midnight) RCV adjustment including the adjustment for the time value of money (which would be much simpler).

We discuss the approaches and relative merits of these two options below.

### Option 1 - PR19 Financial model calculation

This option would entail updating the PR19 Final Determination Financial model for the revised cost baseline and assessing the variance in the resulting allowed revenue over the period as well as the difference in the closing RCV (*ceteris paribus*). The annual difference in revenue could then be adjusted for the time value of money (as is the case under WRFIM) and the total AMP7 variance could be applied to AMP8 revenue requirements alongside other end of period reconciliation adjustments e.g. ODI, totex etc. The difference in closing values of the RCV would also be made as a midnight adjustment prior to AMP8.

One potential issue with this is that it would require greater effort from all parties to calculate and if the magnitude of change becomes significant, the validity of using the PR19 PAYG and RCV run-off rates may be debateable. We do not think it would be appropriate to attempt to revise these rates as it may result in too much volatility and will add a significant amount of further complexity to the reconciliation requirements.

- The advantage of undertaking the PR19 Financial model approach is that the revenue correction would most accurately reflect the change in AMP7 revenues that would have applied if the applicable schemes had been included in the PR19 determination.

### Option 2 - End of period (midnight) RCV adjustment

The alternative option would be to adjust the respective RCV by the additional totex having accounted for the time value of money as a midnight adjustment at the end of AMP7. This would be similar to the 'logging up' process previously utilised by Ofwat, with the inclusion of the time value of money to account for the timing differences between when the expenditure is incurred and when revenue recovery commences (so net present value is equated). For the addition of MaPR, this would therefore require the following adjustment.

*Table 3 Calculating the addition required to the RCV for the additional allowed expenditure (2017/18 CPIH FYA prices)*

[X]

[X]

The advantage of undertaking the RCV midnight adjustment is that it is more simple and transparent to implement and as the RCV returns revenues over a longer period, it will reduce any potential volatility on customer bills.

### UUW proposal

Given these two options, we believe that it would be most appropriate for Ofwat to undertake the second approach if the Appointee (given current cost estimates) subsequently delivers the scheme and add [X] [X] cost of the scheme plus time value of money) to the RCV as part of the AMP8 “midnight adjustment”, as at 1 April 2025. This value would then be updated in accordance with the proposal set out in section 3.3.2, supported by the proposed assurance, depending on the point at which the DPC exit occurs.

Also, as stated in section 3.2 above, any DPC exit is likely to be a material event requiring formal announcements and publications so as to set expectations about the implications for delivery and financing of the required work.

## 3.4. Licence amendments

We recognise and welcome Ofwat’s proposal to consult on licence amendments later in 2019. It is important for certainty on these amendments to allow us to give comfort to potential bidders and our board. Our timeline for delivering the M&PR scheme is challenging; we have committed to the submission of our Outline Business Case in June 2021, approval of which immediately precedes our tender period. To run an effective tender for a CAP, we would require licence amendments to be in place in advance of this date in order to ensure that our tender documents reflected any change, and to provide potential bidders with certainty that United Utilities is able to fund the delivery of the scheme.

In order to achieve this certainty, and to give confidence to our Board about the final determinations in advance, we ask for confirmation that industry consultations will take place and complete this year, in sufficient time to incorporate responses into the final determinations. Beyond this time, we would look to understand at what point Ofwat intends to formally enact any licence amendments.

We also note Ofwat’s proposal to amend only the licences of companies with DPC schemes planned for AMP7. To reiterate, these companies are Anglian Water, Dŵr Cymru, United Utilities Water, Southern Water and Thames Water. Whilst we recognise the need for practicality in developing the most appropriate licence amendments, we are concerned that companies in receipt of later amendments may receive an advantage over those who have proposed schemes in the nearer future. We consider that any learning gleaned from the initial cohort of DPC schemes should be reflected across the industry, and seek confirmation that if licence changes are not to be made unilaterally, then those companies receiving later changes do not receive undue advantage over those whose licences are to be amended sooner.



### 3.5. Performance commitments

In September 2018, we submitted a suite of performance commitments, two of which related to our M&PR direct procurement for customers scheme. These were:

- **B09-DP – Manchester and Pennines Resilience.**
  - This measure is directly linked to our Manchester and Pennines resilience cost adjustment claim, which we propose to deliver through direct procurement to customers. The measure is set up to ensure protection of customers if we don't deliver the work at all, deliver it later than we originally intended to, or if we change the scheme to provide fewer benefits. If we don't deliver on our plans the investment received through the cost adjustment claim will be returned to customers.
- **E09-DP – Successful delivery of direct procurement of Manchester and Pennines Resilience.**
  - We will run a procurement process to deliver one of the largest UK infrastructure projects to improve resilience of water supplies to the Manchester and Pennine areas. This involves competitively tendering for a third party to construct and finance the scheme ("direct procurement", DPC). Customers benefit if the project is procured at lower cost and if it is carried out efficiently. This secures increased long term resilience of water supply to over two million customers.

We later responded to IAP actions related to these performance commitments<sup>11</sup> in order to satisfy Ofwat's requirements for further information.

Whilst B09-DP covers the delivery of our pre-DPC activities, E09-DP aims to provide a reasonable reward for U UW successfully delivering a DPC process. It is highly likely that U UW will be the first company to complete a DPC process, which is expected to deliver better value for customers (of which our proposed reward is a very small proportion). The learning from that process will be invaluable to the success of all future DPC projects. U UW has also been very supportive and positive towards the DPC process, in contrast to many others in the industry. As such, we consider that there is reasonable grounds for Ofwat allowing a reasonable reward for successful delivery in the specific case of this DPC scheme. It is also likely to support better market engagement, if potential CAP participant see that there is some value to be gained by the company in successfully appointing a CAP.

In our fast track Draft Determination, we were also given the opportunity to review and respond to Ofwat's draft decisions in respect of our other performance commitments. However, we have not been given the opportunity to represent on the two DPC related performance commitments listed above. This is because Ofwat has not yet provided a decision in relation to these performance commitments.

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<sup>11</sup> U UW.OC.A35; U UW.OC.A46 and U UW.OC.A47

We request that Ofwat provides UUW with a form of draft decision (in line with the principle of a draft determination) to enable us to provide comments prior to Ofwat concluding its final determinations.

### 3.6. IFRS 16 implications for DPC

In the preliminary feedback that we have received from Ofwat on our Strategic Outline Case, we recognise that Ofwat acknowledges that the introduction of the new lease accounting standard, IFRS16, will have consequences for the reporting in the statutory accounts of the Appointee. Previously, operating leases were ‘off-balance sheet’, with any rental payments being reported within operating expenditure and, from a regulatory perspective, being reported within opex/totex with no impact on the regulatory capital value (RCV). Under IFRS16, operating leases will be treated in the same way as finance leases, with the value of the leased asset recognised within capital expenditure at the inception of the lease, with a ‘Right-of-Use’ (RoU) asset and a corresponding lease liability which is recognised as debt/borrowings on the balance sheet.

Given the size of the project, the Manchester and Pennines Resilience scheme is likely to add a material amount onto UUW’s debt position (initial estimates are greater than £500m discounted value of liability), on the basis that the RoU is categorised as an operating lease under IFRS16. The potential consequences of this are:

- There would be a significant increase in UUW’s debt position without (necessarily) a corresponding increase in UUW’s RCV;
- This could adversely impact primary credit metrics: debt:RCV will increase; FFO/debt will decrease; and interest cover will decrease (as the annual “use of asset” charge will be a finance expense);
- This could adversely impact UUW’s ability to maintain its target credit ratings, which would have a detrimental impact on UUW’s long-term financial resilience and financeability;
- If a credit ratings downgrade resulted, this would increase UUW’s borrowing costs which would not be in customers’ interests;
- There may also be a need to seek a waiver or amendment to any financial covenants that are in place to deal with any (potential) breach, and a failure to secure such a waiver or amendment could lead to default or require pre-payment of the relevant debt; and
- Given the asset will not be included in our RCV, it is unlikely equity would be capable of mitigating such adverse credit related impacts, as UUW’s shareholders’ will not earn any return on the asset, with any income that UUW collects from its customers to finance the project being a ‘pass through’ to the CAP.

We have made some preliminary enquiries with the credit ratings agencies as to the likely treatment of the project, as it will be our aim to seek agreement from the ratings agencies to ‘look through’ (i.e. make the necessary adjustments to remove) the financial reporting impact

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of the project on our debt position. However, before the ratings agencies are able to opine on this, they will need to review the detailed project structure, including evaluation of the project risks and associated risk allocation, along with the project documentation. Likewise, any lender with financial covenants will also want to review such details before contemplating any amendment or waiver in relation to those covenants.

In light of the above we believe that failure to secure appropriate ‘treatment’ in relation to the Manchester and Pennines Resilience project from the credit ratings agencies and/or lenders should be considered as a contributory factor to be a Direct Procurement for Customer (DPC) ‘exit’ trigger – for example, the net detrimental impact on the appointee being included as part of any “Value for Money” test. More generally, we consider that the potential implications of IFRS16 represent a significant risk to the delivery of not only this project through a DPC method, but for the use of DPC more widely. On this basis, it would be appropriate for Ofwat to further describe its approach to dealing with the potential ramifications of this risk were it to materialise.