

UUWR_58

PR24 Draft Determination: UUW Representation

Area of representation: Outcomes - Customer contacts about water quality

August 2024

This document outlines our representation in response to Ofwat's draft determination related to the customer contacts about water quality performance commitment.

Reference to draft determination documents:

- 'PR24 draft determinations: Delivering outcomes for customers and the environment' pages 115-118
- 'PR24-DD-PCM_Customer-contacts-about-water-quality.xlsx'
- 'PR24-DD-ODI-Rates.xlsx' (WaSC rates)

1. Key points

- **We support Ofwat's AMP8 target and its setting of company specific targets:** These appropriately take account of the different circumstances that apply in local regions. The target is stretching, but potentially achievable if we perform very well.
- **We consider that the increase in incentive rate is too high:** An incentive rate increase to £49.738m per number of contacts per 1000 population is approximately 250% of the indicative ODI rate put forward by Ofwat as part of its final methodology. We consider that this incentive rate is too high: the proposed penalty rate of £6,778 for a single customer contact on water quality¹ is over 30 times the value of the current average annual water bill² of £209.

2. UUW's PR24 proposal

We proposed a stretching performance target of 0.8 contacts per 1,000 population by the end of AMP8. This was calculated based on a predicted five year upper quartile rolling average and reflected an assumption of sustained improvements across AMP8, including a 34% improvement compared to our forecast AMP7 outturn position.

We highlighted that this rate of improvement is particularly challenging given the specific circumstances of water supply in the North West. This is because we substantially rely on soft surface water from upland sources. The nature and chemistry of this water is recognised as being likely to contribute to a greater number of customer contacts for aesthetic parameters such as discolouration, taste and smell.

Surface water/softer water companies face significant challenges especially greater contacts for black/brown/orange based on the more corrosive nature of the waters. A common target based on upper quartile or frontier company performance would not reflect the diversity of water source types across the UK and particularly the significant source water challenges that softer surface water companies such as UUW faces.

We proposed an incentive rate of £19.06m per number of contacts per 1000 population in line with Ofwat's final methodology. This is equivalent to £2,597 per customer contact. At draft determination, Ofwat has utilised a rate that is 161% higher than its original proposal.

3. UUW's understanding of the position in the draft determination

Ofwat has determined a company specific PCL of 0.8 contacts per 1000 population. This reflects the challenges faced by water companies with different source waters in meeting a common target. Ofwat has also made a minor change to the profile of improvement. We note and welcome that the methodology is aligned to the latest DWI information letter as expected and accounted for in our analysis and predicted performance.

The proposed incentive rate at draft determination is an increase to £49.738m per number of contacts per 1000 population compared to £19.06m in submission. Ofwat states that 'the ODI rates for water quality are significantly higher at PR24 compared to PR19. This reflects the strong priority that customers place on water quality as well as our overarching aim to set more powerful incentives on performance'.

Additional enhancement funding was also facilitated in the draft determination to address raw water deterioration in catchments and complete the relining of the Vyrnwy aqueduct, supporting our progress to reduce the number of customer contacts received. Ofwat has taken these into account in setting its proposed performance commitment level.

¹ Underperformance rate per contact, in 2022-23 price base, using resident population (water) (calendar year) for 2022-23

² Average annual water bill for 2024-25, in 2022-23 price base

4. Issues and implications arising from the draft determination

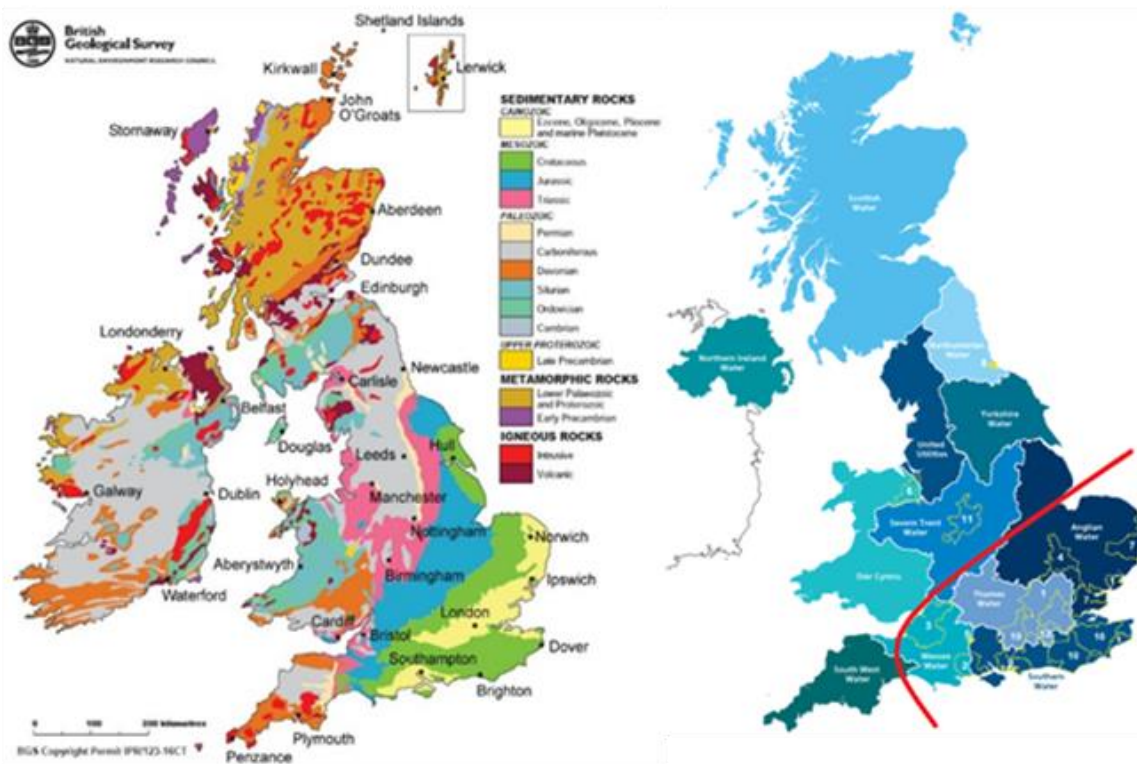
4.1 Performance commitment level

The PCL at the end of AMP8 has been set at 0.8 customer contacts per 1000 population as proposed. We believe that this represents a highly stretching but potentially achievable target if we perform very well. We therefore support the proposal.

Within the North-West, our water is primarily supplied from upland, surface water (i.e. reservoir and river intake) sources. Discolouration is more prevalent in these areas where peat or other high colour catchment soils can discolour reservoirs during high rainfall periods.

Underlying geology impacts discolouration through relatively high levels of iron found in the North West’s geology. There is a correlation between companies with a higher proportion of soft surface water sources compared to harder source waters. This aligns to underlying geology of the UK with a split illustrated in Figure 1 below.

Figure 1: Water hardness and UK geology



Source: *Water Hardness / Hard Water - Drinking Water Inspectorate (dwi.gov.uk)*³

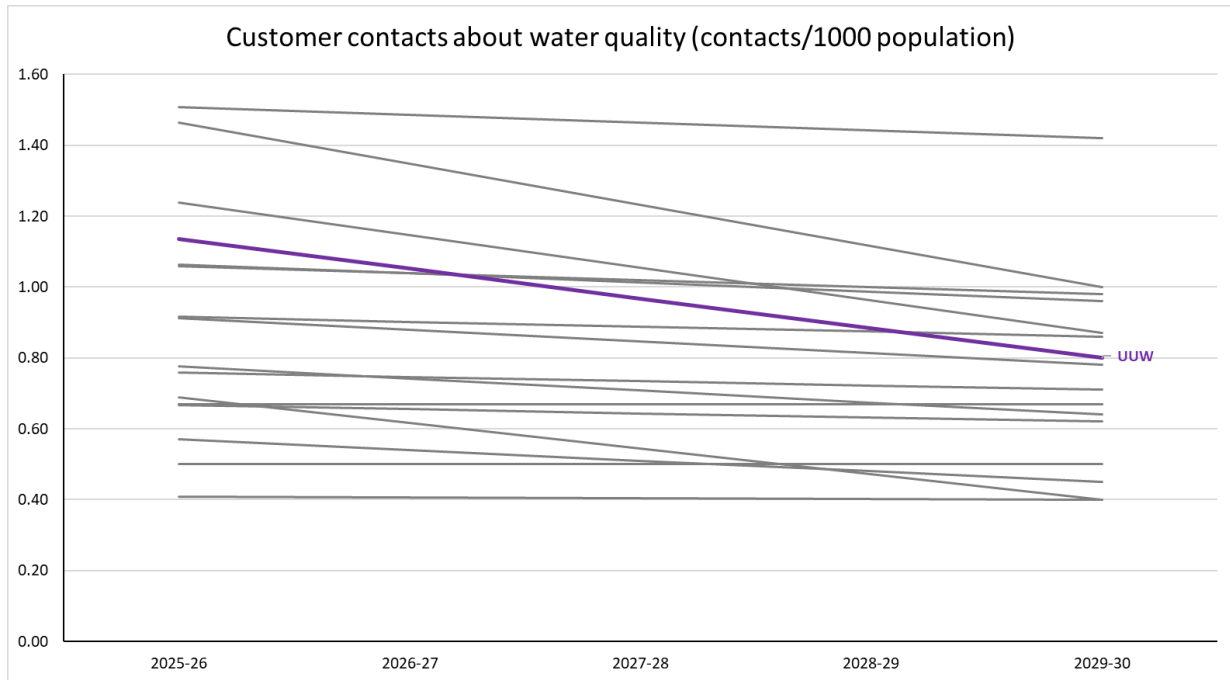
We are actively involved in research to further our understanding on discolouration risk and the optimum ways to mitigate discolouration risk for customers.

Water sources are actively managed to minimise potential taste, smell and appearance issues for customers, such as not using raw water sources that may have compounds such as geosmin, this is linked to the unplanned outage ODI.

³ <https://www.dwi.gov.uk/consumers/learn-more-about-your-water/water-hardness-hard-water/>

Figure 2 below illustrates the challenging PCL for UUW highlighted in purple, with a more stretching improvement rate than many other companies. Nevertheless, we accept the proposed PCL and will challenge ourselves to delivering against it.

Figure 2: Comparative PCL improvement for all companies across AMP8



Source: Ofwat Draft Determination Key Dataset 1

4.2 Incentive rate

The incentive rate has increased significantly and is now overly punitive for a single customer contact. The proposed penalty rate of £6,778 for a single customer contact on water quality⁴ is over 30 times the value of the current average annual water bill⁵ of £209.

We also note that the penalty is very much higher than the values that were generated through Ofwat’s customer research. The results showed that household customers valued avoiding one incident at £78 for discoloured water with a 24-hour impact⁶ and non-household customers valued this at £4,857. For taste and smell with a 24-hour impact, household customers valued this at £81 and non-household customers valued this at £4,813.

Ofwat’s DD ODI rate is over 80 times greater than the household customer valuation and 1.4 times the valuation given by non-household customers. Although Ofwat has stated that its top-down approach to setting ODI rates is informed by customer research, we consider that the differences here are so large that they warrant further consideration. We consider that there is scope to better calibrate the actual ODI rates with those emerging from the research and that this is particularly the case where, as in this case, the incentive rate is being set at many times the average annual household bill.

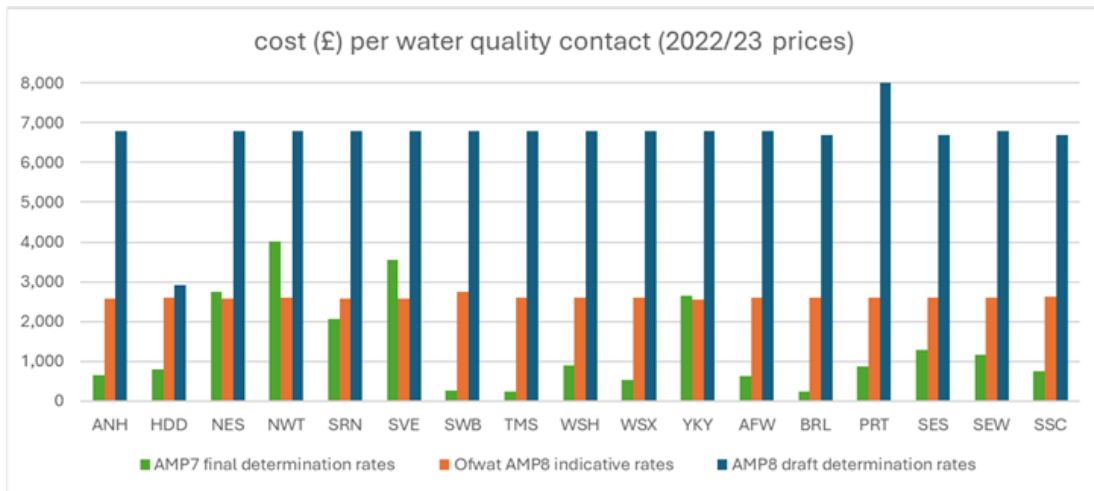
Figure 3 below illustrates the significant increase in rates for this PC, normalised for all water companies by population.

⁴ Underperformance rate per contact, in 2022-23 price base, using resident population (water) (calendar year) for 2022-23

⁵ Average annual water bill for 2024-25, in 2022-23 price base

⁶ 2021-22 average price base

Figure 3: Normalised cost of water quality contact



Source: UUW analysis based on PR19 FD and PR24 DD ODI Model

We consider that ODI rates that are poorly calibrated to customer valuations can tend to incentivise uneconomic decision-making by companies, chasing uneconomic performance levels to avoid over-valued ODI rates, not grounded in customer valuations. Such uncalibrated outcomes will lead to ineffectiveness of incentives and will incentivise inefficient allocation of resources and investment decisions, to the detriment of company, customers and the environment.

5. What Ofwat can do in the final determination to address these issues

PCL: We concur with Ofwat’s view that a company specific target is appropriate for this measure. We believe that Ofwat’s approach to the PCL results in a highly stretching target for UUW – particularly given the rate of improvement required - but one that we stand a chance of achieving if our performance is very good.

Recognising that different source waters contribute to unique challenges for water companies, we will continue to research this relationship to fully understand and optimise the most suitable inventions to drive improvements in this area.

Incentive rate: The proposed increase in the penalty rate is excessively punitive and we believe it should be reconsidered. This is particularly the case given the misalignment to customer valuations identified through Ofwat’s customer research and the disproportionate size of the penalty compared to the average annual household bill.

We consider that the ODI rate of £19.06 million, consistent with the final methodology proposed by Ofwat, remains appropriate. This is equivalent to £2,597 per contact.