UUWR_05

PR24 Draft Determination: UUW Representation

United Utilities Briefing Note

August 2024

This document provides a two page briefing note, covering 5 topics, as requested by Ofwat.

Reference to Draft Determination documents:
‘Ofwat Information notice IN 24/02’,

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United Utilities

Water for the North West

United Utilities Briefing Note

We welcome Ofwat's ambition to deliver PR24 determinations that set companies on the path for long term transformation, delivering better outcomes for customers and the environment. United Utilities submitted a high quality and ambitious plan to deliver step change improvements for customers, communities and the environment for a Stronger, Greener, Healthier North West. We are pleased that many aspects of our plan have been recognised and accepted by Ofwat, including "sector leading" recognition of our extensive and ongoing efforts to manage affordability issues for customers who would otherwise struggle to pay their bills. However, we do not believe that the draft determination as a whole supports the outcomes we need to deliver and our stakeholders want to see. You have asked us to identify five of the key points for your consideration.

1. Enhancement allowances for overflows are not sufficient

Dealing with overflows matters to customers and communities in our region. Improvements are also a legal requirement that UUW must deliver. We have put together a detailed programme of work for 449 sites where investment is required. Ofwat recognises the need for this work but has rejected £1.5bn of the claim value. This means the draft determination expects us to deliver 100% of the programme for 50% of the costs. Our top five most expensive sites have received an allowance of £138m opposite an estimated cost of £395m. It is not feasible for us to deliver such requirements at that cost. We have provided evidence of why this is so, reflecting regional factors that Ofwat has not yet taken into account.

Ofwat has based its assessment on simplistic models, despite the significant variation in individual scheme costs. The models reflect costs generated by generic company cost curves, whereas UUW has performed detailed bottom-up analysis at each location. Ofwat's models do not properly reflect key local factors such as the extremely rural nature of our operations in Cumbria, or the high number of SSSIs and environmentally sensitive areas in the North West. We have provided evidence of how Ofwat's modelling approach could be improved from here. We have also provided additional bottom-up analysis on 90 sites to explain which cost items are driving levels of investment.

We have demonstrated our commitment to further efficiency in our revised business plan submission. We are applying a £249m adjustment to costs on a site-specific basis, reflecting solution optimisation. We are also proposing to apply a further £250m efficiency challenge as a top-down adjustment. These efficiencies are not applied at a site by site basis but reflect an expectation that we will be able to identify some (as yet unidentified) efficiencies across the portfolio. Cost levels in Ofwat's assumed efficient frontier will likely be based on interventions that may offer short term cost saving opportunities by, for example, utilising some solutions that have both a lower cost and a lower expected lifespan. We will look to utilise such opportunities where they arise to reduce the overall cost in AMP8.

Ofwat should accept the evidence provided by UUW to demonstrate the cost of securing compliance at the sites comprising the AMP8 programme and we are happy to provide further information such as Ofwat may require. UUW's primary interest is in delivering environmental programmes robustly, reliably and at least in line with the expectations that have been set. We will go further if we can, and if there is a capacity to achieve this. But we are clear that the current proposed cost allowance is not sufficient for us to deliver statutory requirements.

2. Performance commitments are too skewed to the downside, especially on internal flooding

Amongst many issues with its package of performance commitments, Ofwat has not taken account of our representations on internal sewer flooding. It has not acknowledged the ambitious target proposed of a 32% reduction in AMP8, reflecting a 55% reduction since AMP6, in line with the two-AMP strategy we outlined at PR19. Ofwat has proposed a target that would represent a 70% reduction of incidents in two years (2025/26 compared with 2023/24.)

This target does not meet the basic criteria of "stretching but achievable." This unattainable target is compounded by tripling the penalty rate (vs AMP7) and removing the penalty collar. UUW has never been funded to provide this level of performance, and there is clear evidence from previous determinations that such investment would have been rejected as not being cost beneficial. Urban rainfall runoff and combined sewers are clear and unambiguous drivers of incidents – 1% of days account for 29% of incidents – and it would not be cost effective to 'weatherproof' the system.

A common performance target is not appropriate for this metric. The target suits some company circumstances. They will find it easy to achieve and earn incentive rewards. This leaves those customers overpaying for their service levels. Meanwhile, it leaves other companies with no chance of meeting the target, resulting in guaranteed financial penalties. On a P10 basis – with rainfall broadly equivalent to 2023/24 – we expect that the current metric could yield a £63m penalty each year for UUW. We believe that Ofwat needs to review its approach to this metric. It is a major contributor to the overall downward skew on performance that is implied by wastewater performance commitments but results from exogenous factors that are outside of management control.

More generally, as Ofwat has already recognised, performance commitment targets and incentives need substantial revision and recalibration from the draft determination position. We believe the example of the Water Quality Contacts incentive rate is "high profile" but not an isolated issue; it is the symptom of a broader problem that should be addressed before final determination.

3. Gated allowance operation and scheme selection should be revised
Ofwat's draft determination puts nearly 30% of UUW's allowances into gated processes. We agree that, in principle, gated processes can provide room for better solutions when the situation is uncertain. They have the potential to facilitate better, more efficient outcomes for customers and the environment. However, the schemes put into the process need to be funded properly, and the process should only be used where there is genuine uncertainty about the schemes. Otherwise, the gated process acts to increase, not decrease, uncertainty and slow down, not assist, delivery, harming overall deliverability. With 30% of our plan subject to these new processes at draft determination, this is a material consideration.

We are submitting evidence that four WINEP schemes that Ofwat placed into the "Large Scheme Gated Process" should be moved to the "Enhanced Engagement and Cost Sharing process." Costs, scope and deliverability are more certain now than in October 2023 and our enterprise partners are already under contract to deliver. Meanwhile, in embracing the benefits of the gated approach, we propose that £186m of new WINEP requirements at Windermere should be added to the "Large Scheme Gated Process". This will allow us to work closely with stakeholders, including the Environment Agency, to further refine solutions and drive ambitious action plans for improvement.

To truly reap the benefits of a gated approach, funding arrangements need to reflect legitimate financing costs that companies incur in delivering their functions. Under current proposals, Ofwat appears to conflate the issue of funding costs with applying a cost challenge. This is unlikely to result in outcomes that mean companies are funded for the delivery of their statutory requirements. It also undermines confidence in the broader gated approach.

4. There are frequent examples of "aiming down" which, combined, undermine any sense of a "fair bet"
There are many individual examples where Ofwat has tended to meaningfully "aim down" on cost allowances, modelled approaches or financing arrangements. Examples include:

- Business rates – where a £200m cash shortfall is expected in AMP8;
- Reservoir safety – where Ofwat does not recognise that the implications of the Balmforth review and the Environment Agency's reassessment of flood risk areas mean that interventions will be more extensive and expensive in future than they have been in the past; and,
- Bioresources – where we welcome the considerable movement from Ofwat in recognising uncertainties, but we see the landbank uncertainty mechanism as too narrowly drawn.

Ofwat should re-evaluate many of its challenges and take a fresh and open-minded look at the evidence.

Meanwhile, the Price Control Deliverable framework proposed is unworkable and, as currently proposed, will undo many of the benefits secured through the totex and outcomes framework Ofwat championed in the past. PCDs drive restrictive and inflexible approaches to outputs. This means that activity cannot be replanned in the face of new information and changing circumstances, compounding the problem of securing efficient delivery opposite very challenging cost allowances. We understand and support the need to increase accountability for outputs, and the need for customers to have confidence that increased bills are leading to tangible investment results. However, we propose a more forward thinking PCD regime, focused on the outcomes that matter rather than intermediate outputs.

5. Risk and return is skewed to the downside and is unlikely to be sufficiently attractive to new equity
We are concerned that the risk and return balance is unattractive, especially for equity investors. Many of Ofwat's mechanisms tend to put upward pressure on gearing, whilst equity returns would be depressed by the current RoRE drivers such as performance commitments and totex allowances. Given the very substantial investment requirements for the next 20 years, we need to make a convincing case to investors as to why they should invest both debt and equity into the water sector in England and Wales. We note that multiple external commentators are concerned that the industry's draft determinations insufficiently support the sector in making such a case.