

UUWR_62

PR24 Draft Determination: UUW Representation

Area of representation: Outcomes - Biodiversity

August 2024

This document outlines our representation in response to Ofwat's draft determination related to the biodiversity performance commitment.

Reference to draft determination documents: Biodiversity performance commitment query guidance published 2 August.

1. Key points

- **Ofwat has confirmed that the PCL should have been set differently to what was published in the draft determination:** We support the adjustment detailed by Ofwat following query OFW-IBQ-UUW-020. We have reflected the revised PCL, set consistently at 0.73 units per 100km² of monopoly area served, in our data tables.
- **The proposed cap and collar range for the PC is too high, with a potentially disproportionately large variation in outcomes:** We propose that Ofwat should implement a tighter cap and collar range to 1) protect customers from the risk of very large outperformance payments and 2) to protect companies from disproportionately high penalties, particularly when events that are outside of their control have biodiversity impacts.
- **Ofwat has slightly reduced the ODI rate compared to our business plan proposal:** We support Ofwat's approach, which utilises the Defra expected level for biodiversity net gain

2. UUW's PR24 proposal

UUW's approach was consistent with the Ofwat methodology with UUW setting a company specific PCL as suggested. The UUW proposed PCL was based on assessing projects within our WINEP enhancement with predicted biodiversity improvement over and above the requirements for biodiversity net gain. This resulted in proposed biodiversity delivery from our water catchment improvements and the blue green elements of the hybrid overflow programme. There was no expected delivery from base totex allowances.

UUW proposed a cap and collar for this performance commitment across the AMP that was set with reference to the maximum possible reward (uplifted to 2022/23 CPIH FYA) achievable for the AMP7 Enhancing Natural Capital for Customers PC, a comparable AMP7 PC. This value was then applied to give a low cap and collar in the first two years of the AMP to reflect the low expected delivery and then the remaining value profiled in line with the PCL.

As Ofwat did not set an indicative ODI rate for this PC, UUW proposed an ODI rate of £22,800/unit. This was based on Defra's expected net gain market average values¹ which gave a range of £20,000 - £25,000/unit but based on expected unit scarcity predicted the mean unit value to be £22,800.

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

UUW supports the response to query OFW-IBQ-UUW-020 which establishes a common PCL set for all companies at 0 delivery for years 1-3, 0.08 units /100km² for year 4 and 0.73 units /100km² for year 5. This better represents the expected delivery across companies than the level originally included in the draft determination documentation published. UUW is supportive of this PCL level and the fact that biodiversity can be delivered from base or enhancement spending.

The cap and collar have not been set in line with a specific performance based limit as with comparable performance commitments in AMP7 as suggested by UUW, but has instead been set based on a cap and collar linked to RoRE at 0.5% of water /wastewater RoRE. For UUW this results in a potential annual outperformance or underperformance payment of £21.50m.

Ofwat has set a consistent ODI rate across companies using the rate set in Defra's estimated national average price for a biodiversity unit. Ofwat set this at £20,000 per unit in line with the low end of the range proposed by Defra, representing the expected cost of biodiversity units in planning authorities with a unit surplus.

¹ <https://randd.defra.gov.uk/ProjectDetails?ProjectID=20608>

4. Issues and implications arising from the draft determination

Performance commitment level

UUW supports the approach to the PCL used by Ofwat which sets a consistent expected delivery across companies using the median value of the company plans. UUW supports the reviewed target set in the document "Biodiversity performance commitment" issued on 2 August 2024 which amended the originally published target and set the consistent industry target at 0 units/100km² for years 1-3, 0.08 units /100km² for year 4 and 0.73 units /100km² for year 5. We have incorporated this data into our tables.

Cap and collar

We believe that the approach taken to use 0.5% of water/wastewater RoRE to set the cap and collar for this performance commitment leaves too wide a range of outcomes and significantly increases the cap and collar level compared to UUW's business plan. This results in a large potential reward or penalty that could be incurred under this PC, despite the fact that this is a relatively new performance commitment and the fact that biodiversity levels can be very significantly impacted by events that are outside of company control.

This potentially presents opportunity for considerable out performance, resulting in customers paying a high level of reward but also the risk of significant under performance. For UUW the 0.5% RoRE would equate to a potential annual reward/penalty of £21.50m. This is extremely high and does not link to the expected level of biodiversity delivery through this performance commitment. This also results in companies being exposed to significant risk of penalty for factors which are beyond their control.

In the event land included in the PC was to suffer significant biodiversity loss as a result of natural disaster such as storms - or resulting from events that are materially outside of company control, such as wildfires - then there could be significant penalty incurred. Whilst the company would endeavour to recover this biodiversity the nature of this recovery is that it is slow and would take place over many years, companies would not be able to do this within the 4-year reporting cycle and so would likely have to report significant reduction in biodiversity, resulting in a penalty. The high level of the collar does not provide suitable protection from this.

An example of this would be Storm Arwen which caused significant damage to UUW land in 2021 and had that land been included in the PC would have resulted in UUW incurring significant penalty.

In query reference OFW-IBQ-UUW-022 Ofwat identified that it had set the P10 for the PC at 0 increase in biodiversity units. This assumes that there is no potential for named sites to suffer deterioration. Whilst UUW would endeavour to prevent this there are situations where land included in the PC could deteriorate resulting in loss of biodiversity and therefore incurring significant penalty as referenced above.

As a result of this there is high potential that companies would be reluctant to include land with high existing biodiversity due to the potential significant negative impact and this would mean some of the most important sites for biodiversity may not see the benefit of enhanced delivery through this PC. This further supports the argument that an adjustment is required for the cap and collar performance range.

ODI rate

UUW supports the approach taken by Ofwat to setting the ODI rate in line with market expectations as set out in Defra's estimated national average price for a biodiversity unit. UUW recognises the importance of a financial incentive for companies to encourage increased delivery of biodiversity improvement for customers.

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

UUW supports the approach taken by Ofwat to setting the PCL in line with the median of the values proposed by companies in their business plans and supports the amended PCLs as confirmed to companies in the document "Biodiversity performance commitment", issued 2 August 2024 which established the targets at 0 delivery for years 1-3, 0.08 units /100km² for year 4 and 0.73 units /100km² for year 5 of AMP8. UUW also supports the approach taken by Ofwat to setting the ODI rate and supports the set rate at £20,000 per unit. The financial incentive associated to this performance commitment is important in encouraging increased biodiversity delivery for customers.

Based on the significant potential exposure to risk as identified in section 4 of this document UUW proposes an alternative approach to setting the cap and collar for this PC in line with the proposal included in the business plan in *UUW30, Chapter 5 supplementary document: Performance Commitments Technical Document*, page 81, section 4.3.13. As this is a new performance commitment and there is limited data to support expected delivery, and to restrict the potential for exposure to significant risk which is not in line with the expected biodiversity delivery, UUW proposes that the limits for the cap and collar are not linked to RoRE as proposed by Ofwat but are instead set at specific performance limits.

As a result of this UUW has assessed the cap and collar used for the AMP7 performance commitment Enhancing natural capital for customers, which was also a new performance commitment at the time and sought to incentivise similar delivery. UUW has uplifted this to 2022/23 CPIH FYA and this results in a proposed cap set at £16.65m for AMP8. This has been profiled across the period as indicated in Table 1 based on no delivery being expected in years one and two and increasing delivery at the end of the AMP. In line with the principle of symmetrical financial incentives potential we also propose a penalty collar of £16.65m.

Table 1: UUW proposed cap and collar levels

	2025-26	2026-27	2027-28	2028-29	2029-30
Reward Cap	£1.00m	£1.00m	£1.65m	£7.00m	£6.00m
Penalty Collar	£1.00m	£1.00m	£1.65m	£7.00m	£6.00m

This financial cap to the potential reward and penalty that companies could incur protects customers from potential large cost impacts resulting in higher than expected delivery with a new and relatively untried performance commitment and also provides fair protection to companies in the event of significant impacts on biodiversity beyond management control.