UUWR_64

PR24 Draft Determination: UUW Representation

Area of representation: Outcomes – Business demand

August 2024

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

Reference to draft determination documents: "PR24 Common performance commitments – Business Demand", "PR24-DD-PCM-Business-demand-1.xlsx" and "Overview of United Utilities' PR24 draft determination" page 10

United Utilities

Water for the North West

1. Key points

- **We believe that our proposed 8.3% target reduction to 3yr average Business Demand (as included in our PR24 Business Plan submission) can safely be accepted without intervention:** Ofwat should update rWRMP input values into the PCL model "PR24-DD-PCM-Business-demand-1.xlsx" to adjust for UUW's allocation of void non-household consumption to 'water unbilled' in the WRMPs, but to NHH demand in PR24 tables. As a result of this input update UUW's proposed demand reduction target for 2029/30 will pass all intervention tests.
- **Changes should be made to the end of period PCL adjustment mechanism and end of period performance payment:** Ofwat should reduce the materiality threshold to +/-1.7% and make indicative adjustments annually to allow companies to understand their performance throughout the AMP, rather than waiting until the end of the period. The proposed reward lockup related to collaboration with retailers and third parties should be removed as it is already appropriately enforced through existing regulatory mechanisms.

2. UUW's PR24 proposal

As set out in October 2023 business plan document *UUW30 – Performance commitments Technical Document*, sections 4.10 and 4.11 of the UUW Business Plan we proposed:

- **PCL:** Company Specific PCL in line with Ofwat methodology. The UUW proposed PCL is based on assessing projects within our WRMP enhancement programme, with predicted demand reduction aligned with long term national targets to achieve a 9% reduction by 2038 in consumption compared to the 2019/20 baseline, and a specific target to reduce business demand by 8.3% by 2029/30.
- **Exceptions to methodology:** No exceptions were applied but we proposed that large users be excluded from the measurement of the PC to reduce significant volatility from third parties.
- **PC design:** We used a standard PC design aligned to Ofwat methodology and annual targets following WRMP profiles in AMP8.
- **ODI rate:** We used the Ofwat indicative rate and proposed underperformance collars calibrated based on the maximum exposure UUW faced from Covid effects on PCC. Outperformance caps were also proposed at the long-term demand reduction targets set out in UUW's WRMP24.

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

PCL

Ofwat has set out in PCL model "PR24-DD-PCM-Business-demand-1.xlsx" and "Overview of United Utilities' PR24 draft determination" page 10, a more stretching PCL for business demand. Ofwat state that "the company can work with water retailers and large users to deliver greater improvements in water efficiency".

Analysis of the methodology embedded in the PCL model for Business Demand shows that there has been an intervention generated due to a variance in company data provided in rWRMP and PR24 data tables.

Table 1 below presents the PCL submitted in our original business plan against the draft determination PCL.

Table 1: UUW PCL for Business demand against Ofwat draft determination PCL

Business Demand		2025/26	2026/27	2027/28	2028/29	2029/30
BP - Jan submission	PCL - % reduction from baseline	4.0%	4.9%	6.1%	7.2%	8.3%
BP - Jan submission	PCL - Ml/d	360.3	357.1	352.6	348.4	344.1
Draft Determination	PCL - % reduction from baseline	4.1%	5.2%	6.8%	8.4%	10.0%
Draft Determination	PCL - Ml/d	360.0	356.0	350.0	344.0	337.9

Source: UUW business plan PCL and Ofwat draft determination PCL

End of period PCL adjustment mechanism – this will be triggered if there is a material difference between the outturn and PCL, which for this performance commitment means the net difference between the outturn and the PCL across the 2025-30 period is at or larger than +/-3%; and the material difference is caused by factors such as operational inactivity, or increased consumption at new or existing premises due to growth. This is subject to the company demonstrating efforts to proactively engage with the relevant customer to promote water efficiency. Companies will be required to report on performance annually, but the adjustment mechanism will only apply at the end of the period.

Reward lockup - Evidence of collaboration with retailers and other third parties will be required.

Further details of these changes, and a selection of further adjustments have been set out in "PR24 Common performance commitments – Business Demand".

4. Issues and implications arising from the draft determination

Changes to PCL targets:

An issue with aligning UUW data reported in rWRMP and PR24 data tables has resulted in Ofwat applying a stretch to the UUW PCLs.

This appears to be due to a data input issue into the Ofwat PCL model "PR24-DD-PCM-Business-demand-1.slsx".

Specifically, in the model 'PR24-DD-PCM-Business-demand-1.slsx', on the worksheet 'Analysis_Additional Information' in cell F16 Ofwat select the lower of each company's 2029/30 annual average NHH demand, the companies' rWRMP projection or Ofwat's assessment of a 'Validated Enhancement Minimum Stretch'. This selected figure is then used as the 2029/30 annual target for the calculation of Business Demand PCLs.

However, in the case of UUW an issue has emerged because of a key difference in the basis on which we have reported NHH demand in the PR24 and rWRMP tables.

As set out in our commentary to Business Plan Submission table CW5 in October 2023 business plan document *UUW83 - Costs (Wholesale) Water - Table Commentary*, paragraph 7.3.8-

"In table OUT4, line OUT4.70 Total business consumption for 2022/23 to 2029/30 is auto-populated as the sum of table CW5 lines CW5.33 and CW5.34, which excludes the water use of non-household void properties (reported within line CW5.37). However, Ofwat has stated elsewhere "For the avoidance of doubt, where water is delivered to business premises that are recorded as void it should still be included in the business demand performance commitment." Therefore, we have adjusted Unmeasured non-household consumption excluding supply pipe leakage (CW5.34) to include the water use of non-household void properties and we have adjusted Water taken unbilled (CW5.37) to remove the water use of non-household void properties."

Historically UUW has reported void non-household demand as a component of 'water taken unbilled'. It is on this basis that rWRMP tables were originally completed. After first publication of the WRMP we have modified NHH demand values when completing key PR24 tables to align to Ofwat's requirement that water use of non-

household void properties be recorded against NHH demand. An equal and opposite adjustment is made to 'water taken unbilled'.

As currently calibrated the Business Demand PCL model observes that UUW's proposed 2029/30 annual average NHH demand is greater than projections included in our rWRMP, and consequently intervenes to select the lower figure.

However, correctly adjusting rWRMP input data for the impact of void non-household consumption results in the rWRMP and PR24 data table input values being fully aligned, in line with Ofwat guidance. The PCL model captures these inputs on worksheet "Input_WRMP data", rows 82 and 83 and worksheet "Input_Additional data' row 20.

Proposed rWRMP input data corrections

Table 2: Current input data – directly transposed from rWRMP

Input data location	Item description	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30
'Input_WRMP data' row 82	Total Non-Household Consumption_rWRMP24_Table 2a: WC Level Normal Year planning scenario_3NY	369.581	315.222	350.642	354.656	353.958	353.866	348.594	344.511	340.341	335.704	331.789
'Input_WRMP data' row 83	Total non-household consumption_rWRMP24_Table 2e: WC Level DYAA_4FPW	369.581	315.222	350.642	354.656	353.958	353.866	348.594	344.511	340.341	335.704	331.789
'Input_Additional data' row 20	rd WRMP DYAA Non-household Forecast Baseline Demand	369.58	315.22	350.64	354.66	353.96	353.87	352.06	351.44	350.75	349.59	349.16

Source: rWRMP

Table 3: Corrected input data – Adjusting rWRMP values to include the water use of non-household void properties

Input data location	Item description	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30
'Input_WRMP data' row 82	Total Non-Household Consumption_rWRMP24_Table 2a: WC Level Normal Year planning scenario_3NY	379.10	323.00	358.30	373.66	362.10	362.00	356.74	352.67	348.52	343.90	339.99
'Input_WRMP data' row 83	Total non-household consumption_rWRMP24_Table 2e: WC Level DYAA_4FPW	379.100	323.000	358.300	373.660	362.100	362.000	356.740	352.670	348.520	343.900	339.990
'Input_Additional data' row 20	rd WRMP DYAA Non-household Forecast Baseline Demand	379.10	323.00	358.30	373.66	362.10	362.00	360.21	359.60	358.93	357.79	357.36

Source: rWRMP adjusted to align with PR14 deffinitions of Non-housheold demand

Once this correction to input values is applied UUW's proposed demand reduction target for 2029/30 passes all interventions tests included within the model, and we believe that our proposed 8.3% target reduction to 3yr average Business Demand (as included in our PR24 Business Plan submission) can safely be accepted without intervention.

We note that there are differences in the annual profiling of PCLs across AMP8, resulting from differing approaches to modelling demand reductions profiles between UUW and Ofwat models. We do not raise objection to the application of industry wide standardised assumptions to PCL profiling.

End of period PCL adjustment mechanism:

We recognise the value in the introduction of an end of period adjustment mechanism.

We continue to believe the best approach to managing uncertainty and unpredictability within the Business Demand PC is to exclude customers that typically use more then 50Ml/yr of water from the measurement of the PC. Failing that the proposed approach of applying an end of period adjustment in the event of material changes has merit. However, we believe the mechanism should act across a narrower band of outcomes and propose changes to prevent the mechanism becoming a source of substantial procedural risk for companies.

We are supportive of many elements of this proposal, including that any performance variance caused by non-delivery of water efficiency activities funded under enhancement expenditure should be excluded from the adjustment mechanism.

Mechanism range

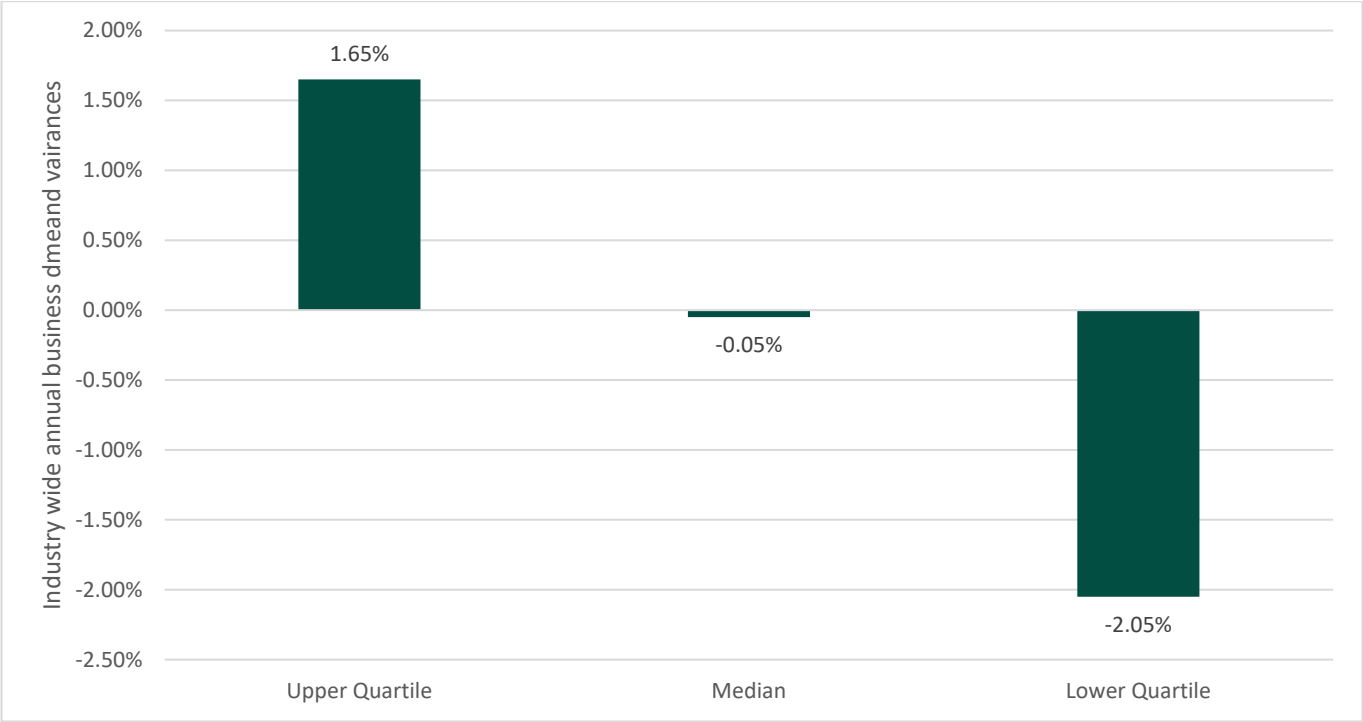
Having considered evidence on past variability of business demand we believe that a narrower definition of a material difference under the end of period PCL adjustment mechanism is merited, reducing the range from +/-3% to a tighter +/-1.7%.

For the variability mechanism to be effective it should be able to consider materially important external variances in the wider business environment. Considering past variability in Business Demand, excluding the large variances seen during the period when Covid related measures impacted Business Demand, we can see that the 3% threshold is substantially wider than normal uncertainty ranges. It would therefore be appropriate to apply a narrower range to the materiality thresholds.

The materiality ranges will act as a gateway to an assessment, prompting water companies and Ofwat to engage in further analysis. It does not mechanistically apply an adjustment. As such it should act filter out minor variations from expected demand, whilst allowing larger deviations from forecasts to be investigated.

Using Ofwat analysis of past business demand trends, as set out "PR24-DD-PCM-Business-demand-1.slsx", worksheet 'Analysis_Business Demand Growth', rows 34-69, we observe that upper and lower quartile ranges tend to be between +1.7% and -2.0% around median annual change. This is shown in Figure 1 below.

Figure 1: Industry wide volatility in annual business demand variances



Source: Ofwat "PR24-DD-PCM-Business-demand-1.slsx"

This analysis shows that in any given year a company may expect variances in business demand of +1.7% and -2% away from the long term trends, with variances larger than that indicating an unusual event. In our view these upper and lower quartile ranges presents a reasonable assessment of the inherent variability in business demand that water companies should reasonably be expected to operate within over a single year.

If demand over a five-year period were to cumulatively drift outside of these ranges it seems reasonable that Ofwat and companies collectively consider whether an end of period PCL adjustment should be made. This does not of course mean that in every case an adjustment is appropriate, simply that if demand drifts outside of expected upper/lower quartile norms the issue could be considered.

Overall, we believe that adjusting the +/-3% materiality threshold to +/-1.7% is supported by the available evidence on historic Business Demand changes.

End of period adjustment

We recognise that a final decision on adjustments will need to wait until such time as the net performance position across the full AMP can be accurately projected. However, where a company experiences substantial changes in NHH demand they will, under the current proposal, be left unclear for several years as to what their ultimate performance targets are. A company will likely produce evidence as to what they believe the drivers of demand change are but, as experienced during the recent review of AMP7 PCC targets, it is likely Ofwat will develop an independent view on the appropriate adjustment that should be applied to PCLs.

If Ofwat were to provide an annual indication as to which adjustments were likely to be acceptable it would remove a substantial amount of company uncertainty for this measure. This exercise would not require a substantially greater amount of work on the part of Ofwat, only bringing forward the assessment of annual variances to the point in time that companies provide evidence on the drivers of variance. As such assessments will ultimately be required as part of the end of period adjustment process in any case this should not prove an additional burden on resources overall.

Providing early indicative guidance around potential future PCL adjustments is of particular importance when considering scenarios where companies are performing above or below PC caps and collars. Absent guidance on future changes to PCLs companies may believe that they are no longer financially incentivised to improve if their

performance is substantially outside cap/collar ranges, even if this has come about due to factors that ultimately are judged to qualify for end of period adjustment.

Reward lockup - Requirement to collaborate with retailers and third parties:

We are fully supportive of the collaborative sentiment of this requirement and our plan includes collaborating with retailers and third parties to deliver business demand reduction. However, we do not believe this should be a binding requirement to access reward.

Companies are already required to behave in a collaborative way and adopt Retailer Wholesaler Group (RWG) Good Practice. Where wholesalers are not working collaboratively with retailers or are failing to meet retailer expectations in key areas, we have seen, and expect to see going forwards, this reflected in Retailer Measure of Experience (R-MeX) scoring.

The R-MeX element of BR-MeX will carry a significant financial incentive in its own right. To reflect levels of collaboration across both the Business Demand and BR-MeX Performance Commitments would introduce an unnecessary risk of double counting across measures.

We believe that R-MeX provides a far more robust assessment as to whether wholesalers are meeting the needs of the market, including collaborative working with retailers on water efficiency measures. In addition, allowing levels of collaboration to be reflected in the R-MEX scoring rather than having a separate assessment will help avoid likely complexity of making a separate assessment of "collaboration".

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

Changes to PCL targets: Ofwat should update rWRMP input values into the PCL model "PR24-DD-PCM-Business-demand-1.xlsx" to adjust for UUW's allocation of void non-household consumption to NHH demand. As a result, UUW's proposed demand reduction target for 2029/30 will pass all interventions tests, and we believe that our proposed 8.3% target reduction to 3yr average Business Demand (as included in our PR24 Business Plan submission) can safely be accepted without intervention.

End of period PCL adjustment mechanism and end of period performance payment: We continue to believe the best approach to managing uncertainty and unpredictability within the Business Demand PC is to exclude customers that typically use more then 50Ml/yr of water from the measurement of the PC (as Ofwat itself proposed in the PR24 draft methodology for this PC definition) but, failing that, acknowledge that Ofwat's PCL adjustment mechanism is a step in the right direction to help manage uncontrollable risks such as business growth and large water users.

Having considered evidence on past variability of business demand we believe that a narrower definition of a material difference under the end of period PCL adjustment mechanism is merited, reducing the range from +/-3% to a tighter +/-1.7%.

We accept an end of period performance payment is the best approach to applying this mechanism; however, we believe Ofwat should provide an annual indication of adjustments to allow companies to understand their performance throughout the AMP, rather than waiting until the end of the period.

The proposed reward lockup related to the requirement to collaborate with retailers and third parties should be removed as it is already appropriately enforced through existing regulatory mechanisms.