

December 2019

PR19 final determinations

South Staffs Water – Delivering outcomes for customers additional information appendix

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Water quality compliance (compliance risk index)

1 Introduction

Compliance risk index (CRI) is a statutory compliance measure developed by the Drinking Water Inspectorate (DWI) in consultation with the industry. It is a measure of risk against a variety of water quality compliance measures and is reported as a score. Provision of high quality water that is safe to drink is a key duty of a water company to its customers, and this measure incentivises companies to reduce the risk of these failures occurring.

2 Our draft determinations

At draft determinations we set a standard performance commitment level of zero for water quality compliance for all companies in all years for the 2020-25 period. Because of the requirement for 100% compliance we also set a standard deadband for all companies. This allows a margin in performance before an underperformance payment applies. At draft determination, the deadband was set at a level of 2.00 in years 1 and 2, followed by a level of 1.50 in years 3-5, in order to retain some flexibility for likely new prohibition on the use of metaldehyde to come into force.

In September Business plans the company reduced the incentive on the Compliance Risk Index and lifted the incentive on the water quality contacts measure to rebalance the package. In its April business plans the company further reduced the rate which was a concern since its rate was lower than our reasonable range and we were concerned that the company's rate would not offer sufficient customer protection. We intervened to set South Staff Water's underperformance ODI rate to the lower bound of our reasonable range. This led to an underperformance rate at - £0.267m per index score. We set a standard collar for all companies at a level of 9.50.

3 Stakeholder representations

The company states that due to its asset configuration it could have a disproportionately large underperformance payment for compliance risk index (CRI). It states that this is due to the way in which the CRI scores are normalised by total

company volume. The company states that its two treatment works ‘Hampton Loade’ and ‘Seedy Mill’ account for a high proportion of its overall supply volume. It states that a company with a smaller number of larger works will incur a higher CRI score for the same failure as a company operating a larger number of smaller works. It also provides a table to show the impact of a single coliform failure (parameter score 5 and inspector score 4) at various other treatment works from different companies. This appears to show that the impact for South Staffs Water (having only two works making up the majority of their output) is higher than other companies who have similar size works (but make up a smaller proportion of their total output).

The company states it is trying to improve performance, addressing risks with the treatment works in this period by investing in ultraviolet (UV) disinfection at several locations. It is also proposing to continue to invest in the 2020-21 to 2024-25 period by upgrading the treatment processes at both surface water works in a programme which was submitted as part of the business plan. It states that the optioneering for this improvement programme considered the issue of legacy asset configuration by looking at options for a greater number of smaller works, to reduce reliance on these large assets. However, these options were significantly more expensive and more difficult to deliver and were not considered cost beneficial. Therefore, the company considers that its reliance on these large assets for a high proportion of its supply – is outside of management control and will not change.

It expects the work it is undertaking in the 2020-21 to 2024-25 period to deliver a material improvement in CRI performance. The upgrading works are expected to be delivered by 2023 (Seedy Mill) and by 2024 (Hampton Loade), but this will not change the issue that the size of these works is high compared with its overall treatment capacity, relative to other companies. The company considers that until an adjustment of some kind is adopted, there is a significant underperformance payment risk in all scenarios. The company proposes that Ofwat should either:

- Descale the underperformance payment rate so that it achieves the same average risk range as other companies as a percentage of regulated equity. It considers the draft determinations show an average RORE range for all companies (excluding Southern Water and South Staffs Water) of 0.3%, compared with 1.2% for it. It suggests that a descaling factor of 4 should be applied to the underperformance payment rate; or
- Exclude ‘Hampton Loade’ and ‘Seedy Mill’ from the calculation of CRI for the purposes of calculating the underperformance incentive only until the DWI ‘notice’ periods are completed (see below).

The company is subject to undertakings to the Drinking Water Inspectorate (DWI) in relation to improving treatment processes (at Hampton Loade and Seedy Mill) to reduce the risk of exceedances related to metaldehyde and total pesticide parameters. These improvements are due to be completed by March 2020. In addition the company has received multiple DWI notices for the period 2020-21 to 2024-25 at the same treatment works, the most significant of which are related to the provision of additional filtration to reduce the risk of exceedances of clostridia (at Hampton Load), total trihalomethanes (at Seedy Mill) and disinfection by-products at both sites. The company is also required to reduce the risk of customer contacts from both sites.

4 Our assessment and reasons

The CRI definition has been set by the DWI in collaboration with the whole industry, and the final definition and its measure did not allow for any exceptions. The analysis provided by the company to show the potential impact from a single coliform failure is based on a limited dataset, which the company acknowledges. Nevertheless, we acknowledge that a poor inspector score at a large site with notices in place is likely to result in the CRI score being worse than 2.00. On this specific issue the DWI states that the presence of a legal instrument means that any failures for parameters covered in the notice occurring at these sites whilst the legal instruments are in place impact the CRI score more than if there was no legal instrument in place. This reflects the fact that this is a known risk and the DWI expects the short term measures to mitigate any failures whilst the notice is in place. However, we consider that if the company is compliant with water quality requirements, as it currently is on these sites on some days, then the CRI score would not result in any underperformance payments.

Whilst the company has inherited its assets and their configuration (e.g. only two large works rather than several smaller ones) on privatisation, it has known about the increased risk of service impacts for many years. Therefore it should have suitable risk mitigation in place, actions which are within management control. Because of its asset configuration, operational practices and other historical investment decisions, its customers continue to suffer from a higher risk of poor water quality than the customers of other companies. The company must manage its assets and the service it provides in the most effective way to minimise the risk of failures. The company is able to take mitigating actions to improve performance until the upgrading works as set out in the DWI notice periods are completed. These are

stated Section A of the in the DWI notice. In addition, the improvements it expects to be in place by March 2020 should also beneficially impact its compliance.

In addition, we consider that the configuration of the company assets could be beneficial in terms of compliance compared to an alternative configuration with a greater number of sites. The current configuration of two large sites means that it has to deal with a smaller variety of issues and can focus resource on only two sites to maintain compliance.

We have considered South Staffs Water's historical levels of performance in this area. In 2016, the first year of CRI scores the company had median performance of 2.825. In 2017 and 2018 performance deteriorates and the company scores are 6.11 and 13.69 respectively. For performance before 2016, we need to assess performance against alternative measures. The company has poor performance against the water treatment works (WTW) coliforms measure from 2010 to 2014 (with the exception of 2011), but then appears to improve performance over the last four years against its PR14 levels. However, it has failed to meet its PR14 performance commitment levels in three out of the last four years for mean zonal compliance (MZC). Performance against this measure has been poor since 2013, although it did not fail its less stretching PR09 reference levels of performance.

The company's proposed ODI underperformance rate was not developed with willingness to pay data. The company has provided no additional evidence of customer support for its proposed ODI rates. The ODI rate we set at the draft determination aligns the rate closer with rates (and in some cases customer valuations) proposed by other companies.

Our assessment of the two options proposed is as follows:

- Descale the underperformance ODI rate: A descaling of the rate would mean there is a reduced incentive for the company to meet its compliance requirements compared to other companies. Compliance with water quality requirements is very important to customers.
- Exclude Hampton Loade and Seedy Mill from the calculation of the underperformance payment incentive until the notice periods are completed: This option would mean there is a reduced incentive for the company to comply with compliance requirements and put mitigations in place, until the remedial works are complete, potentially exposing a majority of its customers to a higher risk of water quality issues in the meantime. Additionally, the DWI considers that omitting individual sites from CRI scores for any companies is not a suitable

methodology because the company should take temporary actions to ensure compliance.

We consider that South Staffs Water did not respond sufficiently to performance failures that occurred over a number of years (as failures continued to occur) and that has resulted in official undertakings and notices being placed on them by the DWI. The notices have resulted in the need for extensive upgrading works at both treatment works, the funding for which is being allowed in the final determination. Maintaining the draft determination ODI rate (which is line with other companies) places a strong incentive on the company to continue to perform to the required compliance standards. We consider this can be achieved through effective management of the facilities and the adoption of necessary temporary mitigation measures (until the upgrading works are complete).

However, if we set collars following our standard approach, we consider that the financial exposure to the company resulting from underperformance related to the compliance risk index would be disproportionate. We have therefore reduced the financial underperformance exposure by setting the collars at a tighter level, in this case so that the maximum underperformance payments do not exceed 1% of return on regulatory equity. The collars become wider over time so that the risk for the company increases and therefore we maintain the incentive to improve.

5 Our final decision

We are making changes to CRI for the final determination:

- We change the standard deadband level to 2.00 in all years. This change allows more flexibility in performance to take into account the uncertainty created by the ban on the use of metaldehyde being overturned by the High Court and also aligns with the median level of current company performance.
- We amend the standard collar compared to our draft determination at 1.0% return on regulatory equity which will reduce the maximum underperformance payments and provide a more balanced spread of risks and incentives for the company.

However, we retain the underperformance payment rate for the company, as well as the assets that go into the calculation of the score for the purposes of calculating underperformance payments.

Our allowance for the company's enhancement cost claim for the final determination is an increase of £5m from the draft determination allowance. We now allow £68m enhancement funding for water quality improvements including the improvements the company proposes at its Hampton Load and Seedy Mill treatment works. This includes a £10.5m contribution from Severn Trent Water.

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