

Information notice

IN 17/05 June 2017



This is a formal document that alerts our stakeholders to a change in the way that we regulate the water sector in England and Wales.

The process for determining the application of in-period outcome delivery incentives – updated for 2016-17

This information notice details our policy for determining the application of in-period outcome delivery incentives (ODIs) for 2016-17. We have updated our policy as set out in the information notice IN 16/08 taking into account our experience of carrying out the first year of in-period ODIs determinations in 2015-16. This information notice supersedes the previous information notice (IN 16/08).

In-period ODIs are applied during the five-year price control rather than at the end of the period. **In-period ODIs only apply to three companies during this price control period: Anglian Water, Severn Trent Water and South West Water.** For the next price control period all companies will be able to propose in-period ODIs.

ODIs can result in performance related payments being made to or by companies. Payments are made in the form of adjustments to companies' allowed revenues under their wholesale water and wastewater price controls for the next charging year. Payments relating to performance levels for 2016-17 can be made in 2018-19. Payments can take the form of:

- a penalty paid by a company to compensate customers for performance below its committed performance level; or
- a reward received by a company to reflect stretching levels of performance provided to customers beyond its committed performance levels.

A payment can be spread over more than one year to reduce bill volatility, where this is in customers' interests. In the determination we will confirm what the net payment due to each company for its 2016-17 performance is. We will also determine what adjustments will be made to allowed revenues in the 2018-19 charging year. This will include any payments that have been deferred from previous performance years and the appropriate proportion of net payment relating to the 2016-17 performance year to allow for bill smoothing.

Changes to previous policy [in IN 16/08] for this year's in-period ODI determinations

We have made a number of changes to the section 'Further details on the in-period ODI process'. In particular, we have provided clarity on what information a company should provide when it is not proposing to submit a request for a determination. We have also highlighted the importance for companies to consider bill smoothing as part of their application.

We have removed the sections on 'Relationship to licensing discussions for PR19' as these discussions have now concluded and the 'PR14 reconciliation rulebook' as the relevant information for in-period ODIs is contained in a new section on 'adjustments to the ODIs'.

We have simplified the K-model so that it does not require future forecasts of RPI after the next charging year. These forecasts are not needed to calculate the adjustment to each of the wholesale price limits resulting from the application of in-period ODIs for the next charging year. However, companies should still provide future forecasts of RPI in connection with any bill smoothing proposals.

Background

We introduced in-period ODIs at the 2014 price review (PR14). Three companies chose to adopt in-period ODIs following consultation with their customers and agreed to a change to their licences.

In-period ODIs increase the power of incentives by bringing a reward or penalty closer in time to the actions that earned it.

They are also likely to reduce the size of adjustments at price reviews.

The process set out in companies' licences

The modification made to the licences for Anglian Water, Severn Trent Water and South West Water at PR14 sets out the key features of the in-period ODIs determination process. This can be summarised as follows:

1. A company can make a claim for its in-period ODIs no later than 15 September. Ofwat can also initiate the determination process.
2. A company must provide Ofwat with whatever information we "may reasonably require for the purpose of making a determination".
3. In making the determination Ofwat can consider the company's performance in relation to its in-period ODIs in preceding and expected performance in future years (not including the years covered by the next price review).
4. Ofwat will make the determination no later than 15 December.

Further details on the in-period ODI process

The licence text, intentionally, does not describe in detail how the in-period ODI determination process operates. This allows for the process to evolve as we, companies and other stakeholders learn from experience. This section sets out further details on the process for making determinations in relation to performance in 2016-17, for which companies need to request a determination by 15 September 2017 (or Ofwat can initiate the process).

In relation to the three companies (Anglian Water, Severn Trent Water and South West Water):

- Given the timeline, and our desire to publish draft determinations, we would expect companies to make us aware of the likely content of their in-period ODI claims earlier than 15 September. If a company plans to submit its claim early we would be grateful if it would inform us of this in advance.
- A company's request for a determination must be accompanied by information about what reward or penalty payment it considers is appropriate for each in-period ODI, its supporting evidence and whether its request differs in any way from the automatic operation of the in-period ODIs as set out in the company's PR14 final determination company-specific appendix (subject to any amendments allowed by Ofwat through its corrigenda or recalibration of ODI rates).
- If a company is not claiming the full net reward or penalty implied by the automatic operation of its in-period ODIs, the company must provide all its evidence in support of this.
- The company must submit a separate completed [ODI spreadsheet from the PR14 reconciliation rulebook](#) for the price controls that have in-period ODIs.
- The company must submit a completed version of our "[K factor model](#)" for calculating the adjustment to K for each relevant price control.
- We expect the performance a company reports for 2016-17 on its in-period ODIs to be the same as that reported in its annual performance report. If this is not the case the company must provide an explanation for why it is not the case.
- We require a company to explain whether and how any mitigating factors (e.g. weather, third party actions or exceptional events) have been applied to its reported performance for each in-period ODI and its justification for applying these. In such cases, the company must provide assurance on its judgment that a mitigating factor applies and how it has been applied.
- The company must explain whether there was any ambiguity in the definition of each of its in-period ODIs, how the company interpreted the ambiguity and what assurance it obtained on its interpretation of the ambiguity.
- We require assurance that the information provided is accurate and complete. The company must explain what internal and external assurance, including from its Customer Challenge Group (CCG), it has obtained for its in-period ODI claim. The company must provide a full and accurate summary of the outcomes from any audits carried out, outlining any issues that have arisen and what actions it is taking to rectify them.
- Where the company has identified issues with the past reporting of its data, the company must explain what impact it has had on its past reported figures. The company must explain how it proposes to

adjust its in-period ODI claim for any issues identified with the past reporting of its data.

- The company must confirm whether it has refined its methodology for reporting any of its performance commitments (e.g. improving the accuracy of its calculation). Where the company has changed its approach it must estimate what impact this has had on its reported figures.
- The company must provide reasons for any significant changes in performance compared to previous years. The company must explain to us whether it considers its performance on any of its in-period ODIs in 2016-17 to be one-off. For example, where the company is performing poorly it must provide details on what actions it will take to improve its performance. This must include an indication of timescales for achieving its performance commitment levels. Where the company is performing significantly better than its performance commitment level, it must explain whether it expects to continue to outperform in future years. The company must take its current performance and future forecasts of performance into account in its assessment of the need for bill smoothing.
- The company must explain what impact its reward or penalty claim will have on its customers' bills for each relevant price control and outline whether any customer groups are likely to be particularly impacted. Companies must take into account all adjustments that will be made to bills. We recognise the bill impact figures will be indicative during the determination process, therefore companies must explain any uncertainties around these figures and the main assumptions they have made. This must take into account our charging policy, which requires companies to consider the impact on any customer group if a bill is likely to increase more than 5% in nominal terms.
- The company must provide details of its communication plan to engage with customers and other stakeholders in relation to its in-period ODIs, the impact on bills and the net change in overall bills from all factors (including the inflation or the K factor agreed at PR14). The company must consider how it will communicate with customers whose bills will show above average increases, customers in circumstances that make them vulnerable and those that are struggling to pay. The company must also include details of its engagement with other water companies whose customers could also be affected by the changes in bills.
- The company must consider whether it is appropriate to defer payments until after the following charging year for bill smoothing purposes and its rationale for doing so. The company must provide information on what engagement it has had on bill smoothing and the outcome of this engagement.
- **A company not requesting a determination should still provide information to support its approach.** The company should confirm the net reward or penalty relating to the performance year and provide a completed [ODI spreadsheet from the PR14 reconciliation rulebook](#) for each relevant price control. The company should explain its rationale for not requesting a

determination, why this is beneficial to customers and whether this is supported by its relevant Customer Challenge Group. The company should provide a full and accurate summary on the assurance of its proposal not to request a determination and an explanation of how it addressed any issues that were identified by the assurance process.

In relation to Ofwat:

- We plan to issue a draft determination for a short consultation, probably in late October or early November, before issuing our final determination no later than 15 December.
- If any of the three companies with in-period ODIs does not request a determination of its in-period ODIs, we have the ability under the company's licence to initiate the

determination process and require the information we need to make the determination, if we consider this is appropriate.

Adjustments to ODIs

In-period ODIs can be adjusted for inflation and tax. Where an in-period ODI is not being paid in the next charging year, for example due to bill smoothing, the weighted average cost of capital, set out in companies' final determination at PR14, can also be added to the in-period ODI payment.

Enquiries

If you have any questions about this information notice please email water2020@ofwat.gsi.gov.uk

More information

Water company licences, <http://www.ofwat.gov.uk/regulated-companies/licences/>

The PR14 reconciliation rulebook, October 2016, <http://www.ofwat.gov.uk/publication/ofwat-pr14-reconciliation-rulebook/>

The company-specific appendices to the PR14 final determinations, December 2014, <http://www.ofwat.gov.uk/regulated-companies/price-review/price-review-2014/final-determinations/>

Charging scheme rules, December 2016, <http://www.ofwat.gov.uk/wp-content/uploads/2016/12/December-2016-charges-scheme-rules.pdf>

The K factor model: The model for calculating the adjustment to wholesale price limits (the K factor) resulting from the application of in-period outcome delivery incentives (ODIs), June 2017, <http://www.ofwat.gov.uk/publication/k-factor-model-inperiod-odis/>

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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