

**Consultation under section 13 of the Water Industry Act 1991 on proposed modification to condition B of Anglian Water Services', Severn Trent Water's and South West Water's licences**

## About this document

This document invites comments on our proposal to modify condition B of the conditions of appointment (licences) of Anglian Water Services Limited, Severn Trent Water Limited and South West Water Limited (the 'three companies'). The proposed amendment will allow us to make changes to price controls for performance against specific commitments.

Under section 13 of the Water Industry Act 1991 (WIA91), we are able to modify the conditions of a company's licence if it agrees to the change we are proposing to make.

This document and the attached appendix is a Notice under section 13 of the WIA91.

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## Responding to this consultation

We invite stakeholders to comment on our proposed modification by **16 January 2015**. Companies should also indicate their acceptance or otherwise of the proposed modification by this date. You can email your responses to [christopher.pepper@ofwat.gsi.gov.uk](mailto:christopher.pepper@ofwat.gsi.gov.uk) or post them to:

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If you wish to discuss any aspect of this document, please direct your enquiry to Christopher Pepper on 0121 644 7784 or by email to [christopher.pepper@ofwat.gsi.gov.uk](mailto:christopher.pepper@ofwat.gsi.gov.uk).

We will publish responses to this document on our website at [www.ofwat.gov.uk](http://www.ofwat.gov.uk), unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

## 1. Background

In 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (our 'final methodology statement'), we confirmed that companies' boards should develop and propose outcomes and associated performance commitments and outcome delivery incentives (ODIs). We said that these should reflect the views and priorities of customers, both now and in the future, as well as environmental priorities. Each of the companies set these out in their business plans for the 2014 price review. In line with our final methodology statement, the outcomes (and supporting performance commitments) have been developed with input from customer challenge groups (CCGs) and we have assessed them.

In our final methodology statement, we explained that, where appropriate, companies should put forward proposals for financial rewards and penalties (ODIs) associated with their performance commitments. Penalties may be appropriate if a company fails to deliver or where its performance deteriorates; and rewards may be appropriate for outperformance (where justified by customers' willingness to pay).

In our final methodology statement, we explained that each company could determine the form of any incentives that it is proposing. Anglian Water Services, Severn Trent Water and South West Water asked to take the rewards and penalties for some of the performance commitments that each of them was proposing in-period (that is, ahead of the next price review).

Under each of the three companies' existing licences, changes to price controls can only be made in between price reviews through an interim determination. These are only permitted in specific circumstances. This means that price controls cannot be changed before the next price review to take account of any rewards or penalties that are due as result of the company's performance. The licence change we are proposing would allow each of the three companies to receive rewards or penalties in-period through changes to price controls, if appropriate.

We are proposing to make the same change for each of the three companies rather than individual, tailored changes. We consider this will support our stated aim of moving towards licences that are consistent across companies, as set out in our [forward programme for 2014-15](#). This approach will also mean that the modification can be used for future price reviews and adopted by other companies (if appropriate and subject to consultation).

Prior to the publication of this Notice, we have worked individually with each of the three companies to develop the modification. We welcome the constructive approach taken. Each company has indicated its agreement in principle to the modification and we are now seeking formal agreement to our proposed modification.

## 2. What are the changes that we are proposing?

This modification will allow us to make changes to each of the three companies' price controls in between price reviews for penalties and rewards due for performance against specific commitments. Companies must be notified of the eligible specific commitments by 31 December in the year before new price controls take effect.

When necessary, we will (no later than 15 December in any year) determine whether there should be a change to the level of the relevant price control(s) for the following year and, if so, what that change should be. Each company may also ask us (no later than 15 September in any year) to make a determination. The companies will be required to provide us with the information that we reasonably need to make determinations.

In making our decisions we will examine each company's performance against the specific commitments we set out as being eligible for in-period changes. We will also consider the proposed adjustments to the level of the relevant price control(s). When we make a determination we will publish our reasons for that determination.

We set out the outcomes and associated performance commitments and the ODIs each of the three companies has proposed, including the impact of any interventions that we have made, in their [final determination notices \(company-specific appendices\)](#). The document for each company sets out which performance commitments are eligible for in-period price control changes in the 2015-20 period.

### **3. Why do we need to make the changes we are proposing?**

Making in-period changes to price controls to take account of rewards and penalties more immediately links customers' experience to companies' performance. We consider this may provide a stronger incentive in terms of encouraging improved performance that benefits customers. We expect it to also increase investor confidence in the incentive framework, given the more immediate impact of any rewards or penalties due.

Each of the three companies have explained why they think that an in-period change to price controls is needed, rather than waiting until the next price control period. Without this modification, there will be no impact of rewards and penalties until the next price control period, because they will not be applied until then.

Anglian Water requests the ability to take rewards and penalties in-period for one performance commitment only. This commitment relates to reducing leakage where the company has removed expenditure from its business plan and will only be able to recover this from customers should it meet or exceed the targets it has committed to delivering. As a consequence, it considers that it is appropriate that any rewards or penalties due should be received in-period.

The company's CCG supports the application of in-period rewards and penalties for this commitment and the company states it has strong customer support (if the alternative was the work not being done).

Severn Trent Water considers a range of performance commitments are suitable for in-period rewards and penalties where performance can be accurately assessed on a yearly basis. The company's CCG considers that in-period changes should be restricted to such performance commitments.

South West Water wants to be able to receive rewards or penalties in-period for those performance commitments where achievement of the performance commitment results in a revenue adjustments (as opposed to adjustments to the regulatory capital value).

## 4. What is the impact of our proposals?

As explained above, we are seeking the ability to change price controls for the three companies to take account of any rewards or penalties which they have earned for performance against specified commitments. This could mean that the price controls for the three companies could be higher or lower in some years than our final determinations for each of the three companies.

The modification will not change the level of any penalty or reward that is due; it will only affect the timing of when it is received (that is, in-period as opposed to the next price control period). For example, following the 2014 price review, if this licence modification is made, the three companies will be able to receive rewards and penalties during the 2015-20 period instead of having to wait until 2020-25.

Our final methodology statement states that companies should demonstrate that their proposed performance can be measured and recorded consistently. And, in addition, that they should have the appropriate governance and quality assurance processes in place to achieve this. We also expect companies to be transparent with their customers about their performance against their commitments to their customers. We will have regard to this information when we decide whether we need to make any changes to price controls and, if so what, those changes should be.



## 5. Next steps

We would like responses to this document, including formal responses by the three companies to our proposals, by **16 January 2015**.

Subject to agreement, we will amend the three companies' licences by 31 March 2015.

## Appendix 1: Proposed modification to condition B

This appendix sets out an illustrative example of the proposed modification. The purpose of this example is to help to show the effect of the proposed modifications. It does not necessarily show the exact wording that will apply for each water company.

New part (IIIA – that is, 3A) to be inserted into condition B.

### **Part IIIA Performance Measure Adjustments**

- 12 This paragraph applies where the Water Services Regulation Authority has notified the Appointee by 31 December in the Charging Year before the Review Charging Year that a Price Control determined under sub-paragraph 9.4 in respect of the Appointee's Wholesale Activities may be adjusted to reflect the Appointee's performance in relation to a specific Outcome or Outcomes. Where this paragraph applies:
- (1) the Water Services Regulation Authority may determine, and the Appointee may by notice given no later than 15 September in the Prior Year refer to the Water Services Regulation Authority for determination, the question whether, in accordance with and subject to sub-paragraph 12(3) below, the level of the Price Control or one of the Price Controls determined under sub-paragraph 9.4 in respect of the Appointee's Wholesale Activities should be changed for the following Charging Year and, if so, the amount of such change;
  - (2) the Appointee shall furnish to the Water Services Regulation Authority such Information as the Water Services Regulation Authority may reasonably require for the purpose of making a determination pursuant to this paragraph;
  - (3) in making a determination pursuant to this paragraph, the Water Services Regulation Authority shall:
    - (a) consider the Appointee's performance in relation to the Outcome or Outcomes in the preceding years and, if relevant, its expected performance in the current year or one or more future years up to, but not including, the next Review Charging Year; and

- (b) have regard to the proposed adjustments to the level of the relevant Price Control or Price Controls which the Water Services Regulation Authority notified to the Appointee when the Appointee was notified that a Price Control determined under sub-paragraph 9.4 in respect of the Appointee's Wholesale Activities might be adjusted to reflect the Appointee's performance in relation to a specific Outcome or Outcomes;
- (4) no determination shall be made by the Water Services Regulation Authority under this paragraph later than 15 December in the Prior Year.

For these purposes:

- (i) in this paragraph "**Outcome**" means a target or other measure of the performance of the Appointee in relation to the carrying out of the Regulated Activities that the Water Services Regulation Authority has notified to the Appointee by 31 December in the Charging Year before the Review Charging Year; and
- (ii) in this Condition references to a "**Price Control**" include a Price Control whose level has been changed in accordance with a determination made under this paragraph.

#### Drafting notes:

1. "Charging Year" is defined in Condition A as "a year commencing on 1 April".
2. "Prior Year" is defined in Condition A as "the year commencing on 1 April immediately prior to the relevant Charging Year".
3. "Review Charging Year" is defined in Condition A as "the first of the Charging Years in respect of which any Periodic Review is carried out".
4. The 15 September and 15 December deadlines correspond with the normal interim determination deadlines.



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