

Information notice

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2014 price review – information for companies on revising their outcomes proposals

This information notice provides additional information to help companies revise their outcomes proposals as part of the 2014 price review.

In particular, it identifies a number of questions that will help the management team of each company to consider their own proposals critically ahead of submitting them to us. Using these questions will help companies achieve the best results for their customers. They will also help ensure that the review process is as efficient and transparent as possible.

The 2014 price review is our process for setting the price and service packages ('price controls') that each monopoly company must deliver over the five years between 2015 and 2020.

This information notice should be read alongside:

- our [guidance on risk and reward](#), which we published in January;
- the [results of our risk-based review](#), which we published on 4 April;

- the information we published following the [workshop](#) held on 9 April; and
- the feedback companies have received on their individual performance commitments and outcome delivery incentives.

The information notice has been drafted following recent engagement with companies and, therefore, reflects our most up-to-date experience from the assessment of company proposals.

Background

Outcomes are a key part of the 2014 price review process, which we set out in '[Setting price controls for 2015-20 – final methodology and expectations for companies' business plans](#)' (our 'methodology').

The new framework ensures that companies are incentivised to deliver efficiently what customers and society need, want and are willing to pay for, as well as helping to legitimise their role in providing important public services. The focus on outcomes will deliver a number of clear benefits. For example, companies

are encouraged to engage directly with their customers and take ownership of their business plans. They also have more freedom to innovate and find sustainable and longer-term solutions that deliver lower costs overall.

So we can be sure that companies are able to deliver these benefits, we will continue to examine closely the outcomes that they submit in their revised business plans.

For the avoidance of doubt, this information notice does not in any way alter the requirements of our methodology but is intended to emphasise our expectations for how the methodology will be used in this important new area. The 'themes' set out below simply provide a focused way for companies' management to check whether their revised proposals meet the requirements of that methodology.

Demonstrating effective incentives

We will still assess companies' revised proposals against the requirements of our methodology. But how we apply the

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.

assessments will be more focused, and we will look at a number of key themes in particular. Together with other points on quality of evidence, and consideration of our risk-based review feedback and the further views of customers and customer challenge groups, these themes can form a helpful checklist for the management teams of each company to self-appraise their revised proposals.

Following the procedures we used during the risk-based review and in line with previous guidance, our assessment will focus on how well companies demonstrate (with supporting evidence) that their proposed incentives:

- **are supported by customers** – including evidence that the incentives cover areas that are important to customers, that customers are willing to pay for any reward elements, and that that they can afford to do so;
- **protect customers** – including evidence that penalties protect customers against under-delivery, ensuring that companies cannot be better off by choosing not to deliver the commitments they have made to customers in their business plans;
- **promote efficiency** – including evidence that companies are choosing the most cost-beneficial performance levels to target for each outcome area and applying reasonable costs to do so;
- **‘stretch’ their performance** – including evidence that any rewards are being earned by

innovation or performance beyond the planned and expected levels. Performance levels underpinning all incentives should be consistent with companies striving to improve their absolute performance and performance relative to their peers to the levels that represent the best value for money for their customers;

- **are fair** – including evidence of balance in the upside/downside risk and that incentives cannot be ‘double counted’ with other incentive mechanisms such as the total expenditure (‘totex’) efficiency incentive;
- **are likely to apply in practice** – wide deadbands or neutral zones where no financial consequences are associated with changes in performance can mean that the practical impact of financial incentives is greatly reduced, while a sufficient breadth of financial incentives proposed is also important to ensure that key aspects of performance are covered to at least some extent, and actual delivery does not become unduly biased towards areas where financial rewards are greatest; and
- **are transparent** – including evidence that performance can be assured independently and that companies will use it to explain their performance achievements (or shortfalls) in their continuing discussions and engagement with customers.

‘Stretching’ company performance

Each of the seven themes above is important. But, following the

risk-based review results and the more recent discussions with companies, we would like to draw particular attention to the fourth bullet point on ‘stretch’. To address this, we want to see companies:

- include more stretching incentives; and
- provide more complete, and higher-quality, evidence. In many business plans, companies have not supported the explanation of incentives with evidence that allows us to confirm whether the proposals follow our price control methodology, or if a departure from it methodology can be justified.

Together, these seven themes help to define an effective incentive. But however well an incentive is put together, we may still need to intervene to amend companies’ business plan proposals to safeguard customers if the supporting evidence is not provided to demonstrate that the incentive is effective.

A recurring theme across previous risk-based review testing of companies’ December business plans was that they typically provided explanations of what they proposed, but not the supporting evidence to justify their proposals. Without the supporting evidence, we will not be able to confirm whether the proposals follow the methodology (or, if relevant, that a departure from the methodology has been justified). This is particularly important as outcome incentives represent a key new development in the price review process.

Interventions to safeguard customers' interests

Our preferred approach is for companies to develop proposals after consultation with their customers that comply with our methodology. We think that, with regard to the need for relevant supporting evidence, the seven themes we have set out above provide a helpful checklist for the management team of each company to critically self-appraise their own business plan proposals for this purpose. Combined with a further check to ensure that all relevant aspects of our feedback from the risk-based review have been considered and addressed as necessary, this checklist should help ensure that companies' revised proposals are capable of being reflected in our draft determinations without significant intervention on our part.

In the event that any company is unable – or unwilling – to do this, we have put contingency plans in place that will allow us to introduce delivery incentive proposals to safeguard customers as part of the draft determination process. These fall-back proposals may include, for example, adjustments to company-proposed parameters

More information

'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans', July 2013

'Setting price controls for 2015-20 – risk and reward guidance', January 2014

'Outcomes of the risk-based review and next steps', April 2014

'Outcomes of the risk-based review and next steps – outcomes, risk and reward workshop: slides and questions and answers', April 2014

[2014 price review web pages](#)

within the proposed incentives such as changes to penalty or reward rates, deadbands, caps/collars or, in some instances, more stretching performance levels. And in some circumstances, our fall-back proposals may also introduce additional obligations or other incentives on companies.

If we have to propose such interventions in our draft determinations, we will explain why we have done this and present the evidence we have used to support the specific adjustments we have proposed. We expect that our interventions will focus in particular on the

continued protection of customers, and the need to ensure that incentives stretch the performance of the companies affected consistent with the objectives set out in this information notice.

Enquiries

If you have any questions about this information notice, please send them to price.review@ofwat.gsi.gov.uk.

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May 2014

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