

Draft determination of Anglian Water's in-period outcome delivery incentives for 2015-16

About this document

This document sets out our draft determination for Anglian Water's in-period Outcome Delivery Incentive (ODI) for 2015-16. ODIs incentivise companies to deliver on the outcomes that matter to customers. The draft determination proposes an increase in Anglian Water's wholesale water price control of £0.515m (2012-13 prices, net of tax) in 2017-18 for one year only.

The change to the wholesale water price control represents the operation of incentives which were an element of our decision at the 2014 price review (PR14). The payments reflect a 1.5% reduction in leakage that Anglian Water delivered in 2015-16.

Responding to this consultation

We welcome your responses to this consultation by close of business on **22 November 2016**. Please email your responses to water2020@ofwat.gsi.gov.uk. You can submit your responses by post to:

In-period ODI draft determination for Anglian Water
Water 2020
Ofwat
Centre City Tower
7 Hill Street
Birmingham, B5 4UA

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished.

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At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons that the contents of those written responses remain confidential.

1. Introduction

This document sets out our draft determination for Anglian Water's in-period Outcome Delivery Incentives (ODIs) for 2015-16.

Outcomes-based regulation was a major innovation at the 2014 price review (PR14). We set the overall framework for outcomes. Water companies¹ engaged with their customers and stakeholders to identify the high level outcomes they value. The outcomes are supported by performance commitments (PCs) which are the pledges companies make to their customers and other stakeholders about their service levels in order to secure the desired outcomes. Companies have reputational and financial incentives to deliver their PCs. The reputational incentive results from companies reporting their performance against their commitments each year. The financial rewards and penalties which apply to PCs are called outcome delivery incentives (ODIs).

ODIs focus companies' attention on delivering the outcomes that matter to customers. They help align the interests of companies and investors with those of their customers. ODIs not only incentivise companies to deliver on their commitments to customers but also to deliver stretching levels of outperformance on the services that matter to customers. By linking companies' revenue to ODIs we took an important step at PR14 towards rebalancing the financial rewards that companies can earn in relation to outperformance on financing costs and total expenditure and those they can earn in relation to delivering their outcomes.

All water companies have ODIs, which were decided on at the 2014 Price Review (PR14). Water companies proposed their ODIs following extensive engagement with their customers and local stakeholders. Each company had a Customer Challenge Group (CCG) which reviewed the companies' engagement with their customers on various issues including their ODIs. We also scrutinised companies' ODIs at PR14 and intervened where necessary to protect customers.

Most financial ODIs will be reconciled at the 2019 price review (PR19). We call these 'end-of-period' ODIs. Any end-of-period ODI financial rewards or penalties will be received by companies and applied to customers' bills in the next control period, 2020-2025². At PR14 three companies proposed ODIs that would be paid within the current price control period of 2015-20. These companies agreed to change their

¹ In this Draft Determination we refer to water and sewerage undertakers, as defined in the Water Industry Act 1991, as water companies for simplicity.

² Where an end-of-period ODI is applied through an adjustment to a company's regulatory capital value (RCV) it can take over 20 years for the full impact of the reward or penalty to be felt on customers' bills.

licences to enable this to happen. We call these “in-period” ODIs as they are applied within the current price control period rather than being reconciled at the end of the price control period.

There are benefits from in-period ODIs. They sharpen incentives on company management to deliver what matters to their customers. With in-period ODIs a company's performance in 2015-16 generates a reward or penalty which has a financial effect on the company in 2017-18. This is much closer in time than a financial effect which takes place in 2020 onwards and is more likely to focus a company's management on delivering for its customers. The sharper incentives should drive a higher level of performance that will set a new benchmark for the next price control period leading to better services for all customers. In-period ODIs are also fairer to customers whose bills reflect more recent service performance.

There is a balance to be struck between linking incentives more closely in time to performance and a smoother path of bill changes year on year which customers tend to prefer. In some cases it might be appropriate to apply the in-period ODIs over several years to smooth bills while still capturing some of the benefits of bringing forward incentive payments closer to the performance that generated them. There are also reasons why end-of-period ODIs might be more appropriate than in-period ODIs, for example, if a company was delivering an investment programme where its success should be judged at the end of the period rather than during it.

Reflecting the benefits of both in-period and end-of-period ODIs the three companies with a licence allowing for in-period ODIs in 2015-20 proposed a package of both in-period and end-of-period ODIs for this price control period. The licence modification enabled the three companies to propose an approach to reconciling their ODIs which reflected their customers' views and which incentivised them appropriately.

1.1 Summary of our draft determination

Anglian Water has one in-period ODI for leakage for the 2015-2020 period, as set out in its PR14 final determination³. Anglian Water's performance commitment on the leakage in-period ODI relates to a three year average of mega litres per day (MI/d) lost to leakage.

For 2015-2016 Anglian Water's leakage was 189 MI/d as against its performance commitment target of 192 MI/d and its reward cap of 191 MI/d. Accordingly, Anglian Water claimed the full net reward on its leakage in-period ODI.

³ See pages 133-135 of [Anglian Water's PR14 final determination company-specific appendix](#)

Payments to the company 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.

We apply the in-period ODIs to companies through adjustments to their wholesale water and wastewater price controls. At the price review we set a limit for each of the following five years on the amount of revenue companies can recover by limiting the percentage change from the previous year. This limit on the percentage change is called 'K'. Companies can also recover an amount for the change in the overall price level in the economy as measured by the Retail Prices Index (RPI). So customers' nominal bills usually change each year by around RPI +/- K. The Ks we determine at the price review reflect the net effect of efficiency improvements and service improvements in areas such as drinking water quality and the environment. In-period ODIs take effect through an adjustment to K, which enables companies to adjust their prices to recover their net reward or requires them to pay their net penalty.

We set out in the following sections the information we required from Anglian Water and the tests we carried out on its in-period ODI claim. The tests we applied related to the quality of the information provided, cross-checks against information from the Annual Performance Report (APR), the quality of the internal and external assurance provided, the bill impacts, past and future expected performance, ambiguities in the definitions of in-period ODIs and any mitigating factors applied.

Following the application of the tests we have no material concerns with the information submitted by Anglian Water and agree with the reward of £0.515m (2012-13 prices, net of tax) requested by the company. The effect of Anglian Water's reward will be an increase of approximately £0.27 to customers' average household water bill for 2017-18 for one year only. To implement this reward our draft determination is that Anglian Water's K factor for 2017-18 should be 1.05%.

The conclusion of our draft determination on Anglian Water's in-period ODI claim for the financial year 2015-16 is in section 3.3. In Annex 1 we set out the details of our draft determination.

2. Our approach to assessing companies' ODIs

Three companies (Anglian Water, Severn Trent Water and South West Water) agreed to licence modifications which provide for in-period ODIs in 2015-20. Their final determination company-specific appendices include in-period ODI(s). The licence allows the company to refer their in-period ODIs to us for determination provided they give notice to us no later than 15 September in any relevant year. We can also initiate the in-period ODI determination process.

According to the terms of the licence:

- companies shall provide the information we reasonably require for making the determination;
- in making the determination we shall consider the company's performance in relation to its in-period ODIs in preceding years and, if relevant, its expected performance in the current and future years (not including the years covered by the next price review);
- we shall have regard to the terms of the in-period ODIs agreed at the price review; and
- we shall not make a determination later than 15 December in any relevant year.

We set out further details of the in-period ODI process in our [Information Notice 16/08](#) in July 2016. In particular, IN 16/08 included the details of the process set out in companies' licences, the information we require from companies for the determination process and the relevant rules in the [PR14 reconciliation rulebook](#) in relation to inflation and tax adjustments to in-period ODIs.

In the Information Notice we required companies to provide information in relation to the reward or penalty payment it considered appropriate for each in-period ODI, its supporting evidence and whether its request differed in any way from the automatic operation of the in-period ODIs and, if it did differ, why that was the case. We also required companies to explain what impact its reward or penalty claim would have on its customers' bills and the engagement it had carried out, or would carry out, with customers and other stakeholders about the bill impact. There were further requirements in relation to submitting completed ODI spreadsheets, K factor models, information on any difference between the claim and the company's APR, any ambiguities in the definitions of the in-period ODIs and any mitigating factors applied. We also required each company to explain what internal and external assurance it had obtained for its in-period ODI claim, including from its CCG.

The in-period ODI to which this draft determination relates was an element of our decision in relation to Anglian Water's PR14 final determination. In making this draft determination, in order to protect customers, we have applied a series of risk-based tests to companies' proposals. In doing so we were able to prioritise our assessment to focus on areas that matter most for customers.

We initially reviewed the companies' submissions at a high level to ascertain whether all the required data was provided and whether sufficient assurance had been carried out. We then carried out a review on each in-period ODI and deep-dives on particular in-period ODIs which were material or where potential issues were identified. As Anglian Water only has one in-period ODI, we applied a deep dive analysis of the entire submission. Throughout our review process we made additional information requests from the companies when required.

The risk based tests we applied to each company when assessing the in-period ODI claims are described below:

Provision of information

We initially applied checks on whether the company had submitted the required information. The required submissions were:

- An explanation of what reward or penalty the company considers appropriate for each in-period ODI including information on assurance, bill impact, past and expected future performance, ODI definition (ambiguity) and mitigating factors.
- Completed ODI spreadsheets from the PR14 reconciliation rulebook.
- Completed versions of our K-factor model for calculating the adjustment to K.

Ofwat's cross-checking calculations

We applied checks to the completed K-factor models and ODI spreadsheets to ensure that these had been correctly completed by the company. We compared the submitted spreadsheets against our own calculations on the PR14 company-specific appendix, rulebook and APR performance information.

Assurance

In the Information Notice we required each company to:

- explain what internal and external assurance it had obtained, including from its CCG, on its in-period ODI claim;
- provide assurance that the information provided was accurate and complete;

- provide assurance on how any ambiguities in the definition of in-period ODI definitions had been interpreted; and
- provide assurance on how the company had applied any mitigating factors.

We assessed the extent of internal and external assurance that the company carried out. The information was cross-checked against the assurance analysis that we had carried out on the company's APR.

Bill impact

In the Information Notice we required each company to explain what impact its reward or penalty claim would have on its customers' bills. We also required the company to explain what engagement it had carried out, or would carry out, with customers and other stakeholders about the bill impact in the context of the overall bill and other changes to the bill e.g. for inflation or the K factor agreed at PR14.

We required each company to explain to us whether it considered that its performance on any of its in-period ODIs in 2015-16 was exceptional in any way and whether this required it to consider measures to smooth bills. Although not expressly mentioned in the Information Notice, a company could also make its own proposals for bill smoothing.

We assessed the information provided by the company on bill impacts and its consideration of bill smoothing. We also reviewed the level of engagement that had been carried out on the bill impact, in proportion to the materiality of the change in customers' bills.

Past and expected future performance

We checked whether the information provided on performance in 2015-16 was in line with what we would expect from a company's past performance and whether future performance was expected to be materially different from the current year. In the event that the company's in-period ODI performance appeared to be exceptional (one-off) we assessed the company's approach to smoothing its bills.

ODI definition (ambiguity)

We asked the company to explain whether there was any ambiguity in the definition of each of its in-period ODIs. This reflects that not all of the details of ODIs definitions are always captured in the final determination company specific appendix. For example, there can be ambiguities about what constitutes a water quality contact or an internal sewer flood if this is not fully defined in the company-specific appendix. We considered whether the company had found any ambiguities in the ODI

definitions, how it had interpreted them and what assurance the company had provided on its interpretation.

Mitigating factors

We checked whether the company had applied any mitigating factors, such as exemptions related to weather, third party actions or exceptional events, to its reported performance for each in-period ODI. We expected a company applying any mitigating factors to justify its reasons for doing so. If a company did apply any mitigating factors we expected those mitigating factors and the way in which they were applied to have been subject to specific assurance.

Deep dives on certain in-period ODIs

In the event that the claim for any specific in-period ODI was material⁴ or where concerns were raised over the initial review of the information provided, we applied a deep dive assessment of the in-period ODI. The deep dive included requests for additional information and an in-depth inspection of the company's calculations and assurance.

⁴ We used as a rule of thumb that the reward or penalty for a specific in-period ODI was material if it was greater than £1m or that it constituted more than 25% of the total rewards or penalties being claimed.

3. Anglian Water's ODIs

Anglian Water has 39 performance commitments of which 22 have financial ODIs attached to them. Only one performance commitment has an in-period ODI for the 2015-20 period.

Table 3.1: Summary of Anglian Water's financial ODIs

	Penalty only		Reward only		Reward and penalty	
	In-period	End-of-period	In-period	End-of-period	In-period	End-of-period
Water	-	6	-	-	1	4
Wastewater	-	4	-	-	-	4
Retail	-	-	-	-	-	3
Total	-	10	-	-	1	11

3.1 Summary of company request for 2015-16

Anglian Water submitted a letter of application, a completed version of the ODI spreadsheet from the PR14 reconciliation rulebook and a completed version of the K-factor model spreadsheet in relation to its sole in-period ODI on leakage reduction.

The letter of application provided a breakdown of the ODI reward claim for leakage, highlighting how the company had outperformed its performance commitment level for 2015-16.

The application included an overview of the assurance that had been carried out on leakage performance by an external assurance provider, within the context of the company's assurance framework. This included confirmation that Anglian Water's Board had approved the final reported leakage figure for 2015-16 at its meeting in May 2016.

A section detailed the engagement undertaken with regard to the impact on customers' bills referencing where the leakage performance had been discussed in the company's annual report. It also referenced meetings that the company had held with its CCG, the Customer Engagement Forum (CEF), as well as scheduled meetings with CCWater. In addition to this, we requested further information on whether the CEF and CCWater supported the application. The details of the response are provided in section 3.2. Further sections were included on exceptional

performance, mitigating factors, ambiguity in ODI definitions and whether there were any differences between the submission and the 2015-16 APR.

Anglian Water stated that it did not regard the performance as exceptional but rather that it was consistent with what they expected as a result of their AMP6 strategy and investment. Anglian Water also stated that it did not consider there was any ambiguity in the definition of its ODI.

As Anglian Water uses a three year average figure for leakage, it already acts as a form of mitigation by smoothing the impact of weather extremes. The company noted that while mild weather contributed favourably to leakage performance in 2015-16, they would still have exceeded the reward cap for leakage in 2015-16 even in a year of average weather. Anglian Water did not apply any mitigation factors, beyond the three year average agreed at the price review, to the claim. In Annex 1 we set out Anglian Water's claim for its in-period ODI for leakage in 2015-16.

3.2 Our Assessment

Provision of information

The K-factor model and the ODI model spreadsheets were completed correctly by Anglian Water, with the exception of one technical query on the ODI model spreadsheet that was resolved. The company provided sufficient information for us to assess its ODI reward claim for leakage.

Ofwat cross-checking calculations

The company's calculations matched our internal calculations based on the information provided in the APR.

Assurance

We found that Anglian Water had provided a sufficient level of assurance with regard to the leakage performance and the methodologies that had been applied in its calculations.

Halcrow, Anglian Water's external assurance provider, undertook three pieces of assurance work around leakage. First, Halcrow reviewed the assessment by Anglian Water of the risks to data quality in its leakage measurement process. Second, Halcrow examined more closely the risks to data quality that had been identified in the first phase as requiring a more detailed review. These audits identified a range of

ongoing activities and initiatives that are expected to reduce the risk of data error in the future.

Halcrow carried out an audit in May 2016 to review the reliability of Anglian Water's year-end reported leakage figure. Halcrow determined that the leakage data provided and reporting procedures used by Anglian Water were accurate and that ongoing activities were in place to improve the data quality in the future.

We consider that the external assurance Anglian Water provided was sufficient to give us confidence that the leakage data provided by Anglian Water was accurate.

We requested further information/evidence from Anglian Water regarding engagement with customers and stakeholders about the bill impact of the in-period ODI claim. Specifically, we requested the minutes from Anglian Water's meetings with its CEF and CCWater.

The company responded with a satisfactory explanation of the feedback/commentary from the meetings. Anglian Water confirmed its in-period ODI claim with its CEF in June 2016 and the CEF did not challenge the claim as it was operating in accordance with the mechanism that had been discussed at length and was an element of Anglian Water's PR14 determination.

At a meeting in September, Anglian Water informed CCWater of the impact of the in-period ODI claim on 2017-18 bills. CCWater acknowledged that the impact of £0.27 for 2017-18 was not significant, but noted that the potential rewards in future years could be more material and suggested that it would be desirable that Anglian Water establish a process to provide customers with more transparency on bill impact in the future. Anglian Water plans to address CCWater's view by improving transparency. We expect Anglian Water to demonstrate it has done so in its future in-period ODI applications.

Bill impact

Anglian Water provided information on the bill impact of its in-period ODI reward claim. It will result in an increase in its average water bill in 2017-18 of £0.27 for one year only. Our PR14 final determination already allows Anglian Water to increase its water bills in 2017-18 by 0.89% (the K factor) and the in-period ODI draft determination increases this to 1.05%. Anglian Water can also increase bills in line with inflation (the change in RPI). The original and revised K-factor figures are also provided in table 3.4.

Bill smoothing

We agree with Anglian Water that there is no need to smooth the impact of the one-year-only £0.27 bill increase. This is because the size of the bill impact is relatively small compared to Anglian Water's average combined bill of £411 in 2016-17. Anglian Water expects to earn further rewards in relation to its leakage in-period ODIs in the rest of the price control period as it pursues its leakage reduction strategy. This means that delaying the £0.27 reward would increase bill volatility rather than smooth bills.

Past and future expected performance

Anglian Water sufficiently justified that its improved performance on leakage was due to the substantial resources it had devoted to leakage reduction. In its PR14 business plan, Anglian Water had set out its intention to achieve a step-change reduction in leakage reflecting the importance attached to this outcome by its customers. The company's improved performance is consistent with its expected glidepath in its AMP6 strategy and the scale of its investment in leakage reduction.

ODI definitions (ambiguity)

Anglian Water stated that it did not consider there was any ambiguity in the definition of its ODI. Anglian Water provided information and assurance about how it had measured leakage and assessed its performance which we have detailed above. We consider that the external assurance Anglian Water provided was sufficient to give us confidence that the leakage data provided by Anglian Water was accurate.

Mitigating factors

The company did not apply any mitigation factors to the claim. The use of a three year average for leakage agreed at the price review for Anglian Water helps mitigate the impact of weather extremes. The company noted that mild weather had contributed favourably to leakage performance in 2015-16, but considered the improved leakage performance would still have exceeded the reward cap in a year of average weather. We agree that Anglian Water has applied no mitigation measures beyond the three year average included in the definition of its in-period ODI.

Deep dive assessments on certain ODIs

As Anglian Water only had one in-period ODI claim we decided to undertake a deep dive analysis, despite the fact that it was a relatively small claim with a modest impact on customers' bills. This analysis included requests for additional information and an in-depth review of company's calculations of its leakage performance and

reward claim. Our deep dive assessment did not reveal any information which suggested Anglian Water's leakage performance was not as it had claimed.

3.3 Our draft determination

This section sets out our draft determination for Anglian Water.

To put the amounts into context, table 3.2 sets out the allowed revenue for Anglian Water's wholesale water price control for the 2015-20 period. This was included in the company's [PR14 final determination company-specific appendix](#) (tables A2.10). The table uses 2012-13 prices which is the basis of ODIs in PR14.

Table 3.2: Anglian Water's wholesale water allowed revenue

Allowed revenue (PR14 FD, £m, 2012-13 prices)	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Wholesale water	411.7	414.8	418.0	421.3	424.4	2090.2

Note: totals may not add up due to rounding

In the tables below we set out the overall in-period ODI draft determination for Anglian Water in £m for wholesale water. The first table uses 2012-13 prices, net of tax, which is the basis of ODIs in PR14. The second table uses 2017-18 prices gross of tax which is the basis for adjustments to the price controls in 2017-18.

Table 3.3: Our draft determination on in-period ODIs for 2015-16 – price control totals

£ million in 2012-13 prices (the base year for PR14), net of tax	Company claim £ million	Ofwat draft determination £ million	Difference £ million
Water	0.515	0.515	0

£ million impact on the price control for 2017-18 (the figures in the table above uprated by inflation and adjusted for tax)	Company claim £ million	Ofwat draft determination £ million	Difference £ million
Water	0.735	0.735	0

Notes

- marginal tax rate = 19%

We have used the K factor models to calculate the adjustment to Anglian Water's wholesale water price limits resulting from the application of its in-period ODI. The revised K number is set out in table 3.4 below.

Table 3.4: Revised K numbers for the charging year beginning 1 April 2017

Wholesale price control	Final determination of price controls⁵	Revised K
Water	0.89 %	1.05 %

This draft determination reflects a 1.5% reduction in leakage that Anglian Water delivered in 2015-16.

In Annex 1 we set out our draft determination on Anglian Water's in-period ODI for leakage for the financial year 2015-16.

⁵ Our formal notification of the determination of price controls for Anglian Water's retail and wholesale activities was published on 12 December 2014. The wholesale K numbers for water are set out in table 1 of the [Formal letter about our determination](#).

Next steps

We welcome responses to this consultation by close of business on **22 November 2016**.

We must make our final determination of Anglian Water's in-period ODIs for 2015-16 no later than 15 December 2016.

Annex 1 Anglian Water's in-period ODIs for 2015-16

In-period ODI	2015-16 target	2015-16 actual	Reward or penalty due £ million	Company claim ⁶ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
W-D4: Leakage - three-year average	192 MI/d	189 MI/d	0.515	0.515	As detailed in Anglian Water's PR14 final determination, the reward for 2015-16 is capped at 1MI/d below the PC of 192MI/d (or at 191MI/d). Applying the incentive rate of £0.515m per MI/d results in a maximum claim of £0.515m.	0.515	0	We propose accepting Anglian Water's in-period ODI reward application.
Total			0.515	0.515		0.515	0	

⁶ The £0.515m figure is in 2012-13 prices, which was the base year for PR14, and net of tax. To calculate the impact on the price control for 2017-18 we uprate the figure by inflation and make an adjustment for tax.

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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