

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

About this document

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

ODIs incentivise companies to deliver on the outcomes that matter to customers. In 2015-16 Severn Trent Water's customers benefited from the company outperforming its stretching performance targets. For example, Severn Trent Water outperformed its category 3 pollution incidents target by 32%, its internal sewer flooding target by 21% and its external sewer flooding target by 7% in 2015-16.

Reflecting the benefits the company has delivered for its customers this draft determination proposes an increase in Severn Trent Water's wholesale price controls of £18.787m (2012-13 prices, net of tax) in 2017-18 for one year only. This consists of a £0.981m reduction in the wholesale water price control and an increase of £19.767m in the wholesale wastewater price control for one year only. Severn Trent Water has voluntarily foregone an additional £1m of revenue it would otherwise have received under the operation of the in-period ODIs. Severn Trent Water's targets become increasingly demanding during this price control period so the company will need to perform even better if it wants to earn a similar net reward next year.

The changes to the wholesale price controls represent the operation of incentives which were an element of our decision at the 2014 price review (PR14).

The company has engaged with its Water Forum¹ and CCWater on the impact of the in-period ODIs on customers' bills and its proposed approach to communicating the impact.

¹ The Water Forum is the name of Severn Trent Water's customer challenge group (CCG)

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 determination for Severn Trent 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this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished.

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 1988 and the Environment Information Regulations 2004.

If you would like the information you have provided to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' with which public authorities must comply and 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, in itself, be regarded as binding on Ofwat.

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 Severn Trent 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 companies² 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 price control period, 2020-25³. At PR14 three companies proposed ODIs that would be paid within the current control period of 2015-20. These companies agreed to change their

² In this Draft Determination we refer to water and sewerage undertakers, as defined in the Water Industry Act 1991, as water companies for simplicity.

³ 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

Severn Trent Water has 15 performance commitments with in-period ODIs for the 2015-20 period, as set out in its [PR14 final determination](#). Of these, 12 have rewards or penalties that are payable as a result of the company's performance during the 2015-16 financial year (1 April 2015 to 31 March 2016). These payments will be made by adjustments to the company's revenue allowance for the financial year 1 April 2017 to 31 March 2018.

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 Severn Trent 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 Severn Trent Water and agree with the overall reward of £18.787 million (2012-13 prices, net of tax) requested by the company. Severn Trent Water has voluntarily foregone an additional £1m of revenue it would otherwise have received under the operation of the in-period ODIs (see section 3.1 below).

The effect of the £18.787m payment is an increase of approximately £6.00 to customers' average combined household bill for one year only in 2017-18. The impact on an average water bill is a decrease of £0.50 and the impact on the average wastewater bill is an increase of £6.50. To implement the rewards and penalties our draft determination is that Severn Trent Water's K factors for 2017-18 should be -0.14% for the water price control and 4.04% for the wastewater price control.

The payments reflect the benefits customers have experienced in 2015-16 of Severn Trent Water outperforming its stretching targets. For example, the company outperformed its category 3 pollution incidents target by 32%, its internal sewer flooding target by 21% and its external sewer flooding target by 7% in 2015-16. Severn Trent Water's targets become increasingly demanding during this price control period so the company will need to perform even better if it wants to earn similar rewards next year.

The conclusions of our draft determination on Severn Trent Water's in-period ODI claim for the financial year 2015-16 are 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 ODIs to which this draft determination relates were an element of our decision in relation to Severn Trent 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. 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 considered 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; and
- Completed **K factor models** for calculating the adjustment to K.

Ofwat's cross-checking calculations

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

Assurance

In the Information Notice we required each company to:

- explain what internal and external assurance it had obtained, including from its Customer Challenge Group (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 considered 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 ODI 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 if it constituted more than 25% of the total rewards or penalties being claimed.

3. Severn Trent Water's ODIs

Severn Trent Water has 45 performance commitments of which 33 have financial ODIs attached to them. There are 15 performance commitments with in-period ODIs attached for the 2015-20 period.

Severn Trent Water set their performance commitments and incentives following extensive engagement with their customers through focus groups, surveys and meetings. The Water Forum, containing customer groups and local stakeholders, then challenged companies' proposals. We also scrutinised companies' performance commitments and incentives to make sure they were appropriately stretching over time.

Table 3.1: Summary of Severn Trent 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	1	8	-	-	9	2
Wastewater	-	2	-	1	5	4
Retail	-	-	-	-	-	1
Total	1	10	-	1	14	7

3.1 Summary of Severn Trent Water's request for 2015-16

Severn Trent Water submitted a request on or before 15 September 2016 for us to determine its in-period ODIs for its performance in the financial year 2015-16.

Severn Trent Water submitted as part of its application, completed versions of the ODI spreadsheet from the PR14 reconciliation rulebook and completed versions of the K factor model spreadsheet by the deadline of 15 September required by the licence.

The application provided a breakdown of the ODI reward and penalty claims, highlighting how the company had performed against its performance commitment levels for 2015-16 (these are included in appendix 1).

The application included information on:

- The extent of outperformance and underperformance and the associated rewards and penalties that are payable;
- The impact on customers' bills;
- Customer engagement;
- Data assurance; and
- Water Forum engagement.

The information contained in the application supplemented the performance and assurance documents published on the [Severn Trent Water website](#):

- Annual Performance Report – 2015/6 (July 2016);
- Annual Performance Report – 2015/6: a summary for customers (July 2016);
- Statement of risks, strengths and weaknesses and draft assurance plan 2015/16 (November 2015);
- Final assurance plan for 2015/16 (February 2016); and
- Assurance summary for 2015/16 (July 2016).

In addition, Severn Trent Water had provided us with the following supporting information during the 2015-16 financial year:

- Leakage calculation, reporting and assurance processes (November 2015);
- Update on the assurance of the company's wholesale performance commitments (March 2016); and
- Minutes of the Water Forum meetings and conference calls from February 2015 to June 2016.

Severn Trent Water stated that, overall, operating conditions within the year were considered to be benign. They were not considered exceptional and were within the range of conditions expected when the performance commitments and ODIs were designed. Therefore, the company has not applied any adjustments to the calculated incentives based on external factors.

The company identified the potential for ambiguity in measurement against two of its in-period ODIs:

- W-E1: Size of our carbon footprint (water); and
- S-D1: Size of our carbon footprint (wastewater).

This matters because any ambiguity in the definition of in-period ODIs means there is scope for the company to interpret that ambiguity which can affect its reported performance. Our assessment of the company's approach to ambiguity in the definitions of these two in-period ODIs is included in section 3.2.

With the exception of the rewards earned for leakage (W-B2) and the number of customer minutes lost (W-B4) Severn Trent Water applied for the full value of the reward/penalty to be taken into account in this draft determination. The reasons for these exceptions are explained below.

In Annex 1 we set out Severn Trent Water's claim for each in-period ODI for 2015-16.

Forgoing rewards on two in-period ODIs

For two of Severn Trent Water's ODIs there is a difference between the reward due on the performance figures provided and the actual amount that the company is claiming. These are set out below:

W-B2: Leakage

Severn Trent Water has reported a reduction in leakage levels of 10MI/day. 9MI/day of this reduction was driven by 'real' improvements – where the company has actively invested to reduce the volume of water leaking from the network. This includes, for example, fixing bursts, managing pressure in the network and proactive maintenance of the network. The remainder reflects methodological and data changes.

The company had identified leakage as an area needing particular focus in its assurance plans. It undertook its own review and also asked its independent technical assurers, Jacobs Consulting, to carry out a 'deep dive' review. This review found that there was a minor error in the calculation of the 2014/15 reported level of leakage. As a consequence the 2014/15 reported level of leakage was revised to 444 MI/day; an increase of 3 MI/day.

The level of outperformance the company is seeking to be applied to customer charges only reflects the real improvements reported. That is, the company is not applying for the portion of outperformance earned as a consequence of improvements in the way that they measure leakage (£0.123 million).

W-B4: The number of minutes customers go without supply each year

The company is forgoing the reward due on this performance commitment (£0.913 million) in recognition of a small number of larger impact, single incidents which

affected its customers in 2015-16. The company stated: “At the close of the financial year, a drinking water quality incident at our Castle Donington reservoir affected 3,700 properties in Derbyshire and Leicestershire, the majority of which were able to use their water supply again within 24 hours. [...] We recognise that this event, and a significant supply interruption in Nottingham in February 2016 impacting over 7,000 customers, may have affected how our broader customer base perceives our service. [...] In recognition of this, we have chosen to forego the reward of £0.9m we earned for reducing supply interruptions and will not be seeking for this to be reflected in bills during 2017/18.”

3.2 Our Assessment

Provision of information

The K factor models and the ODI spreadsheets were completed correctly by Severn Trent Water, with the exception of one minor technical query on the ODI model spreadsheet that was resolved. The company provided sufficient information for us to assess its ODI reward and penalty claims.

Ofwat cross-checking calculations

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

Assurance

Within the in-period ODI application the company summarised the assurance it had undertaken and the outcome of the independent technical assurance on performance commitments that was provided by Jacobs. This information supplemented the company's [Assurance summary for 2015/16](#) published in July 2016.

Jacobs' assurance process used a staged approach and was completed before any internal sign-off of data by Severn Trent Water. Stage one focussed on process and included both desktop reviews and face-to-face interviews. Stage two focussed on the data produced and associated commentaries; audits were carried out in person with the responsible data owners.

Stage one and stage two reviews of all 45 performance commitments were carried out at both half and full year. During the stage one and stage two reviews undertaken halfway through the 2015-16 financial year (October 2015), two areas of risk associated with performance commitments with in-period ODIs were identified – these are summarised below. In both areas more targeted assurance was undertaken before the financial year end.

- **Categorisation of drinking water quality complaints** - Jacobs' half year review highlighted concerns about the quality of the company's input data, particularly the categorisation of complaints. Severn Trent Water completed data checks of over 16,000 records which indicated an error rate of less than 1%. The company amended its reporting processes to ensure there was greater quality assurance embedded prior to the financial year end.
- **Sewer flooding** - Jacobs' assurance highlighted a potential weakness with the way the company was allocating sewer flooding incidents to private assets (those not owned by Severn Trent Water) and excluded from the company's performance reporting. A further internal review found that overall the company's processes were robust. However, in a number of cases (less than 5%), incidents that had been recorded as something other than flooding were retrospectively reviewed and changed to a flooding incident on the basis of evidence collected. The full dataset of cases for 2015-16 was reviewed in time for year-end reporting. The company's reporting processes are being revised for 2016-17.

We consider that Severn Trent Water has provided sufficient evidence on its level of assurance with regard to its performance and the methodologies that it has applied in its calculations.

During the course of the year Severn Trent Water engaged with its Water Forum about its assurance plan (and the outcome of that assurance); where there was potential ambiguity in the measurement of its in-period ODIs and its proposed resolution; its half year ODI performance; and its full year ODI performance.

We requested the draft minutes of Severn Trent Water's most recent meeting with the Water Forum on 12 September 2016. At this meeting, the Forum was provided with a draft of the company's in-period ODI submission. The Water Forum did not raise an objection to Severn Trent Water's submission at the meeting.

The company explained the engagement it had carried out with the Consumer Council for Water (CCWater). Severn Trent Water stated that during the discussions CCWater raised some concerns about the scale of the rewards earned for outperformance, but noted that the ODIs have operated in line with the PR14 final determination.

CCWater also challenged the company to demonstrate how it would communicate the impact of ODIs on customers' bills. Severn Trent Water explained the key elements of its approach to engaging with customers about service performance and resulting ODI performance. In summary, these are:

- understanding customers' views;

- transparency about performance and the potential bill impact;
- seeking to better understand what and how to communicate;
- communication at 'main billing'; and
- managing incidence effects on customers groups.

We consider that Severn Trent Water has provided sufficient evidence that it has engaged with its Water Forum and CCWater on the impact of the in-period ODIs on customers' bills and its proposed approach to communicating the impact.

Bill impact

Severn Trent Water has stated that the indicative bill impact from ODIs for household customers is likely to be an increase of £6.50 for wastewater services and a decrease of £0.50 for water services. This is for one year only in 2017-18.

Since its ODI submission on 15 September 2016 the company has been preparing indicative wholesale charges for 2017-18. It will be finalising the bill impacts in December and publishing these in January 2017.

We found that the company had provided sufficient explanation and assurance of the bill impacts of its in-period ODIs application.

Bill smoothing

The company's ODI submission did not propose any measures to smooth bills over more than one year. We asked the company to explain whether it had considered such measures. And if it had considered bill smoothing measures, we asked it to explain what measures had been considered and whether these were tested with Water Forum members or other stakeholders.

The company responded that, in relation to in-period ODI performance, it did not consider there was a need to smooth the £6.50 impact on wastewater bills. This is because:

- the impact of ODIs on bills is limited (that is, less than 2% on the average combined bill); and
- smoothing is likely to defer the impact from 2017-18 to later years of the price control period given that the company is aiming to deliver higher service levels each year.

The company also responded that smoothing the in-period ODI impact would undermine the principle of in-period service incentives and could negatively impact on customers. This is because in-period ODIs create a stronger and more immediate

link between service performance and returns. Accordingly water companies' face stronger pressure to deliver higher service levels where customers value it most.

Our assessment is that it is appropriate for Severn Trent Water not to smooth the impact of its net reward for its wastewater in-period ODIs. Severn Trent Water is expecting to deliver stretching levels of outperformance in future years of this price control period. This would mean that delaying the 2017-18 bill impact would lead to less smooth bills throughout the 2015-20 period than if the whole reward was applied to 2017-18 bills. Applying the reward in 2017-18 also means that customers experience the benefits of the service improvements and pay for them more closely in time than if the reward was delayed. The Water Forum did not raise an objection to Severn Trent Water's approach of taking the reward in 2017-18.

Past and expected future performance

We checked whether the information provided on 2015-16 performance was in line with what we would expect from the company's past performance and whether future performance was expected to be materially different from the current year. In its [Annual Performance Report 2015-16](#) Severn Trent Water has explained the reasons for any underperformance and over performance.

Our assessment is that there are no examples of exceptional, 'one-off', performance which might warrant further investigation or further consideration of bill smoothing.

ODI definition (ambiguity)

The company identified the potential for ambiguity in measurement against two of its in-period ODIs (W-E1 and S-D1: carbon footprint). The ambiguity in measurement relates to the use of Global Warming Potential factors. Specifically, the factors have been revised by the Intergovernmental Panel on Climate Change (IPCC). Severn Trent Water is proposing to retain the same basis as it used in the 2014 final determination.

We consider this to be an appropriate approach. We support the company using a definition consistent with its final determination company-specific appendix. Severn Trent Water's approach reflects our policy in relation to requests for changes to outcomes, performance commitments (PCs) and outcome delivery incentives (ODIs). In the [Information Notice 16/07](#) ('Changes to outcomes in the 2014 price review company-specific appendices') we stated: "The PR14 final determination definition of a PC and ODI remains the default position we will use for reconciling 2015-20 performance at PR19" unless a company could satisfy us that it had met the demanding steps in that Information Notice for making a change to its PC and/or ODI.

Mitigating factors

Severn Trent Water has confirmed that for each ODI it has reported performance in accordance with the definitions in the PR14 final determination company-specific appendix. It has not applied any mitigating factors to its performance.

The only exceptions the company has applied to the translation of its performance into financial payments under its in-period ODIs are:

- for leakage (W-B2) it is not applying for the portion of outperformance associated with improving data; and
- for supply interruptions (W-B4) it is forgoing the full extent of outperformance earned in recognition of a small number of large impact, single incidents which affected a small proportion of customers.

In neither of the above cases is Severn Trent Water applying mitigating factors to its performance.

Deep dives on certain in-period ODIs

As this is the first year that Severn Trent Water is reporting performance in relation to its in-period ODIs we undertook a deep dive analysis on the performance of its ODIs with material⁵ rewards and penalties. We also carried out a further analysis on the company's other rewards and penalties.

This analysis included further requests for additional information and in-depth review of the company's calculations and its submissions in relation to: assurance, mitigation and ambiguity.

We did not find any errors or areas of concern during our in-depth analysis.

3.3 Our draft determination

This section sets out our draft determination for Severn Trent Water.

To put the amounts into context, table 3.2 sets out the allowed revenue for Severn Trent Water's wholesale water and wastewater price controls for the 2015-20 period. This was included in the company's [PR14 final determination company-specific appendix](#) (tables A2.10 and A3.9). The table uses 2012-13 prices which is the basis of ODIs in PR14.

⁵ 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 if it constituted more than 25% of the total rewards or penalties being claimed.

Table 3.2: Severn Trent Water's wholesale water and wastewater allowed revenue

Allowed revenue (PR14 FD, £m, 2012-13 prices)	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Wholesale water	620.7	620.3	620.0	619.7	619.3	3,100.0
Wholesale wastewater	661.0	662.8	664.6	666.4	668.2	3,322.8

Note: totals may not add because of rounding

In table 3.3 below we set out our provisional conclusions on the overall in-period ODI determination for Severn Trent Water in £m for water and wastewater.

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

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.

£ million in 2012-13 prices (the base year for PR14), net of tax	Company claim £ million	Ofwat draft determination £ million	Difference £ million
Water	-0.981	-0.981	0
Wastewater	19.767	19.767	0
Total	18.787	18.787	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	-1.341	-1.341	0
Wastewater	27.034	27.034	0
Total	25.693	25.693	0

Notes

- totals may not add because of rounding
- marginal tax rate = 19%

We have used the K factor models to calculate the adjustment to Severn Trent Water's wholesale price limits resulting from the application of in-period ODIs. The revised K numbers are 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 controls ⁶	Revised K
Water	0.05%	-0.14%
Wastewater	0.37%	4.04%

This draft determination reflect the benefits customers have experienced in 2015-16 of Severn Trent Water outperforming its stretching targets. For example, the company outperformed its category 3 pollution incidents target by 32%, its internal sewer flooding target by 21% and its external sewer flooding target by 7% in 2015-16. Severn Trent Water's targets become increasingly demanding during this price control period so the company will need to perform even better if it wants to earn similar rewards next year.

In Annex 1 we set out our draft determination on each of Severn Trent Water's in-period ODIs for the financial year 2015-16.

⁶ Our formal notification of the determination of price controls for Severn Trent Water's retail and wholesale activities was published on 12 December 2014. The wholesale K numbers are set out in tables 1 and 2 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 Severn Trent Water's in-period ODIs for 2015-16 no later than 15 December 2016.

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

In-period ODI	2015-16 target (CPL ⁷)	2015-16 actual	Reward or penalty due £ million	Company claim ⁸ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
W-A1: Complaints about drinking water quality	11,900	13,941	-1.837	-1.837	Unit of measurement = number of water quality complaints Committed performance level = 11,900 Actual performance level = 13,941 Penalty rate = £0.0009 million Penalty = (13,941 – 11,900) * 0.0009 = -£1.837 million	-1.837	0	We propose accepting Severn Trent Water's net penalty application and the company's penalty calculation
W-A2: Compliance with drinking water quality standards	99.970%	99.962%	-	-	Unit of measurement = Mean zonal compliance (%) Committed performance level = 99.970% Actual performance level = 99.962% Penalty collar = 99.910 Penalty deadband = 99.945 Actual performance is within the penalty deadband and therefore no penalty is due	-	-	We confirm that actual performance is within the penalty deadband and therefore no penalty is payable

⁷ CPL = committed performance level

⁸ The £ million figures are 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 update the figure by inflation and make an adjustment for tax.

In-period ODI	2015-16 target (CPL ⁷)	2015-16 actual	Reward or penalty due £ million	Company claim ⁸ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
W-A4: Successful catchment management schemes	-	0	-	-	<p>Unit of measurement = number of catchment management schemes</p> <p>Actual performance level = 0</p> <p>The Severn Trent Water PR14 final determination company-specific appendix (pages 159-160) states that the reward or penalty is to be applied after assessment of performance to 2018-19 – however, payment may be made earlier if the total number of schemes shown to be successful is above the target at an earlier date.</p> <p>The target is 12 successful schemes by the end of the 2018-19 financial year (31 March 2019)</p>	-	-	Our view is that no reward or penalty is payable for 2015-16

In-period ODI	2015-16 target (CPL ⁷)	2015-16 actual	Reward or penalty due £ million	Company claim ⁸ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
W-B2: Leakage	444 MI/d	434 MI/d	1.230	1.107	<p>Unit of measurement = megalitres per day (MI/d)</p> <p>Committed performance level = 444</p> <p>Actual performance level = 434</p> <p>Reward rate = £0.123 million</p> <p>Reward = $(444 - 434) * 0.123$ $= 10 * 0.123 = £1.230$ million</p> <p>The company is not applying for the portion of outperformance (10%) earned as a consequence of improvements in the way that they measure leakage</p> <p>Reward = $1.230 - 0.123$ $= £1.107$ million</p>	1.107	0	<p>We propose accepting Severn Trent Water's net reward application and the company's reward calculation.</p> <p>Based on the company's actual performance level the maximum reward due is £1.23 million. However, it is not applying for the portion of outperformance (10%) earned as a consequence of improvements in the way that leakage is measured. We therefore propose accepting the company's application for 90% of the £1.23 million reward</p>

In-period ODI	2015-16 target (CPL ⁷)	2015-16 actual	Reward or penalty due £ million	Company claim ⁸ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
W-B3: Speed of response in repairing leaks (% visible leaks fixed within 24 hours)	70%	53%	-0.173	-0.173	Unit of measurement = % visible leaks fixed within 24 hours Committed performance level = 70% Actual performance level = 53% Penalty deadband = 60 Penalty rate = £0.024663 million Penalty = (60 - 53) * 0.024663 = 7 * 0.024663 = £0.173 million	-0.173	0	We propose accepting Severn Trent Water's net penalty application and the company's penalty calculation
W-B4: Minutes customers go without supply each year	13.60	11.17	0.913	0.00	The company is forgoing the reward that is due on this performance commitment	0.00	0	We propose accepting Severn Trent Water's decision to forgo the full extent of outperformance earned (£0.913 million reward) in recognition of a small number of larger impact, single incidents which affected its customers in 2015-16

In-period ODI	2015-16 target (CPL ⁷)	2015-16 actual	Reward or penalty due £ million	Company claim ⁸ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
W-B7: Customers at risk of low pressure	250	162	0.070	0.070	Unit of measurement = number of customers at risk of low pressure Committed performance level = 250 Actual performance level = 162 Reward rate = £0.00079 million Reward = (250 - 162) * 0.00079 = 88 * 0.00079 = £0.06952 million	0.070	0	We propose accepting Severn Trent Water's net reward application and the company's reward calculation
W-B8: Restrictions on water use	0	0	-	-	Unit of measurement = number of water restrictions in the five-years 2015-20 No reward or penalty is payable for 2015-16. This performance commitment measures the number of water restrictions in place on customers in a five-year period. The five-year penalty is to apply in full in the year after a water restriction is applied.	-	-	Our view is that no reward or penalty is payable for 2015-16

In-period ODI	2015-16 target (CPL ⁷)	2015-16 actual	Reward or penalty due £ million	Company claim ⁸ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
W-C1: Customers rating our services as good value for money (water) ⁹	47%	58%	0.125	0.125	Unit of measurement = % of customers rating Severn Trent Water's services as good or very good value for money, as measured by its quarterly Customer Satisfaction Survey Committed performance level = 47 Actual performance level = 58 Reward deadband = 57 Reward rate = £0.125 million Reward = (58 - 57) * 0.125 = 1 * 0.125 = £0.125 million	0.125	0	We propose accepting Severn Trent Water's net reward application and the company's reward calculation
W-E1: Carbon footprint (water)	228.000 ktCO ₂ e	246.632 ktCO ₂ e	-0.273	-0.273	Unit of measurement = ktCO ₂ e (thousand tonnes of carbon dioxide equivalent) Committed performance level = 228.000 Actual performance level = 246.632 Penalty rate = £0.01463 million Penalty = (246.632 - 228.000) * 0.01463 = 18.632 * 0.01463 = £0.273 million	-0.273	0	We propose accepting Severn Trent Water's net penalty application and the company's penalty calculation

⁹ Rewards and penalties for the 'Customers rating our services as good value for money' performance commitment are divided equally between the water and wastewater price controls.

In-period ODI	2015-16 target (CPL ⁷)	2015-16 actual	Reward or penalty due £ million	Company claim ⁸ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
S-A1: Internal sewer flooding incidents	1,014	804	8.992	8.992	Unit of measurement = number of internal sewer flooding incidents Committed performance level = 1,014 Actual performance level = 804 Reward rate = £0.04282 million Reward = (1,014 - 804) * 0.04282 = 210 * 0.04282 = £8.992 million	8.992	0	We propose accepting Severn Trent Water's net reward application and the company's reward calculation
S-A2: External sewer flooding incidents	7,639	7,142	6.131	6.131	Unit of measurement = number of external sewer flooding incidents Committed performance level = 7,639 Actual performance level = 7,142 Reward deadband = 7,452 Reward rate = £0.019779 million Reward = (7,452 - 7,142) * 0.019779 = 310 * 0.019779 = £6.131 million	6.131	0	We propose accepting Severn Trent Water's net reward application and the company's reward calculation

In-period ODI	2015-16 target (CPL ⁷)	2015-16 actual	Reward or penalty due £ million	Company claim ⁸ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
S-B1: Customers rating our services as good value for money (wastewater) ¹⁰	47%	58%	0.125	0.125	Unit of measurement = % of customers rating Severn Trent Water's services as good or very good value for money, as measured by its quarterly Customer Satisfaction Survey Committed performance level = 47 Actual performance level = 58 Reward deadband = 57 Reward rate = £0.125m Reward = (58 - 57) * 0.125 = 1 * 0.125 = £0.125 million	0.125	0	We propose accepting Severn Trent Water's net reward application and the company's reward calculation
S-C2: Category 3 pollution incidents	429	293	4.366	4.366	Unit of measurement = number of category 3 pollution incidents Committed performance level = 429 Actual performance level = 293 Reward deadband = 374 Reward rate = £0.0539 million Reward = (374 - 293) * 0.0539 = 81 * 0.0539 = £4.366 million	4.366	0	We propose accepting Severn Trent Water's net reward application and the company's reward calculation

¹⁰ Rewards and penalties for the 'Customers rating our services as good value for money' performance commitment are divided equally between the water and wastewater price controls.

In-period ODI	2015-16 target (CPL ⁷)	2015-16 actual	Reward or penalty due £ million	Company claim ⁸ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
S-D1: Carbon footprint (wastewater)	248.000 ktCO ₂ e	237.564 ktCO ₂ e	0.153	0.153	Unit of measurement = ktCO ₂ e (thousand tonnes of carbon dioxide equivalent) Committed performance level = 248.000 Actual performance level = 237.564 Reward rate = £0.01463 million Reward = (248.000 - 237.564) * 0.01463 = 10.436 * 0.01463 = £0.153 million	0.153	0	We propose accepting Severn Trent Water's net reward application and the company's reward calculation
Total			19.823	18.787		18.787	0	

Price control totals

Price control	Reward or penalty due £ million	Company claim ¹¹ £ million	Ofwat draft determination £ million	Difference £ million
Water	0.055	-0.981	-0.981	0
Wastewater	19.767	19.767	19.767	0
Total	19.823	18.787	18.787	0

Note: totals may not add because of rounding

¹¹ The £ million figures are 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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