

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

About this document

This document sets out our decision on opening a determination and our draft determination for South West Water's in-period Outcome Delivery Incentives (ODIs) for 2015-16. ODIs incentivise companies to deliver on the outcomes that matter to customers.

South West Water did not request a determination for 2015-16, in part because it considered a net penalty of only £0.11 million was due. On reviewing South West Water's supporting information we identified that South West Water had wrongly classified its water restrictions placed on customers ODI reward of £1.624 million as being in-period when it should have been accrued for the end of the price control period. We have decided to make an in-period ODI determination for the reasons detailed in this draft determination, including that there was a material error in the information South West Water provided to us and because it allows us to consider the issues and ensure a full and transparent discussion of them with stakeholders.

Our provisional view is that during 2015-16 South West Water incurred a net penalty of £1.873 million (2012-13 prices, net of tax) in wastewater. The penalty is mainly due to the company missing its target on category 1 and 2 wastewater pollution incidents by 7 incidents. Our provisional view is that during 2015-16 South West Water earned a small net reward of £0.141 million in water. This leads to an overall net penalty of £1.731 million. South West Water has also provisionally accrued a net reward on its end-of-period ODIs of £3.56 million.

We have determined that a penalty is due for South West Water's in-period ODIs. However, we are minded to accept South West Water's proposal not to apply the penalty in 2017-18. In South West Water's specific case the in-period ODIs need to be seen in the context of its WaterShare framework which involves the company publishing a scorecard on an annual basis that summarises its performance, including on in-period ODIs, and allows for the sharing of net benefits with customers in a timely manner. The framework includes the WaterShare panel, which is an independent body that the company set up to provide independent challenge and assurance that customers are legitimately and fairly sharing in company performance on a timely basis.

As part of its WaterShare framework, South West Water is returning £3.1m of outperformance to customers by reinvesting to improve services. The Chair and Deputy Chair of the independent WaterShare panel support South West Water's proposal that the £1.731 million in-period ODIs penalty is deferred to the 2019 price

review to offset rewards that South West Water has already accrued (£3.56m), which will be applied at the 2019 price review, in order to smooth bills.

We will consider next year whether we should make a determination and, if we do, when the penalty due for 2015-16 performance should be applied taking into account all relevant circumstances at the time, including whether South West Water has improved its performance on category 1 and 2 wastewater pollution incidents. We are also minded to accept South West Water's proposal that the penalty will be adjusted for inflation and interest if it is applied at the 2019 price review and we would make similar adjustments if we applied the penalty after 2017-18, but before the 2019 price review, in any future determination.

We therefore propose not to make any adjustment to the levels of South West Water's wholesale Price Controls, as determined at PR14, for 2017-18. Instead we will consider next year whether we should make a determination and, if we do, when the penalty due for 2015-16 performance should be applied, taking into account all relevant circumstances at the time.

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 South West 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 South West 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 incentivise companies to deliver on the outcomes that matter to customers.

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

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.

current price control period of 2015-20. These companies agreed to change their 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 decision to carry out a determination and of our draft determination

South West Water has 11 performance commitments with in-period ODIs for the 2015-20 period, as set out in their PR14 final determination. Of these, 4 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).

Payments can take the form of:

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

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 South West 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.

South West Water wrote to us on 15 September to inform us that the company would not be requesting a determination for 2015-16 for a net penalty of £0.11 million, but would use the net penalty to offset future rewards of £1.94 million that they had provisionally accrued through its end-of-period ODIs. We reviewed South West Water's request and supporting information. We identified that South West Water had wrongly classified its water restrictions placed on customers ODI reward of £1.624 million as being in-period. This means that South West Water has incurred a net in-period penalty of £1.731 million for 2015-16 and provisionally accrued a higher end-of-period reward of £3.56 million. The net penalty is mainly accounted for by a £1.730 million penalty for poor performance in relation to its ODI concerning category 1 and 2 wastewater pollution incidents.

We have decided to make an in-period ODI determination for the reasons detailed in this draft determination, including that there was a material error in the information South West Water provided to us and because it allows us to consider the issues and ensure a full and transparent discussion of them with stakeholders.

Our provisional view is that during 2015-16 South West Water incurred a net penalty of £1.873 million in wastewater (resulting in an indicative bill reduction of £2 on the average household wastewater bill for one year only if it was applied in 2017-18). The penalty is mainly due to the company missing its target on category 1 and 2 wastewater pollution incidents by 7 incidents. Our provisional view is that during 2015-16 South West Water earned a small net reward of £0.141 million in water (resulting in no noticeable effect on the average household water bill if it was applied in 2017-18). This leads to an overall net penalty of £1.731 million (resulting in an indicative bill reduction of £2 on the average combined water and wastewater household bill for one year only if it was applied in 2017-18). South West Water has also provisionally accrued a net reward on its end-of-period ODIs of £3.56 million.

We have determined that a penalty is due for South West Water's in-period ODIs. However, we are minded to accept South West Water's proposal not to apply the penalty in 2017-18. In South West Water's specific case the in-period ODIs need to be seen in the context of its WaterShare framework³ which involves the company publishing a scorecard on an annual basis that summarises its performance, including on in-period ODIs, and allows for the sharing of net benefits with customers in a timely manner. The framework includes the WaterShare panel, which is an independent body that the company set up to provide independent challenge and assurance that customers are legitimately and fairly sharing in company performance on a timely basis.

As part of its WaterShare framework, South West Water is returning £3.1m of outperformance to customers by reinvesting to improve services. The Chair and Deputy Chair of the independent WaterShare panel⁴ support South West Water's proposal that the £1.731 million in-period ODIs penalty is deferred to the 2019 price review to offset rewards that South West Water has already accrued (£3.56 m), which will be applied at the 2019 price review, in order to smooth bills.

We will consider next year whether we should make a determination and, if we do, when the penalty due for 2015-16 performance should be applied taking into account all relevant circumstances at the time, including whether South West Water has improved its performance on category 1 and 2 wastewater pollution incidents. We are also minded to accept South West Water's proposal that the penalty will be adjusted for inflation and interest if it is applied at the 2019 price review and we

³ South West Water's final determination company specific appendix refers to in-period ODIs operating in the context of its WaterShare mechanism.

⁴ As well as the Chair and Deputy Chair of the WaterShare panel, the Deputy Chair of the PR14 WaterFuture Customer Panel, who is a member of the WaterShare panel, also agreed the in-period ODI penalty should be deferred to the 2019 price review.

would make similar adjustments if we applied the penalty after 2017-18, but before the 2019 price review, in any future determination.

We therefore propose not to make any adjustment to the levels of South West Water's wholesale Price Controls, as determined at PR14, for 2017-18. Instead we will consider next year whether we should make a determination and, if we do, when the penalty due for 2015-16 performance should be applied, taking into account all relevant circumstances at the time.

In Annex 1 we set out the detail of our draft determination for each in-period ODI claim for the financial year 2015-16.

2. Initiating an in-period ODI determination

South West Water wrote to us on 15 September to inform us that the company would not be requesting a determination for 2015-16 for a net penalty of £0.11 million, but would use the net penalty to offset future rewards of £1.94 million that it had provisionally accrued through its end-of-period ODIs.

We reviewed South West Water's request and supporting information. We identified that South West Water had wrongly classified its water restrictions placed on customers ODI reward of £1.624 million as being in-period. This means that South West Water has incurred a net in-period penalty of £1.731 million for 2015-16 rather than the £0.11 million in South West Water's letter of 15 September.

Our default position is that we will initiate an in-period ODI determination for a company that has not requested one unless there are good reasons not to open the determination. We considered carefully whether there was a case for not opening an in-period ODI determination in this case, based on:

- the quality of information and assurance provided;
- the WaterShare panel's views;
- customer benefits; and
- achieving the policy objectives of in-period ODIs.

Conclusion on initiating an in-period ODI determination for South West Water

We have decided to make an in-period ODI determination for the following reasons:

1. By opening an in-period ODI determination we can consider the issues and ensure full and transparent discussion of them with stakeholders through consultation on a draft in-period ODI determination.
2. There was a material error in the information South West Water provided to us, which raised some concerns over the company's assurance and customer engagement on the original submission. We therefore required further supporting evidence to address these concerns.
3. We consider that making a determination is consistent with the policy objectives of in-period ODIs. The determination process allows us to properly consider the merits of South West Water's novel request to offset its in-period penalty against other considerations in order to achieve bill smoothing for customers.

4. If we did not make a determination we would not have the option of deciding that South West Water should pay its in-period penalty in 2017-18, nor could we fix the amount of such penalty for future reference whether or not it is applied to 2017-18 or applied in the future.
5. There could be benefits to South West Water customers of the company incurring in-period ODI penalties for its poor performance on pollution incidents. The poor performance by South West Water in regard to pollution incidents is a serious issue and in-period penalties might encourage South West Water to improve its pollution incidents performance which is to the benefit of customers.

3. 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 South West 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 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 cross-checking calculations

We applied checks to the completed K-factor model and ODI model spreadsheets to ensure that these had been correctly completed by the company. We compared the submitted spreadsheets against our own calculations on the 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 applied checks on 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 material⁵ 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.

Other relevant factors

We assessed South West Water's in-period ODI performance within the context of the overall 'WaterShare' framework. This framework, which is unique to South West Water, was setup to allow for the sharing of net benefits for its customers in a timely fashion. The framework operates at the appointee level and takes account of the company overall position in relation to gains and losses against the final determination before returning benefits to customers (further details on the WaterShare Framework and what our PR14 final determination company specific appendix states in relation to the framework are set out in section 4.2 below).

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.

4. Company ODIs

South West Water has 42 performance commitments of which 25 have financial ODIs attached to them. There are 11 performance commitments with in-period ODIs attached for the 2015-20 period.

Table 4.1: Summary of South West Water's financial ODIs

	Penalty only		Reward and penalty	
	In-period	End-of-period	In-period	End-of-period
Water	3	4	4 ⁶	2
Wastewater	3	3	1	4
Retail	-	-	-	1
Total	6	7	5	7

4.1 Summary of company request for 2015-16

South West Water informed us that they would not be requesting a determination for 2015-16 for a net penalty of £0.11 million. South West Water provided the following reasons:

- The £0.11 million in-period ODI penalty is much smaller than the £1.94 million reward it has accrued on its end-of-period ODIs. South West Water will use the £0.11 million penalty to offset future rewards, allowing it to smooth bills.
- The £0.11 million penalty translates into only 12 pence off customer bills for 2017-18 (one year effect only).
- Separately, South West Water is returning £3.1 million to its customers through its WaterShare framework⁷ (resulting from other items including its outperformance on the cost of debt). After engagement with the WaterShare Panel South West Water has opted to reinvest the £3.1 million to improve services for customers. The panel considered that it was too early to return

⁶ The ODI for 'water restrictions placed on customers' allows for penalties to be paid annually. Rewards accumulate annually but are only paid at the end of the period if South West Water has not applied any water restrictions measures during the course of the price control period (2015 to 2020).

⁷ South West Water's WaterShare framework involves the company publishing a scorecard on an annual basis that summarises its performance on the totex incentives, ODIs and other items such as debt outperformance and allows for the sharing of net benefits with customers in a timely manner.

revenue to customers as it could lead to bill volatility later on in the period and that this was in line with customer research.

- South West Water notes that the aim of the in-period ODIs is to encourage companies to improve their performance. The main penalty the company incurred during the year related to category 1 and 2 wastewater pollution incidents. South West Water has put an improvement plan in place to improve its performance in this area. This plan has been reviewed and discussed with its WaterShare panel.

We have provided details of South West Water's in-period rewards and penalties that relate to their net penalty of £0.11 million in Annex 1.

4.2 Our Assessment

As South West Water did not request a determination it only provided limited supporting information. We carried out an initial assessment on South West Water's in-period ODIs using its APR data. We reconciled the outcomes table (table 3A) and the definitions set out in the company specific appendix for the final determination at PR14 against its overall net penalty claim. This indicated that South West Water had wrongly classified the reward for the water restrictions placed on customers ODI as in-period, rather than being end-of-period.

To allow us to further assess South West Water's claim we asked the company to provide evidence that was set out in our [Information Notice 16/08](#) of July 2016 as well as other targeted information. The company provided the following documents:

- Completed ODI spreadsheets and K-factors models for both wastewater and water services;
- A copy of the Water Share panel end of year report for 2015-16;
- Performance data on each of its in-period ODIs from 2012-13 to 2015-16;
- Its [Water Share ODI policy document](#) that provides details of the governance and assurance for the company's ODIs;
- An extract from its technical auditors' report, providing details of the auditors' findings on ODIs;
- A copy of South West Water's audit procedure;
- A letter from the WaterShare panel chairman dated 10 October 2016; and
- South West Water's pollution action plan.

In carrying out our assessment we also considered:

- South West Water's APR (and the findings from our assessment);

- The PR14 company specific appendix for South West Water and the annex on recalibrating of ODIs;
- The Environment Agency's summary of companies' environmental performance (dated July 2016); and
- The WaterShare panel minutes from 2015-16 (December 2015 and March 2016).

South West Water's WaterShare framework

At PR14, South West Water proposed a WaterShare framework that would monitor its performance and provide transparency on sharing its performance with customers. This framework involves the company publishing a scorecard on an annual basis that summarises its performance and allows for the sharing of net benefits with customers in a timely manner. The WaterShare panel is an independent panel that the company set up to provide independent challenge and assurance that customers are legitimately and fairly sharing in company performance on a timely basis. The overall governance of this framework is set out in the company's published [WaterShare ODI policy document](#).

In our Final Determination company-specific appendix for South West Water we set out our expectations of WaterShare's role in relation to in-period ODIs. We stated:

“South West Water's business plan contained a Board pledge to share the benefits of success fairly between customers and investors. In line with this, it proposed an independently monitored and transparent performance sharing framework for 2015-20 called 'WaterShare' that allows for the sharing of net benefits with customers in a timely manner. The company's framework operates at the appointee level and takes account of the company's overall position in relation to gains and losses against the final determination before returning benefits to customers. Its business plan also contained a Board pledge that price rises would be below inflation to 2020.

The proposed licence modification for South West Water will operate within this context. This means that any in-period outcome delivery rewards (which could increase customers' bills) and any outcome delivery penalties (which could decrease customers' bills) should be considered in the context of the net gains or losses between customers and investors and the upward impact on customers' bills”. (page 18)

The WaterShare approach was unique to South West Water. We have taken into account the WaterShare framework in our assessment of South West Water's in-period adjustments.

Provision of information

South West Water completed the K-factor models and the ODI spreadsheets. We reviewed the data entered by South West Water and did not find any issues with the information it provided.

Ofwat cross-check calculations

When carrying out the cross-check calculation we found that the company's calculations matched our own and the information provided in the APR. However, we identified that South West Water had wrongly classified the 'Water restrictions placed on customers' reward as in-period. Although South West Water has provisionally accrued a reward for not implementing a water restriction in 2015-16, this reward is only paid at the end of the price control period if no water restrictions were made at any point during the price control. We have removed the reward for 'Water restrictions placed on customers' from our in-period assessment for South West Water.

Assurance

South West Water is currently a 'self-assurance' company under the company monitoring framework and does not need to publish its assurance plan. The company provided details of its overall assurance framework in its APR.

In line with the [Information Notice 16/08](#) we asked for further details of its assurance process for its ODI assessment. Due to the error we found in relation to 'Water restrictions placed on customers', we asked for greater detail on the audit methodology, its main findings and follow-up actions.

South West Water explained its assurance process. It provided us with its [Water Share ODI policy document](#) that provides details of the governance and assurance for ODIs, which is published on its WaterFuture website. This document provides details of its internal and external assurance processes and responsibilities, including those of the WaterShare panel.

South West Water also provided us with an extract from its technical auditors' report. The report explains how the technical auditors have challenged the company's data and methodologies and have reached agreement with South West Water on comments that were made in key areas. From their review they consider that South West Water had a good standard of care and attention in compiling the data. The report found that although the company had made some improvements based on the technical auditors' recommendations, some further work needed to be done, particularly on newer measures.

From reviewing the additional information provided by South West Water there is evidence that its external auditors have reviewed the company's procedures and processes in compiling the outcome data and have challenged the company on its approach. Although the classification error for 'water restrictions placed on customers' was not identified as part of this process, we did not identify any other issues with the company's assurance.

Bill impact and bill smoothing

South West Water has considered the bill impact on its customers from the in-period ODIs. South West Water estimates that the overall net penalty of £1.873 million for wastewater, will result in an indicative bill reduction of £2 on the average household wastewater bill for one year only if it was applied in 2017-18. The company estimates that its net reward of £0.141 million for water will result in no noticeable effect on the average household water bill if it was applied in 2017-18. The net effect on the average combined water and wastewater household bill would be £2 for one year only if the overall net penalty was applied in 2017-18.

South West Water provided evidence to support its proposal to defer the overall net penalty from 2017-18 to PR19 with appropriate adjustments for inflation and interest. We discuss the evidence and our assessment of it in section 4.3 below.

ODI definition (ambiguity)

South West Water considered that there is some ambiguity around the reporting of S-C4: Pollution incidents (category 1 and 2) where the Environment Agency has increased its use of category 2 pollution assessments for amenity impacting events. The company highlighted that this impact had not been taken into account when it designed its performance commitment and ODI. However, it confirmed that these incidents had been included in its reported performance for this ODI.

We agree with South West Water's approach. This is in line with the definition of this ODI, set out in South West Water Final Determination Annex. This requires the company to report the number of wastewater asset pollution incidents categorised as South West Water's responsibility and as either category 1 or 2 according to the Environment Agency definition as reported to Ofwat by the Environment Agency in MD109 for the relevant calendar year. It also allows for consistency with the data reported to the Environment Agency.

Mitigating factors

South West Water reported that it had applied no mitigating factors to its reported performance. This is in line with our assessment of the company's in-period ODIs.

Past and expected future performance

To allow us to assess whether any of South West Water's performance on its in-period ODIs was exceptional relative to its previous performance we requested performance data for 2012-13 and 2013-14. This data indicated that, apart from pollution measures, the performance of its in-period ODIs is in line with its historical performance.

We investigated in more depth South West Water's environmental performance. This was for a number of reasons:

- The company's performance on waste water pollution incidents for category 3 and 4 (reference S-C5) had improved significantly over the year by around 30% from 315 incidents in 2014-15 to 222 incidents in 2015-16.
- The performance on wastewater descriptive works permit compliance (reference S-C3) had improved by 7.7 percentage points over the year from 91.4% to 99.1%. This is a significant increase in performance compared to previous years. This improvement also meant that South West Water did not have to pay a penalty.
- South West Water's in-period ODI net penalty payment is driven primarily by its performance on wastewater pollution incidents for category 1 and 2 (reference S-C4). It also incurred a small penalty on its water pollution incidents for category 3 and 4 (reference W-E5).
- South West Water has been performing poorly on environmental issues. The Environmental Agency summary of companies' environmental performance⁸ rates South West Water as the only company that is 'poor performing'. It also notes that South West Water's performance has deteriorated from a 'below average' rating in 2014.

We asked South West Water to provide further supporting information on its environmental performance, the reasons for any significant changes in performance, its strategy for improving its performance as well as its current performance. The company provided the following information:

1. Wastewater descriptive works permit compliance (reference S-C3): South West Water explained that its improved performance has been the result of reviewing Compliance Assessment Reports (CARs) from wastewater treatment works and where appropriate preparing action plans to address the issues, the recruitment of five additional and dedicated descriptive works operators and continuing to

⁸ Environment Agency (2016) Water and sewerage companies' performance – 2015 Summary. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/541622/Water_company_performance_report.pdf

work with the Environment Agency to review the agreed list of descriptive consent sites.

2. Wastewater pollution incidents for category 3 and 4 (reference S-C5): South West Water reports that its improved performance for this measure has been a result of ongoing performance reviews of the gravity sewer network and the continual identification of sewer blockages via increased monitoring and cleansing activities. The company has also invested in sewage pumping stations at targeted locations on the network and updated its internal Pollution Incident Reporting System (PIRs) in mid-2015 to allow improved detail of all pollutions. Further upgrades, training and briefings are planned for 2016.
3. Wastewater pollution incidents for category 1 and 2 (reference S-C4): South West Water reports that all seven category 2 incidents from 2015 were the result of loss of amenity rather than a category 1 and 2 or significant impact on the environment. The company has put a pollution action plan in place (which they provided us with) to improve its current performance. This action plan covers a number of different actions, including: continuing its customer awareness programme to reduce sewer misuse; enhancing its sewer network intelligence; and addressing known issues at critical pumping stations.

We are pleased to see that South West Water has undertaken a number of initiatives that have resulted in improvement in its environmental performance in some areas. However, we are disappointed that South West Water's environmental performance in relation to wastewater pollution incidents for category 1 and 2 (reference S-C4) and water pollution incidents for category 3 and 4 (reference W-E5) remains poor in 2016 so far (see below).

We are encouraged to see that its WaterShare panel is highly engaged in this matter. South West Water has been transparent and open about its performance to the panel members, including presenting its position in relation to other companies.

Detailed assessment of individual ODIs

We undertook a deep dive analysis on the performance of its environmental ODIs, which was the main driver behind South West Water's net penalty. We also carried out further analysis on the company's other rewards and penalties.

Overall assessment of the size of the price control adjustment

Based on the assessment above we are proposing to determine that South West Water incurs a penalty of £1.731 million (2012-13 prices, net of tax) for its in-period ODIs across water and wastewater. This is £1.624 million higher than South West

Water initially expected due to it misclassifying the reward for 'water restrictions placed on customers' as in-period.

Given South West Water's Watershare framework and the Watershare Panel's concerns about bill smoothing for customers, we have also considered the timing of when the in-period ODI penalties should be applied.

4.3 The timing of the price control adjustment

South West Water proposes that instead of applying the in-period ODI penalty to customer bills as a one-off adjustment in 2017-18 it would be better for customers if the in-period ODIs penalty was used to offset the end-of-period rewards the company has already accrued, which will be applied at the 2019 price review, to smooth bills.

The case for delaying the in-period ODI price control adjustment

South West Water considers that it would not be in customers' best interests to make an in-period penalty adjustment at this early stage of the price control period. The company has already accrued an end-of-period ODI net reward which is greater than its in-period ODI net penalty (see table below). South West Water argues that delaying the penalty will lead to smoother bills in 2017-18 and at PR19.

Table 4.2: South West Water's in-period and accrued end-of-period rewards and penalties for its 2015-16 performance

	Water (£million)	Sewerage (£million)	Total (£million)
In-period (Revenue)	0.141	-1.873	-1.731
End-of-period (Revenue)	1.624	0.000	1.624
End-of-period (RCV)	-1.156	3.094	1.938
Total	0.609	1.221	1.830

Notes

- totals may not add because of rounding;
- The £ million figures are in 2012-13 prices, net of tax;

South West Water provided evidence that bill smoothing is important to its customers from the customer research it carried out at PR14. South West Water refers to two studies:

- Understanding customers' views on the overall balance between bills, penalties and rewards (ICS, 27th January 2014); and
- Acceptability testing carried out by ICS & Eftec.

The main finding from this research was that although customers consider service performance should be incentivised they also thought it was important to manage bills and budgets and disliked bill volatility. The research found that customers only want lower bills if prices remain steady thereafter.

South West Water engaged with the independent WaterShare panel chair in early October on the revised net penalty of £1.73 million at short notice following a request from us. Due to the time constraints of the request and of the determination process, the WaterShare panel chair submitted a response in a letter dated 10 October 2016 supported by the deputy chair and the deputy chair of the PR14 WaterFuture Customer Panel (a WaterShare panel member). This reflected the fact that the WaterShare panel was not due to meet until 6 December 2016. The letter supported the company's position on deferring the penalty to PR19. In the letter, the chair stated: "We are clearly unanimous following much discussion in our agreement that passing bill reductions to customers for a small sub set of performance (wastewater pollutions mainly) when overall company performance realistically expects future net rewards will only result in steeper bill rises in the future and a level of bill volatility and instability that we are fully aware that customers specifically dislike."

The PR14 final determination company-specific appendix for South West Water envisages in-period ODIs operating with the framework of the WaterShare mechanism: "The company's [WaterShare] framework operates at the appointee level and takes account of the company's overall position in relation to gains and losses against the final determination before returning benefits to customers. [...] This means that any in-period outcome delivery rewards (which could increase customers' bills) and any outcome delivery penalties (which could decrease customers' bills) should be considered in the context of the net gains or losses between customers and investors and the upward impact on customers' bills" (page 18). This interaction of in-period ODIs with a separate sharing mechanism is unique to South West Water.

For 2017-18 South West Water is reinvesting a £3.1 million net gain from 'other items', including outperformance on debt financing costs, for its customers through its WaterShare mechanism in 2017-18 (without any adjustment to the company's RCV and net of the totex efficiency incentives). South West Water argues that it is already returning revenue to customers in the form of re-investment in 2017-18. It was the WaterShare panel who decided that the £3.1 million of benefits should be handed back to customers through reinvestment to improve services for customers.

The panel considered that it was too early in the price control period to give revenue back to customers as it could lead to bill volatility later on in the period.

South West Water says that it is fully aware that it needs to improve its performance in relation to pollution incidents. In response to our information requests it explained the measures it has put in place to improve its performance on wastewater pollution incidents (category 1 and 2). As explained above the company has put a pollution action plan in place to improve its current performance. The plan covers a number of different actions, including: continuing its customer awareness programme to reduce sewer misuse; enhancing its sewer network intelligence; and addressing known issues such as critical pumping stations.

The WaterShare minutes from meetings held on 15 December 2015 and 14 March 2016 show the panel were clearly engaged in discussions with South West Water over the performance of the ODIs and in particular on the company's performance on its pollution measures. The panel has challenged South West Water on whether it could invest more and whether the panel could have an influence on investment. South West Water agreed to present the investment options it was considering to improve service performance to the panel. It was also clear from the WaterShare minutes that South West Water has been transparent and open in discussing its performance, including providing comparative information on its environmental performance with other water companies.

The case for imposing the in-period ODI penalty in 2017-18

One of the main purposes of in-period ODIs is to sharpen the incentive on companies to improve their service performance by bringing the application of rewards and penalties closer in time to the performance that generated them. South West Water was the poorest performer on category 1 and 2 wastewater pollution incidents in 2015, incurring seven incidents. Although awaiting confirmation from the Environment Agency, the company considers that it has already incurred 5 category 1 and 2 wastewater pollution incidents this calendar year (with 2 months to go).

It is not clear how much impact delaying the penalty will have on bill smoothing at PR19. South West Water could smooth any accrued net reward at PR19 over the following years in the absence of delaying the £1.7m penalty. In the event that South West Water is due a net reward on its end-of-period ODIs at PR19 bills would be slightly higher at PR19 if the penalty was not delayed. However, this might not be noticeable, given all the other adjustments made at a price review.

Although South West Water has accrued a net end-of-period reward which is larger than the net in-period ODI penalty there is some uncertainty over the company's net position on end-of-period ODIs at PR19 at this stage.

Overall assessment of the timing of the price control adjustment

We are minded to accept South West Water's proposal, supported by the Chair and Deputy Chair of the independent WaterShare panel, not to apply the penalty in 2017-18. In reaching this view we have taken account of:

- in South West Water's specific case the in-period ODIs need to be seen in the context of its WaterShare scheme which allows for the sharing of net benefits with customers from the company's performance. As part of its WaterShare scheme, South West Water is returning £3.1 million of outperformance to customers by reinvesting to improve services. The Chair and Deputy Chair of the independent WaterShare panel have supported South West Water's proposal that the £1.731 million in-period ODIs penalty is deferred to the 2019 price review to offset rewards that South West Water has already accrued, which will be applied at the 2019 price review, in order to smooth bills; and
- the main element of the South West Water's penalty is its performance on category 1 and 2 wastewater pollution incidents. The company has engaged with the WaterShare panel over its performance and has put a pollution action plan in place to improve its current performance.

We will consider next year whether we should make a determination and, if we do, when the penalty due for 2015-16 performance should be applied taking into account all relevant circumstances at the time, including whether South West Water has improved its performance on category 1 and 2 wastewater pollution incidents.

4.4 Our draft determination

We propose to make an in-period ODI determination for South West Water for the reasons given above, even though the company did not request a determination.

In Annex 1 we set out our draft determination for each of South West Water's in-period ODIs for the financial year 2015-16. This results in an overall penalty of £1.731 million (2012-13 prices, net of tax), with a penalty of £1.873 million for wastewater and a reward of £0.141 million for water.

To put the amounts into context, table 4.3 sets out the allowed revenue for South West 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 A3.10). The table uses 2012-13 prices which is the basis of ODIs in PR14.

Table 4.4: South West 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	188.2	185.8	182.6	181.5	181.6	919.8
Wholesale wastewater	238.4	239.8	241.9	243.4	243.6	1,207.1

Note: totals may not add because of rounding

We propose not to make any adjustment to the levels of South West Water's wholesale Price Controls, as determined at PR14, for 2017-18. Instead we will consider next year whether we should make a determination and, if we do, when the penalty due for 2015-16 performance should be applied, taking into account all relevant circumstances at the time.

Next steps

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

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

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

In-period ODI	2015-16 target	2015-16 actual	Reward or penalty due £ million	Company claim ⁹ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
W-A1: Compliance with water quality standard	99.98%	99.97%	-		Unit of measurement = Mean zonal compliance (%) CPL ¹⁰ = 99.98% 2015-16 actual performance level = 99.97% 2015-16 CPL met? = No 2015-16 penalty collar = 90.00% 2015-16 penalty deadband = 99.90% SWT's performance falls within the penalty deadband. Therefore no penalty is due.	-	-	In our view actual performance is within the penalty deadband therefore no penalty is payable.
W-A2: Taste, smell and colour contacts	4.2	2.92	-		Unit of measurement = Number of contacts per 1,000 population 2015-16 CPL = 4.2 2015-16 actual performance level = 2.92 2015-16 CPL met? = Yes 2015-16 reward cap = 1.50 2015-16 reward dead band = 2.02 This is within the deadband, therefore no reward or penalty is due.	-	-	In our view actual performance is within the reward deadband and therefore no reward is payable.

⁹ 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.

¹⁰ CPL stands for committed performance level.

In-period ODI	2015-16 target	2015-16 actual	Reward or penalty due £ million	Company claim ⁹ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
W-B1: Water restrictions placed on customers (number)	0	0	1.624		<p>Unit of measurement = number of water restrictions</p> <p>CPL = 0.000 actual performance level = 0.000 CPL met? = Yes reward cap = 0.000 reward deadband = 0.000 Reward incentive rate = £1.624 m</p> <p>This performance commitment measures the number of water restrictions in place on customers in a five-year period.</p> <p>Only the penalty is subject to the in-period mechanism. The rewards are provisionally accrued yearly but are only applied after assessment of performance to 2018-19, based on expected delivery to 2019-20.</p> <p>If restrictions on use are imposed in a part of SWT's area in the five-year period no reward will be earned.</p>	0.000	1.624	We have removed this reward. Although we confirm that South West Water has not applied any water restrictions during the year this reward is only paid at the end of the price control if no water restrictions were made at any point during the price control.

In-period ODI	2015-16 target	2015-16 actual	Reward or penalty due £ million	Company claim ⁹ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
W-B3: Leakage levels (megalitres a day, MI/d)	84 MI/d	84 MI/d	-		Unit of measurement = Megalitres per day CPL = 84 MI/d actual performance level = 84 ML/d CPL met? = Yes CPL was met, no reward or penalty due.	-	-	In our view no reward or penalty has been incurred.
W-D1: Operational customer contacts resolved first time (%)	91.0%	94.8%	0.163	0.163	Unit of measurement = % customer contacts resolved first time 2015-16 CPL = 91.0% 2015-16 actual performance level = 94.8% 2015-16 CPL met? = Yes 2015-16 reward cap = 100.0 2015-16 reward deadband = 91.0 Reward incentive rate = £ 0.043m 94.8 (performance) - 91.0(deadband) = 3.8 * 0.043 (unit reward) = 0.163m	0.163	0	We propose accepting South West Water's net reward application and the company's reward calculation.

In-period ODI	2015-16 target	2015-16 actual	Reward or penalty due £ million	Company claim ⁹ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
W-E4: Pollution incidents (category 1 and 2)	0.000	0.000	-	-	Unit of measurement = Number of pollution incidents (categories 1 and 2) 2015-16 CPL = 0.00 2015-16 actual performance level = 0.00 2015-16 CPL met? = Yes CPL has been met, therefore no penalty is due.	-	-	In our view no penalty has been incurred.
W-E5: Pollution incidents (category 3 and 4)	2.000	5.000	-0.022	-0.022	Unit of measurement = Number of pollution incidents (categories 3 and 4) CPL = 2.00 actual performance level = 5.00 CPL met? = No Penalty collar = 4.00 Penalty dead band = 2.00 Penalty rate = £0.011m 4 (penalty collar) -2 (deadband)*0.011m = 0.022m	-0.022	0	We propose accepting South West Water's net penalty application and the company's penalty calculation.

In-period ODI	2015-16 target	2015-16 actual	Reward or penalty due £ million	Company claim ⁹ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
S-B1: Operational customer contacts resolved first time (%)	91.0%	88.2%	-0.143	-0.143	Unit of measurement = % customer contacts resolved first time CPL = 91.0 actual performance level = 88.2 CPL met? = No Penalty collar = 75.0 Penalty deadband = 91.0 Penalty rate = £0.051m 91.0 (deadband) – 88.2 (performance) = 2.8 * 0.051 (unit reward) = 0.143	-0.143	0	We propose accepting South West Water's net penalty application and the company's penalty calculation.
S-C3: Wastewater descriptive works permit compliance (%)	100.00	99.09	-	-	Unit of measurement = % wastewater descriptive works permit compliance CPL = 100.00 actual performance level = 99.090 CPL met? = No Penalty collar = <95 Penalty deadband = 95.0 This is within the deadband, therefore no penalty is due.	-	-	In our view actual performance is within the penalty deadband and therefore no penalty is payable.

In-period ODI	2015-16 target	2015-16 actual	Reward or penalty due £ million	Company claim ⁹ £ million	Claim calculation	Ofwat DD £ million	Difference £ million	Comments
S-C4: Pollution incidents (category 1 and 2)	0.000	7.000	-1.730	-1.730	Unit of measurement = Number of pollution incidents (categories 1 and 2) 2015-16 CPL = 0.000 2015-16 actual performance level = 7.000 2015-16 CPL met? = No 2015-16 Penalty collar = 8.000 2015-16 Penalty deadband = 2.000 Penalty rate = £ 0.346m 7 (performance) – 2 (deadband) = 5*0.346 = 1.730m	-1.730	0	We propose accepting South West Water's net penalty application and the company's penalty calculation.
S-C5: Pollution incidents (category 3 and 4)	238	222	-	-	Unit of measurement = Number of pollution incidents (cats 3 and 4) 2015-16 CPL = 238.000 2015-16 actual performance level = 222.000 2015-16 CPL met? = Yes	-	-	In our view no penalty has been incurred.
Total¹¹				-0.108 To be delayed to 2019-20		-1.731 To be delayed to 2019-20	-1.624	

¹¹ totals may not add because of rounding;

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.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk

Printed on 75% minimum de-inked post-consumer waste paper.
November 2016

ISBN 978-1-910739-68-26

© Crown copyright 2016

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3 or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email psi@nationalarchives.gsi.gov.uk.

Where we have identified any third party copyright information, you will need to obtain permission from the copyright holders concerned.

This document is also available from our website at www.ofwat.gov.uk.

Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gsi.gov.uk.

