Delivering outcomes for customers - post IAP webinar

15th February 2019

Agenda

- Introduction
- Overview of IAP results
- Performance commitment levels
- Standard & enhanced outcome delivery incentives
- Customer protections
- Q&A and next steps

Overview of IAP results

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Test Question		What we found
OC1	How appropriate, well-evidenced and stretching are the company's proposed PCS and service levels?	**Overall, companies propose PCs which cover the areas of focus set out in our methodology and which generally reflect customer views. However:** • Some companies only propose stretching targets in areas of existing strength, and do not respond to the challenge in areas of weakness. • Some companies do not provide sufficient justification for discontinuing, amending or replacing existing performance commitments. • Some bespoke PC definitions lack clarity. • There is little evidence of innovation in companies' proposals for reporting
OC2	How appropriate and well-evidenced is the company's package of ODIs?	**Concerns around approaches to setting ODI rates led to a lower grade for many companies:** • Some companies set financial out-and under-performance ODIs as default without evidence of customer support for outperformance payments • Deadbands are in some cases suggested without convincing explanation. • Some companies demonstrate sufficient justification for caps & collars in principle but not necessarily for specific PCs. • Some companies use inappropriate methods of calculating ODI rates such as applying adjustments to WTP values without providing sufficient justification
OC3	How appropriate is the company's focus on service performance in its risk/return package?	**A number of companies propose ODI packages that align with our indicative range of ± 1-3% of RoRE. However:** • Some companies do not adequately explain how their incentives align the interests of their management and shareholders with customers • Some companies propose packages which are skewed to deliver certain outcomes at the risk of other outcomes that are important to customers • Many companies do not propose sufficient measures to ensure customers are protected from unexpectedly high levels of outperformance payments. • Most companies do not propose Asset Health ODI packages that provide sufficient long-term protection for customers or sufficient evidence of customer support for outperformance ODIs.

Performance commitment levels

Performance commitment levels

PC	Summary of assessment approach	Summary of actions
The DWI's Compliance Risk Index (CRI)	We review each company's evidence to assess whether our methodology is followed consistently. We expect full compliance should be achieved.	Companies that had proposed not to meet full compliance in each year to change proposals and do so.
Treatment works compliance		
Water supply interruptions	We review each company's evidence to assess whether our methodology is followed consistently. We calculate forecast upper quartile values for each year of the 2020-25 period based on all companies' business plans and expect the proposed commitment levels to reflect the values we have calculated for each year of the 2020 to 2025 period.	All companies to reflect the values we had calculated.
Internal sewer flooding		
Pollution incidents		
Leakage	We review each company's evidence to assess whether our methodology is followed consistently. We calculate the percentage difference between the annual average level expected in 2019-20 and the annual average leakage proposed in 2024-25. We expect the percentage difference to be greater than both the largest actual percentage reduction achieved by the company since PR14 and also at least a 15% reduction in leakage or the company to provide compelling justification why this is not appropriate. We also calculate forecast upper quartile performance in relation to leakage per property per day and leakage per kilometre of main per day in 2024-25 using three-year average leakage values provided in companies' business plans and divided by the corresponding property and mains length values. We benchmark each company against all other companies and consider each company's own circumstances, such as past performance. We expect the proposed commitment levels to be at or exceed these values, or the company to provide compelling justification why this is not appropriate.	A number of companies to adopt the forecast upper quartile values we had calculated or provide compelling justification why this is not appropriate.
Per capita consumption (PCC)	We review each company's evidence to assess whether our methodology is followed consistently. We benchmark all companies against each other, combined with evidence and justification provided for the forecast performance levels. We use each company's water resources position, their supply/demand balance, relative percentage reduction, proposed supply-side investment and the company's own circumstances, geographical location and benchmarking against neighbouring companies or companies with similar characteristics in the same region.	A number of companies to propose lower per capita service levels or provide compelling justification why this is not appropriate.

Performance commitment levels

PC	Summary of assessment approach	Summary of actions
Mains repairs	We review each company's evidence to assess whether our methodology is followed consistently. We calculate forecast upper quartile and median performance expressed as the number of mains repairs per 1000 km of mains in 2024-25 using all companies' business plans to assist our review. We also consider each company's historical performance. We expect there to be no deterioration for asset health as measured by the level of mains repairs.	Where a company has insufficient evidence we ask it to provide further evidence. This is particularly the case if a company has proposed a deterioration in performance.
Unplanned outage	We review each company's evidence to assess whether our methodology is followed consistently. We calculate forecast upper quartile performance expressed as the total unplanned outage as a proportion of total production capacity (%) in 2024-25 using all companies' business plans to assist our review. We benchmark the companies against each other and their own 2017-18 performance and 2019-20 forecast to assess the proposed level of stretch.	For most companies it is not clear that data is consistent with the common definition and should provide fully audited 2018-19 performance data by 15 May 2019 and resubmit 2019-20 to 2024-25 forecast data.
Sewer collapses	We review each company's evidence to assess whether our methodology is followed consistently. We calculate forecast upper quartile and median performance expressed as sewer collapses per 1000 km of sewers in 2024-25 using all companies' business plans to assist our review. We expect improvements in comparison with 2017-18 performance and 2019-20 forecast performance levels.	Some companies had insufficient evidence to support proposed service levels and are asked to provide convincing evidence that the proposed service levels are in the interests of customers and the assets in the context of a long term plan.
Risk of severe restrictions in a drought	We review each company's evidence to assess whether our methodology is followed consistently, and whether the proposed service levels are reflective of its draft Water Resources Management Plan (dWRMP) and any feedback we have given.	For most companies it was not clear that data is consistent with the common definition. These companies should provide and submit the intermediate calculation outputs as shown in the common definition guidance published on our website for the drought resilience metric.
Risk of sewer flooding in a storm	We review each company's evidence to assess whether our methodology is followed consistently. We benchmark all companies against each other using their achieved level for 2017-18, forecast performance for 2019-20 and proposed service level for 2024-25, to assist our review and consider what assumptions are made in relation to measurement and reporting of the metric.	For some companies it was not clear that data is consistent with the common definition. These companies should provide full details of any assumptions in its measurement and reporting methodology, including all the information set out in section 3.6 of Developing and Trialling Wastewater Resilience Metrics, Atkins.
External sewer flooding	We review each company's evidence to assess whether our methodology is followed consistently for the companies which propose this PC. We calculate forecast upper quartile performance expressed as the number of incidents per 10,000 connections in 2024-25 using companies' business plans to assist our review. We expect each company to meet forecast upper quartile levels or provide convincing evidence why this is not appropriate.	A number of companies to adopt the forecast upper quartile values we had calculated or provide compelling justification why this is not appropriate.

Standard & enhanced ODIs

We expect companies to propose packages of ODIs which better align the interests of company management and investors with those of customers, providing incentives for companies to fulfil their service commitments to customers and penalties for those that do not.

ODIs should be financial rather than reputational by default

Companies should demonstrate why a financial incentive is not appropriate if they are proposing reputational-only ODIs.

Outperformance payments are only appropriate if the company can demonstrate the following tests are met:

a) the performance commitment level is stretching so that outperformance payments are for strong outperformance and not for carrying out the "day job";

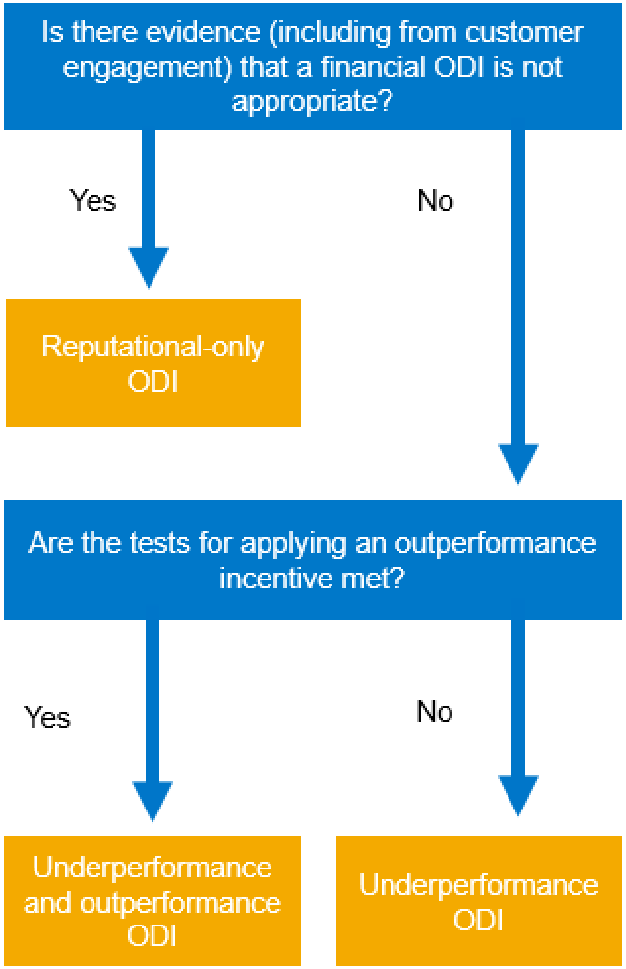
b) there are benefits to customers from improved performance; and

c) there is customer support for the outperformance payment.

We have raised actions requiring companies to submit additional evidence in support of proposed outperformance payments where they have not demonstrated that these tests have been met.

Some companies proposed PCs with outperformance payments for delivering statutory schemes earlier than required.

- Companies must demonstrate that early delivery provides genuine benefits to customers; and
- The associated ODI outperformance payment should be based on the benefits of early delivery (not the cost of the scheme)



✓ ODI rates should be calculated on a **bottom-up basis** using triangulated estimates of marginal benefit and forecast efficient marginal cost.

✗ Companies should not set their ODI rates using **top-down approaches** i.e. through the allocation of a predetermined revenue or Return on Regulated Equity (RoRE).

ODI Rates for common and comparable PCs

- In reviewing proposed ODI rates we find substantial variation across companies both on an absolute and per household basis.
- The degree of variation observed implies large differences in marginal costs and/or customer preferences for incremental changes in the same unit of performance.
- While we do not expect rates to be identical across companies, any differences should reflect genuine variation in customers’ preferences.
- We are therefore asking companies to provide additional information where their proposed rates lie outside our current view of reasonable ranges
- This should help us better understand the causes of variation in ODI rates and assess the appropriateness of companies’ proposals for Draft Determinations

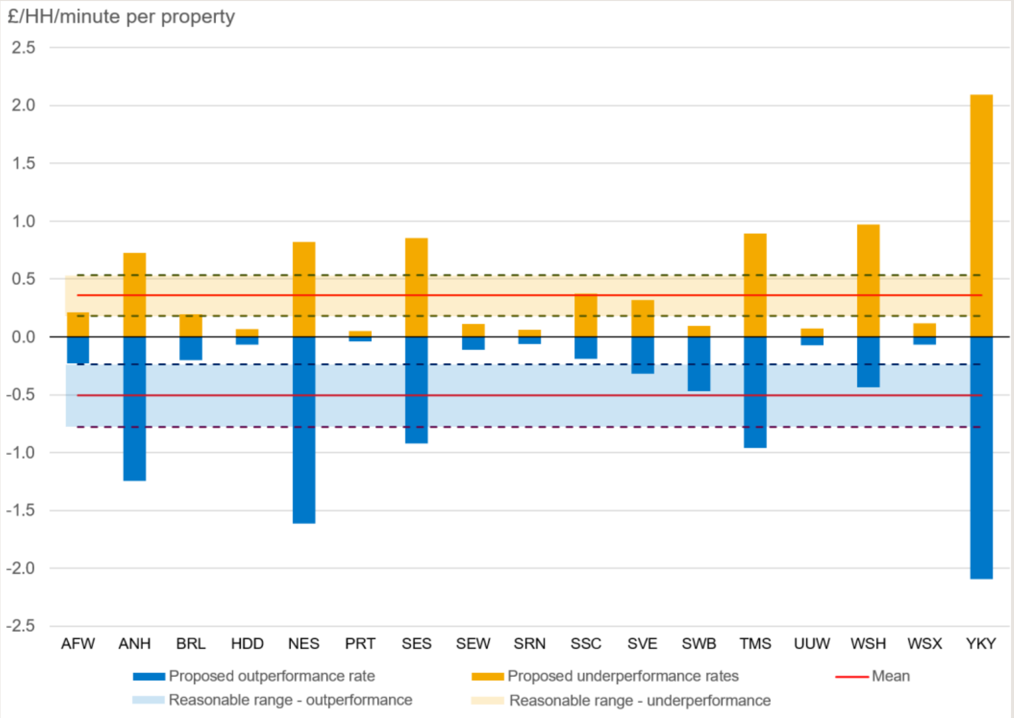
We may intervene at Draft Determinations if companies do not provide sufficient evidence to support their proposals

Approach to forming an initial view of reasonable ranges

- We have been unable to explain the extent of ODI rates variation through factors such as company scale, comparative and historical performance or regional differences in household income or water stress.
- We have therefore based our initial view of reasonable ranges on statistical variation around the mean (i.e. **±0.5 standard deviations**):

- We have calculated reasonable ranges on a **£/HH/unit basis** i.e. taking the aggregate (£m/unit) ODI rates in App1 and dividing by the relevant 2022-2023 household volumes (i.e. water or wastewater)
- For the leakage and external sewer flooding PCs we have also normalised by distribution input and # of properties to obtain performance increments that are directly comparable across companies.
- Where companies propose rates which are not expected to be comparable (for example due to methodological issues with their derivation) we have excluded these from our calculations.

Example: Water supply interruptions



For further detail please see Section 3 and Annex 2 of [Technical Appendix 1: Delivering outcomes for customers].

Asset health ODIs

We expect companies to propose asset health ODI packages that incentivise them to maintain their assets to provide **reliable and resilient** services to customers both now and in the future.

Underperformance Payments

We have assessed the ODI elements of companies proposed asset health PCs together as a package.

In general we have found that companies have not proposed sufficiently larger underperformance payments to protect customers against under-investment and to provide appropriate incentives to maintain asset health.

Where this is the case we are asking companies to provide additional evidence to justify the appropriateness of their asset health ODI package.

Outperformance Payments

We expect companies to demonstrate the following, if proposing asset heath outperformance payments:

- that outperformance payments will not be received for recovering from historic underperformance;
- that there is no double counting with other PCs and that incentives are balanced across system; and
- evidence of **informed** customer support for the specific asset heath measure.

ODI rates actions for common asset health PCs

We have asked companies to provide additional supporting evidence where their proposed ODI rates fall outside our current view of reasonable range.

- for underperformance payments the reasonable range is defined as ≥ UQ rate (on a £/HH/unit basis)
- for outperformance payments, where there are fewer comparator data points, we have taken a more conservative approach at ≤ median rate.

For further detail please see Section 3 and Annex 2 of Technical Appendix 1: Delivering outcomes for customers.

Enhanced outcome delivery incentives

Companies may propose enhanced ODIs as an incentive to innovate to deliver frontier-shifting performance, which all customers should benefit from in the long term.

Enhanced ODI rates

- In our Final Methodology we said that companies could take account of wider benefits of a step-change in outperformance when proposing enhanced ODI rates.
- Many companies have subsequently proposed enhanced ODI rates which are many multiples their standard ODI rates.
- This implies companies have taken account of wider externalities in setting their rates that are considerably larger than their own customers' valuations.
- In assessing companies enhanced ODI rate proposals we want to ensure companies' own customers will be protected.
- We have raised an action requiring companies to submit additional supporting evidence if they continue to propose enhanced outperformance rates which are >2x their standard ODI rate for a given PC

Enhanced ODI thresholds

- Enhanced ODI performance thresholds in 2020-21 should be **at least as good** as performance levels currently being achieved, or forecast, by the best performing company.
- For companies which are already leading performers, thresholds should represent a step change on current levels of performance
- Companies should have regard to the likelihood that UQ and frontier performance **will improve** during the AMP in setting enhanced thresholds for the remainder of the 2021-25 period.

Customer protections

- We expect companies to **apply caps** on enhanced ODIs to protect customers from higher than expected enhanced outperformance payments, where there is no practical maximum performance level.

Customer protections

Customer protections

We have raised two common actions for all companies where we consider protections are not adequate to protect customers from unexpectedly high outperformance payments.

Action 1: Aggregate Outperformance Sharing Mechanism

- Companies should propose a mechanism to share 50% of incremental outperformance payments with customers through bill reductions above a given threshold.
- The threshold for sharing should be calculated as 3% of the RoRE assumed in the PR19 price determination for either wholesale water (i.e. Water Network Plus and Water Resources) or wholesale wastewater activities (i.e. Bioresources and Wastewater Network Plus) as relevant.
- Outperformance payments associated with PCs allocated to the retail controls (including C-Mex and D-Mex) will not be included in the sharing mechanism.
- Companies should adopt a sharing mechanism even if their proposed ODI package is smaller than our indicative guidance range of +/- 1% to 3% of RoRE.

Action 2: Caps and collars on potentially financially significant PCs

- Companies should apply underperformance collars and outperformance caps at p10 and p90 estimates of performance, respectively, for PCs where the following criteria is met:

    i. the p90 outperformance payment is forecast to be at least 10% of the total p90 payments for PCs relating to either water or wastewater activities (as relevant); or

    ii. there is considerable uncertainty about forecast future performance

- The caps and collars should apply to individual PCs (not across groups of PCs).

The sharing mechanism and caps and collars should apply on an annual basis for each year of the 2021-2025 period (i.e. not to outperformance payments aggregated over the price control period).

Further guidance on applying caps and collars to potentially financially significant PCs

In assessing uncertainty around the forecast magnitude of outperformance, companies should have regard to the following factors:

- Whether there are practical or theoretical limits to outperformance that act as a natural cap.
- The level of certainty associated with the company's forecast of future performance including:
  - the availability of historical performance data for the PC;
  - the existence of a robust estimate baseline performance for 2020-21; and
  - the uniqueness of the PC proposed and existence of similar PCs proposed by other companies as benchmarks for forecast performance.

Companies should clearly explain their approach to allocating PCs to water or wastewater activities for the purposes of calculating the potential financial materiality of the ODI as a % of total p90 payments

Q&A and next steps

Question(s) received in advance

Please could Ofwat confirm if companies need to update the ODI payments to account for the assumed totex sharing rate from the IAP assessment, or if companies need to continue using the assumption of a 50% totex sharing rate?

Next Steps

- Further detail on our sector-wide actions and policy decisions can be found in Technical Appendix 1: Delivering outcomes for customers of the IAP publication.
- Companies may submit written questions to us via the formal queries process (email pr19engagement@ofwat.gsi.gov.uk)
- We are offering companies a bilateral meeting to provide ***clarification on the nature of our concerns and associated actions.***
    - Meetings to take place between 21 February – 28 February
    - Companies should submit questions at least 3 business days in advance
    - Companies wishing to avail themselves of this opportunity should contact their Ofwat Company Engagement representative