Delivering outcomes for customers - webinar

24th July 2019

Agenda

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

Performance commitment levels

Overall approach to setting performance commitment levels

Companies should have stretching performance commitment levels:

- To maintain customers' trust and confidence in the outcomes regime
- To ensure outperformance payments are only available for performance beyond stretching levels
- To challenge companies to achieve both a higher level of service, and a more resilient service performance
- To encourage companies to improve their services to current customers, future customers and the environment

More stretching performance commitment levels do not cost customers more money in themselves. We have a separate test for cost efficiency, which challenges companies to have efficient levels of cost, and we do not allow companies a higher cost allowance for a more stretching performance commitment.

We expected that, for common performance commitments, companies would engage with their customers on their performance commitment levels; and challenge the level of stretch in their performance commitments with their customers, CCGs and other stakeholders. This would include challenging their performance commitment levels against forecast upper quartile performance levels because there is more likely to be comparable data available for them.

Our interventions on performance commitment levels deliver levels that we consider are **stretching but achievable.**

Common performance commitment levels

PCs	Key points
Upper quartile measures (UQ): Water Supply Interruptions, Internal Sewer Flooding, Pollution Incidents	PC levels are common to all companies - set at the forecast industry upper quartile (UQ). • No changes since IAP to **internal sewer flooding** and **pollution incidents** • For **water supply interruptions** performance levels, we apply a glidepath to reach forecast UQ performance in 2024-25. Interim forecast UQ levels looked unachievable
Reducing water demand: Leakage, Per Capita Consumption (PCC)	We assess 2024-25 performance level relative to the forecast UQ. For **leakage:** • Is the annual percentage reduction above 15%? • Is past performance good? • Can levels proposed be delivered by base cost allowances? For **PCC:** • Does the company face water resource challenges? • Has the company shown ambition? • What is level of current / planned metering penetration?
Asset health: Mains Repairs, Unplanned outage, Sewer Collapses, Sewer Blockages*, External Sewer Flooding*, Low pressure*, Water quality customer contacts*: taste and odour and discolouration* (* are comparable bespoke performance commitments)	We expect companies to deliver good levels over the longer term. • For comparatively good performers, we are stretching these companies to achieve the average of their 3 best historical years since 2011. Where we do not have good historical data we use percentage reductions. • For comparatively poor performers, we are expecting significant percentage reductions to close the gap between them and the sector.

Common performance commitment levels

PCs	Key points
Statutory measures: Water quality compliance (CRI – DWI's compliance risk index), Treatment Works Compliance	Performance levels must be set at full compliance, but we consider that there should be a deadband before underperformance payments apply: • No change to treatment works compliance deadband. • Glidepath to 1.5 for CRI deadband to allow effects of metaldehyde ban to have an impact.
Resilience measures: Risk of severe restrictions in a drought, Risk of sewer flooding in a storm	Companies need to show us that they understand their resilience challenges: • Wastewater - increasing model coverage in the nearer term and reducing risk over longer term. • Drought – understanding risk and reducing it over time.
Vulnerability: Priority Service Register	We have maintained the performance level for PSR reach (minimum of 7% of households) from IAP but changed the definition of contact : • at least attempted contact (90%) • at least actual contacts (50%)
Customer service: C-MeX, D-MeX	C-MeX and D-MeX policy decisions were outlined in the March 2019 policy decision and shadow year guidance documents and additional decisions are outlined in the outcomes policy appendix. We are continuing to receive data from the shadow year, receiving representations from stakeholders, and speaking to the agent operating the shadow year surveys. We will publish our decision on C-MeX and D-MeX incentive design for 2020-25 as part of final determinations in December.

Water Industry National Environment Programme (WINEP) and National Environment Programme (NEP)

- We have decided performance commitment levels should only apply to WINEP/NEP schemes designated as ‘green’ by 1 April 2019, which avoids any changes being required to performance commitments after final determinations. We have revised performance levels based on available data. Companies could propose revised levels if there is evidence this is more appropriate, but still stretching.
- We have added a further reputational performance commitment for all companies to report whether they have “met” or “not met” all of their WINEP/NEP requirements each year.

Void properties – Household properties

- Our draft determinations increase the stretch of performance commitment levels for some companies based on assessment of business plan data, comparative company performance and empty dwellings data from the Ministry of Housing, Communities and Local Government.
- Alongside this we have changed the performance commitment definition for some companies as part of making performance commitments stretching and focusing on the benefit for customers.

Standard & enhanced ODIs

Overall approach to setting ODI rates

In our PR19 methodology we stated that we are placing a greater onus on financial incentives.

For an ODI outperformance payment to be appropriate, the company must:

- be proposing a stretching performance commitment level so that outperformance payments are for strong outperformance and not for carrying out the “day job”;
- demonstrate there are benefits from improved performance; and
- have customer support for its proposed outperformance payment.

We set out our expectation that companies set their ODI rates on a bottom-up basis using evidence of customer valuations for service increments and the forecast efficient marginal cost of delivering them. We expected companies to provide willingness to pay and /or marginal cost evidence to support their proposed rates.

At IAP we asked companies to:

- provide supporting evidence for outperformance payments;
- explain why their proposed rates differed from our assessment of the reasonable range around the average;
- explain how their asset health ODI rates appropriately incentivise performance; and
- explain how their proposed rates are coherent with their ODI package.

Our interventions on ODI rates deliver rates that we consider provide appropriate incentives to the company **to deliver on its pledges to customers.**

Outcome delivery incentive rates

Assessment of a range of evidence

We make an assessment of whether to intervene based on:

- Customer support (adjusting or removing the outperformance rates where there was insufficient customer support)
- Horizontal comparison (using the reasonable range as a guide to identify potential outlier rates which require further investigation)
- Company use of its specific evidence eg willingness to pay / triangulation check
- Past performance
- Performance commitment / comparative level
- Symmetry check
- 2015-20 rate cross check
- Overall quality of companies' customer valuation evidence and triangulation.

We assess rates for non-customer-facing PCs differently from customer-facing PCs because there was limited use of, for example, willingness to pay data by companies to set these rates. The limited range of data also affects our interventions, eg makes re-triangulation of rates not feasible. The specific nature of the intervention depends on the nature of the concerns identified.

Customer-facing common/comparable performance commitments:
Leakage; per capita consumption (PCC); water supply interruptions; pollution incidents; internal sewer flooding and comparable bespoke performance commitments: water quality contacts (combined measures) and external sewer flooding.
Non-customer-facing common/comparable performance commitments:
Compliance Risk Index (CRI); mains repairs; sewer collapses; unplanned outage; treatment works compliance and comparable bespoke performance commitments: sewer blockages and low pressure.

Outcome delivery incentive rates – approach to interventions

Customer facing:

We used the reasonable range to identify potential outliers for further investigation. We accepted rates where they had appropriately derived marginal benefit and appropriately triangulated based on customer valuations and comparison with PR14 rates, past performance checks did not highlight any concerns.

When we did not accept proposed rates we re-triangulated across relevant data points.

In our interventions we seek to reflect:

- preferences of the company's customers (using willingness to pay data / rates from all sources eg PR14, September plans, April plans),
- preferences of customers across the industry more widely (using industry average rates).

Our analysis of company plans showed that the average ratio of underperformance rates to outperformance rates was 1.2. When we have intervened we have used this factor to set the relevant rates.

We reduce outperformance payment rates if customer support evidence is unclear based on our willingness to pay triangulation or using the nearest bound of the reasonable range as discussed in the policy appendix.

Non-customer-facing:

We used the reasonable range to identify potential outliers for further investigation. We accepted rates where they were within the range or performance checks (past / comparative or stretch) did not highlight any concerns.

Our general approach is to move company rates to a point in the reasonable range based on the data spread and the relative position of the rates against the range and the existence or not of any past or current performance concerns. The resulting rate should sufficiently incentivise companies to maintain and invest in their assets.

We reduce outperformance rates where customers do support outperformance payments but these are greater than underperformance payment rates.

We remove outperformance payments where customers do not support these.

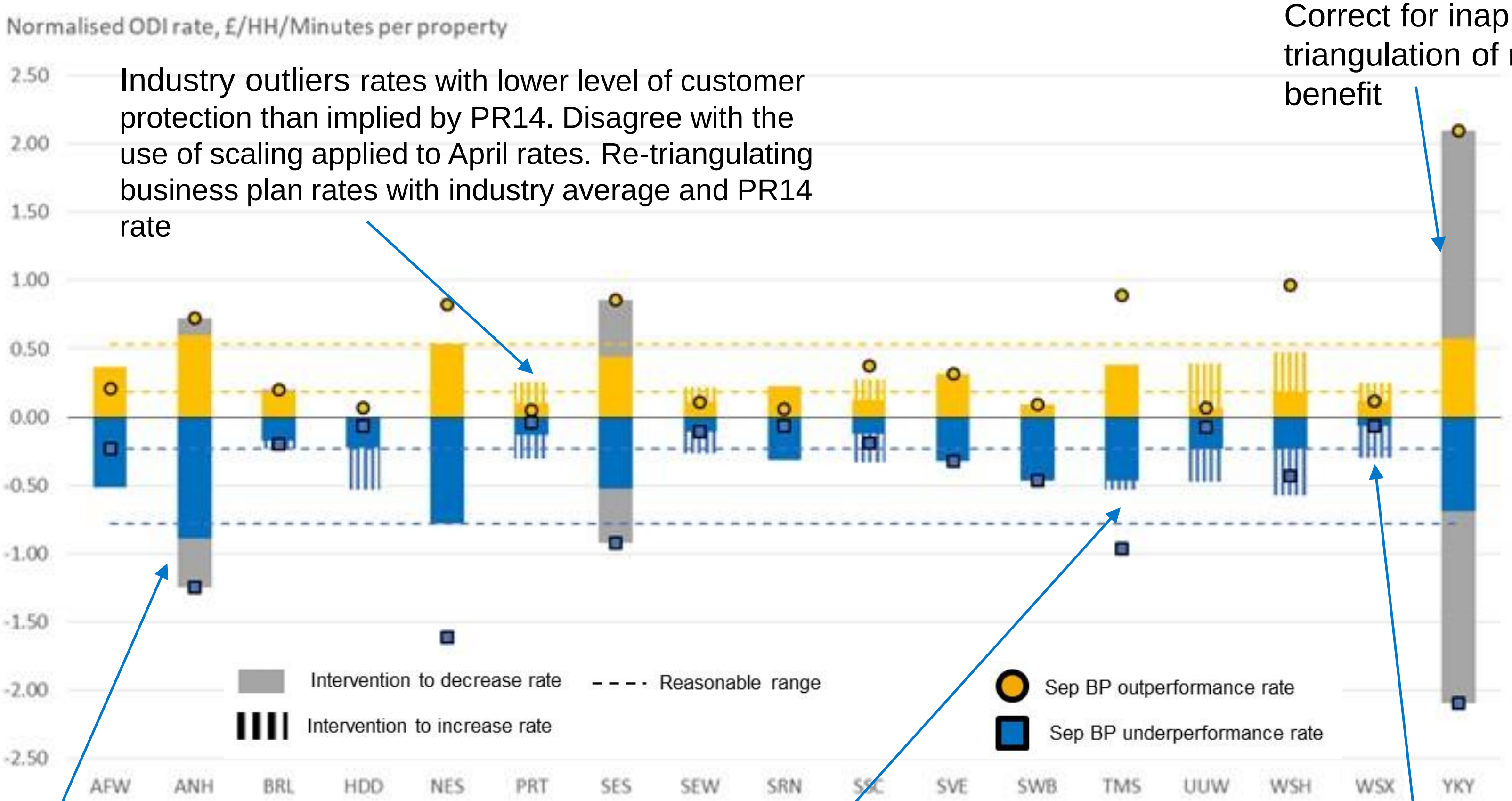
Our interventions also include adding underperformance payment rates to companies that have not proposed one. Where we have added underperformance payment rates we set the rate for these performance commitments at the average rate proposed by all other companies.

In assessing ODI rates we keep totex-sharing rates at 50:50 for the purposes of the draft determinations, but will consider further whether this is appropriate in all cases for final determinations.

Outcome delivery incentive rates – Example: water supply interruptions PC

In general, our recommended interventions increase the average value of incentives attached to the water supply interruptions PC (relative to companies' April Business Plans).

The analysis was done on a normalised basis as shown by the units below £/HH/minutes per property



Correct for inappropriate triangulation of marginal benefit

Industry outliers rates with lower level of customer protection than implied by PR14. Disagree with the use of scaling applied to April rates. Re-triangulating business plan rates with industry average and PR14 rate

Outlier rate but a low priority for customers so customer protection intervention. Re-triangulating business plan rates with industry average

Uplift for low quality of action plan to address past performance issues

Industry outlier and not enough information provided on marginal benefit. Re-triangulate using industry average and business plan rate

Enhanced outcome delivery incentives

Enhanced ODI rates

- In our final methodology we said companies could take account of wider benefits to industry of a step-change in outperformance when proposing enhanced ODI rates.
- We are not limiting enhanced ODI rates at 2x standard ODI rates. Instead, we have estimated the benefit to all customers (the “benchmarking externality”) and adjusted for smaller companies where the bill impact on their customers may be excessive.
- Where companies have proposed enhanced outperformance rates greater than our estimate we have intervened to reduce rates in line with our estimate. Where underperformance rates are different from outperformance rates we have intervened to set them symmetric to outperformance rates.
- Where companies failed to provide convincing evidence of customer support for standard outperformance payments, we have intervened to remove the enhanced ODI payments for that performance commitment.

Enhanced ODI thresholds

- Enhanced **outperformance thresholds** should represent a level that improves the industry frontier as a whole.
- We have estimated a threshold for each performance commitment by using either the forecast frontier / current best performance and applying a “frontier shift” based on the historic rate of improvement. This then follows the profile of the upper quartile across the period. We have intervened to set our frontier estimate where company proposals were less stretching.
- Enhanced **underperformance thresholds** will be at the lower quartile of industry performance in 2018-19 (using forecasts at DD or 2017-18 actuals where not available).

Customer and company protections

- We apply **caps** for each enhanced ODI at 1% of water or wastewater regulatory equity each year, which would apply in-period within the aggregate sharing mechanism.
- We also set **collars** for each enhanced ODI to limit company exposure at the lower decile of industry performance in 2018-19 (using forecasts at DD or 2017-18 actuals where not available).

Scheme-specific rates

- We consider ODI rates should compensate customers for foregone benefit. If a company delivers a scheme a year late its customers do not receive the benefit for that year. Where we lack confidence in a company's estimate of annual benefits, but we are confident that it is significant, we use the weighted average cost of capital (WACC) and RCV runoff rate as a proxy for foregone customer benefit. We multiply this by allowed totex for the scheme to arrive at an annual '**late delivery payment rate**' for each year that the scheme is undelivered.
- In addition, we will recover any allowed expenditure related to **non-delivery at 31 March 2025**, accounting for the cost sharing factor. Where the main underperformance rate reflects late delivery we have set a further rate to account for non-delivery at the next price review. We will not recover costs for green WINEP/NEP schemes as we will expect companies to deliver the schemes within the costs we have allowed at PR19 and will not allow costs at future price reviews.

Cost recovery rates

- Some companies proposed 'cost recovery' performance commitments where outperformance payments are designed to fund schemes.
- We have accepted company proposals for such performance commitments in line with our standard criteria – where there is sufficient evidence of customer support and demonstrable benefit.
- We have set ODI rates based on efficient marginal costs. There is less transparency around willingness to pay values, and efficient costs are an appropriate basis for a cost recovery performance commitment.

Residential void properties

- Finding and billing all properties that receive services provides clear benefits to customers via bill reductions. We have intervened to ensure all household void performance commitments have underperformance as well as outperformance payments.
- For ODI rates we have estimated the benefit from identifying a false void using the company's average wholesale residential bill and the marginal cost using the company's view or our default estimate of £30.

Customer protections

Customer protections

We have implemented the two elements set out at IAP for all companies to protect customers from unexpectedly high outperformance payments.

1: Aggregate Outperformance Sharing Mechanism

- A mechanism to share 50% of incremental outperformance payments with customers through bill reductions above a given threshold in each year in 2020 to 2025 period.
- The threshold is 3% of RoRE 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 – or a lower threshold if proposed by companies.
- Outperformance payments associated with PCs allocated to the retail controls will not be included in the sharing mechanism.
- In some cases companies have other mechanisms or expect the ODI package will not reach 3%, but the mechanism will apply as a safeguard even if it is not expected to be required.

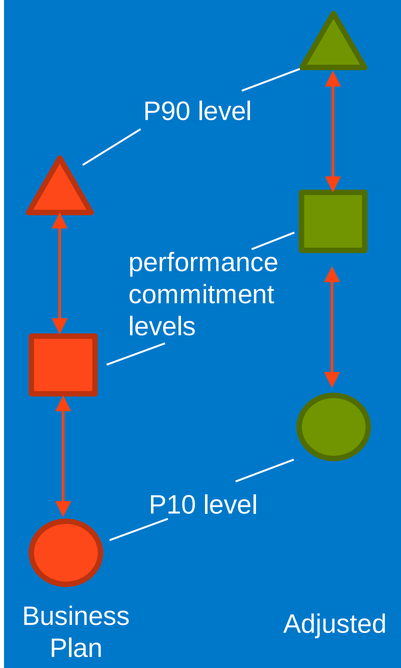
2: Caps and collars on potentially financially significant PCs

- Underperformance collars and outperformance caps are applied, 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

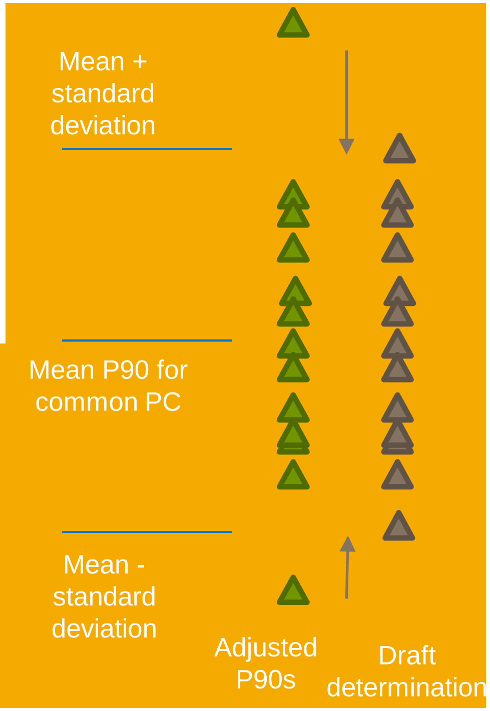
  ii. there is considerable uncertainty for customers about forecast future performance

In order to **select financially material performance commitments**, we first reviewed P90 performance levels.



1. Adjust companies' stated P90 (and P10) levels to retain the same ratio between a company's original P90 levels and the performance commitment levels in its business plan (i.e. where we intervened to change performance commitment levels, we adjusted the P90 levels accordingly).

2. Review the P90 levels for common and comparable bespoke performance commitments that are outside a reasonable range (where the ratio of the P90 level to the performance commitment level was outside the range given by the industry mean +/- 1 standard deviation), adjusting P90 levels to the edge of the range where we did not consider them to be robust.



- All performance commitments which had adjusted P90 payments higher than 10% of the sum of the company's P90 performance payments for all performance commitments within the relevant price control area (wholesale water or wholesale wastewater) are considered to be financially material.
- Where we added caps we did this at the P90 level.

As part of their draft determination representations, we expect companies to provide us with updated post-intervention P10/P90 levels and payments for each of their performance commitments, and an updated post-intervention overall P10/P90 RoRE range for their ODI package.

Setting the level for collars

We set **collars** at a level that gives companies sufficient incentive to deliver outcomes for customers. Our standard approach was to set this as a multiple of the performance commitment level relative to the first year of the performance level. We set the collar constant in each year of the 2020-25 period.

- ensures that the annual financial consequences from failing to improve increases in each year of the 2020-25 period.
- improves resilience, by providing companies with incentives to manage against the risk of high impact, low probability events.

If a company has proposed a collar that provides a wider range to the performance level, then we accept this.

The multiplier values capture worst levels of recent historical performance across the industry. We consider that this is an indication of the performance level under plausible circumstances against which a company should ensure that it is resilient. The table sets out the multipliers we used as a standard approach – there are some variations to the standard approach in some cases .

	Collar
Interruptions	4 x 2020-21 level (21.6 minutes)
Internal sewer flooding	2 x 2020-21 level (3.35 incidents per 10,000)
Pollution incidents	1.5 x 2020-21 level (36.8 per 10,000km)
Leakage	Cap at -5% (an increase of 5% from 2019-20)
PCC	1.1 x 2020-21 level
Mains repairs	1.5 x 2020-21 level
Sewer Collapses	1.5 x 2020-21 level
Unplanned Outage	2 x 2020-21 level
Drinking Water Contacts	2 x 2020-21 level
External sewer flooding	1.5 x 2020-21 level
Low pressure	10 x 2020-21 level
Sewer blockages	2 x 2020-21 level

Q&A and next steps

Question(s) received in advance

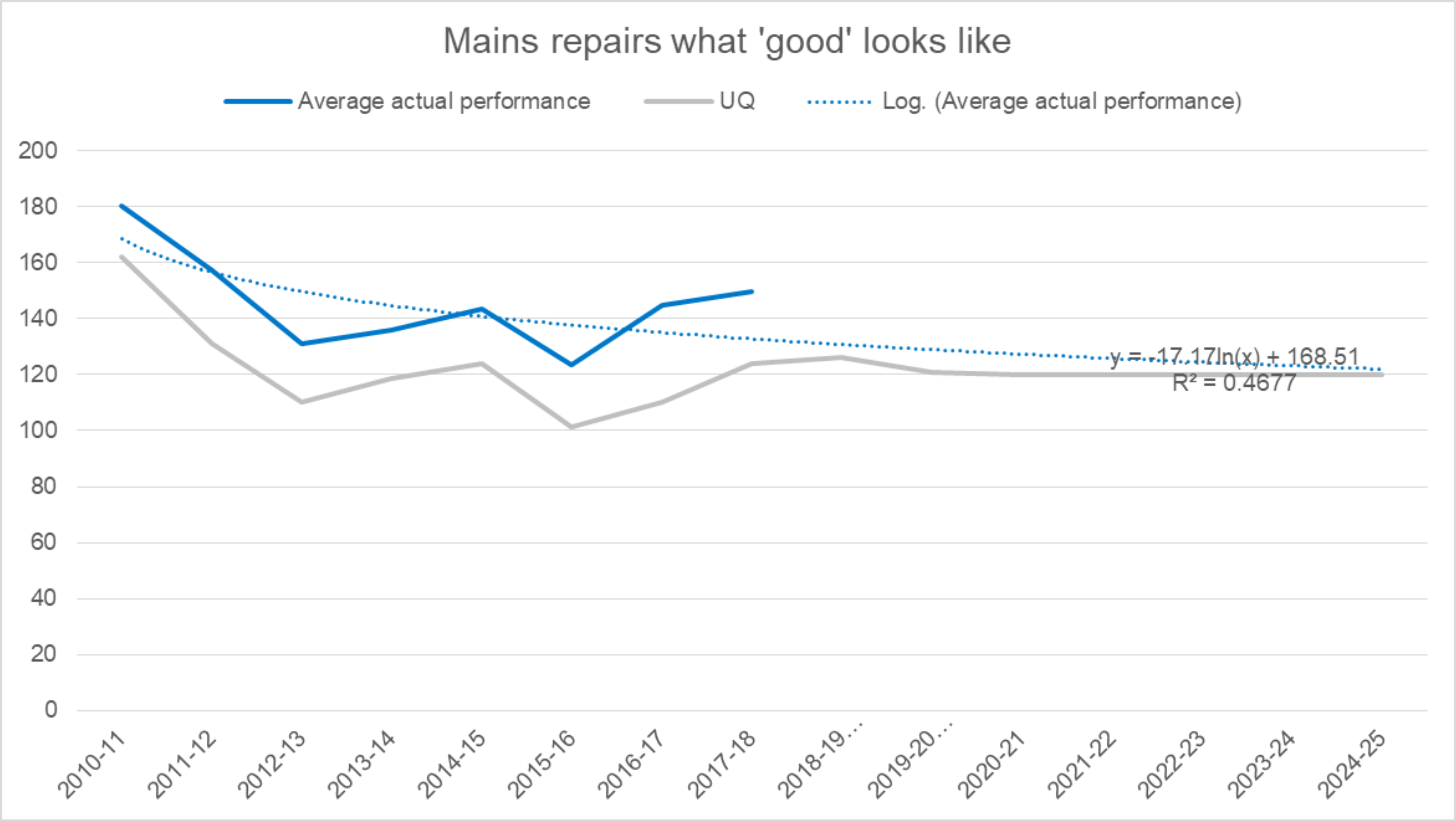
No questions were received in advance

Next steps

- Further detail on our sector-wide actions and policy decisions can be found in the policy appendix.
- Please note: We are going to publish the Outcomes representations data submission template shortly.
- Companies may submit written questions to us via the formal queries process (email pr19engagement@ofwat.gov.uk)

Annex

How did we derive a “good” level against which to assess performance



What good performance looks like chart
What ‘good’ looks like for this PC is based an extrapolation of historical performance. We do not consider there are any exogenous factors which would result in us altering the historical performance. The freeze/thaw event did raise the number of repairs in 2017/18 across all companies, but this may be offset by benign weather in other years. Extreme weather events are more likely in the future and should therefore be included in extrapolation to determine future performance.