Our Ref: [redacted]

Your Ref:

25 March 2022

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Dear Ofwat

**Response to the consultation on PR24 ODI rate setting**

Many thanks for the opportunity to respond to the above consultation – please find attached our views on the specific points raised in the consultation paper.

We are happy to engage in further discussion and consultation to improve the ODI rate setting in the future.

Yours faithfully

[redacted]

Group Chief Financial Officer

**SES Water response to discussion paper consultation**

**Q1. Do you have any comment on what the purpose of ODIs should be in PR24?**

**Response**

We agree with the listed purposes of ODIs and believe that ODIs continue to serve as useful benchmarking metrics to compare companies' performance in the industry and encourage emulation toward delivery of better service.

**Q2. Do you have any comment on our observations on the standard ODI rate formula and how we are considering revising it?**

**Response**

In relation to the standard ODI rate formula, we note that:

- Cost is not the only determinant of performance. Multiple factors affect performance and these multi-dimensional impact from external factors, in particular those beyond the management control, need to be isolated from the impact of cost on performance.
- It is true that the cost-performance relationship is non-linear. Therefore, a non-linear formula should apply to account for the diminishing return of cost and diminishing marginal benefit. The formula may take into account companies' ranking, upper quartile or bottom quartile, to address some of the non-linearity.
- We do not support the complete removal of marginal cost from the formula, as it involves high risk of losing quantitative information for ODI rate setting.
- If marginal cost is to be completely removed from the formula, it should be estimated from the base cost models to answer the question 'What base buys?' and based on certain assumptions about comparability across companies.
- The appropriate share of marginal benefits between companies and customers should also reflect the non-linearity of benefit as we move along the performance curve.

**Q3. What are the risks of unintended consequences from this approach? How can they be mitigated?**

**Response**

The risk of having no marginal cost in the formula would be to lose the information about what it costs to deliver the performance.

**Q4. Do you have any comments on using a bottom-up approach based on marginal benefits for setting ODI rates?**

**Response**

We do not have any comment on using a bottom-up approach for setting ODI rates.

**Q5. Do you have specific comments on setting ODI rates for asset health-related PCs?**

**Response**

We do not have any comment on using a bottom-up approach for setting ODI rates for asset health-related PCs.

**Q6. What are your views on using top-down allocation approaches for setting ODI rates or for other uses?**

**Response**

We do not support the top-down approaches, as there are challenges in quantifying and allocating the incremental rates to different PCs. There can be too much estimation and variations involved, which makes it difficult to standardise across companies. We see the particular risk when RCV is involved, as this figure tends to vary significantly across companies as well, causing some disproportionate impact on the calculation, if not carefully designed and sufficiently tested.

**Q7. How would we ensure that the performance increments for individual PCs are sufficiently robust and protect customers?**

**Response**

Performance increment can be set based on feasible levels of improvement or deterioration, historical performance, or natural limit. Wherever customer preferences are available, e. g from customer research or survey, these preferences need to be analysed and compared with feasible levels.

**Q8. Should we retain enhanced ODIs at PR24? If we do, should they apply to all companies? And which PCs should have enhanced ODIs?**

**Response**

We support keeping enhanced ODIs at PR24, as it would incentivise companies to choose the PCs they want to excel in.

**Q9. How should we approach assessing and setting enhanced ODIs at PR24?**

**Response**

Enhanced ODIs can be structured based on the combination of the following:

- Average past performance of the individual company and the industry as the whole
- Standard deviation from the mean, which measures both the variability and the probability of falling far from the mean
- Upper and bottom quartile companies' performance
- Marginal cost or benefit of outperformance at each incremental level.

**Q10. For water companies: how have enhanced ODIs influenced your company's decision making around achieving high performance?**

**Response**

Having enhanced ODIs would encourage the company to select a PC to excel and not to aim for being the industry average for all PCs. It would also reflect the company's strength and preference for being at the frontier in certain PCs versus the others.