Outcomes Working Group

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Ofwat

Agenda

Aim: to discuss options to set underperformance collars and outperformance caps at PR24

10:00	Welcome
10:05	Presentations and clarification questions
10.30	Breakout session
11.00	Feedback and discussion
11.25	Conclusions and look ahead
11:30	Close

Some thoughts

Our regulatory approach aims to allocate risk to those best able to manage and control it.

Protections impact incentives

Companies can't control the weather, but should mitigate the risk that weather impacts their customers.

PR19 approach

What we said and did at PR19

We set caps and collars:

- to protect customers from higher than expected outperformance payments (and companies from disproportionate exposure from very poor performance);
- to prevent companies from overfocusing on some performance commitments (and counterbalance any skews in exposure); and
- where there was considerable uncertainty in the data, either because of limited comparative or historical performance information, or low data quality.

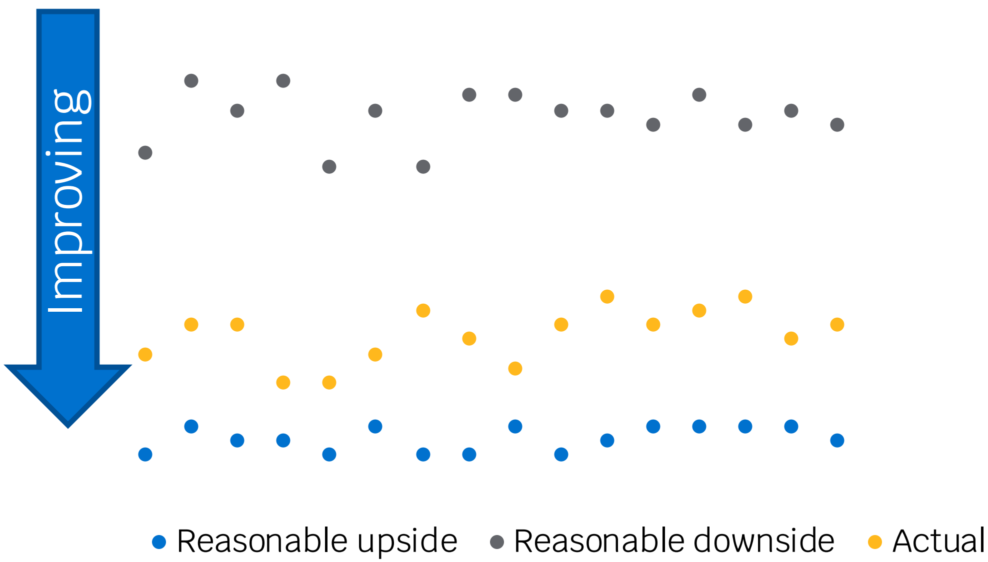
During the **final determinations**, we generally applied caps and collars to common PCs where:

- we considered they were financially material;
- there was considerable uncertainty in the data;
- there were caps and collars for other companies’ corresponding PCs.

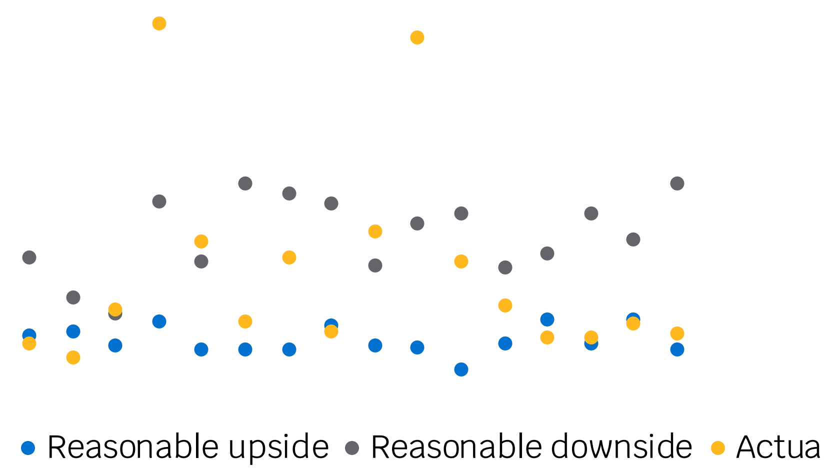
P10 and P90 estimates

At PR19 we made substantial use of the P10 (reasonable downside) and P90 (reasonable upside) estimates of performance that companies provided as part of their business plans. However, there are significant challenges in producing such estimates.

Theoretical expectation



Real data



Customer and company protections

We have two common ways to protect customers and one common way to protect companies in the 2020-25 period.

Caps and collars on potentially financially significant PCs

- Companies have underperformance collars and outperformance caps, for PCs where one of the following criteria was met at PR19:
  1. the p90 outperformance payment was forecast to be at least 10% of the total p90 payments for PCs relating to either water or wastewater activities (as relevant);
  2. there was considerable uncertainty about forecast future performance;
  3. it is a common PC and most other companies had caps and collars; or
  4. a company provided another reason and there was sufficient evidence of customer support.
- The caps and collars apply to individual PCs (not across groups of PCs).
- Outperformance caps were generally set at the P90 estimate of performance
- Common PC underperformance collars were set on the basis of previous worst service in the industry.
- Collars for other PCs were based on P10 estimates.

Aggregate Outperformance Sharing Mechanism

- Share 50% of incremental outperformance payments with customers through bill reductions above a given threshold.
- The threshold for sharing is 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 are not included in the sharing mechanism.

PR24 approach

Context for PR24

Greater focus on common PCs

Reduced uncertainty due to more years of historical and comparable data

Aiming to simplify and streamline the price review where possible

Note – there is an interaction with enhanced ODIs, and our upcoming discussion paper on ODI rates will invite views on this.

Potential approaches for PR24

Caps and collars on individual PCs, informed by historical performance (e.g. best and worst)	Caps and collars on individual PCs, informed by probability estimates	Limit the payments from individual or groups of PCs (e.g. to £m or % RoRE) Could be linked to customers' views	Remove caps and collars and rely on aggregate mechanisms

Considerations:

- Sufficient incentives on companies
- Role of customers', companies' and Ofwat's views
- Protections needed by customers and companies
- Overall balance of package

Breakout group questions

1. What **factors** should we consider when determining appropriate protections for customers and companies in the ODI framework?

2. What role should **historical performance** and **companies' probability estimates** have in the setting the level of caps and collars?

3. To what extent should caps and collars **differ between companies**?

4. What should the role of **customers' views** be?

5. How do we ensure a **balanced package** of PCs?

6. What should the balance be between caps and collars on individual PCs, and the role of **aggregate mechanisms**?

Look ahead

We suggest the following dates and subjects for **working groups**, although this is subject to change.

10 February	ODI risk: caps and collars
10 March	Operational resilience and asset health PCs
April	Business demand/ leakage / PCC / Distribution Input