

IPD2022 Consultation response
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Dear Ofwat

Draft determination of Northumbrian Water's in-period outcome delivery incentives 2021-22

I would like to comment on the draft determination of Northumbrian Water's claim that part of its underperformance payment for supply interruptions should be excluded on the grounds that the interruptions were caused by Storm Arwen. Northumbrian (NES) has claimed that the impact of Storm Arwen constituted a civil emergency, and Ofwat has agreed with that assessment. In applying for an exemption, NES relied on the wording of the common water supply interruptions performance commitment, which states that 'Companies may make a representation to Ofwat for an exception to be granted on the basis of a civil emergency under the Civil Contingencies Act 2004, where the supply interruption is not the cause of the emergency.'¹

We object in principle to some of the grounds which Ofwat has used in refusing NES' claim, as follows:

1. Ofwat considered NES' claim not on its own merits but in the context of NES' overall performance. Ofwat said that in spite of the number of interruptions caused by Storm Arwen NES' overall performance on supply interruptions was below the collar for this performance commitment. Ofwat also said that in spite of the number of interruptions caused by Storm Arwen NES' overall underperformance payment from all PCs was not out of step with the range of out/underperformance payments that the company might reasonably be expected to incur during 2020-25 and the broad potential RoRE five-year average range for ODIs set out in the PR19 methodology.

In our opinion NES' wider performance is irrelevant to the determination of NES' claim. The words relating to the civil emergency exemption in the performance commitment are not caveated by consideration of a company's wider performance. The question of whether an exemption is warranted should therefore be determined by questions narrowly related to the case in point, such as whether a civil emergency took place and was responsible for the service failures, and not an 'in the round' assessment of whether a company deserves an exemption, which is of course highly subjective.

¹ Note that my comments here relate to the common interruptions performance commitment, which includes the civil emergencies exclusion, rather than NES' bespoke PCs on interruptions



2. Another ground that Ofwat gave for refusing NES' appeal was that to do so might weaken the company's incentives in relation to such events in the future and managing the impact on customers. When Ofwat determined the specification of the supply interruptions performance commitment it clearly gave consideration to where the risk from unforeseen events should lie and the impact this would have on incentives. In general, it concluded that risk should lie with companies. For example, it concluded that there would be no exclusion for interruptions caused by third parties. However, it also determined the limits of companies' responsibilities in setting the collar on underperformance payments and including the civil emergencies exclusion.

Decisions about the impact of the performance commitment on incentives were therefore made in the final determination. It is not acceptable to seek now to reverse those decisions in the middle of the price control period. Ofwat may now perhaps regret offering the civil emergencies exclusion, but it was part of the package that companies accepted and must be honoured.

My final point is a broader one around the use of protections, such as the civil emergencies exclusion, in the regulatory regime. When these protections are put in they are described as intending to reduce the exposure of water companies to extremes, which is said to be reflected in a lower cost of capital. Other protections in this list include the cost-sharing mechanism, the collars on performance commitments and the IDoK mechanism. If, when tested, these protections do not mitigate extreme situations, then it seems the balance laid out between risk and reward becomes skewed.

Refusal of NES' civil emergencies claim would demonstrate the civil emergencies exemption was not able to be used in the way it was designed. In assessing claims on protection mechanisms Ofwat should refrain from looking at whether risk has or has not materialised in other areas and assess only whether the criteria as laid out in the regulations has been triggered.

Yours sincerely



Director of Strategy and Regulation