15 November 2022

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

Ofwat

About this document

This document provides notice of our final determination on the extent to which the price controls set by the Competition and Markets Authority (CMA) redetermination, are to be adjusted to reflect Northumbrian Water's performance for the 2021-22 charging year, under Part 3A of condition B of the company's licence (Performance Measure Adjustments, referred to in this document as 'in-period' determinations).

The specific adjustments, and our reasons for these, are set out in this document and in our Sector overview: Final determinations of in-period outcome delivery incentives for 2021-22.

We also publish models related to our final determinations on our website.

Background

At the 2019 price review (PR19), companies made performance commitments, or pledges, to their customers and stakeholders about the service levels they would meet to make progress towards their outcomes. Northumbrian Water's performance commitments for the 2020-25 period are set out in PR19 final determinations: Northumbrian Water - Outcomes performance commitment appendix.[1]

Each performance commitment has an outcome delivery incentive (ODI) that provides either financial or reputational consequences for companies of outperforming or underperforming their performance commitments. Many of the financial ODIs are paid during the 2020-25 price control-period. The reason for this is to bring payments closer in time to when customers experience a given level of performance. The remaining incentives are paid at the end of the period.

ODIs act as an incentive for companies to deliver their committed levels of performance, returning funding to customers for foregone benefits if they deliver less than is expected. Companies that go beyond and deliver greater benefits than expected to customers and the environment can receive outperformance payments.

Northumbrian Water reported its performance against these performance commitments in its annual performance report (APR) in July 2022. We assessed the company's performance against its performance commitments and, in October 2022, consulted on our draft determinations for companies' in-period ODIs for 2021-22.

[1] We take account of performance commitments as set out in the PR19 definitions adjusted, if relevant, in accordance with Annex 2 of the company's performance commitment appendix. Annex 2 provides for changes and corrections to be made to performance commitment definitions during the 2020-25 period in certain circumstances. An overview of changes and corrections made to companies' performance commitment appendices can be found at PR19 Outcomes performance commitments: changes and corrections.

In our final determination we set out relevant adjustments to the company's price controls, for one or more future years, in accordance with Part 3A of Condition B of the company's licence. The results of our assessment for 2021-22 will affect Northumbrian Water's customers' bills in the 2023-24 Charging Year.

Further details regarding the responses we received, our final determinations and the adjustments that we have made are presented in sections 1 and 2, and in Sector overview: Final determinations of in-period outcome delivery incentives for 2021-22.

In our Sector overview Final determinations of in-period outcome delivery incentives for 2020-21 we deferred our determination of the value of companies' Per Capita Consumption (PCC) ODI payments for the 2020-21 to 2023-24 charging years to the end of the 2020-25 period. We set out this decision and the reasons for it in the Consultation on changes to per capita consumption performance commitments – our decision on reporting performance and ODI timing which we published after having considered stakeholder responses to our July 2021 consultation.

Executive summary

Having assessed Northumbrian Water's performance against its performance commitments in 2021-22, the ODI payments and performance are as reported by the company with the following exceptions:

- C-MeX and D-MeX – we are including a C-MeX outperformance payment of £2.879m and a D-MeX outperformance payment of £0.700m;
- Greenhouse gas emissions – we are including a larger outperformance payment of £7.646m compared to our draft determinations
- Request for interventions for storm events – we are including a bespoke adjustment for £12.894m, which is a change from our draft determinations.

See section 1 for details of our interventions and policy decisions.

Contents

1. Results of our assessment

1.1 Interventions and policy decisions

Table 1.1 below sets out our view of the payments due for performance commitments on which we have intervened compared to the values reported by Northumbrian Water.

Table 1.1: Summary of interventions

Performance commitment	Company's reported payments 2021-22 (£m)	Our draft determination after interventions 2021-22 (£m)	Our final determination after interventions 2021-22 (£m)	Difference between company view and our final determination (£m)
PR19NES_BES21 Greenhouse gas emissions	7.646	3.873	7.646	0.000

Note:

We have also intervened in relation to Northumbrian Water's reported payments for its three water supply interruption performance commitments in relation to the impact of Storm Arwen. We have applied a bespoke adjustment of £12.894m which we explain in section 1.1.2 and summarise in table 1.1.2.

In our final determination we are intervening on the following performance commitment(s):

1.1.1 Greenhouse gas emissions

Our position at draft determination

In our draft determination, we intervened to reduce Northumbrian Water's outperformance payment for the Greenhouse gas (GHG) emissions performance commitment (PR19NES_BES21) by £3.773m, from £7.646m to £3.873m. This was because, following a review of company reported performance on GHG emissions, we did not consider that the company's reporting of reductions attributable to the purchase of Renewable Energy Guarantee of Origin Certificates (RGGOs) was fully consistent with the PR19 expectation that companies' ODI payments should only relate to real changes in performance.

When the referenced version of the Carbon Accounting workbook (CAW) was updated in June 2022, from version 13 (CAWv13) to version 16 (CAWv16), we reminded companies of the expectation that ODI payments will only relate to real performance changes and not definitional, methodological or data changes. We were clear that a change to the version of the CAW should not make the performance commitments materially more or less challenging.

In its 2021-22 APR, the company reported emissions reductions attributable to the purchase of RGGOs. We queried Northumbrian Water to better understand its reporting in light of the

new CAW methodology and the revised baseline against which the company measured its 2021-22 performance. Based on the information the company provided, it appeared that it was not reporting its baseline and performance on a consistent basis.

This brought to our attention a difference between CAWv13 and CAWv16: the former did not include emissions reductions attributable to the purchase of RGGOs, whereas CAWv16 does.

The effect of reporting with reference to CAWv16 is to make the performance commitment materially less challenging to achieve than was the case in the company's PR19 redetermination. Consequently, we considered that some of Northumbrian Water's improved performance in relation to GHG emissions was due to a methodological change as opposed to a change in real performance.

Taking these points into account, we intervened to remove £3.773m of the company's reported outperformance payment. This drew on information provided by NES and sought to remove the benefit of the RGGOs which were included in the reported performance but not the baseline. We based this adjustment on the RGGOs contributing to 43.4% of the reported reduction in GHGs.

Stakeholders' responses

Northumbrian Water's response, which is available on our website, demonstrated that its baseline and performance for 2021-22 are reported on a consistent basis. The company provided an audit report in support of its arguments that the appropriate outperformance payment for this performance commitment for 2021-22 is £7.646m. This audit report is also available on our website. The company confirmed that the move to CAWv16 provides for the use of additional market-based approaches to those available under CAWv13 when calculating emissions reductions. It said that one such market-based intervention is the purchase of RGGOs.

The company's response acknowledges that one element that contributed to its outperformance in 2021-22 was the purchase of RGGOs in relation to green gas. It also noted that it purchased the RGGOs at significant cost and that RGGOs are accredited through the Green Gas Certification Scheme which is aligned with the Greenhouse Gas Protocol and based on Ofgem data. The company also stated that the use of such certificates has been externally assured to be compliant with ISO14064-1.

We subsequently met with the company to discuss how the actions the company took in 2021-22 contributed to this performance and how the adoption of CAWv16 influenced the decisions the company made.

Consideration of responses and final determination

Having considered stakeholders' responses on this matter, we are increasing the company's outperformance payment on this performance commitment to £7.646m, as in its July

submission. This is because the company has demonstrated sufficiently that it did adjust its baseline to align with its reported performance and it took actions that are included within CAWv16 to improve its performance. The outperformance payments have not arisen solely because of a change in methodology. However, we will continue to monitor the operation of this performance commitment, the purpose of which is to incentivise reductions in GHGs arising from the company's operational activities. Should the company exceed its performance commitment levels for this performance commitment in any subsequent year in the 2020-25 period any reported outperformance must be clearly explained, supported by appropriate assurance evidencing and making clear how such outperformance relates to actions which directly or indirectly reduce GHGs and should not result from changes to methodology.

1.1.2 Request for intervention for storm events

In this section, we set out:

- our position at draft determination;
- stakeholders' responses to our draft determination;
- our consideration of the points raised in those responses; and
- our final determination.

Our position at draft determination

Background

Northumbrian Water reported a total underperformance payment of £22.979m on its water supply interruptions performance commitments[2], which it attributed to the impact of Storm Arwen (which it said had a £25.787m impact on ODI payments). The company requested that we intervene to exclude the impact on ODI payments of Storm Arwen from these performance commitments. It stated that the full impact of the storm on ODI payments could be removed but it proposed retaining some of the underperformance payment for areas where it considered it could have improved. The impact for customers of these service interruptions was severe. Northumbrian Water saw up to 8,000 properties interrupted, with around 1,200 without water up to 45 hours later.

The partial exclusion put forward by Northumbrian Water would have reduced the company's underperformance by £22.411m across its water supply interruption performance commitments.[3] This means that Northumbrian Water's proposal would have returned

[2] It has a common water supply interruptions performance commitment, which all companies had to have at PR19. It also has two bespoke performance commitments, on interruptions to supply greater than 12 hours and interruptions to supply between one and three hours which the company proposed at PR19.
[3] The company requested a partial exclusion of £6.061m on its common water supply interruptions performance commitments, £16.067m on its interruptions to supply greater than 12 hours performance commitment and £0.283m on its interruptions to supply between one and three hours performance commitment.

£3.375m of the £25.787m related to Storm Arwen to customers, resulting in a total underperformance payment of £0.567m.[4]

The company considered that the storm amounted to a civil emergency under the Civil Contingencies Act 2004 (CCA 2004) and that the supply interruption was not the cause of the emergency. The company stated that customers' supply was impacted due to the loss of power which caused telemetry failures across the network and failures at sites without back-up generation. The company stated that the scope of the outages was beyond anything it could reasonably have prepared for. The company provided extracts from an Ofgem report to evidence that the impact was caused by various deficiencies on the part of Northern Powergrid (NPg).

The company also referred to: (i) the exclusions that energy networks have for extreme weather events, comparing its underperformance payments with the smaller financial penalties that were incurred by the Distribution Network Operators (who Northumbrian Water says had greater numbers of customers affected for longer) following the Ofgem and Department for Business, Energy and Industrial Strategy (BEIS) reviews of Storm Arwen; and (ii) the exemptions that the Environment Agency has offered for pollution events incurred during the same storm. The company concluded that the underperformance payment did not appear to be reasonable and would be disproportionate to the scale of the harm.

Our draft determination

Having reviewed the company's requests and supporting evidence we considered that it was not necessary to intervene to exclude the impact on ODI payments of Storm Arwen from the three relevant performance commitments which would have led to adjustments to the payments that would ordinarily flow under the price control package in the CMA redetermination. We said our proposed decision ensured that the company bore the appropriate level of risk and remained incentivised to deliver for customers and the environment.

The effect of our draft decision was that the company's reported performance on its supply interruptions performance commitments remained unchanged and was as follows in our draft determination:

- Water supply interruptions performance commitment – underperformance of £5.770m
- Interruptions to supply greater than 12 hours performance commitment – underperformance of £17.530m
- Interruptions to supply between one and three hours performance commitment– outperformance of £0.321m

[4] Since publication of our draft determination, we now understand that our interpretation of the company's proposed partial exclusion underestimated the overall reduction in the company's underperformance by £2.8m.

This resulted in our draft decision proposing to return £25.787m to customers under the company's three water supply interruptions performance commitments related to Storm Arwen's impact on ODI payments.

Stakeholders' responses to our draft determination

We received five responses specifically to Northumbrian Water's draft determination. All of these are available on our website.

Northumbrian Water

Northumbrian Water disagreed with our decision not to exclude the supply interruptions directly attributable to Storm Arwen from the assessment of its performance against the three supply interruption performance commitments. It provided detailed arguments in response to the draft determination, all of which we have considered. In summary those are:

The approach to civil emergencies

- The company considered that the reporting guidance provides for a Civil Emergency (CE) Exception "CE Exception" and that Ofwat has sought to exercise a level of discretion that is not provided for in the context of the reporting guidance and which is inconsistent with how the CE Exception is intended to operate. The company considered its interpretation is consistent with its expectation as to how the CE Exception would be applied by Ofwat.
- The company stated that there is nothing explicit in the language of the reporting guidance to suggest that the application of the CE Exception is discretionary, nor to indicate other criteria that would need to be met for an exception to be made. The company referred, in this regard, to the intention of the reporting guidance to be "comprehensive, clear, unambiguous and easily understood" and to the process of its development. The company considered that the effect of the criteria chosen by Ofwat renders the CE Exception pointless in all but a very few of the cases in which it was obviously intended it should bite, supposedly on the basis that the relevant performance commitments transferred the risk to the companies, thus depriving the CE Exception of all utility. It said the factors Ofwat considered are either irrelevant or given improper weight.
- The company said that the CE Exception is intended to protect water companies from unreasonable penalties for supply interruptions that arise from extreme events which meet the CE Exception criteria. The company said this protection is an important aspect of balancing the risk associated with such events, particularly where the interruptions are clearly outside the reasonable control of management; it is consistent with the reasonable expectations of customers and other regulated sectors.
- The company said Ofwat's suggestion that the exclusion of some supply interruptions, even as an exception, has the same effect as a change to the performance commitment in-period in that it may create a disconnect between the intended cost/service package and what is delivered, is neither rational nor relevant. It stated that other regulatory

initiatives are much more likely to introduce distortive effects, such as the response to the Green Recovery agenda and associated funding for some of the water companies.

The risk that should fall on the company and the scale of the underperformance payment

- The company stated it is incorrect for Ofwat to assert that it didn't think it needed protection against underperformance. It considered that it did have protection against extreme underperformance outside its control by virtue of the inclusion of the CE Exception in the reporting guidance.
- The company considered that Ofwat's comments suggest that Ofwat would only consider that an intervention might be required where the performance has been sufficiently poor so as to trigger the collar. But the company considered that CE Exception is an area of excluded risk, so triggering of caps/collars should have no bearing this.
- The company considered that the CE Exception results in a disproportionate ODI penalty relative to its normal standards of performance and to how the impact of Storm Arwen have been accounted for by other regulators. It said that, given Ofwat's approach, the more extreme the impact (and so the more extreme the civil emergency) the larger the underperformance payment. The company stated that it is regularly an upper quartile performer in this measure and that this year's performance is out of line with historic performance. It considered that the underperformance payment it is facing is greater than the penalties paid out by its electricity Distribution Network Operator (DNO) whose failures were the root cause of the water supply interruptions. It emphasised that such an underperformance payment would be disproportionate to the scale of the harm and to the degree that these events were within the company's reasonable control.
- The company stated that weather impacts are not symmetric, rather adverse weather has a greater impact on performance than benign weather. It also stated that cost allowances (which are sometimes based on upper quartile performance), reflect more benign weather conditions and the econometric models do not take this into account.

The incentives created by Ofwat's approach

- The company considered that Ofwat's approach is short-term and irrational. The company went on to provide examples of risk sharing mechanisms for extreme weather adopted by other regulators both in the UK and internationally. It also stated that the impact of Ofwat's proposals would be to expose the companies to a low probability but very high impact set of risks that are outside of their control. The company said this "will distort behaviours and decisions as they seem (sic) to manage this extreme weather risk", driving inefficient investment/outcomes that shareholders would finance, but which customers would ultimately end up funding.
- The company stated that not applying the CE Exception would push costs onto customers through higher cost of capital or uneconomic investment to mitigate the risk of an ODI underperformance payment for qualifying civil emergency events that are inherently exceptional. It said this would not be in the customer interest and it would have an opportunity cost to other service areas.

Other points

- The company repeated its proposal of a partial underperformance payment of £3.375m as it considers there is room for improvement in some specific areas. It stated that the partial underperformance payment proposed fits within the balance of risk determined by the PR19 price control.
- The company also pointed out that a partial underperformance payment would benefit all customers, as opposed to those directly affected by the event. It said it indicated that it would be open to an alternative proposition whereby, instead of incurring a partial underperformance payment, it would make an equivalent transfer of value from the company to customers in a different manner – for example by additional investment to mitigate the impact of future storms, alternative schemes/investment to benefit the communities affected and/or additional and more targeted compensation payments.
- The company said that in circumstances where customers are dissatisfied with its service, it would expect to see this reflected in the various measures used to track and evaluate customer experience. It said that had the customers affected considered that the company was responsible for those interruptions, or that its efforts to restore supply were lacking, this should be visible in the relevant performance measures. The company said that it observed no material adverse impact on its Customer Satisfaction (CSAT) metrics nor on its C-Mex scores and that there was no material adverse impact on its written complaints.

As part our consultation process for developing the PR24 methodology, Northumbrian Water submitted a report by Frontier Economics (commissioned by Northumbrian Water, Yorkshire Water and South East Water) on managing extreme weather risk within regulatory frameworks[5]. While this report focused on the development of our PR24 methodology, which we will conclude next month, and our in-period determination process must focus on the PR19 framework, we have considered the points to the extent they are relevant to this process.

Anglian Water

Anglian Water said that when Ofwat specified the supply interruptions performance commitment it clearly considered where the risk from unforeseen events should lie and the impact that this would have on incentives. "In general, [Ofwat] 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." Therefore, Anglian Water said it is not acceptable to "reverse those decisions in

[5] Frontier Economics (commissioned by Northumbrian Water, South East Water and Yorkshire Water), 'Managing extreme weather event risk in the regulatory framework', October 2022.

the middle of a price control period…the civil emergencies exclusion was part of the package that companies accepted and must be honoured."

It also states that refusal of NES' civil emergencies claim would "demonstrate the civil emergencies exemption was not able to be used in the way it was designed." Its states that such protections are "intended to reduce the exposure of water companies to extremes, which is said to be reflected in a lower cost of capital… If, when tested, these protections do not mitigate extreme situations, then it seems the balance laid out between risk and reward becomes skewed."

CCW

The Consumer Council for Water (CCW) responded to our consultation. It agreed with our decision "not to make exceptions for Northumbrian Water, South West Water, South East Water and Yorkshire Water where a combination of extreme weather events and third-party damage to company infrastructure contributed to failure. CCW supports this view by saying companies should carry this risk, as they can also gain benefits if they experience a period of good weather leading to reduced pressure on their water and wastewater networks."

Unite

The trade union, Unite responded to our consultation. Its response says if we granted Northumbrian Water relief, it would mean higher bills for workers and consumers. It also states that £20.3m is a tiny fraction of the £3.3bn Northumbrian Water has recorded in operating profit, or the £1.8bn the company has paid out to shareholders since the company was acquired by its current owner.

A customer of Northumbrian Water

A customer asked when they can expect their share of the underperformance payments from Northumbrian Water.

Consideration of stakeholders' responses to our draft determination

In addressing the points made by respondents to our draft determination, we consider it helpful to start by setting out the overall framework within which we make our in-period determinations. As such, in this section we set this out:

- The overall regulatory framework within which we make our in-period determinations;
- The approach to civil emergencies; and
- Assessing whether an intervention is required

The overall framework

Our price reviews specify the costs that we allow companies to recover from their customers, and the service that we expect them to deliver for that. Our policy objectives under our price reviews are set by reference to our statutory duties[6] and the UK and Welsh Governments' strategic priorities and objectives statements which we have to act in accordance with.

The outcomes framework

Within our price control regime, the outcomes framework holds companies to account for the level of service they provide. While this includes broad measures of customer satisfaction (C-Mex for households and D-Mex for developers), other performance commitments focus on more specific features of the underlying service, such as supply interruptions, and asset health measures to measure the operational resilience of companies' networks.

The determinations specify performance commitment measures and performance commitment levels that we expect companies to attain for several areas of service, based on the business plans that companies put forward. Performance commitments are linked to outcome delivery incentives (ODIs). If companies fall short of their performance commitment levels, they incur underperformance payments which are calculated using the specified ODI rate. This incentivises them to deliver the service levels expected of them. We also encourage companies to push themselves to provide even better service by providing outperformance payments where they go beyond the performance commitment level.

Where a company does not deliver the expected level of service this means customers are affected. A company's customers bear the impact of a reduction of service, in this case an interruption to supply, no matter what the cause or reason for that service failure.

Companies have a significant level of control over the delivery of the outcomes that we specify when defining performance commitments. However, in some cases external factors can also have an effect on the ability of companies to meet their performance commitment levels. Where appropriate, we maintain incentives on companies to mitigate the impact of external factors on customers through how they prepare and respond to such events. For example, in dry weather, mains may be more likely to burst and cut off supply to customers, but companies can reduce the likelihood of this happening through the way they monitor and maintain their assets, and if supply is cut off, they can mitigate the impact on customers by repairing the fault quickly.

Our 'base' expenditure allowance for maintaining the network allows for a level of resilience and has been sufficient for companies to maintain and improve performance and asset health metrics.[7,8] If overall industry costs are higher than forecast then this will impact on

[6] The general statutory duties for most of our work as an economic regulator are set out in the Water Industry Act 1991: https://www.legislation.gov.uk/ukpga/1991/56/contents
[7] Ofwat, PR24 draft methodology: Appendix 9: Setting expenditure allowances, chapter 3.
[8] Ofwat, Assessing base costs at PR24, chapter 5.

the base allowances for the next period which are based in part on historical efficient expenditure. Good management is critical to delivering resilient services. Companies can also put in enhancement claims to improve resilience or service quality further, although they will have to demonstrate this is in customers' interests, and they will be held to account for higher service standards if it is allowed.

Our regime does not, therefore, aim or profess to insure companies against all risks outside of their control. Just like in a competitive market, there will be some risks that regulated companies bear the consequences of, even if the cause was not their fault. However, the flip side of the regime is that there are instances where companies benefit from improved performance when the circumstances are more favourable and may gain outperformance payments as a result. For example, if there is a wet summer, per capita consumption, one of the performance commitments we measure, will be lower than normal, even without any company action, as people tend to water their garden less.

Our price review determinations recognise that companies bear risk, including some external risk, and so have a degree of variability in their returns that is outside of their control. What is important is that the upside and downside risks for an efficient company are broadly balanced so that it anticipates a "fair bet" on a forward-looking basis.

Although we consider companies should bear some risk, we limit the extent of this through a range of protection mechanisms.[9] This includes cost sharing, which means that customers bear a portion of any company overspend (generally 50%). It also includes collars on ODI payments to protect companies against large underperformance payments on specific performance commitments, as well as caps to protect customers against unexpectedly high payments.[10] Companies were able to propose caps and collars in their business plans at PR19, including on bespoke performance commitments.[11]

Companies were able to refer their final determinations to the Competition and Markets Authority (CMA) for redetermination. Northumbrian Water did this and received a redetermination by the CMA, which included a higher allowed return on capital in part to counterbalance perceived downward skew in companies' ODIs, recognising that some individual ODIs, including supply interruptions, may not be truly symmetrical. Once the

[9] These include reconciliation mechanisms (such as inflation indexation of the cost of new debt, changes to tax rates and changes in customer numbers) protecting for circumstances that arise outside of management control; protections for changes in business rates, abstraction charges and wages; interim determination provision which allow price controls to be reopened in specific circumstances; along with the linked substantial effect provision which provide protection to both companies and customers where circumstances have a material adverse (or favourable) effect on a company.

[10] At PR19, we set caps and collars on performance commitments which we considered were financially material and uncertain. If the performance commitments proposed by companies did not meet these criteria, we generally did not add caps or collars.

[11] We set a cap and collar on Northumbrian Water's common water supply interruptions performance commitments, because we considered it to be financially material. At no stage during the price review process, did Northumbrian Water propose caps or collars on either of its bespoke performance commitments.

determination has been set, we consider companies should bear the consequences of their price review packages to avoid later unbalancing the package in companies' favour.

Impact on wider framework

We also consider how the ODI regime interacts with the wider regime, including investor returns and incentives to invest.

For example, in considering the package as a whole, we consider whether our outcomes regime may create unwanted incentives to invest so as to minimise risk in an inefficient way, which would not be in customers' interests. This applies both to the package as set and to our judgement about any interventions put forward by companies in period, as reflected in our draft determinations. In our draft determinations, we said we did not think our proposed decision would give rise to issues in this respect and we remain of that view.

First, in relation to supply interruptions, the package set at PR19 reflects the possibility of an intervention only in relation to the impact of a qualifying emergency.[12] This is acknowledged by Northumbrian Water which observes that "the performance commitments were intended to transfer [to companies] all risks in relation to supply outside those caused by qualifying civil emergencies." Even in cases where a company evidences that there has been a qualifying emergency (our approach to which is discussed below), a decision whether to intervene has to be taken in light of what the performance commitment definition says, and consistently with our stated policy objectives and statutory duties. Our decision in this final determination on whether or not to intervene reflects that.

Accordingly, by reference to the position we set out at PR19, we do not consider that the approach we have taken leads to companies bearing any more risk than assumed at PR19 or creates any broader consequences which distort the wider regime. Therefore, investors will not require a higher allowed return at PR24 with respect to this.

Further, we do not consider that our decision in this final determination on whether or not to intervene will otherwise affect companies' incentives to invest at PR24. As now, companies will be funded to meet a level of resilience through base expenditure. We will also consider companies' requests for additional expenditure to enhance resilience during our price review process. We set out our proposed approach to assessing these requests as part of the PR24 draft methodology.[13] Our criteria include a clear and systematic risk assessment process that shows the investment is a priority. Investments must address specific relevant hazards, and investments should be cost beneficial, and represent 'best value'. We would not expect to make enhancement allowances to be resilient to very rare events. Enhancement investments that prevent very rare occurrences are only likely to be value for money where customers place a very high value on the service.

[12] see footnote 14, below.
[13] Ofwat, PR24 draft methodology: Appendix 9: Setting expenditure allowances, p62-63.

Companies will therefore not be 100% resilient and may not meet their performance commitment levels in all cases. However, that does not necessarily imply customers should bear the risks of such events occurring under our outcome incentive package, although this package should be balanced in the round. Companies may incur underperformance payments due to events outside of their control, as under PR19 final determinations and reporting guidance. We link ODI incentives to customer valuations at a price review – so companies will only be incentivised to invest efficiently, i.e. where the likely change in ODI payments, which reflects customers' valuations of improving service, outweigh any associated incremental costs of the investment.

The approach to civil emergencies

In our PR19 methodology and subsequent PR19 final determinations we said that in relation to adverse events, such as weather events, we wanted companies to be incentivised to minimise the impact on customers. We said these are precisely the events we want the sector to be resilient to. That having been said, the water supply interruptions performance commitment and Northumbrian Water's two bespoke supply interruptions performance commitments incorporate the Reporting guidance for PR19 – Supply Interruptions. The reporting guidance states:

> *"The default position is that the water company manages the risk of supply interruptions and there are no exclusions. This measure covers planned and unplanned interruptions. The cause of the interruption is not relevant to the calculation of the reported figure. That is, asset failure caused by third parties would be treated the same as the failure of the company's assets and planned or unplanned interruptions are the same.*
>
> *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*."[14]

As can be seen from the text set out above, there is no automatic or unqualified exemption from the supply interruptions ODI underperformance payments in the reporting guidance. On the contrary, the sentence concerning a civil emergency explains that companies "may make a representation to Ofwat for an exception to be granted"; in other words, that Ofwat will consider making an exception in the event of a qualifying emergency, should the company make a representation to us to do so.

That is not to say that the sentence concerning a qualifying emergency in the reporting guidance is irrelevant or pointless: it sets out that if such an event has occurred Ofwat should (upon receipt of a representation from the company) consider the matter further. However, the reporting guidance is not mandating the outcome of that consideration: Ofwat may

[14] In this determination, we refer to a civil emergency under the Civil Contingencies Act 2004, where the supply interruption is not the cause of the emergency as a "qualifying emergency".

consider that, despite suffering an impact on its performance as a result of a qualifying emergency, the company should nevertheless incur an underperformance payment. Nor does the reporting guidance specify any particular criteria which Ofwat should consider in deciding whether to make an exception.

Where a company makes a representation, Ofwat must exercise its discretion in line with the legal framework. This means that where a company demonstrates that there has been a qualifying emergency, in considering whether to intervene, Ofwat should consider all the relevant circumstances in light of our statutory duties and PR19 policy objectives.

Finally, we have considered Northumbrian Water's comments about its expectation as to the application of the reporting guidance and the process of the development of the reporting guidance. Our view, as explained above, is that the language is not that of an automatic exemption. We do not consider, particularly in the light of the overall regulatory framework described in the subsections above and the clear intention of the performance commitment and ODI regime as regards risk transfer and limited exclusions, that companies would reasonably have expected at PR19 that in the event of a qualifying emergency, any supply interruption would be excluded automatically and in its entirety from the ODIs, irrespective of any other considerations or circumstances.

Our approach to assessing whether an intervention is required

We have considered the representations made on our draft determination. As explained above, the sentence concerning a qualifying emergency in the reporting guidance allows a company to make a representation to Ofwat to consider making an exception. As noted above, it is explicitly not an automatic exclusion, nor does it prescribe any particular criteria to be considered when deciding whether to make an exception. Therefore, in light of our statutory duties and our PR19 policy objectives, we have considered the qualifying emergency, including its impact on ODI payments and the company's response.

Although not necessarily determinative in this case, wider factors we take into account when considering our duties include the factors set out above concerning how the overall outcomes framework is intended to operate. They also include the fact that the PR19 final determination comprised a package over a five-year period and that some events over that period will in any given year benefit companies while others will not. We are also mindful of the natural information asymmetry between companies and regulators that favour companies in identifying circumstances that have a negative financial impact on them but makes it harder to identify circumstances which provide fortuitous benefits. These benefits can arise for example in the event of favourable weather conditions making it easier to achieve outperformance against the performance commitment levels as set at the previous price control. If we did not take such possibilities into account, it could lead to one-off adjustments that asymmetrically favour companies.

This is why we consider it appropriate to assess overall risk in the PR19 package, as well as the severity and the impact on ODI payments of individual events.[15] This is in line with our PR19 determinations (as redetermined by the CMA) which set out the overall level of risk we would expect a company to face over the 2020-25 period. For example, if an efficient company, with notional levels of gearing, faced an individual event outside its control that risked its ability to finance its functions, that might well, depending on all the relevant circumstances, be a situation in which we considered it appropriate to intervene.

In its response Northumbrian Water argued that by assessing company performance across all performance commitments, in practice we were disadvantaging good performing companies and favouring poorly performing companies because good performance would mitigate the impact of such events on the company position. They argued that this would make it more difficult for them to 'qualify' for an intervention.

We do not think the company's description is a fair and complete reflection of the approach we took in the draft determination (which looked at a range of factors). We do not consider that our approach disadvantages better performing companies.

Further, the company has compared its underperformance payment with the treatment of other regulators in relation to Storm Arwen. However, Ofwat must consider the impacts of these water supply interruptions in accordance with our own regulatory framework. The allowance of additional expenditure on green recovery initiatives for additional schemes is not a comparable situation here, where there is no such change.

Our final determination

Having reviewed the company's requests and supporting evidence, we consider it is clear that the language in the reporting guidance with respect to civil contingencies does not confer an automatic exclusion of the impact of Storm Arwen on Northumbrian Water's performance commitments. But we recognise that a qualifying emergency is a significant event and we need to consider whether an intervention is warranted when one has occurred. Our view, set out at draft determination, was that the company demonstrates that there has been a qualifying emergency under the express wording of the performance commitments in question and that remains our view at final determination.

In relation to whether to adjust the company's reported underperformance payments, the company argues in its response to our draft determination that our consideration should focus on the impact of the event on the performance commitments in question, rather than look at the wider performance by the company on all performance commitments in the reporting year and the control period to date. Having considered the company's arguments,

[15] When we made our draft determinations, we compared the size of the requested reduction in the underperformance payment against the size of the company's regulatory equity. Comparisons of this sort are normal practice in the water sector and in other regulated sectors.

we agree that in these particular circumstances, we should consider carefully the specific financial impact of this event on the performance commitments in question.

Our price review set out the range of ODI payments that we expect companies to experience over the 2020-25 period, taking account of caps, collars and other relevant factors. In the PR19 methodology, we expected returns from ODIs[16] would generally be between ±1% and ±3% return on regulatory equity (RoRE).[17] [18] At the time of setting the PR19 package, we estimated companies' ODI risk range, and checked it fell within this range. For Northumbrian Water, we estimated a range of -1.54% to +1.36%.[19]

Northumbrian Water attributes £25.787m of underperformance payments to the impact of the storm associated with the qualifying emergency across its three performance commitments. This is equivalent to -1.59% return on notional regulatory equity (of £1,619m in 2021-22 in 2017-18 prices) at an appointee level for a single year. Because we assess and allocate risk over a five-year period, this would lead to an impact on the company's return on notional regulatory equity of -0.32%, before accounting for any other performance across the period.

Overall, therefore, although Storm Arwen's impact on ODI payments averaged over the period is within the expected risk and return range in the company's overall price review package, we recognise that it was relatively significant, particularly viewed in terms of the single year figure (-1.59%).[20] This requires further consideration, which we assess below. Taking together the fact that there was a qualifying emergency, which the performance commitments expressly refer to, and that the size of impact on the company was relatively significant, we have considered the appropriate level of underperformance payment.

We considered the proposal Northumbrian Water made, in its APR submission and again in its draft determination consultation response, to pay a £3.375m underperformance payment. Northumbrian Water said that this "partial penalty" reflected that there was room to improve in its performance in some specific instances.

Northumbrian Water considers that its proposal is in the interests of customers and preserves incentives to manage service efficiently and effectively in extreme events.

We agree with the company that an ex-post exercise of discretion as to the level of intervention should maintain the incentives on the company. This means that during any

[16] The expected returns for ODIs excludes expected returns for C-MeX and D-MeX.
[17] RoRE represents the return to shareholders as a proportion of the equity component of the regulatory capital value (RCV), calculated by reference to the notional capital structure. It is a well-established regulatory tool to provide insight on a normalised basis of the return that companies can earn.
[18] The lower limit of the company-level range reflected levels above which we would expect companies to be 90% of the time (the package P10) and the upper limit reflected where we expected companies to perform below 90% of the time (the package P90).
[19] 'PR19 final determinations: Northumbrian Water final determination', Ofwat, December 2019, page 72.
[20] The company commented on the financial impacts based on water regulatory equity only (equivalent to -3.13% in a single year). We assess return on regulatory equity at a company level, consistent with the risk ranges in the company's final determinations and to reflect the level of equity invested in the regulated business. In any case, we consider the financial impact of the event at an appointee level to be relatively significant.

event there should remain a strong incentive on the company to strive to perform as well as possible. However, we are not convinced that the company's proposal, which takes as its starting point that it should only bear the risk for factors reasonably within its control, with the remainder being borne by customers, is appropriate in view of the PR19 policy intent. The company referred to the way events that companies considered to be outside of management control had been dealt with in earlier price reviews. But it is important to recognise that those statements related to a different regime - the PR19 regime focuses on outcomes for customers and the environment.

Northumbrian Water also indicated that instead of the £3.375m applying to all customers it would be open to an alternative whereby it would make an equivalent transfer of value from the company to customers in a different manner, for example by additional investment to mitigate the impact of future storms, alternative schemes/investment to benefit the communities affected and/or more targeted compensation payments. We do not consider such alternative to be appropriate. Without an intervention, we note that all customers are due an underperformance payment. Also, certain of Northumbrian Water's proposals involving the company investing the amount would give rise to an additional benefit to the company by reducing the risk that it is otherwise expected to bear under the PR19 package and improving its ODI balance. The company is also able to choose to make additional payments to affected customers over and above existing mechanisms.

We do not consider a test based on whether matters were within the company's control is appropriate in light of our duties and our clear underlying policy intent at PR19. We have considered carefully and weighed the points made by the company, including those about the extreme nature of the impact of Storm Arwen and the steps the company took to mitigate its impacts on water customers; the potential impact on the overall PR19 package of risks and incentives; and the need to ensure that there are continuing incentives on companies to respond and mitigate adverse impacts on customers even in the face of a qualifying emergency. We have also borne in mind that the in-period regime generally operates annually and is not intended to be as burdensome as a full price control. In this case, we have reviewed evidence from the company that demonstrated that it worked hard to mitigate the impact on customers.

We have set out above our reasons why we do not consider Northumbrian Water's proposal on the size of the underperformance payment would be appropriate. In light of all the above considerations, we consider it appropriate and proportionate to exercise our discretion in favour of a broad sharing of risk (risk-sharing being an approach we adopt in other parts of our regime such as totex, to maintain incentives while sharing burdens between companies and their customers). In our judgement, in the specific circumstances of this case, the appropriate share for the financial impact of the event is 50:50 between customers and the company.

This means for each of the three performance commitments in question we are excluding 50% of the impact on reported ODI payments. As such, customers will still receive some

underperformance payments, which acknowledges customers' services were severely disrupted.

We consider this achieves an appropriate balance between the interests of customers and the company, retaining incentives on the company to continue to strive to deliver the best possible service and response to supply interruptions and is in line with the risk and reward package. It recognises the particular circumstances set out above and the steps the company took to mitigate the impact of the storm.

This leads to a bespoke adjustment, in aggregate, that reduces the size of the underperformance payments by £12.894m to £10.086m for the company's three water supply interruptions performance commitments (see table 1.1.2 below).

Table 1.1.2: Equal sharing of the impact of Storm Arwen (£m)

Performance commitment	ODI payments reported in the APR	Company estimate of the full storm impacts	Company view of ODI payments due without storm impacts	Company requested exclusion	Company proposed ODI payments	50:50 sharing of the full storm impacts	Implied revised ODI payments
	A	B	C=A-B	D	E=A+D	F=B*50%	G=A+F
Water supply interruptions	-5.770	-7.158	1.388	6.061	0.288	3.579	-2.191
Interruptions to supply greater than 12 hours	-17.530	-18.324	0.794	16.067	-1.462	9.162	-8.368
Interruptions to supply between one and three hours	0.321	-0.305	0.626	0.283	0.607	0.153	0.474
Total	**-22.979**	**-25.787**	**2.808**	**22.411**	**-0.567**	**12.894**	**-10.086**

1.2 C-Mex and D-Mex

On 21 September we published the relative performance of all companies. Our draft determination included a C-MeX outperformance payment of £2.877m and a D-MeX outperformance payment of £0.700m, based on our assessment of 2021-22 company performance.

Further details on C-MeX and D-MeX can be found on the Customer and Developer Services experience pages of the Ofwat website and in the published C-MeX and D-MeX models.

Stakeholders' responses

Northumbrian Water responded to the consultation and said that the annual C-MeX score for the current reporting year should be reported to two decimal places in line with RAG4.10. It suggested that this was not always the case.

Consideration of responses and final determination

To ensure the C-MeX reconciliation model operates consistently with RAG 4.10 and the PR19 Reconciliation rulebook guidance, we have updated the model to round the input scores to 2 decimal places. This has a minor impact on the payment values calculated by the model. For Northumbrian Water, this increases its C-MeX outperformance payment by £0.002m to £2.879m. The D-MeX payment remains unaffected from draft determination.

1.3 Payment deferrals and abatements

As set out in our PR19 final determinations and the PR19 Reconciliation Rulebook: Guidance Document, companies can ask us to defer outperformance or underperformance payments, or abate outperformance payments on individual performance commitments. A deferral results in us delaying when the adjustment will be made to companies' revenue. An abatement results in no adjustment to the company's revenues in relation to the relevant performance commitment in the subsequent charging year.

Northumbrian Water did not request any payment deferrals or abatements. Based on our assessment of the company's performance, we do not consider any are required. As such, we do not apply any payment deferrals or abatements in our final determination.

2. Impact of 2021-22 in-period ODI assessment on price controls

2.1 Our final determination

In this section we outline the financial impacts of our final determinations.

Unless otherwise stated all values are £m in 2017-18 FYA CPIH prices.

Table 2.1: Change between draft and final determination on total ODI payments to be applied to customer bills in 2023-24 (£m)

This table sets out the change between our draft and final determinations.

Price control	Draft determination on total ODI payments to be applied to customer bills in 2023-24 (£m)	Change between draft and final determination (£m)	Final determination on total ODI payments to be applied to customer bills in 2023-24 (£m)
Water resources	0.449	0.415	0.864
Water network plus	-24.469	14.588	-9.881
Wastewater network plus (WaSCs only)	-0.685	1.275	0.591
Bioresources (WaSCs only)	0.112	0.109	0.222
Residential retail	4.310	0.281	4.591
Total	**-20.282**	**16.669**	**-3.614**

Table 2.2: Final determination on adjustment to 2023-24 price controls as a result of performance against ODIs

This table sets out our final determination on the ODI payments to be applied to price controls in the 2023-24 charging year after accounting for:

- the in-period ODI payments for each company based on their performance in 2021-22;
- our final determination on these payments after any interventions;
- our final determination on 2022-23 deferrals and abatements;
- bespoke adjustments, including prior year restatements, where relevant; and
- our final determination on C-MeX and D-MeX payments.

For further details on the interventions, deferrals, abatements and bespoke adjustments, see section 1.

This final determination on the ODI payments to be applied for Northumbrian Water is also set out in the in-period adjustments model published on our website.

Price control	Company's reported ODI payments (£m)	Ofwat FD interventions (£m)	ODI payments deferred from 2020-21 (£m)	Ofwat FD deferrals (£m)	Ofwat FD abatements (£m)	Bespoke FD adjustments (£m)	C-MeX FD payments (£m)	D-MeX FD payments (£m)	Final determination on total ODI payments to be applied to customer bills in 2023-24 (£m)
Water resources	0.864	0.000	0.000	0.000	0.000	0.000	0.000	0.000	**0.864**
Water network plus	-23.353	0.000	0.000	0.000	0.000	12.874	0.000	0.598	**-9.881**
Wastewater network plus (WaSCs only)	0.492	0.000	0.000	0.000	0.000	-0.003	0.000	0.102	**0.591**
Bioresources (WaSCs only)	0.222	0.000	0.000	0.000	0.000	0.000	0.000	0.000	**0.222**
Residential retail	1.898	0.000	0.000	0.000	0.000	-0.187	2.879	0.000	**4.591**
Total	**-19.878**	**0.000**	**0.000**	**0.000**	**0.000**	**12.684**	**2.879**	**0.700**	**-3.614**

Table 2.3: Breakdown of bespoke adjustments

This table provides a breakdown of the bespoke adjustments included in our final determinations.

Price control	Prior year restatements (£m)	Prior year C-Mex indexation (£m)	Prior year D-Mex indexation (£m)	Time value of money adjustment on prior year total (£m)	Green recovery (£m)	Total bespoke adjustments to be applied to customer bills in 2023-24 (£m)
Water resources	0.000	0.000	0.000	0.000	0.000	**0.000**
Water network plus	0.000	0.000	-0.019	-0.001	0.000	**12.874**
Wastewater network plus (WaSCs only)	0.000	0.000	-0.003	0.000	0.000	**-0.003**
Bioresources (WaSCs only)	0.000	0.000	0.000	0.000	0.000	**0.000**
Residential retail	0.000	-0.181	0.000	-0.006	0.000	**-0.187**
Total	**0.000**	**-0.181**	**-0.022**	**-0.006**	**0.000**	**12.684**

Note:

The total bespoke adjustment for the water network plus price control includes the separate company specific adjustment of £12.894m for the equal sharing of the impact of Storm Arwen, that is not shown in the breakdown of adjustments in the table.

The prior year C-Mex and prior year D-Mex values correct an error in how the C-Mex and D-Mex models applied indexation in 2020-21. Where applicable we adjust for the time value of money.

Table 2.4: Changes to price controls (final determinations)

This table sets out the impact of our final determination on the company's price controls, as set out in the in-period adjustments model published on our website. See Sector overview: Final determinations of in-period outcome delivery incentives for 2021-22 for how we apply adjustments for tax and inflation.

Price control		2021-22	2022-23	2023-24	2024-25
Water resources (K factors)	Previous determination	-1.31	12.24	12.47	10.90
	Revised	-1.31	12.24	13.95	9.57
Water network plus (K factors)	Previous determination	0.39	1.14	-0.02	0.83
	Revised	0.39	1.14	-4.67	5.33
Wastewater network plus (WaSCs only)	Previous determination	0.41	3.80	1.63	2.56
	Revised	0.41	3.80	2.02	2.21
Bioresources (WaSCs only)	Previous determination	20.739	23.658	23.840	24.062
	Revised	20.739	23.658	24.135	24.062
Residential retail (total revenue, TRt – £m, nominal prices)	Previous determination	56.015	62.921	57.758	58.634
	Revised	56.015	62.921	65.236	58.634

We have based Northumbrian Water's final determination on the data and commentary provided to us by Northumbrian Water. Should any of this information be revised or restated in future years, we will take account of adjustments we have made to the relevant price control in relation to the performance commitment(s) in question in making future in-period determinations.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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