

Draft determination of Severn Trent Water's in-period outcome delivery incentives (ODIs) for 2021-22

Severn Trent Water response

21 October 2022

WONDERFUL ON TAP



Severn Trent's response to Ofwat's draft determination of Severn Trent Water's in-period outcome delivery incentives (ODIs) for 2021-22

We welcome the opportunity to respond to Ofwat's draft determination of Severn Trent Water's in-period outcome delivery incentives (ODIs) for 2021-22.

The benefits of ODIs for customers and the environment

We strongly support ODIs as a proven way of driving service improvements for customers and the environment. A [report](#) we sponsored by Fast Track Squared this year estimates that Ofwat's ODIs framework has delivered net benefits of between £850m and £1.3bn to customers and the environment over its first six years. This is equivalent to £32-£54 of net benefits per customer over six years.

Payment deferrals

In its draft determination Ofwat allows our requested deferral of £69.804m of our ODI outperformance payments (which includes the deferral of £46.214m from 2020-21). Ofwat asked us "to provide additional supporting evidence on [our] approach to managing the effect on customers ahead of the final determination" "[g]iven the significant size of the deferral and the potential for further outperformance in future years."

We have reflected on Ofwat's comments and consider there is a case for reducing our requested deferral of ODI outperformance payments from £69.804m to a new proposal of £30.698m. While this will mean a slightly higher bill increase for our customers in April next year, we are still able to commit to a below-inflation increase. A larger increase in April 2023 will also help us to avoid a bill spike in the final year of AMP7, which would be more difficult to explain to customers at a time when inflation is expected to be lower. Deferring less now will enable us to reduce the amount of ODI outperformance payments we will need to take in future years, including at PR24 where recent increases in interest rates might mean there is more upward pressure on customer bills than anticipated when we submitted our original proposal in July.

Effect on charges next year

In our July submission, we estimated that our deferrals would lead to a bill increase of 4.8% based on our preliminary charges modelling and an inflation forecast of 8.5%. Two developments since then are:

- We have the benefit of more data about the year to date, which allows us to improve our forecasts for properties, volumes and other variables.

- Inflation has been unpredictable. In our indicative charges we assumed a rate of 11%, but our most recent forecast from Oxford Economics is that the November rate of CPIH will be lower at 9.2%.

We are mindful of the financial pressures that our customers are experiencing, but we note Ofwat's concerns about the effect that our deferral proposal might have on future bills. Our original proposal anticipated an increase of 4.8%, which was around 3.7 percentage points lower than forecast inflation. This main reason underlying the lower-than-inflation bill increase was the workings of the revenue correction mechanism. In particular, in 2021-22 the Midlands economy recovered more quickly than we expected from Covid-19 leading to over-recovery of revenues which requires a negative correction in 2023-24.

The table below sets out the effect of our revised proposals compared to the view in the Draft Determination on a like-for-like basis (i.e. with the same view of inflation and other assumptions).

Table 1 – Bill effect of revised proposals compared to the draft determination

	Combined bill (nominal)			Increase %	
	2022-23	2023-24	2024-25	2023-24	2024-25
Draft determination	386	400	428	3.5%	7.0%
Revised proposal	386	414	428	7.0%	3.5%
No deferral	386	424	428	9.6%	1.0%
Inflation forecast				9.2%	2.9%

All else equal, the deferral we proposed back in July could have given rise to a bill increase in 2024-25 of 7.0%, substantially above forecast inflation of 2.9%. If we include more ODI outperformance payments in next year's bills, our average bill increase will remain more than two percentage points less than the expected rate of CPIH inflation.

In July we proposed to include more ODI outperformance payments for wastewater than for water – this was because we have earned more ODI outperformance payments for our wastewater service. Our July proposals would have led to a higher bill increases for wastewater (+6.6%) than for water (+0.7%). In our revised proposals we have aimed for a greater balance between the two services – this is why we end up with no remaining deferred ODI payments on water but a balance to carry forward for wastewater (please see table 4). Table 2 below sets out how our new proposal affects average customer bills for each service.

Table 2 – The effect on water and wastewater bills by type of customer (revised proposal)

	Increase %			Increase £/month		
	Water	Waste	Combined	Water	Waste	Combined
Unmetered average	7.2%	9.8%	8.5%	1.50	1.75	3.00
Metered average	6.6%	6.2%	6.4%	1.00	0.75	1.75
Average combined	6.4%	7.7%	7.0%	1.00	1.25	2.25

We have conducted customer research about the level of bill increase that customers consider to be significant. Most customers think that bill increases of less than £2 per month will have little or no effect on their household finances. We refresh this research in our tracker survey every six months, and the results are very stable.

Higher-than-average bill increases for unmetered customers are due to customers switching to meters. Switchers tend to be lower volume users meaning the average consumption of customers that stay unmetered will rise over time and so will their bills. Unmetered customers have the option of moving to a meter.

Supporting customers who struggle to pay

As shown in table 2, our revised proposals would lead to average bills increasing by just over £2 per month, with bills for unmetered customers rising by more. In the context of high inflation we do not think these changes would be excessive, and we are expanding our support options to ensure that help will be available for customers that struggle to pay.

In May we announced a £30m affordability package, which we are funding through improved efficiencies in our retail operations, more efficient use of our assistance programmes and with the balance being contributed by us. Our package will help a further 100,000 people to reduce their water bill by up to 90%, meaning we will be helping around 315,000 of our most financially vulnerable customers by 2025 (substantially above our PR19 commitment of 195,000). This will take the proportion of our customers we support to around 6%, in line with the proportion of customers assessed as living in water poverty in our region.

Effect on bills in future years

We expect there will be upward pressure on bills in AMP8 due to the need for investment to meet future challenges such as river water quality, water resources and the drive to net zero. It also appears more likely than when we submitted our original proposal in July that interest rates on new borrowing will be higher.

Deferring ODI payments lowers bills now, but will affect bills in the future. Some ODI outperformance payments and penalties will be carried forward to AMP8 under any circumstances - the in-period ODIs earned in 2023-24 and 2024-25, with any ODIs that are measured at the end of the AMP. It is too soon to know what outperformance payments or penalties we might deliver in the final two years of AMP7, but if it is in line with our performance in the first two years of AMP7 then we might expect an annual effect of £7 on average bills as a result of ODIs that will always be carried forward into AMP8 (please see table 3 below).

We are also conscious that our customers have been bearing only part of the cost of the Green Recovery during AMP7, with the balance taking effect through an uplift to the Regulatory Capital Value at the start of AMP8.

If we had deferred around £107m of in-period ODI outperformance payments to AMP8, this would have added £5.75 to bills (assuming an even spread across the five years). Our revised proposals would reduce this by around £2.25 to £3.50, as shown in table 3 below.

Table 3 – Bill effect of carry-forwards in AMP8 (assuming an even spread)

Bill effect, 17/18 prices	£
Green recovery	9.00
ODIs from last two years of AMP 7 (assuming equal level of performance)	7.00
Deferred ODIs (original)	5.75
Deferred ODIs (revised)	3.50

Taking account of all pressures on future bills and Ofwat’s comments in the draft determination, we consider that taking more of our in-period ODI outperformance payments closer to the time when they were earned is the right approach, and represents a better balance between the interests of customers in the future compared to immediate bill effects.

Summary view of ODIs and deferrals

Table 4 below sets out our revised proposals. As noted in the sections above, we have removed the balance of deferred ODIs from the water service first to balance the effect on water and wastewater bills. The values are analysed by price control and the assumed value for D-MeX is included within the network controls.

Table 4 - In-period adjustments and our proposed deferral

£m 2017-18 prices, net of tax	Brought Forw'd ¹	Earned 21-22 ²	Green Rec ³	Adjustm't ⁴	Deferred	Claimed 23-24
Water Resources	10.4	16.7	1.7		-	28.8
Water Network +	2.7	8.6	10.9	(1.6)	-	20.7
Waste Network +	33.2	32.8	16.8	(0.1)	(30.7)	52.0
Bioresources	-	-	-	-	-	-
HH Retail		0.3				0.3
Total	46.2	58.4	29.4	(1.6)	(30.7)	101.8

Notes to Table 4:

1. Brought forward - payments deferred from the previous reconciliation year.

2. In period ODIs earned in 2021-22, which we would normally put into 2023-24 charges. Note that we have not included the voids outperformance payment applied by Ofwat, as discussed below.
3. Green recovery – the Pay As You Go element of this is being funded similarly to an ODI. For the purpose of Ofwat’s In-Period Determination (IPD) Model, Green Recovery funding has been included within “other bespoke adjustments.”
4. Adjustments to prior year. These include the prior restatements (including the time value of money adjustments) shown in table 2.2 of Ofwat’s draft determination relating to supply interruptions, leakage and D-MeX.

We are attaching to our response an updated in-period adjustments model reflecting our new proposed deferral of ODI outperformance payments.

Reducing residential void properties

We can confirm we are voluntarily not claiming the ODI outperformance payment of £0.230m that Ofwat has intervened in the draft determination to give us for our 2021-22 performance in reducing residential void properties. This is without prejudice to any ODI outperformance payments for our future performance on reducing residential void properties.

We recognise Ofwat’s is not agreeing to alter our performance commitment levels (PCLs) for reducing residential void properties. We continue to consider that to improve the transparency of our reporting for customers, stakeholders and regulators it would be best to remove “invalid service provisions” from both our PCLs and our reported performance. As such, we will continue to monitor “invalid service provisions” and ensure we are only receive ODI outperformance payments for genuine improvements in performance. We will ensure our customers and Ofwat are informed and consulted as needed.

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