

Summary of discussion at April 2023 Outcomes Working Group

Wednesday 19 April 2023
11.30 am to 12.30 pm

Introduction

Ofwat introduced the session by thanking participants for joining.

Batch 1 update

There was an error in the batch 1 results that Ofwat issued to the working group in February. It was created by the independent consultants multiplying the modelling results by the components of the bill instead of the average, which affected the underlying non-household valuations. The corrected batch 1 results and supporting materials were issued to companies on 20 April 2023.

A participant queried whether the revised data for batch 1 were consistent with those issued to the working group on 28 February. In particular, the medians for bathing water quality and supply interruptions might be different. Post meeting note: Ofwat confirms that there was a mistake on slide 12 of the update to the working group on 28 February. The charts for bathing water quality and water supply interruptions were presented in the wrong order on the slide.

Someone asked whether the data for individual companies could be shared with the group. Ofwat said that this was fine in principle, subject to confirming with the group there were no objections to doing so. Post meeting note: this has been done.

A participant asked that information be shared with the working group about what bill amounts had been used by the consultants for individual companies. These data are important because of the variations that are disguised in the averages i.e. there is significant variation in bills across non-households. Post meeting note: this has been done.

Participants at the meeting asked for a separate follow-on discussion about on the batch 1 errors, which took place on 27 April 2023.

Batch 2 results – CRI

Ofwat presented the batch 2 results for the compliance risk index performance commitment, which were based a marginal benefits approach on customer valuations.

Someone queried the relative weighting of discoloration versus do not drink or boil water notices, because of a concern that Ofwat might be putting too much weight on do not drink notices because the biggest users have plentiful back up supplies, which means it tends not to be such a big issue for them.

Ofwat explained that our approach was based on what Thames had done at PR19 and was supported by the Drinking Water Inspectorate in our conversations with them. A participant asked Ofwat to share information about Thames' approach for PR19, which was supported by other participants. Post meeting note: this has been done.

Batch 2 results – asset health

Ofwat presented the batch 2 results for asset health, which was based on a "top-down" approach.

A participant asked on what basis we set the hypothetical ranges and if they are consistent across all three performance commitments presented. He also asked if low performance is correlated with this incentive rate and if this is the reason we have made an upward adjustment or if it is an untargeted adjustment. Ofwat explained that we used informed judgement from multiple performance ranges to set the ODI rates. It also highlighted that we only have two years of PR19 data to look at, but decisions were made in the round using informed judgement.

Issues raised

- **Consistency with PR19 rates:** companies flagged that the batch 1 results are very different to PR19 rates, which would mean inconsistent incentives over time.
- **Company-specific variations:** companies asked whether there would be scope for their rates to vary between each other to ensure there was a sufficient incentive to drive the right behaviours.
- **Calibration and high-level sense check:** Ofwat highlighted that this would be done for individual companies and across the sector at the determination stage i.e. summer 2024 instead of now. The purpose of these indicative ODI rates was to give a consistent starting point for the assessment of companies' business plans.
- **Customer research versus top-down approach:** the top down approach was different from the one that stakeholders were expecting from the customer valuation approach that we had emphasised in our communications. The PR24 final methodology did allow

Ofwat the flexibility to use the top-down approach. Ofwat was exploring whether the development in its approach warranted a change to its QAA guidance for this area.

- **QAA interactions:** participants queried whether Ofwat's approach on QAA was consistent between WACC and indicative ODI rates because the return might not be consistent with the risk profile. Their preliminary analysis of the indicative ODI rates from batch 1 suggested that they would push them over the 2% of regulatory equity return at risk because they were so high and created a greater downside risk. One option could be multiplying the ODI rates by a factor to bring them back in the RoRE range while maintaining their relativity. This was the equivalent of varying the benefit sharing factor. However, it was limited by the floor for the benefit sharing factor being 0.5.
- **Business plan submissions:** some companies want to use their own ODI rates in their business plans. Ofwat encouraged companies to use Ofwat's consistent indicative ODI rates in their business plans and data tables because they would be the starting point for Ofwat's determinations and basis for collaborations, which mean they would be the most useful guide to companies' planning. They were able to provide information as part of their submission about what they think their indicative ODI rates should be and their justification for why they should be different to the rest of the sector.

Next steps

Batch 3 results are delayed to early June from end of May. Ofwat representatives apologised for how late this information was arriving for inputting to companies' business plans. Creating indicative ODI rates has taken more resources and time than expected.

Someone asked about when companies would receive indicative ODI rates for on biodiversity and GHG emissions PCs. Post meeting note: Ofwat confirms this information will be released at the draft determination stage.

Ofwat thanked participants for their time and closed the meeting.