



# **Draft determination of Severn Trent Water's in-period outcome delivery incentives for 2015-16**

**An Ofwat consultation paper**

## Introduction

1. The Consumer Council for Water is the statutory consumer organisation representing water and sewerage consumers in England and Wales. The Consumer Council for Water has four regional committees in England and a committee for Wales. We welcome the opportunity to respond to Ofwat's draft determination of Severn Trent Water's in-period outcome delivery incentives for 2015-16.

## Executive Summary

- 2.1 Outcomes-based regulation was a major innovation at the 2014 price review (PR14). Water companies engaged with their customers and stakeholders to identify the high level outcomes they value. Desired outcomes are supported by performance commitments (PCs), many of which have reputational and financial incentives attached to them. These are called Outcome Delivery Incentives (ODIs).
- 2.2 ODIs are intended to focus companies' attention on delivering good outcomes on the services that matter to customers, financially rewarding companies for outperformance but financially penalising them when they fall short of their commitments.
- 2.3 All water companies have ODIs as part of their 2014 price review (PR14) settlement. They broadly reflect extensive engagement with customers and local stakeholders. Most financial ODIs will be reconciled at the 2019 price review (PR19), and will impact customers' bills from 2020. However, three companies, including Severn Trent Water, proposed some ODIs that would be paid within the current control period of 2015-20 - the so called 'in-period' ODIs.
- 2.4 At PR14 CCWater undertook research to establish consumers' views on ODIs. Our research showed that customers generally do not support the use of penalties or rewards as a method of driving companies' improvements in service<sup>1</sup>. Customers tend to see improving services as an integral part of companies' activities and not something that requires additional reward.
- 2.5 In our 2013 response to Ofwat's consultation on setting price controls for 2015-20<sup>2</sup>, our assessment of the 2014 price review published in August 2015<sup>3</sup>, and most recently in our response to Water 2020 - Regulatory Framework for wholesale markets and the 2019 price review<sup>4</sup>, CCWater warned of the risk of setting ODIs that did not stretch companies and opened the possibility of easy wins.
- 2.6 Our analysis of the initial suite of ODIs indicated that many were easily achievable and that companies were likely to receive significant rewards for marginal improvements. Ofwat's subsequent horizontal audit and requirement that ODI rewards were linked to upper-quartile performance ameliorated but did not remove our concern. There remains the prospect of customers being faced with bill spikes in 2020-21 (or earlier in the case on in-period ODIs) for a regulatory initiative which they did not support. Customers are, therefore, unlikely to react positively to this round of determinations, and both Ofwat and the companies will need to recognise this when communicating the outcome and effect of both in-period and end of period ODIs.
- 2.7 CCWater recognises the intention behind in-period ODIs is to sharpen incentives on company management to deliver what matters to customers by generating a reward or penalty which has a more immediate effect on the company, and that is more obviously linked to recent service performance.

- 2.8 CCWater recognises Ofwat’s view that a balance is required between linking incentives more closely in time to performance and maintaining a smoother path of bill changes year on year which customers tend to indicate they prefer. We agree that, in some cases, it might be appropriate to apply in-period ODIs over several years, or to defer them, to smooth bills while still capturing some of the benefits of applying them closer to the performance that generated them.
- 2.9 We are happy that the draft determination follows the correct process in terms of Severn Trent Water’s application and Ofwat’s consideration of it. We have no concerns with the way in which Ofwat has reached its conclusions described in its draft determination.
- 2.10 Our detailed comments are given below, but the key points are:
- We agree with the rationale behind Ofwat’s draft determination.
  - We have concerns about the absence of bill smoothing and therefore the impact of the ODI reward on wastewater bills in 2017-18.
  - We welcome Severn Trent Water’s decision to forego part of their water service rewards.
  - Severn Trent will need to communicate effectively with all customers affected by the increase in wastewater charges, but particularly customers:
    - whose charges increase at a level above the publicised average bill; and
    - of South Staffordshire Water (who bill for wastewater charges on behalf of Severn Trent).

## Comments on Draft Determination

- 3.1 Severn Trent Water has 45 PCs of which 33 have financial ODIs applied to them. Of these 15 have in-period ODIs for 2015-16. The company’s performance has resulted in 12 ODIs attracting financial rewards or penalties in the period as shown in tables 1 and 2 below.

Table 1: ODI Rewards and penalties: Water service - figures in ( ) indicates reward claimed

Measure	Reward (£m)	Measure	Penalty (£m)
Leakage	1.23 (1.107)	Complaints about drinking water quality	-1.837
Customer at risk of low pressure	0.070	Repairing visible leaks	-0.173
Minutes water supply lost	0.913 (0.0)	Carbon footprint (water)	-0.273
Value for Money (water)	0.125		
<b>Total</b>	<b>2.338 (1.302)</b>	<b>Total</b>	<b>-2.283</b>

The overall impact is an indicative 50p reduction off the average household water bill.

- 3.2 For water services the company received penalties totalling £2.283m and rewards of £2.338m. However, the company has chosen not to claim rewards in two areas:
- Its leakage performance was improved partly through a change to reporting processes rather than to actions taken by the company. It has therefore chosen to claim only 90% of the reward, foregoing the amount that relates to more robust reporting; and
  - It has chosen to forego the reward due to an overall reduction in supply interruptions to customers. This follows two major incidents late in the year which impacted large numbers of customers.

This results in a net penalty to the company of £0.981m.

- 3.3 CCWater considers Severn Trent Water’s decision to forego both part of its leakage reward and all its reward for customer minutes lost is appropriate. In the latter case, this would be difficult to justify to customers. Foregoing the reward reflects the company’s recognition that it needs to do more to minimise large impact supply interruptions.
- 3.4 For wastewater services the company received rewards totalling £19.767m, as is shown in table 2 below

Table 2: ODI Rewards and penalties: Wastewater service

Measure	Reward (£m)	Measure	Penalty (£m)
Internal sewer flooding	8.992		
External sewer flooding	6.131		
Value for Money (Wastewater)	0.125		
Cat 3 pollution incidents	4.366		
Carbon footprint (wastewater)	0.153		
<b>Total</b>	<b>19.767</b>	<b>Total</b>	<b>0.000</b>

The overall impact is an indicative £6.50 increase on the average household wastewater bill.

#### Impact on customers

- 3.5 Severn Trent Water’s wastewater customers will see a sizeable increase in their bills. We question whether bill smoothing could have been given greater consideration in view of customers’ dislike of volatility in bills year on year. The company’s ODI targets will become harder to achieve in future years. Ofwat has accepted Severn Trent Water’s statement that it will continue to outperform its PCs, but we question the company’s optimism that outperformance, and so reward, will continue at the level seen in 2015-16.
- 3.6 The scale of the company’s net reward will require effective communication to prevent negative reaction from customers and the media. Customers will need to be reassured that each of the individual rewards that make up the total package is justified by improved services or environmental benefit. This will be particularly important for customers receiving their water services from South Staffordshire Water who will not receive the offsetting reduction in water charges.
- 3.7 We would expect Ofwat, in the final determination, to reinforce our message to Severn Trent Water and South Staffordshire Water that they need to work together to communicate the reasons for the bill increases. This will be particularly important where the impact leads to bill increases significantly different to the publicised average bill change. We have encouraged the two companies, and their retail partners, to collaborate in assessing the incidence effect for all categories of customers. Initial analysis suggests that the largest percentage increases will be seen by some non-household customers, just at the time when the retail market opens.
- 3.8 Customers will also need reassurance that the ODIs for which rewards have been given were set at the right levels, given that outperformance has been achieved in the first year of the control period, and that the company is confident outperformance will continue in future years.

1. <http://www.ccwater.org.uk/wp-content/uploads/2014/03/Outcome-and-Delivery-Incentives-Report-FINAL.pdf>  
2. <http://www.ccwater.org.uk/wp-content/uploads/2013/12/Setting-price-controls-for-2015-20---framework-and-approach..pdf>  
3. <http://www.ccwater.org.uk/wp-content/uploads/2015/08/A-Step-In-The-Right-Direction-CCWaters-assessment-of-the-2014-Price-Review.pdf>  
4. <http://www.ccwater.org.uk/wp-content/uploads/2015/08/A-Step-In-The-Right-Direction-CCWaters-assessment-of-the-2014-Price-Review.pdf>

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