



Draft determination of South West 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 South West 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 South West 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 service¹. 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 2015-20², our assessment of the 2014 price review published in August 2015³, and most recently in our response to Water 2020 - Regulatory Framework for wholesale markets and the 2019 price review⁴, 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 shows that the correct process has been followed in determining South West Water’s application and in 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 set out below, but key points are;
- We agree with Ofwat’s draft determination
 - We support Ofwat’s decision to defer the in-period penalty.
 - We expect South West Water to improve its environmental performance.
 - We expect South West Water to be open with customers in communicating Ofwat’s determination.

Comments on Draft Determination

- 3.1 We agree with Ofwat that it should have undertaken a determination of South West Water’s in-period ODIs. We are disappointed that in its initial communication with Ofwat, South West Water had misapplied an end of period ODI as in-period. We expect the company to submit accurate applications in future years.
- 3.2 South West Water has 42 PCs of which 25 have financial ODIs applied to them. 11 have in-period ODIs for the period 2015-20, and of these 4 have financial awards for performance in 2015-16.
- 3.3 We are disappointed that South West Water’s poor environmental performance has resulted in ODI penalties totalling £1.895 million. While these are offset by a reward of £0.163m for improved first time handling of water contacts, the company has earned a net penalty of £1.731 million, as shown in table 1 below.

Table 1: ODI Rewards and penalties: Water and Wastewater

Measure	Reward (£m)	Measure	Penalty (£m)
Handling water contacts	0.163	Pollution incidents (cat. 1 or 2)	-1.73
		Pollution incidents (cat. 3 or 4)	-0.022
		Handling wastewater contacts	-0.143
Total	0.163	Total	-1.895

- 3.4 We expect South West Water to do more to improve its environmental performance in future years, and welcome the improvement plan the company has put in place to achieve this.
- 3.5 The penalty incurred by South West Water represents a potential reduction in household customers' wastewater bills of £2 in 2017-18. We note that in the same period the company has accrued net end-of-period rewards worth £3.56 on the average household bill. South West Water has proposed that the in-period penalty should not be applied in 2017-18 but held back and offset against potential end-of-period rewards in 2020. Customers consistently indicate that they do not like bill volatility, and the company's proposal would help keep bill profiles smooth.
- 3.6 We support Ofwat's acceptance of South West Water's proposal. We agree that the deferred penalty should be subject to adjustment for inflation and interest to reflect the lost benefit to customers of reduced bills in 2017-18. We also agree that the proposed offset should apply to this year only and that Ofwat should make a further determination next year based on the company's reported performance against both its in-period and end-of-period ODIs.
- 3.7 Whilst no penalty is being imposed, we will expect South West Water to be open with its customers in communicating its performance, and the measures it is taking to improve.

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>

Enquiries

Enquiries about this consultation response and requests for further information should be addressed to:

Michael Barnes
Policy Manager
Consumer Council for Water
1st Floor, Victoria Square House
Victoria Square
Birmingham
B2 4AJ

Tel: 07824 416 654

Fax: 0121 345 1001

Email: Michael.barnes@ccwater.org.uk