

Wessex Water Services Ltd Response to Ofwat's PR19 Draft Determination – August 2019

Representation reference: Outcomes O1

Representation title: Event risk index (WW)

Summary of issue

Drinking water quality is consistently rated as the most important outcome by our customers. The updated proposals in this representation are aligned to our extensive customer research and best practice implementation. They are based on evidence and consistent approaches used elsewhere in the PR19 process.

The draft determination has made a number of inappropriate interventions to our performance commitment for ERI that have little basis in evidence or customer research. These include a reduction in our PC target, a reduction in our outperformance rate that is not supported by customers and an increase in our underperformance rate that would imply maximum penalty at a level better than the industry average – again, unsupported by customer evidence.

As it stands, if the PC had been in place during this AMP period we would have incurred maximum penalty (£4.4m each year which is the equivalent of a c.0.3% reduction to the allowed equity return) for all of 2015, 2016, 2018 and 2019 (based only on YTD incidents), as well as a significant penalty in 2017, while during this time being considered a high performing company by the DWI.

Our board is therefore of the opinion that we would be extremely likely to incur maximum penalty in each year of PR19. In this context it is of note that to date in this year, 18.5 points of our 19.5 has been through events caused by third parties. We are prepared to take this risk as part of the performance commitment but not to such an extent that it is able to cause maximum penalty for what would still be well above industry average performance.

Should Ofwat not be able to accept the updated proposals set out in this representation, we request that this PC is changed to a non-financial ODI.

Change requested

- Set the PC target level at the average of 2017 (10.1) and 2018 (15.4) upper quartiles – i.e. at 12.8.
- Set the outperformance incentive rate at £0.754m, as supported by customers.
- Set the collar at the industry average of 402.
- Set the underperformance incentive rate at £26,594.
- Should the above package of changes not be implemented, we request that the ODI is non-financial.

Rationale (including any new evidence)

PC target level

We note that Ofwat's IAP reported that we had a high-quality approach to the effective use of a wide range of customer engagement techniques, innovative engagement approaches and a clear two-way dialogue with customers. This same research led us to include ERI in our business plan. However, it was also noted that, despite evidence of high-quality triangulation, we did not demonstrate evidence of customer support for ERI.

We commissioned two extra pieces of research specifically into ERI and outperformance payments to answer Ofwat's concerns. We explained in our response to the IAP how the research demonstrates that customers support our original approach and full details can be read in our response document. We welcome Ofwat's acceptance that this evidence shows support for outperformance payments.

At the draft determination, Ofwat has intervened to set the target level at the upper quartile of the 2017 industry data, which was the latest available data. 2018 industry data is now available. As the measure is too immature to produce accurate forecasts of upper quartile performance to 2025, and the industry upper quartile was slightly worse in 2018 than in 2017, we believe the most appropriate methodology to set a stretching performance commitment level is to use the average of the upper quartile performance levels from the two available years of data. For all other PCs, the approach to setting targets is to use all the available data and we believe this should also apply here. The upper quartile in 2017 was 10.1 and, in 2018, was 15.4 – the average of which (before rounding) is 12.8. This is particularly stretching as our previous scores were 148.9 and 56.0 in 2015 and 2016. Data on ERI for other companies is not available for these years.

We note that in 2019, our year to date performance is also affected by third parties. In the year to date, we expect to have scored c.19.5 points. 18.5 of these have been scored over three events by third parties whose work has impacted our network. Whilst we are comfortable that events caused by third party impacts should be included as part of this measure, it is clear that it would be inappropriate for us to face close to our maximum penalty for a small number of events that are largely outside of our control.

We request that Ofwat sets our PC target level at 12.8.

Outperformance incentive rate

The outperformance incentive rate was further tested with customers using two additional pieces of research after the IAP. This research finds that the "majority are willing to pay +£13 for highest water quality target", equivalent to the £0.960m incentive rate we proposed. It is critical to note here that the 'highest water quality target' that customers were referring to when making this assessment was one where two incidents scoring <5 ERI points each were presented ("the green level"). This is clearly aligned with our reward cap at 5.93.

Our quantitative research shows that 66% of customers would be in support of a £6.56 increase and 38% would be in support of a £13.12 increase. Interpolating between these

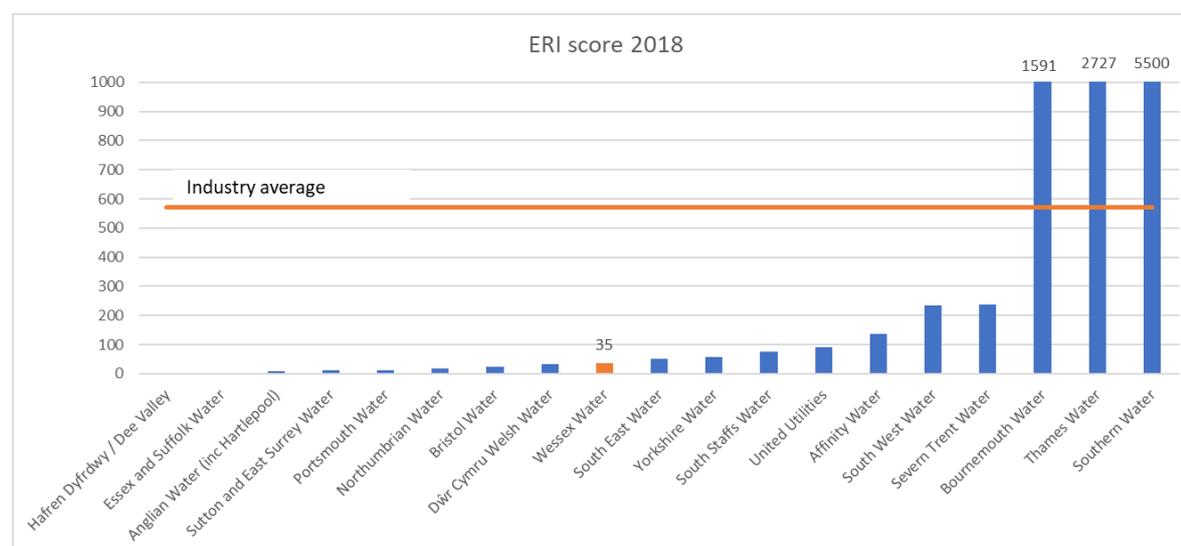
values, a majority of customers would be in support of an outperformance incentive payment equivalent to a £10.30 increase in their annual bill. The equivalent incentive rate is £0.754m. This incentive rate is clearly supported by a majority of our customers (more than 50%). Setting the incentive rate on the basis of the £6.56 as suggested by Ofwat ignores those customers that willing to support an increase between £6.56 and £13.12. Our interpolation is justified as it is common practice to derive a demand curve on the basis of the customer research.

We request that Ofwat sets our outperformance incentive rate at £0.754m.

Collar

The setting of the collar is important as part of the package, because having fixed the amount of revenue that should be at risk, and then the collar, the value of the underperformance incentive unit rate is a derived value.

The draft determination has proposed a collar at an ERI score of 19, compared to our submission of 591. This should be considered in relation to industry performance, as it is for all other ODI collars. In this case, we propose a collar at the average industry performance, which equates to 402 across the available data. For reference, 2018 data is shown below – for three companies, their performance cannot reasonably be shown on an industry scale and so their scores are shown at the top of their respective bars on the chart.



Ofwat's DD view would imply a collar at a level that would be equivalent to a 95% improvement to the industry average. There is no other PC and ODI where Ofwat imposes or supports a collar of this magnitude. This type of collar would undermine customers' trust and confidence in our ability to manage water quality as we could be facing the maximum underperformance payment at a performance that is 95% better than the industry average. We note that if Ofwat maintains its position, we would receive a maximum penalty at a score of 19. In 2018, 13 of the 18 companies performed worse than this.

We request that, subject to also making the corresponding change in the underperformance incentive rate set out below, Ofwat sets the underperformance collar at 402.

Underperformance incentive rate

We note that the draft determination provides no evidence that aligning the underperformance rate with the outperformance rate is consistent with customer preferences. The document states that Ofwat wants to “avoid the scenario where an incremental improvement in performance is much more strongly incentivised than an incremental decrease in performance” – but again, with no justification of why that should be important.

However, should Ofwat accept the points above on the PC, collar and outperformance rate, we can accept the draft determination’s view that our total underperformance risk can be set at double the outperformance risk. This would imply that, at a target of 12.8, with a cap set at our P90 value of 5.93 and an outperformance incentive rate of £0.754m, we have an outperformance risk of £5.18m. Doubling this to £10.36m, applied across a range of 12.8 to 402, this equates to an underperformance incentive rate of £26,594.

We request that Ofwat sets our underperformance incentive rate at £26,594.

Alternative approach

Should Ofwat not accept this proposal, we request that the PC is made non-financial. Our board is not prepared to accept the level of risk proposed by Ofwat in the draft determination due to the reasons outlined above.

It is also clear that the DD proposal is not in customers’ interests.

Why the change is in customers’ interests

Drinking water quality is consistently rated as the most important outcome by our customers. These proposals, as set out above, are aligned to our extensive customer research and best practice implementation. They are based on evidence and consistent approaches used elsewhere in the PR19 process.

Our customers value being able to compare us against our peers and would expect this performance commitment and ODI to be aligned with industry performance.

Links to relevant evidence already provided or elsewhere in the representation document

DD representation - Outcomes summary

Response to IAP – standalone document

Response to IAP – appendix 21

Response to IAP – appendix 22

Chapter 1 and associated appendices of business plan

Chapter 3 and associated appendices of business plan