

IAP Response

Ref B2.WSH.OC.A4

ODI Rates

1 April 2019

WSH.OC.A4

Action

ODI rates

The company should provide further evidence, either from its own customer base or wider industry studies, to demonstrate that the ODI incentive rates it proposes are reflective of customer valuations or willingness to pay for each financial ODI proposed. We note that the company proposes a number of ODI outperformance incentive rates that are of high magnitude relative to industry comparators. Whilst this may result from the methodology that the company has employed to calculate ODI incentive rates, the company is still required to demonstrate that the rates proposed are reflective of its customer valuations.

The company should also provide further evidence to justify and demonstrate the following specific concerns with the methodology that it has selected:

- The company provides the total underperformance and outperformance payments ranges in Table 5 of Appendix 5.5, which have been used to inform the maximum payment ranges set out in Table 6 for each customer importance category. The company should provide further detail as to the exact process and considerations made when determining the payment ranges of £25m, £13m and £7m for each customer importance category from the values in Table 5.
- The company should clarify the process by which the ODI incentive rates for each measure were calculated from the maximum payment ranges developed. In particular, the company should:
 - provide the underlying workings to demonstrate how the Measure of Success (MOS) and willingness to pay (WTP) research has been used to inform the total financial incentive per category and
 - how the rates have been calculated using the P10 and P90 within Appendix Ref 5.5 (p20).
- The company should provide further evidence to demonstrate that customers are willing to pay for the ODI rates and service increments developed by the company's methodology. It is observed, for example, that WTP for company outperformance on internal sewer flooding, leakage and pollution incidents (Table 5) is lower than the £25m maximum payment range assigned for the measure (table 4, Appendix 5.5).

In cases of rejection or revisions to enhancement expenditure or a cost adjustment claim, the company should consider the implications, if any, for the associated level of the PC and ODI incentive rates proposed, and provide evidence to justify any changes to its business plan submission.

In cases where a scheme will no longer be undertaken, the company should consider the removal of the associated scheme-specific PC.

The company should provide further evidence to detail the estimation of forecast efficient marginal costs within its ODI calculations, in line with our PR19 Final Methodology. In particular, the company should provide evidence to demonstrate how these marginal cost estimates relate to the cost adjustment claims or enhancement expenditure proposed by the company, where applicable.

Reflecting customer valuations

Given the availability of new industry data we have revised our ODI rates to be in line with Ofwat's lower bound and our customer valuations. Further information on our approach to revising rates is in our supporting document 'B2.4.WSH.OC Outcome Delivery Incentives IAP Response'. For those measures where we did not undertake willingness to pay we are undertaking further research into the acceptable range of financial incentives. We will revise our ODI package given the customer research by 30 April.

Process and considerations made for (£25m, £13m and £7m)

Within our September business plan our maximum financial incentives for our three ODIs categories (£25m, £13m and £7m) were based on management judgement from our payments ranges as set out in Table 5 of the supporting document 5.5 PR19 Outcome Delivery Incentives. Our approach included both a bottom-up and top down review across the customer categorises. The payment ranges were calculated by combining the estimated P10 and P90 ranges and the ODI rates informed by our customer research.

Category 1 (£25m) We have revised our ODI rates for common performance commitments and given the availability of new information we have reduced our rates to be in line with Ofwat’s lower bound which is consistent with our WTP.

Category 2 (£13m) This category was based on evidence on Acceptability of Water. Customers’ categorised this as medium importance. The £13m was informed by our WTP and MOS research which produced maximum underperformance and outperformance incentives of £16m and £12m respectively. The chosen value of £13m is between the two values.

Category 3 (£7m) The maximum financial payments for category 3 was based on customer research on external sewer flooding. A value of £7m was chosen as this was the average underperformance and outperformance financial incentive based on our two pieces of research.

Whilst customer research was undertaken on river water quality and Rainscape, these two measures produced very low financial incentives therefore little weight was placed on these.

Process for calculating payment ranges and total financial incentive

The total payment ranges in table 5 is calculated by multiplying the outperformance (underperformance) rate informed by our WTP research by the difference between the target level of performance and the P90 (P10) level of performance. The table shows the target for supply interruptions and the forecast P10 level of performance.

Supply Interruptions (Minutes)

	2020-21	2021-22	2022-23	2023-24	2024-25	Total
Target	11.2	10.4	9.6	8.8	8	
P10	19.8	19.1	18.6	17.4	17.1	
Difference	(8.6)	(8.7)	(9.0)	(8.6)	(9.1)	(44.0)

The difference between the target and P10 level of performance is multiplied by both the WTP and MOS underperformance ODI rate to determine the total level of financial payments. The maximum financial underperformance payments are reported in table 5.

	MOS Research	Average	WTP Research
Underperformance Rate (£)	159,130	766,890	1,374,650
Target less P10	(44)	(44)	(44)
Max Financial Underperformance Payment (£m)	(7)	(34)	(60)

Calculation of the ODI Rates

Within our approach, a maximum ODI payment is determined for financial outperformance and underperformance given customer’s priorities. Given the category of £25m, £13m and £7m the ODI rate is determined by dividing the maximum underperformance value by the total difference

between the target level of performance and the P10 level of performance. Water supply interruptions is provided as an example in the table below:

Maximum Underperformance Payment	£25m
Target performance less P10 Performance	44
Underperformance ODI Rate (£ per Unit	$25/44 = 0.568$

Internal sewer flooding, leakage and pollution incidents

Given the availability of new information we have revised our ODI rates for internal sewer flooding, leakage and pollution incidents to be in-line with our willingness to pay and Ofwat lower bound.

Rejection or revisions to enhancement expenditure or cost adjustment claim

We are not proposing any changes to PCs or ODIs arising from rejection or revisions to enhancement expenditure or cost adjustment claims as there are no changes to the aggregate enhancement expenditure or cost adjustment claims with a PC or ODI attached.

Forecast efficient marginal costs within ODI rates

The marginal cost has been calculated from an analysis of the enhancement investment plan split into the performance commitments that benefit from projects and programmes. The costs have been annualised using the cost of capital and then divided by the number of performance units improved and number of customers served to create the marginal cost per unit of improvement which was directly read across to inform the penalty rate in line with the PR19 methodology. However, the marginal cost were found to be lower than the marginal benefit so the rates were set using the latter. This includes cost adjustment claims and enhancement expenditure.