

IAP Response

Ref B2.1.WSH.OC

Performance commitments IAP response

1 April 2019

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1. Introduction

The purpose of this document is to provide an overview of our response to the IAP in relation to the performance commitments we proposed in our Business Plan in September 2018. Much of the detailed analysis relating to performance commitments is dealt with in other documents and these are referenced as appropriate.

2. Selection and definitions of Performance Commitment measures

Following Ofwat’s feedback we have added three new “customer protection” measures with ODIs attached, namely:

- delivery of our Cwm Taf scheme;
- delivery of Reservoir Safety Programme; and
- delivery of the Network Water Quality programme.

We have clarified and/or made minor changes to the definitions in line with Ofwat guidelines for the following measures:

- Unplanned Outages;
- Risk of Sewer Flooding in a Severe Storm;
- Priority Service Register; and
- Lead pipe replacement.

See our revised Performance Commitments Definitions document (Ref B2.3.WSH.OC) for details on these.

We have provided further justification of why the Customer Trust PC is required in addition to C-Mex (see B2.WSH.OC.A36), and provided further explanation of how our asset resilience scorecards work in practice (see B2.WSH.OC.A1).

We have removed one performance commitment, namely Wastewater Treatment Works ‘Look Up Table’ Compliance. We found that there was a risk that customers were confused between this measure and Water and Wastewater Treatment Works Compliance.

3. Targets: Recap of approach to targets taken in Business Plan

Our Business Plan proposals were informed by an extensive consultative and analytical process that was designed to give our customers what they want. We carried out detailed customer research to ascertain what their priorities are. This was combined with Willingness to Pay evidence and cost benefit analysis to produce a suite of performance targets that, together, would stretch the business and focus on the things that matter.

In carrying out this process, we gave careful consideration to comparative information, including historical performance and industry comparisons. We acknowledge the validity of horizontal benchmarking to provide relevant information but we do not share Ofwat's rigid application of upper quartile calculations to determine performance targets, because these inevitably cut across companies' different operating circumstances and the legitimate preferences of their customers, properly assessed.

The targets we set in our Business Plan are all deliverable, though in many respects this will be challenging and will involve the commitment of sizeable resources. The associated funding is subject to a separate challenge from Ofwat, so our commitment to our targets is contingent upon that funding. We have set significant reward and penalty rates (with relatively few deadbands) to reinforce our resolve to meet the aspirations of our customers.

4. Ofwat feedback on our targets

The IAP feedback on our targets can be summarised as follows:

- Ofwat is proposing that we set the targets for three common measures – water supply interruptions, pollution incidents, and internal sewer flooding – in line with forward-looking industry upper quartile, calculated on a simplistic count-of-companies basis;
- Ofwat is seeking further evidence that we set “stretching” targets for three further measures – acceptability of water, per capita consumption, and external sewer flooding; and
- in line with other companies, we are expected to validate 90% of the entries on the Priority Services Register at least every two years.

Ofwat has also raised issues in connection with the proposed deadbands for some of our performance commitments. These are addressed in IAP response document B2.2.WSH.OC Performance Commitments and Deadbands.

This is in addition to the responses required on ODIs, which are dealt with in B2.4.WSH.OC. We note that there is an important linkage between target levels and the appropriate level of rewards and penalties (i.e. if Ofwat imposes ‘tougher’ targets we would wish to have the opportunity to reconsider the appropriate level of rewards and penalties associated with these).

Although not formally part of the IAP, since we submitted our Business Plan Ofwat has indicated how it plans to operate the new D-mex measure. Our position on this is set out below.

5. Our response summarised

We have given careful consideration to the IAP feedback, and have also studied other companies' proposals in detail. Our specific responses in relation to the above-listed measures are described below. Where we have not changed our proposals as a result of the IAP feedback, this is generally for the following reasons.

First, we do not believe it is legitimate to take the upper quartile of the targets that very different companies have put into their business plans on very different bases and calculated an upper quartile which is then applicable to all companies. Whilst horizontal comparisons of performance undoubtedly have an important role to play, benchmarks should not be applied rigidly without taking into account and making allowance for the following factors that are specific to individual companies:

- Customer priorities do vary from region to region. Ofwat should not over-ride the views of customers;
- Companies' operating environments differ, such that certain targets are easier to achieve in some areas than others. Ofwat aims to take such factors into account in its modelling approach to allowable costs. There is no reason why it should not do the same for performance;
- The marginal cost of service improvement is also likely to vary considerably between companies, meaning that the optimal service level for each company's customers may also differ significantly;
- Companies' "start points" on individual targets differ, in part due to the fact that some have effectively been allowed enhancement expenditure in the past to improve performance, where there was a case for doing so, while others may not (or at least not to the same degree); and
- Companies' forward-looking performance targets are based on plans that include expenditure that is intended to facilitate improvements. It makes no sense to hold companies that have not proposed to commit additional expenditure to achieve performance improvements to the standards of those that have.
- Furthermore, the forward-looking targets were proposed on the basis of significant enhancement expenditure which is subject to separate challenge by Ofwat, and which Ofwat has signalled that it is not willing to allow as a matter of principle. This undermines the validity of those forward-looking targets as the basis of setting cross-industry targets.

Second, to the extent that cross-industry benchmarking is used as one element in setting targets, we have concerns that Ofwat’s approach to the calculation of upper quartile – based on a “count of companies” – is arbitrary and potentially discriminatory, especially for water supply measures. We think it would be preferable to use an upper quartile calculation that took into account the number of customers. Otherwise, in some cases, the performance of most large companies representing the vast majority of customers, would be set at a standard defined by the performance of a handful of very small companies – that may benefit from some ‘in built’ performance advantages - representing a tiny minority of customers. Our views on this were set out in our original September Business Plan submission in document 5.2 PR19 Performance Commitments, Section 3.1.

Third, if, contrary to the position we have set out above, we should be required to meet tighter performance commitments than we have proposed, this has significant implications for expenditures and customer bills. We note that Ofwat has suggested that companies should be able to achieve upper quartile service performance within the levels of botex expenditure that Ofwat proposes to allow. We do not agree. We have addressed fundamental inconsistencies in Ofwat’s overall methodology in B2.8.WSH.CE.A1 Cost Assessment Methodology. The relevant point here is that Ofwat has approached the derivation of upper quartile service performance independently from the derivation of upper quartile cost efficiency, creating the likelihood that an infeasible cost/service frontier will be applied.

Finally, there are several areas where we have new information compared with the position that we were in last summer, and are making changes to certain targets as a consequence. This includes D-Mex, the updated position on which is explained below.

6. Our response on specific measures

On the three common measures, our response can be summarised as follows:

- on **supply interruptions** we are proposing no changes to our Business Plan targets. We do not think the benchmark Ofwat proposes is valid or appropriate for our circumstances;
- for **pollution incidents**, new information on the way this recently-introduced definition will operate has enabled us to reduce our targets. If measured on a fair ‘multi-asset’ basis we believe our revised target is better than the industry upper quartile (see Appendix to B2.2.WSH.OC Performance Commitments and Deadbands); and
- for **internal flooding** we again have new information that has enabled us to adjust our targets downwards. However, we do not think the benchmark Ofwat proposes is valid or appropriate, for our circumstances.

On the three measures for which Ofwat suggests we reconsider the level of “stretch”, our responses can be summarised as follows:

- taking into account our particular circumstances and our customers' preferences, we reaffirm that our targets for **acceptability of water** are stretching;
- we have doubts about the validity of horizontal comparisons of **per capita consumption**, but in any event have increased the target reduction in the light of new information; and
- we have not adjusted our targets for **external flooding**, on which we have already made significant improvements in recent years and which is not one of our customers' top priorities.

See IAP supporting document B2.2.WSH.OC Performance Commitments and Deadbands for further explanation on the above.

In relation to the other measures that were subject to proposals from Ofwat:

- We have accepted the proposal to validate 90% of the entries on the **Priority Services Register** at least every two years, and in fact we have gone beyond this to 100%.
- We have prepared further evidence on how the **resilience assessment scorecards** will work in practice. This can be found in B2.WSH.OC.A1.
- A query from Ofwat highlighted a minor discrepancy in the figures we submitted in the Business Plan for **the percentage of the population that would experience severe supply restrictions in a 1-in-200 year drought**. The following table presents the changes.

	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
Submitted	4.42	4.42	4.42	4.42	4.42	0
Proposed change	4.46	4.47	4.47	4.48	4.49	0

7. D-mex

In our Business Plan we proposed to set ourselves the target of achieving industry upper quartile on the new D-mex measure. However this was based on the assumption that the measure would be implemented in such a way that made appropriate allowances for the significantly different operating environment in Wales associated with our distinct legal and regulatory framework for developer activity. Ofwat has since indicated that it plans to make no allowances for these differences, as a result of which we would be materially disadvantaged compared with companies operating in England. It remains our position that we would target upper quartile performance provided there was a level playing field, but if there is not, we would propose to modify our position.