Representations: SIM methodology and reconciling past delivery

Document Reference: J005

This document contains UUW's representation on the Draft Determinations of the slow track and significant scrutiny water companies relating to the application of SIM and of our customer experience outcome delivery incentive.

United Utilities Water Limited

Contents

Executive Summary

This document contains UUW's representation on the Draft Determinations of the slow track and significant scrutiny water companies relating to the application of SIM and of our Customer Experience Programme outcome delivery incentive.

In its Slow Track Draft Determinations Ofwat put forward a new methodology for calculating SIM reward/penalty. We strongly believe that moving the goalposts this late in the AMP risks eroding companies' ability to have confidence in future Ofwat incentives and frameworks, and propose that Ofwat change the methodology for calculating SIM rewards/penalties back to the methodology first established at PR14. Failing this, Ofwat should remove outliers (notably Portsmouth) that have an undue impact on industry SIM reward/penalty calculations, and adjust final reward/penalty calculations to account for this.

Ofwat has also invited specific feedback from stakeholders on the treatment of indexation for residential retail outcome delivery incentives. We propose that Ofwat recognise that in the specific case of UU's Customer Experience Programme ODI the Ofwat 'Revenue Adjustment' model is incorrectly applying RPI inflation to Customer Experience Programme ODI penalties, and that adjustment should therefore be made to the model inputs so as to prevent undue inflation of Residential Retail ODI rewards/penalties.

1. AMP6 SIM reconciliation

In its Slow Track Draft Determinations Ofwat put forward a new methodology for calculating SIM reward/penalty. The newly revealed methodology for calculating rewards and penalties for past AMP6 Service Incentive Mechanism performance is inconsistent with the approach that was widely socialised and understood by all water companies at PR14, and the proposed calculation fails to consider and adjust for the impact of outlier companies. A review of other water companies' September business plan submissions shows that almost all WaSCs have applied a near identical understanding of the reward/penalty methodology, which is at odds with the new proposals.

Even more concerning, we strongly believe that moving the goalposts this late in the AMP risks eroding companies' confidence in the predictability and certainty of future Ofwat incentives and frameworks, with implications that extend across the regulatory regime. Such a late, unsignalled change, raises questions about the extent to which the industry can reasonably predict the application of incentive methodologies in future, and puts into jeopardy the strong influence that Ofwat's focus on its key priorities has had. We are particularly concerned that investment to improve customer service may be impeded.

The proposed calculation changes established methodology precedent

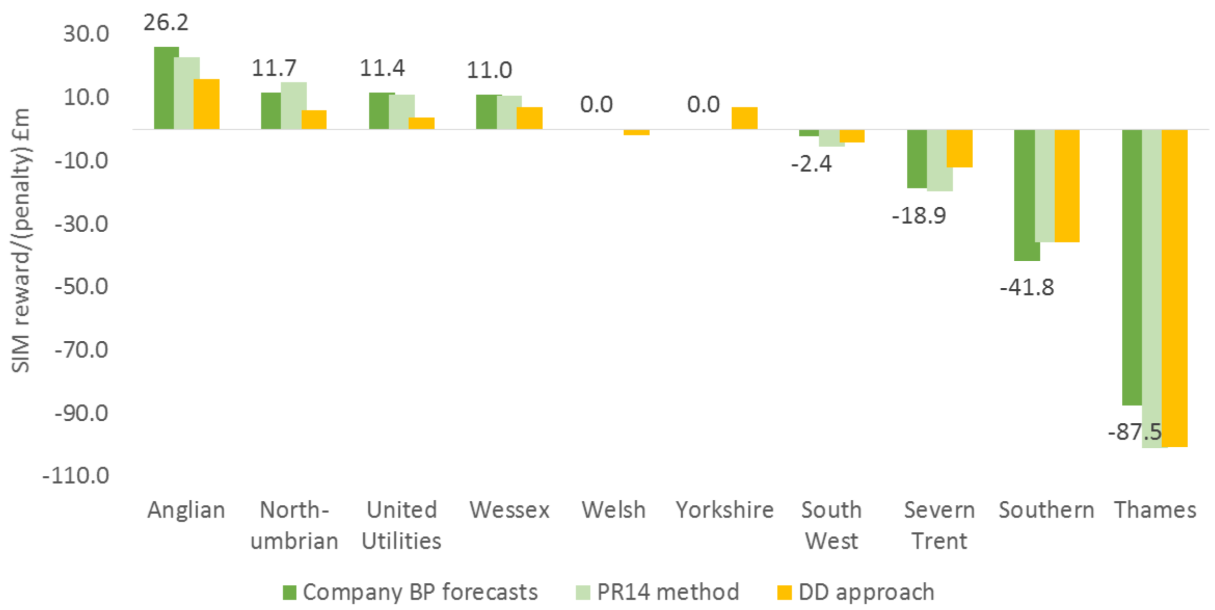
Ofwat has repeatedly described SIM is a continuation of the incentive first introduced in AMP5. At PR14 a methodology for reconciling SIM rewards and penalties was established and subsequent to this Ofwat has published a number of changes to the method of calculating individual company SIM scores. No changes to calculation of final SIM rewards/penalties has been published through this process and therefore Ofwat has not signalled any change in policy on calculating SIM reward/penalties since PR14.

All companies understood the methodology and used this to guide behaviour, with a clear signal around the value that should be placed on improving customer service. We have been using the methodology established at PR14 over the last four years to understand the scale of SIM reward and penalty.

The perceived strength of final SIM incentives has played an important part in driving UU's focus on improving service for customers, and the culture change that has underpinned it. The substantial incentives that all companies believed they could access has enabled us to justify building a 1/3 weight on the SIM outcome into our long term incentive plan for executives, and enabled us to explain to stakeholders that this measure would directly translate into meaningful penalties and/or rewards.

A review of other water companies' September business plan submissions shows that almost all WaSCs have applied a near identical understanding of the reward/penalty methodology[1]. 9 out of 10 WaSCs' business plan submissions included a SIM reward/penalty forecast that closely matches the reward/penalty calculated using the PR14 SIM methodology. This is true for both companies in reward, and those in penalty. In only one case, South West Water, the company's own proposed penalty is slightly closer to the penalty calculated by the new Ofwat method than the original PR14 approach.

Figure 1 Comparison between SIM reward/penalty proposals: Companies' business plans vs. PR14 methodology vs. DD proposed method



The understood methodology encouraged investment in customer outcomes, but the change in methodology now results in many outperforming companies receiving limited reward and underperforming companies receiving limited penalties. This significantly reduces the extent to which Ofwat's system of financial incentives reflect the performance of companies on this critical measure of customer service.

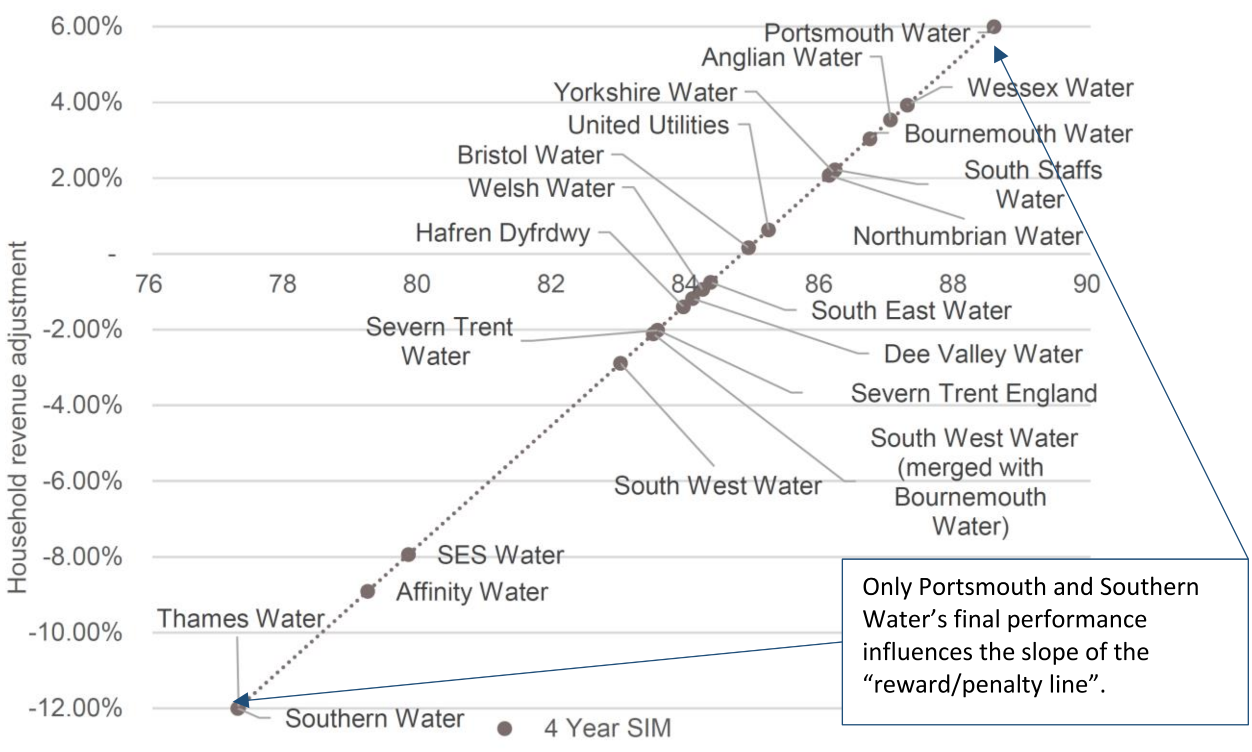
[1] We reviewed all companies' September Business Plan submission, Table R10, including forecast revenue adjustments reported on line 9.

The methodology used since PR14 had the effect of ensuring out performing companies get a reward, and underperforming companies receive a penalty, in fair relation to their level of over or under performance, which was presumably the desired outcome. Under the new methodology this is no longer true, with companies receiving penalties even where they have outperformed the dynamic industry average.

The proposed calculation fails to consider and adjust for impact of outlier companies

Ofwat's proposed methodology only considers the performance of the single highest scoring company and single lowest scoring company when establishing a reward/penalty range.

Figure 2 Four year average SIM scores and % retail revenue adjustments [source 'Accounting for past delivery technical appendix']



Under this method only one company can achieve maximum reward, and one company receives maximum penalty. Under such an approach it is vital that there is robust analysis of the suitability of using the highest and lowest performing companies as benchmarks for the rest of the industry. Ofwat have not presented evidence that they have conducted such an analysis.

For the years 2015/16 to 2018/19 Portsmouth is the highest scoring company; however our own investigation shows there are good grounds for considering Portsmouth as an unsuitable company to use as a benchmark for calibrating other companies' rewards/penalties. Specifically

- In common with Other WoCs, Portsmouth has no wastewater customers, and as a result receives a natural benefit under the quantitative element of SIM, as they have no wastewater unwanted contacts or complaints. Under the reward/penalty mechanism applied at PR14 this difference between WaSCs and WoCs was relatively trivial, as the focus on the industry mean and standard deviations ensured that small differences in approach between companies was averaged out. But under the proposed PR19 approach, the impact on companies' net rewards/penalties is stark. UU wastewater complaint volumes are better than average[2], but even so, if we were to remove the impact of wastewater complaints from our final score we would still see an increase to UU reward of over £7m.

- Portsmouth serves substantially fewer customers than most other companies taking part in SIM (around 300,000 or 1% of total industry customers). This creates a number of challenges when interpreting Portsmouth's results. There is established precedent that given Portsmouth's very small size it is not, on its own, a valid comparator against which to judge other companies' performance[3].
- Portsmouth's small customer base means that there has historically been insufficient customer contacts to conduct a full SIM survey. To resolve this problem Portsmouth, and other small WoCs, have provided the records of three weeks of customer contacts for SIM surveys, instead of one week (as provided by all other companies). As a result Portsmouth will have, in many instances, had an extra three week to resolve customer contacts before they are surveyed. Whilst the differences in survey design between companies is necessary to account for different company contact volumes it has clearly benefited their relative SIM scores, as evidenced in Ofwat's own SIM Survey 2017/18 Annual Report'[4]. The report identifies that the two companies that submit more than one weeks' worth of contact data, Portsmouth and what was Dee Valley, have the highest resolved contact rates. The report concludes:

  > *"[Customers] who considered the matter to be resolved were significantly more likely to be satisfied than those who considered the matter to be unresolved."*

- Portsmouth's water bill is materially lower than any other company. Portsmouth's charges are 24% less than the next highest bill, and a full 55% less than the industry average water service charge. As a result Portsmouth have an embedded customer satisfaction benefit that other companies cannot access. We believe that this natural benefit tends to emphasise why it would be inappropriate for Portsmouth, as an outlier in the sector, to have so much influence on the sector's SIM outcome.

To a material degree, it is clear that Portsmouth's outlier SIM performance is due to necessary differences in survey design and operating environment, rather than significantly differentiated performance. If Ofwat continues to use the newly proposed methodology, these incomparable characteristics means that Ofwat should exclude Portsmouth when setting the upper performance benchmark, and the next best performing company (currently Wessex Water) should instead set the maximum reward threshold.

By excluding Portsmouth's performance when assessing SIM rewards and penalties many of the problems with the proposed methodology are resolved. In particular, all companies with above average performance will receive rewards, with two of the best performing companies

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[2] CCWater, "Household complaints to water companies in England and Wales April 2017 – March 2018"

[3] For example Ofwat applied outlier tests as part of the relative efficiency cost challenge used during the PR09 process

[4] https://www.ofwat.gov.uk/wp-content/uploads/2019/08/Ofwat-SIM-Survey-2017-18-Annual-Report.pdf

receiving full rewards, the poorest performing companies will receive maximum penalties and all underperforming companies will receive some measure of penalty.

Based on the latest SIM 2018/19 performance information we estimated that UU would be in line to receive a reward of c.£16m for SIM performance, under the previously accepted methodology. However Ofwat's newly released methodology allows UU only £3.5m of reward. We estimate that this increases marginally to £6.3m when final 2018/19 data is applied, but represents a material variance from our reasonably held expectations.

Removing Portsmouth from the assessment would, by our estimation, increase UU's reward under this method to c.£15m, which we believe would better reflect the consistent emphasis the company has placed on this metric, and the significant progress we have made in delivering improved customer service throughout AMP6.

In summary, we propose that Ofwat:

- **Continue to apply the methodology first established at PR14 for calculating the rewards and penalties due to companies under SIM.**
- **Failing this, recognise the undue impact outlier company performance has had on reward/penalty calculations, and adjust final reward/penalty calculations to account for this.**

2. PR14 reconciliation: Inflation applied to Customer Experience Programme Retail ODI

In PR19 draft determinations: Accounting for past delivery technical appendix, Ofwat invites *"specific feedback from stakeholders on our approach in the draft determination to the treatment of indexation for residential retail outcome delivery incentives as we recognise this is a complex issue".*

We believe that the Revenue Adjustments model is inappropriately applying RPI inflation to the penalty value of the Customer Experience Programme ODI retail measures.

In draft determinations Ofwat have stated that outcome delivery incentives are a means of compensating customers for the value of the service that they do, or do not receive[5].

The Customer Experience Programme ODI is designed to *"protect customers by returning… funding for this scheme back to customers if the outturn costs of the programme are lower than allowed for in the company's price limit."*[6] The calculation of returns to customers under the ODI should therefore, be subject to the same inflationary uplifts as the original depreciation allowance, i.e. zero uplift. However the design of the Revenue Adjustments model automatically applies RPI inflation to all ODI rewards/penalties. There does not appear to be a mechanism within the model to prevent inflation being applied.

Therefore, as part of our PR19 Business Plan submission, we deflated inputs into the model to correct for this.

[5] "PR19 draft determinations: Accounting for past delivery technical appendix", Section 2.1
[6] PR14 "Final price control determination notice: company-specific appendix – United Utilities"

In our latest reconciliation for past delivery submission[7] we propose to return £5.697m (nominal prices), based upon a return to customers of £3.859m of depreciation because the outturn costs of the programme were lower than allowed for in price limits, and £1.838m for removal of the Customer Relationship Management system (CRM) from the programme.

In the latest UU draft determination Ofwat accepted this calculation approach but have applied the value in 2012/13 prices rather than in nominal/outturn prices.

In total £17.8m was allowed in UU Residential Retail price control limits for additional depreciation associated with the Customer Experience Programme. As retail price controls are not linked to RPI the amount received from customers over AMP6 will equal £17.8m on a nominal basis.

Left uncorrected the application of RPI inflation to this residential retail ODI will result in excess return to customers. As an extreme example, if we had delivered none of the Customer Experience Programme then the full £17.8m of the original revenue allowance would correctly be returned to customers. However using the current Revenue Adjustment model, RPI will automatically be applied to this value, resulting in a penalty of £22.4m, which is £4.6m more than we received in revenues to support the Customer Experience Programme investment.

Table 1 Comparison of indexation approaches to CXP revenue return, in the example of full revenue return

	UU approach to indexation	Ofwat current financial models	
PR14 revenue allowance for Customer Experience Programme	£17.8m	£17.8m	
Inflationary uplift applied to retail revenue allowance	1.00	1.00	This is set by PR14 Final Determination
Nominal revenue for the programme actually recovered from customers during AMP6	£17.8m	£17.8m	
Deflation of nominal revenues to 2012/13 prices	**0.79**	**1.00**	Adjustment applied to ODI penalty before input into 'PR19 Revenue adjustment feeder model'
Revenue for the programme to be returned in 2012/13 prices	£14.1m	£17.8m	
Inflation of returned revenues from 2012/13 to 2017/18 prices	1.14	1.14	Inflation applied within Ofwat's 'PR19 Revenue adjustment feeder model' before transfer into the PR19 Financial Model
Revenue for the programme to be returned in 2017/18 prices	£16.1m	£20.3m	

[7] https://www.unitedutilities.com/globalassets/z_corporate-site/about-us-pdfs/looking-to-the-future/uuw_003_afpd-pr14-reconciliation-update-2019.pdf

Inflation of returned revenues from 2017/18 to nominal prices	1.10	1.10	Inflation forecast applied within the PR19 Financial Model when calculating future residential retail price control
Revenue for the programme to be returned in nominal prices	£17.8m	£22.4m	
Difference between revenue recovered from customers and revenue returned to customers	**£0.0m**	**-£4.6m**	

We agree that this is a complex area, and we continue to welcome the opportunity to discuss the question of inflation on retail ODIs directly with Ofwat in order to ensure no errors are made.

In summary, we propose that Ofwat:

- **Recognise that the Revenue Adjustment model is incorrectly applying RPI inflation to Customer Experience Programme ODI penalties.**
- **Provide guidance on how to appropriately adjust inputs into the Reconciliation model so as to prevent undue inflation of Residential Retail ODI rewards/penalties.**