1. Underspending the cost allowance – is it efficiency?

1.1 We were asked by the panel during our presentation on 20 May 2020:

1.2 "..whether Ofwat has a view on whether that underspend is largely efficient or inefficient. What I mean by that is what I would call an efficient underspend in an RPI minus x system is where the firm grabs the productivity gains after the regulatory cycle is set. You would expect that to happen early on, so they make their efficiency gains. Early they retain those profits in the company. Then at the end of that period, the regulator takes those returns and gives them to customers. That is an efficient cycle that reveals efficient costs and then in due course gives it to customers. Whereas an inefficient cycle is where they underspend but really they are just cutting back on service quality and pocketing the difference. So if Ofwat has a view on how much of each of those we are dealing with, I would appreciate some comment."

1.3 This note brings together our response to the question, drawing on previous submissions to the CMA.

1.4 Firstly, the benchmarking of costs and service in water price control regulation used to reset of price controls depends on information derived from all companies and not just an individual company. This reduces incentives for individual companies to hold back efficiency gains, even later in the period, as the company risks being judged inefficient compared to the remaining companies.

1.5 Our regulatory framework also holds companies to account by performance commitments and outcome delivery incentives. Any underspend which impacts these performance metrics will result in compensation for consumers. We also have powers to enforce company obligations under statute and licence.

1.6 In summary, our response is:

- There is an incentive package to deliver service quality within the five year period from our outcomes regime;
- Some performance commitments incentivise asset health with the expectation that future price controls will continue to encourage companies to deliver in the long term.

- However, incentivising appropriate long term delivery can be challenging which makes our approach across price reviews over time important.

Overall impact of inefficient underspending

1.7 Inefficient underspending can have two key impacts.

1.8 Firstly it can lead to the non-delivery of outcomes in the current or future control periods. This is monitored through a collection of service quality metrics covering customer and environmental outcomes and asset health. Companies will make payments to customers if they do not achieve the required standards. We report on service quality performance in the annual service delivery report, and ultimately can take enforcement action against companies if they breach their legal obligations.

1.9 Second it can impact on future cost benchmarks. If companies that were inefficiently underspending were contributing to the cost efficient benchmark, then the benchmark could be too stretching for efficient companies to maintain performance going forwards. To identify this, for cost efficient companies we separately examined historical expenditure on capital maintenance, an important part of base expenditure and a key area of potential inefficient underspending, and service quality performance.

Service quality

1.10 Our outcomes framework provides incentives for companies to deliver against a suite of performance metrics over the five year period of the price control. In PR19 we built on our PR14 approach and have set stretching expectations of companies delivering on metrics that customers clearly value with financial incentives attached.

1.11 We set performance commitment levels in 15 service quality metrics with common definitions, and across a range of company bespoke performance commitments. Each company has around 30 to 40 performance commitments. Among them are three common performance commitments we set at the same level for all companies (water supply interruptions, internal sewer flooding and pollution incidents), with a similar level of improvement to that achieved by

companies in PR14.[1] For other performance commitments we have expected improvements on historical performance or adherence to statutory compliance.

1.12 We incentivise performance on service quality metrics through outcome delivery incentives and regular comparative reporting. Overall the sector has received £112 million net outperformance payments for service quality performance over 2015-19.[2]

1.13 Many of the performance commitments we set relate to aspects of service dependent on the integrity of companies' assets. This includes four common performance commitments on asset health: mains bursts, unplanned outages, sewer collapses and treatment works compliance. However we acknowledge that no set of asset health metrics will cover every aspect of company service resilience.

1.14 We recognise that underspending on maintaining assets might not immediately impact on service quality, but will eventually show as direct impacts on consumers (for example, leakage and supply interruptions). It is important that we incentivise such performance metrics in successive price reviews to keep appropriate focus on the long term. This means that companies failing to appropriately maintain their assets will be challenged in future price reviews to improve any related decline in performance, and it is not appropriate that customers fund that improvement when they have paid for efficient maintenance in the past. We provided further explanation in our response to the CMA's second request for information about our approach to setting long term asset health performance commitment levels.

Setting efficient benchmarks for cost efficiency

1.15 For each of water and wastewater services, none of the companies that define the cost efficiency benchmark using historical data were in a trough of capital maintenance, and overall these companies perform well on service quality.

1.16 We recognise that companies could underspend their expenditure allowance by not undertaking an appropriate level of capital maintenance and in that way appear efficient. However, as we set out in our response to Anglian Water's statement of case,[3] we could find no evidence that the efficient companies defined by our cost models were in a trough of capital maintenance investment

[1] Ofwat, 'Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case', May 2020, pp.52-53 paragraphs 4:20-4:21
[2] Ofwat, Service delivery report 2018-19 and service delivery report data 2018-19, October 2019.
[3] Ofwat, Response to Anglian Water's statement of case, May 2020, paragraph 1.29.

in our model input data period. For example, the efficient water companies spent on average 3.9% more annually on capital maintenance in the data input period than in the immediately preceding ten years.

1.17 Cost efficient companies for both water and wastewater services also perform well on service quality and on average better than their peers.[4] We therefore do not consider that our cost efficiency benchmarks are impacted by inefficient underspending.

Inefficient underspending

1.18 In our response to Yorkshire Water's statement of case we noted some occasions where the company itself states it has had low rates of asset replacement, which could indicate that, on the wastewater side, the company is not undertaking sufficient investment. We repeat some of what we said there below.

1.19 The company states in its business plan that 'historically we have had very low sewer renewal rates, largely in the interests of affordability for customers'.[5,6] This low level of expenditure could be having a negative impact on service performance where the company is a relatively poor performer on the wastewater, and has the largest rate of sewer collapses in the sector. It is asking the CMA to provide additional funding in PR19 for it to improve its service performance.

1.20 We consider this illustrates the impact of a lack of appropriate capital maintenance investment, the importance of successive price reviews maintaining stretch on associated performance metrics, and the importance of ensuring the cost efficient companies are chosen for their efficiency rather than inefficient underspend.

[4] Ofwat, 'Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case', May 2020, paragraphs 7.33 to 7.42
[5] As stated in Ofwat, Response to Yorkshire Water's statement of case, May 2020, p. 82 paragraph 4.21
[6] Yorkshire Water, Exhibit 66-157, 33_Sewer Collapses_19c.pdf, Yorkshire Water business plan September 2018, pp. 3