Wessex Water
YTL GROUP

By email:
PR14review@ofwat.gov.uk

Direct line: [redacted]
Email: [redacted]
Date: 22 September 2021

Dear PR14 Review Team

PR14 Review: Discussion paper on findings

Thank you for the opportunity to comment on your findings on the impact of PR14.

Whilst there is some good analysis of the impacts of changes introduced in PR14, we are also conscious that much of this review paper appears to make assumptions about causation with little or no supporting evidence. This is particularly concerning if, as you propose in the paper, these elements will be used to help improve the design of PR24.

However, we believe there are some areas with strong supporting evidence that should be translated to the design of the PR24 framework, as well as some that should be avoided as a result of the perverse incentives or unintended consequences they have demonstrated.

Outcome based regulation

It is important to set out what we mean when we talk about inputs, outputs, and outcomes.

<u>Inputs</u>

These are actions or interventions made by companies, our customers, or stakeholders. For example, mains repairs or community engagement.

<u>Outputs</u>

These are changes that happen as a result of the intervention, which can lead to a change in an outcome but are not necessary to meet the outcome. For example, mains repairs can lead to lower leakage (but leakage reduction is not strictly necessary to meet the outcome of sustainable abstraction). And community engagement can lead to lower per capita consumption (PCC) (but again, PCC reduction is not strictly necessary to meet the outcome of sustainable abstraction).

<u>Outcomes</u>

These are the end goals customers, communities, and the environment want their water companies to deliver. For example, sustainable abstraction.

We welcome the recognition that “the outcomes framework aimed to increase companies’ focus on outcomes that customers valued rather than outputs” – this is an aim we fully support. There is then an appropriate recognition that companies ended up with 571 performance commitments. The paper does not, however, recognise that this caused a shift of focus back to inputs and outputs.

A fully outcomes-based approach would not prescribe the actions or outputs that need to be delivered to meet outcome targets. As such, PR14 did not meet the objectives of the reform and significantly limits the shift required to deliver those targets. PR24 should be an expression of customer and environmental outcome targets, underpinned by metrics that are controllable by the company. Targets should be defined at a catchment or company scale, where water companies have the flexibility to choose how to deliver interventions (inputs) that integrate outcomes on the ground.

Performance commitment levels

It is concerning that the paper considers it “an issue” that companies are able to outperform performance commitment levels because they were set at the industry upper quartile. The basis of incentive-based regulation is that all companies should be incentivised to perform as well as possible. This happens through out-performance payments for high-performing companies and under-performance payments for poor-performing companies. There is no evidence presented that customers support ever-improving performance on all performance commitments, at any cost. The assertion that upper quartile companies performing above the historical upper quartile and earning outperformance payments is “an issue”, is misleading and potentially damaging to the reputation of the industry. Rather, we should be celebrating companies that outperform targets that reflect customer preferences.

The corollary of this assertion is that all companies should always be better than the best company has ever performed. This is almost certainly inefficient, unlikely to be cost-beneficial, and will likely reflect a given year with positive externalities that cannot be expected to repeat every year in the future.

Incentives and the balance of risk and reward

We believe there is value in greater recognition of the overall incentive package and the important role this plays in the risk / reward balance. This includes outcome delivery incentives, cost assessment, cost sharing, PAYG ratios, reconciliations, long-term investment certainty, (the PR19) innovation competition, and WACC, among others.

We support the observation that risk can be mitigated through each of these areas, and that where some incentives end, they can be backed up (e.g. via enforcement action) to further mitigate risk.

A clear awareness of the risk / reward balance, and the appropriate level of mitigation will be an important part of the framework in PR24, particularly in areas where inherent risk may be slightly higher in a true outcomes-based world.

Longer-term focus

We agree with the comment that “the longer-term horizon could have been given a greater focus” and feel this needs to focus on integrating strategic planning frameworks, as well as appropriate incentives on ODIs, investment certainty, etc. as set out above.

Importantly, this longer-term focus should align with a move to proper outcomes and away from inputs and outputs. A prime example of this is asset health, which is an output of the numerous interventions we make every day. With the right long-term incentives on the right long-term outcomes, asset health will take care of itself (in the same way all other inputs and outputs will).

Equally, the regime must avoid perverse incentives (including conflicting targets). For example, a target to limit mains repairs cannot work alongside a target to reduce leakage.

Moreover, neither are necessary conditions to deliver the actual outcome of sustainable abstraction.

Cross-sectoral responsibility

The observation that “river water quality is a cross-sectoral responsibility” is a critical one. In fact, this goes much wider – particularly in the field of environmental outcomes such as carbon, biodiversity, and water abstraction. This observation should lead to PR24 recognising the need for cross-sectoral delivery of outcome targets, and providing a regulatory framework that enables, supports, and incentivises it.

Totex

We support the move to a totex regime and agree that “a totex framework encouraged a more efficient balance of opex and capex solutions”. However, the regime must ensure it continues to recognise the whole life cost of innovative approaches and provide the long-term investment certainty required to incentivise companies to deliver those innovative approaches. It is important that this is recognised in the overall risk / reward package and the setting of the PAYG ratio is a key part of ensuring the incentives work appropriately.

We are concerned about the assertion in the paper that the fact that “the [cost assessment] models reflected outturn spend quite closely at an industry level” demonstrates accuracy or appropriateness of the models. Rather, the models are used to set final determinations and associated revenue allowances. It is therefore to be expected that companies’ outturn expenditure will closely align with the models.

Sustainable use of water resources

It is telling, in the context of outcomes-based regulation, that the introduction to this section of the paper states that “one of the objectives of PR14 was to promote a more sustainable use of water resources” and that the remainder of the section contains not a single comment on the delivery of that outcome (apart from the reference to a very small proportion of overall abstraction that happens at AIM sites). Instead, the entire section focuses on inputs and outputs.

This is a shame, and an area that we hope can be rectified in PR24 as we move to a full outcomes-based regulatory framework.

I hope you find this response helpful and would welcome further discussions on any of these points as we look to work collaboratively to deliver a progressive framework for PR24.

Regards

[redacted]

Matt Greenfield

Director of Economic Regulation