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Dear Ofwat

PR24 and beyond: a discussion paper on outcome delivery incentives

We welcome this opportunity to respond to Ofwat's discussion paper on setting PR24 outcome delivery incentives. Reflecting our direct contribution to the creation of the outcomes regime in PR14, we are strong advocates of it, recognising its importance in driving ambition across the sector and as a means by which company progress in delivering exceptional levels of service for current and future customers can be measured.

This discussion paper forms part of a wider suite of consultations and papers published to develop the regulatory approach for PR24. Throughout this response we highlight the linkages between the various consultations to consider whether the overall emerging regulatory framework will drive the sector to deliver outcomes in the interest of customers and the environment both for AMP8 and the longer-term.

For outcome delivery incentives (ODIs), we consider interactions between this paper and the emerging thinking on other notable areas of the PR24 framework, including performance commitments, risk and return, the assessment of base costs, and notably Long-Term Delivery Strategies (LTDS). As requested, we also set out our views on the proposed changes to the calibration of incentives and the ODI rate formula.

Purpose of ODIs and long-term ambition

We welcome Ofwat's desire throughout the PR24 framework to support the sector in focussing on the long term. The outcomes framework and the subsequent calibration of incentive rates linked to performance commitments will play a central role in shaping the incentives faced by companies. It is important that this calibration strikes the right balance between both the near term (I.e. the price control period 2025-30) and the longer-term horizon. The importance of achieving this balance was discussed at the recent seminar discussion the Skylight Consulting discussion paper on how Economic Regulation can evolve to focus on the long term[1].

A desirable outcome of the PR24 outcomes framework is to ensure alignment with ambition identified in companies' developing Long Term Delivery Strategies (LTDS). Achieving the long-term outcomes

[1] https://www.ofwat.gov.uk/wp-content/uploads/2022/01/Skylight-Consulting-Anglian-Water-submission-A-long-term-focus-Future-Ideas-Lab.pdf

identified in companies' LTDS will require an adaptive approach to delivery and the appropriate sequencing of key investments, responding to emerging challenges, new statutory requirements and customer priorities up to 2050. This may call for the acceleration or deceleration of delivery for certain service improvements and related expenditure. To that end, we propose the addition of '*support the delivery of long-term outcomes*' to the purpose of ODIs as outlined within the paper.

Capital Maintenance and Asset health incentives

There is a clear link between asset health and the quantum of capital maintenance allowances. The focus on the long term provides an opportunity to reassess the sufficiency of future capital maintenance allowances. There is a growing consensus that a focus on a purely historical cost assessment will fail to capture the longer-term challenges such as climate change facing these already aging assets. PR24 is an opportunity to deal with this head-on, ensuring sufficiency of maintenance expenditure with the result that companies are able to execute a long-term maintenance focus rather than shorter-term cost minimisation driven by seeking to live within the allowances set based solely on historic cost data.

This issue needs to be addressed to ensure a balance between shorter and longer term incentives such as asset health ODI rates can be effectively resolved.

Implications of removal of marginal costs from the ODI rate formula

The appropriate calibration of incentives, reflecting customer priorities for service improvements while incentivising poor performing companies to improve and strong performers to excel, ensures the best outcomes for our customers, stakeholders and the environment. As stated above, this calibration must carefully balance both the near and long term.

At PR19, to propose incentive rates for many of our PCs, we utilised forecasts of efficient marginal costs from our candidate investments (including those not included in the business plan) along with output from customer valuation research. This information allowed us to develop cost curves to calibrate incentive rates consistent with the output of line of best fit between costs of incremental improvement and the benefits for our customers and the environment. The process also permitted us to challenge and assure the costs and benefits of all investments and for each PC.

Considering the integral role of marginal cost estimates in determining the costs of incremental performance improvements, the removal of marginal costs from the ODI rate formula would see valuable information lost from the price review. This would reduce understanding of the economics of any given service and make it harder to later set stretching yet achievable improvement targets.

Understanding marginal costs allows the industry to establish if the performance commitment level (PCL) for each PC is set appropriately at the level of service balancing the costs of incremental improvements and the benefits for customers in doing so. We note that the removal of marginal costs from the formula also has implications for the wider discussion on the cost-service relationship and the approach to funding companies to maintain and improve the level of service they provide to customers at PR24 and subsequent price reviews. Therefore, there is value in building marginal costs into the ODI rates formula to reduce the risk of losing this information and the insight it offers for setting the PCL at the optimal level between cost and benefit to incentivise best behaviour.

We note Ofwat's concerns regarding marginal cost data accuracy and robustness and agree that current inconsistency in cost estimates between companies poses a challenge for establishing incentives at aggregate level of service as a sector. However, we see this as an indication of there being value in looking to improve marginal cost data accuracy as the advantages extend beyond informing the ODI rate formula alone, not to jettison the use of marginal cost data. Advantages include using marginal cost data for the purposes of cost assessment and understanding the longer-term cost paths for service improvement.

Additionally, recognising the relationship between incremental performance improvements and additional marginal costs is not necessarily linear: it is beneficial to gain a better understanding marginal costs for metrics where this relationship is more complex. For instance, we know the marginal cost of improving and maintaining levels of leakage reduction varies both across regions and as service levels improve and as 'low cost' options are exhausted. This is even more important in a long-term planning context given the link between potential demand side and supply side options to maintain the long-term supply demand balance.

As such, steps must be taken as a sector to improve the accuracy and robustness of marginal cost estimates for future price reviews. Our ideas for this include the development of a 'best practice' framework for deriving and reporting company specific marginal costs would drive consistency in estimates between companies.

We are currently collaborating with other water companies to commission a study on productivity and PC marginal improvement costs to inform the PR24 methodology and company business plans. This study will firstly attempt to improve the understanding of how service improvements (as opposed to cost reductions) translate into productivity improvements. Secondly, it will attempt to develop marginal cost estimates that are less variable than the ones we saw at PR19. On this basis, we welcome further discussion on the potential to improve marginal cost data collection across the sector within future sessions of the Outcomes Working Group and more broadly as a sector ahead of the publication of the draft methodology.

ODI rates as part of the broader PR24 framework including for the long term

It is important that the final approach to setting incentives at PR24 aligns more widely with the approaches to risk and return and cost assessment, including the effective capture of the cost-service relationship and the delivery of long-term objectives. Clear visibility as to how these components align will be essential within the draft methodology.

The appropriate calibration of incentive rates is an iterative process and will continue to be shaped by the output of the ongoing customer research into ODI rates in addition to developments outlined within the draft and final methodologies.

On this account we recognise this paper constitutes the start of a sector-wide conversation on calibrating incentives for companies to deliver the greatest benefit for current and future customers both for AMP8 and the longer term which we welcome, and believe that further discussions on these points, and how ODI design can support goals set out in companies' Long Term Delivery Strategies, will be important.

As always, we would be happy to discuss any of the points set out in this response.

Yours faithfully

[redacted]

Head of Policy and Regulatory Strategy

1. Purpose of ODIs

Q1. Do you have any comments on what the purpose of ODIs should be at PR24?

ODIs are central to the outcomes regime. At PR24 there remains the opportunity to use the incentives framework to galvanize ambition and encourage companies to deliver the outcomes that are most important to customers and for the environment not just over the five years of the price review, but also over the longer term.

We agree with the purpose of ODIs as outlined within the paper, and the principle that companies who deliver strong performance should be rewarded, while customers receiving levels of service below expectations should be compensated through this mechanism.

In addition to the position set out in the paper, we consider there is scope for greater emphasis on how the ODI framework can help support long-term outcomes (i.e. outcomes beyond the period 2025-30.) It is essential that the ODI framework does not have the unintended consequence of focussing companies' attention on the short term at the expense of longer-term ambitions and priorities which we expect to be identified in companies' Long-Term Delivery Strategies.

Therefore, we propose the addition of '*support the delivery of long-term outcomes*' to the list of what ODIs can help to achieve and to embed a long-term approach into the purpose of the framework. This addition would help maintain alignment with the ambition outlined in Ofwat's consultation on Long-Term Delivery Strategies to establish price reviews as staging posts in the realisation of long-term outcomes.

We support of the use of PCDs as a mechanism to provide assurance on the delivery of longer-term outcomes. Where there are clear customer and environmental benefits for accelerating delivery, we suggest Ofwat considers applying symmetrical outperformance and underperformance incentives to PCDs. Funding the acceleration of delivery through a 'two-sided' mechanism could remove the reliance on five-year price controls to fund the delivery of schemes, and subsequently promote flexibility in approach in the delivery which should align with the adaptive nature of companies' long-term delivery strategies.

For instance, certain adaptive pathway triggers may call for acceleration in the delivery of schemes such as smart metering to reduce pressures on demand, for which a funding mechanism enabling the delivery of strategic improvements as soon as possible (and this should include changes within an AMP period) will generate the most benefit for customers. Therefore, this build has the potential to further drive company ambition and to enable the strategic timing of delivery on some of the most material areas of service improvements.

2. Bottom-up approaches: revising the ODI rate formula

Q2. Do you have any comments on our observations on the standard ODI rate formula and how we are considering revising it

The removal of marginal cost estimates from the ODI rate formula has potential consequences for the visibility of the relationship between cost and service. We cover these points in more detail later in our response, including our recommendation for the sector to look to improve marginal cost data.

The results of customer research into ODI rates will be material for establishing whether setting rates equal to estimated marginal benefits or equal to a fixed share of marginal benefits is most appropriate. There is the potential for the ODI rates research to result in high values for which setting rates equal to estimated marginal benefits could compound the value and result in disproportional incentives.

Considering this, we recommend Ofwat retains flexibility on the ODI rate formula at this early stage of the process. We would suggest that a final decision on removing marginal costs from the formula does not need to be made until other aspects of the wider PR24 framework are determined. Ofwat must continue to consult on the optimal approach to setting rates as more evidence becomes available.

Q3. What are the risks of unintended consequences from this approach? How can they be mitigated?

The removal of marginal costs from the ODI rate formula may have wider implications throughout the price control. It is in the best interest of customers and stakeholders to ensure that the calibration of incentives continues to encourage companies to act in line with their preferences and priorities; for this, a rounded knowledge of the costs of delivering incremental levels of service improvements is essential for informing investment decisions both in AMP8 and the longer term. By removing this from the formula the prominence of this information will be diminished.

Disregarding marginal cost estimates represents the loss of valuable information available to establish if performance commitment levels (PCLs) are set at the optimal level of service between costs and benefits. Marginal cost data offer important evidence to inform the calibration of companies' cost allowances and provides vital insight into how companies will respond to the proposed level of incentives. Building marginal costs into the ODI rate formula would reduce the risk of setting the PCL at an uneconomical level for companies to deliver when coupled with improvements in the collection of marginal cost data.

There remains value in looking to improve marginal cost data beyond utilisation within the ODI rate formula for the purposes of cross-checking incentive rates across the ODI package. This is to ensure rates are calibrated at a level where marginal costs do not outweigh marginal benefits, potentially generating perverse incentives for companies to miss targets for financial reasons. For example, a company on the frontier of performance on leakage reduction could be incentivised to allow performance to return to the industry average if ODI outperformance rates were not suitably recompensating for efforts of maintaining or improving this position as the marginal costs increase with performance.

To mitigate the potential risks of this approach, we welcome further discussion on improving marginal cost data across the sector and a broader discussion of the cost service relationship which underpins the regulatory framework for PR24. This is consistent with our response to the discussion paper of Assessing Base Costs at PR24. With sector wide efforts to improve marginal costs data and improve consistency in data between companies, the benefits in doing so extend beyond informing the ODI rate formula to gain a greater understanding of the costs of incremental service improvements.

We are collaborating with other water companies in commissioning a study to establish the productivity improvement implied by improvements in PC performance and to develop marginal cost estimates which are less variable that the ones we saw at PR19. From the suite of published PR24 consultations, this study would set out a framework for capturing the costs of delivering stretching PCLs to ensure service improvements are efficiently funded, identifying where enhancement expenditure for performance improvements and additional expenditure for increased levels of performance are required.

We note that symmetric outperformance and underperformance rates does not necessarily create symmetric risks. To calibrate incentives which balance upside and downside risk, the approach to setting ODIs must consider and be reflected in the approaches taken within the wider price control, including setting cost allowances and establishing PCLs. At the PR19 redeterminations, the CMA adjusted its point estimate for the cost of equity because of asymmetry of risk within the ODI package, noting the inclusion of underperformance incentive only measures. Therefore, for some measures it may be appropriate to set stronger outperformance incentives to balance risk and push companies away from minimising penalty to aspiring to outperform.

3. Bottom-up approaches: asset health-related PCs

Q4. Do you have any comments on using a bottom-up approach based on marginal benefits for setting ODI rates?

We agree it is appropriate to consider bottom-up approaches first when looking to determine an approach to set ODI rates. We support the general principle that incentives should reflect customer views and preferences on marginal benefits of delivering long term ambitions.

Q5. Do you have specific comments on setting ODI rates for asset health-related PCs?

The intended purpose of the asset health related measures and related ODIs is to provide confidence that companies are appropriately maintaining their asset bases.

There is a clear link between asset health and the quantum of capital maintenance allowances. The focus on the long term provides an opportunity to reassess the sufficiency of future capital maintenance allowances. There is a growing consensus that a focus on a purely historical cost assessment will fail to capture the longer term challenges such as climate change facing these already aging assets. PR24 is an opportunity to deal with this head-on ensuring, sufficiency of maintenance expenditure with the result that companies are able to execute a long term maintenance focus rather than shorter term cost minimisation driven by seeking to live within the allowances set based solely on historic cost data.

This issue needs to be addressed to ensure a balance between shorter and longer term incentives such as asset health ODI rates can be effectively resolved.

Establishing customer valuations for asset health-related measures and subsequently calibrating incentives can potentially be challenging. The indirect linkages between customer valuation and asset health PCs can result in low incentive rates. As such we think that Ofwat's consideration of a range of bottom-up approaches to setting ODI rates in this area is sensible and should enable appropriate incentive rates that will push the sector to make strides in maintaining and improving asset health. The outlined option to use inferred marginal benefits by mapping asset health-related measures onto customer-facing metrics is a suitable method for informing incentive rates, dependent on the weighing of metrics given that incidents related to some measures result in limited or no service impact for customers.

We note a few additions that may be made to the mapping exercise, including the addition of treatment works compliance to the list of PCs in consideration. From our own experience utilising a similar approach at PR19, potential customer-facing metrics for this measure include bathing water quality, volumetric compliance, and nutrient and sanitary compliance.

For mains repairs, we agree with use of leakage, interruptions to supply, and water quality as customer facing measures. However, we challenge the use of persistent low pressure as a suitable measure for this exercise as low pressure can often result from pressures on capacity rather than asset health deterioration.

Although we believe the measures associated with unplanned outages are reasonable as proxies, we do not believe unplanned outage is the right asset health measure for consideration within this exercise. Outages in the Anglian region do not usually result in interruptions to supply because of efforts to improve system resilience and reduce reliance on individual water treatment works and are instead typically driven by issues in the network. Nonetheless, we remain supportive of this mapping approach being utilised for applicable asset health measures in conjunction with other bottom-up approaches to inform rates that reflect the willingness of customers to pay for incremental improvements.

Considering the difficulties in establishing marginal benefit for asset health-related PCs and the drawbacks of each approach outlined within the discussion paper, we suggest triangulation when looking to set rates. We used a similar triangulation approach at PR19 to draw upon a range of sources of customer evidence to set incentives for asset health-related performance commitments. Where possible, triangulation between bottom-up approaches, to establish what customers are willing to pay for incremental improvements on each measure, and top-down approaches, to inform the overall range and weighting of incentives including caps and collars, should be considered.

As the asset health-related PCs at PR24 are not currently known, we suggest Ofwat retains flexibility in the approaches utilised to set incentives until more detail is available. Ofwat should continue to seek input from companies until the approach is finalised. However, we are encouraged that Ofwat is considering a range of different bottom-up allocation approaches and believe this approach builds upon strong foundations developed over the course of multiple price reviews.

4. Top-down approaches to setting ODI rates

Q6. What are your views on using top-down allocation approaches for setting ODI rates or for other uses?

We support the use of top-down allocation approaches to support triangulation and calibration of ODI rates in the broader context of assessing the overall balance of risk and return across companies. They could also be used to infer caps and collars for a subset of PCs and provides an important tool in filling potential gaps presented from use of bottom-up approaches. We took a similar approach at PR19 to establish the range of incentives supported by customers and their relative weighing of measures for financial incentives. Where possible we support Ofwat's suggestion to combine top-down with bottom-up allocation approaches to ensure customers' overall priorities align with their willingness to pay for individual measures.

Q7. How would we ensure that the performance increments for individual PCs are sufficiently robust and protect customers?

A range of data sources can be used to derive performance increments for different measures, including historical performance and projections for further improvements.

We suggest that the performance increments used when setting caps and collars on individual PCs where appropriate should align with the performance range used to set incentives. This will ensure incentives associated with increments do not exceed what customers are willing to pay for service improvements. We recognise engaging with customers on setting the appropriate incentives for incremental performance is essential and we will build upon our societal valuation work at PR19 to ensure customers' views are at the heart of deriving our incentive rates. However, cross checking caps and collars across performance commitments and against long-term priorities is required to ensure they do not constrain customer supported ambition.

5. Enhanced ODIs

Q8. Should we retain enhanced ODIs at PR24? If we do, should they apply to all companies? And which PCs should have enhanced ODIs?
Q9. How should we approach assessing and setting enhanced ODIs at PR24?

The enhanced ODI framework as introduced at PR19 aspired to stimulate companies to deliver frontier-shifting performance improvements where there are clear benefits for customers. The purpose of enhanced ODIs must remain front of mind when considering if the calibration of incentives and cost allowances provides suitable incentives to encourage sector leading rather than average performance. We recognise the potential customer benefits in appropriate calibration of enhanced ODIs are two-fold. Firstly, the direct benefit to the company's customers who receive exceptional levels of service, and secondly for customers more broadly through knowledge sharing from frontier-shifting companies leading to more stretching PCL levels for the sector.

If high performing companies are not appropriately funded through the enhanced ODI mechanism for the delivery of service improvements beyond the frontier, the enhanced ODI framework could inadvertently encourage average rather than exceptional company performance. To ensure these benefits are achieved, further consideration is required if the enhanced ODI rates shapes companies' behaviour to prioritise customer benefits instead of capping ambition at the PCL. We welcome further discussion on calibrating enhanced ODIs to best capture the aspirational levels of service improvements this mechanism could help incentivise.

We support retaining enhanced ODIs at PR24, although agree it is pertinent to keep this retention under review as subsequent years of reporting data build a clearer picture of their effectiveness. We emphasise that customer views and priorities for service improvements should play a central role in informing which measures are considered for enhanced incentives to ensure alignment between customer willingness to pay for improvements and incentive rates. Therefore, further consideration of the selection of candidates for enhanced ODIs must be informed by customer preferences and willingness to pay as established through the results of ODI rates customer engagement research. At this stage it will be possible to reach a more definitive conclusion on which PCs are strong candidates for enhanced ODIs at PR24. Nonetheless, wider mechanisms to incentivise innovation such as the innovation fund do not depreciate the opportunities presented through the enhanced ODI framework and the wider outcomes regime to push for aspirational levels of service improvement.