
'Cabot' Created by Bex Glover

By email: [redacted]

25th March 2022

Dear Ofwat,

**Discussion paper on outcome delivery incentives**

This letter and appendix set out our views on Ofwat's PR24 outcome delivery incentives discussion paper. We welcome the way in that the discussion paper sets out the issues involved and our response is consistent with our comments in the other related PR24 discussion papers, in particular base cost and risk and return.

We were pleased to see Ofwat consulting on a top-down approach to setting ODI incentives. Although the consultation was correct in the potential challenges with this approach, we believe similar challenges apply to other bottom up approaches to incentives. Reflecting on the context for this is important. We are still not convinced that moving away from the PR14 and PR19 company led research and plan approach to setting service levels based on companies' identifying the marginal benefits and marginal costs of delivering a mixture of bespoke and standard performance commitments is an improvement in the regulatory framework. We agree that there are potential advantages in greater consistency in service levels and incentives, in terms of simplifying how price controls are set. However, in practice we observe complexity, uncertainty and delays in the development of this methodology and the information that companies need to prepare a plan on this basis, both in terms of identifying "what base buys" and the bottom up centralised ODI rate research. We do not believe a centralised, bottom up approach as Ofwat are planning will work in practice.

The advantage of a top down approach to informing ODI incentives, accepting its limitations, is that it is consistent with a simpler approach to setting outcome incentives, especially if we move away from trying to identify service levels and incentive rates from an assumption they reflect a point where marginal costs equals marginal benefits. Our overall concern ultimately is risk and return, and the potential that, as at PR19, we have to move away from standardisation because the outcome from it is an unfeasible risk and return balance for a substantial proportion of the industry, when the component incentives are applied by Ofwat. A top-down approach as a minimum will provide a cross-check and some information on customer priorities to inform calibration.

The consultation clearly sets out there are a number of areas of complexity that exist when we try and apply a simpler approach to setting ODI incentives to the different situations that apply, particularly for asset health and where customer valuations may be difficult to obtain or apply. Whilst individual incentives will have unintended consequences, this is a relatively modest problem compared to the risk of an unfeasible and asymmetric risk and return


'Cabot' Created by Bex Glover

package. [redacted] be helpful for Ofwat to test the scenarios for incentive packages depending on the future investment challenges faced by companies individually before fixing the incentives approach. At this point, we have a number of questions on the methodology such as how incentives will align with cost assessment assumptions before we can attempt to calibrate the incentives package.

We would welcome the opportunity to test these scenarios further in the design of a top-down approach to calibrating incentives, at least as a cross check to marginal benefits and marginal cost approaches that company develop bottom up. This can be done on a notional industry-level basis, and can as we suggested be separated into the customer, environment and asset-health baskets of ODIs. A top-down allocation approach does not necessarily need to be applied through different incentive rates for different companies, but depending on the methodology and risk and return calibration, this remains one option that we may still need to consider at PR24.

Yours faithfully,

[redacted]

Director of Strategy & Regulation


'Cabot' Created by Bex Glover

**Response to specific comment questions**

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

An additional purpose to outcome delivery incentives (ODIs) to those set out in the discussion paper is to enable automatic adjustments to customer bills as performance changes. This is important to trust in the regulatory regime that, in normal circumstances, has price controls ex ante and allows for enough certainty for efficient and effective investment to occur.

This should be distinct from the principle of compensating customers – companies compensate customers in different ways for service failures that customers experience directly. It will be confusing to describe ODIs as compensating customers, which customers would understand as payments they receive direct, such as GSS for supply interruptions. Regulators also take action and levy consequences for environmental failures, whether that is enhanced scrutiny, restorative expenditure or fines.

It is probably better to describe ODIs as helping to incentivise companies to not just focus on minimising costs in the short term, by ensuring that bills adjust to reflect the performance levels companies achieve, Through ODIs it can be easily described to customers and stakeholders how the regulatory regime does this. We find this structure works well in aligning our regulatory reporting and customer and stakeholder transparency.

In our view, the other purpose for ODIs is that is allows for the regulatory framework and its incentives to be set with appropriate consideration of local customer and stakeholder priorities, reflecting that water services are fundamentally local in nature. This should include acceptance of the role of bespoke ODIs, and that asymmetry in ODIs is not beyond that consistent with the risk associated with the cost of capital. The role of investment in water services on the local economy is something that customers and stakeholders often mention as a concern, and is relevant to the regulatory framework that investment is not constrained by inappropriate allocation of risk through skewed and misaligned incentives.

**Q2: Do you have any comments on our observations on the standard ODI rate formula and how we are considering revising it?**
**Q3: What are the risks of unintended consequences from this approach? How can they be mitigated?**

Our comments start from the perspective that the PR24 methodology was looking for greater consistency of incentive rates, and that perspective then changes the formula for setting the standard ODI rate. This is not our preference as we have made clear throughout the PR24 discussion, as we do not think the move away from the logic of the PR14 totex and outcomes approach is in customers' long term interests. However, in the context of Ofwat's current position on the PR24 methodology, identifying a customer valuation, and then


'Cabot' Created by Bex Glover

assuming a percentage of it would be shared between companies and customers was logical. Outperformance rates in particular have followed this approach, and in general 50% sharing of the customer valuation / marginal benefit set these incentives. As the CMA found and what generally was also applied at PR14 and PR19, if the incentive rate doesn't make a direct link to specific company costs, which for outperformance is generally likely to be the case, then we can just assume how incentives based on marginal benefits can be shared. There are potential issues when cost and ODI sharing rates diverge significantly, but this is an issue on risk and return which extends beyond ODIs to the risk package as a whole.

For Price Control Deliverables / end of period ODIs, there is a stronger rationale for these to be cost based. The same can apply to asset health, but as the consultation notes there is far more interaction here with other performance measures at the time (such as mains bursts and leakage). Cost base for PCDs helps for adjustments for expenditure that protects customers from delivery, or where the output is uncertain (e.g. for metering). However, when we move to a narrower range of performance commitments that are ODIs but potentially a larger number of other price control deliverables, we may create the complexity that some of the marginal cost is already incentivised through PCDs (in this example the link between metering and PCC reduction), alongside the general customer and investor protection that comes from totex sharing.

In general, therefore if Ofwat are moving to the regulatory framework that is standardised and simpler to set, then both out and underperformance can be set as a proportion of marginal benefits, and we believe 50% is a good starting point.

However, in its practical application there are a number of reasons why Ofwat may wish to depart from this starting point. From our point of view, this comes back to the risk and return balance, and to answer this question we would need Ofwat to a) finalise the approach to "what base buys"; b) understand the degree to which common performance commitments will have common service levels; c) understand what happens to incentive design if companies are already beyond a common service level (part of the service-cost relationship); d) how differential enhancement requirements will affect service level targets; e) how asset health incentives are approached; and f) the calibration of risk and return. Without clarity on this, we do not know whether moving away from understanding marginal costs and benefits will just result in incentives misaligned with both customer and stakeholder views on investment priorities, and the future cost of that investment.

In some cases the calibration of these incentives might benefit from understanding marginal costs. With this information there are two approaches which arrive at the same impact – either the formula for underperformance deducts the marginal cost from the marginal benefit (as the PR14/19 formula), or it is used to estimate a the "$X_{under}$" percentage as per Box 4.1 of the consultation. We think this should focus on the areas where the service cost relationship is established. We note from the CMA PR19 review however that the CMA reviewed the


'Cabot' Created by Bex Glover

marginal [redacted] and enhancement leakage, and ended up undertaking a bespoke assessment for each company from these principles. This was because leakage historical performance and future approaches to reducing leakage were context dependent, and it wasn't clear to the CMA whether a particular company strategy could be judged based on the observed future marginal cost. In Bristol Water's case we could evidence that the plan leakage target had been based on testing what could efficiently be delivered through operational improvements from a current leakage approach, and beyond that there appear to be an exponential increase in marginal costs beyond the customer WTP at the time, but technology was emerging for the longer term. In the context of longer term adaptive planning this is important.

The unintended consequences of the incentives approach can be to skew long-term planning and investment decisions in the water sector. If faced with uncertainty about long-term investment needs and there are large environmental and societal consequences from underinvestment, the incentives need to be balanced with customer protection from over and under investment.

In our view Ofwat should focus on the risk and return balance, and what are the scenarios that there might be for different risk and return balances through incentive packages, and if that isn't possible through the cost of equity. We previously suggested that there could be more than one scenario, for instance should underperformance incentives and cost sharing rates vary where, for instance, where a company evidences sufficiently that additional capital maintenance expenditure is needed. Because this expenditure will contribute to a wide range of common (and bespoke) ODIs, a price control deliverable could be used to protect customers from the specific spend (e.g. a resilience scheme, or delivery of a particular length of mains replacement), but this sunk cost forms part of the marginal cost and the base cost for future common and bespoke ODIs. Whilst our start point may be notional ODI rates (and potentially estimates of marginal cost), calibration for risk and return may end up being more bespoke than this – to ensure the right investment is made and the right incentives. We are not convinced the resilient water sector is one size fits all on these questions, even for the long-term outcomes. We will need to understand company specific marginal costs and marginal benefits.

The consultation is right to highlight the CMA findings on asymmetry risk and this risk reflected expected performance rather than just related to ODI rates. For Bristol Water the CMA fixed the asymmetry through both adjusting ODI rates and design, but also identified the balance of ODI under/outperformance looking at the risks and opportunities in the round. Top-down customer research played some part in this, and our proposal here suggests linking to risk and return by considering how different investment outlooks could affect the calibration of ODI rates, including what X% and elements of cost to reflect in the ODI rate formula. We agree that setting X at 100% of the marginal benefit will probably provide incentives that are too strong, and that 50% is a pragmatic and balanced starting point.


'Cabot' Created by Bex Glover

The consultation paper is right to highlight the risks to customers from underinvestment and underperformance that arise from asymmetric cost sharing rates out of line with a linked rate used to calculate ODI incentives. The solution however to set the ODI rate to match the cost sharing rate just increases the asymmetry risk, and would not align to the CMAs findings, which only applied such adjustments to Price Control Deliverables. The illustration of a 75% / 25% underperformance/outperformance cost sharing rate is a problem with such asymmetric cost sharing rates, not just with outcome incentives.

The question is why there should be such asymmetry, where base costs are equated to a base level of service, and price control deliverables are used for enhancement outputs separate to the ODI framework? Ofwat accepted this in the RoRE consultation, stating a preference to remove asymmetry skew at source rather than through "aiming up" on the cost of capital.

In the risk and return consultation we then suggested a process for applying notional assumptions (including the ODI rate) at a company level and then aggregating, in order to test and calibrate these assumptions. We think this a practical approach to balance the questions this discussion paper raises about how to approach the ODI rate formula.

| | Standard | High enhancement spend / environmental obligations | High maintenance spend needed | Long term: Innovative and ambitious |
|---|---|---|---|---|
| Finance and customer service outperformance | 1.00% | 1.00% | 1.00% | 1.00% |
| Min. Totex outperformance | 1.50% | 1.50% | 3.00% | 1.50% |
| Investment totex outperformance | 0.50% | 1.50% | 1.00% | 0.00% |
| Local ODIs outperformance | 0.50% | 0.00% | 0.00% | 1.00% |
| Resilience ODIs (e.g. supply interruptions) outperformance | 0.30% | 0.30% | 0.00% | 0.50% |
| Environment (e.g. leakage, PCC) outperformance | 0.20% | 0.20% | 0.00% | 0.50% |
| Asset health ODIs outperformance | 0.00% | 0.00% | 0.00% | 0.00% |
| Base return | 4.00% | 4.00% | 4.00% | 4.00% |
| Finance and customer service underperformance | -1.00% | -1.00% | -1.00% | -1.00% |
| Min. Totex underperformance | -1.50% | -0.50% | 0.00% | -2.00% |
| Investment opex underperformance | -0.50% | -0.50% | 0.00% | -0.50% |
| Local ODI underperformance | -0.50% | 0.00% | 0.00% | -1.50% |
| Resilience ODIs (e.g. supply interruptions) underperformance | -0.50% | -1.50% | -1.00% | -1.00% |
| Environment (e.g. leakage, PCC) underperformance | -1.00% | -2.00% | -2.00% | -1.00% |
| Asset health ODI underperformance | -1.00% | -1.00% | -3.00% | -1.00% |
| | | | | |
| | | | | |
| Upside | 4.00% | 4.50% | 5.00% | 4.50% |
| Downside | -6.00% | -6.50% | -7.00% | -8.00% |


'Cabot' Created by Bex Glover

This is the [redacted] used to illustrate the risk and return balance – if there are scenarios with more potential for totex outperformance, there may be less justification for ODI outperformance *in extremis*. Customer protection may apply through a customer-weighted totex sharing rate and higher asset health underperformance ODIs. Ofwat have the option to take a principles or scenarios approach, which can either be reflected through collecting some marginal cost information, or just through standard determined assumptions on totex sharing and ODI incentive rates. It is possible to have a standard approach which has linked customer and investor protections where this is needed for ODI calibration, as long the industry notional package has been tested through applying to actual company positions, so that notional reflects the average (which can be forecast with some asymmetry as at PR19, which the CMA accepted, but there are limits to this as the CMA found).

Without the scenarios and top-down ODI calibration research, we question what simplification from PR19 we will achieve in practice. Industry level marginal costs may in themselves prove to be useful to collect, but difficult to apply in practice. There would remain a disconnect between costs and risk which ultimately one way or another has to be reflected in equity buffer and financeability. As an example, a company at the frontier of leakage will become more vulnerable to weather impacts and exogenous leakage factors such as customer side leakage. Similar impacts also apply to supply interruptions, and the related asset health metrics such as mains repairs. The tighter the overall incentives, the more likely it is we either require incentive scenarios for calibration and/or plans will need to be calibrated with bespoke ODIs in order to reflect the company position even within a broadly notional framework. We also need to be clear how customers are protected that a company will deliver that plan, and not focus on the short term notional incentives because they are managing asymmetry risk in ODIs against a equity return buffer that is insufficient for the normal range of performance for the sector.

We remain far from convinced that the centralised ODI rate research approach will produce ODI rate estimates that will be easy to apply to a different context, in a way that they could be described as marginal benefits. They are focusing on compensation, rather than water bills, as the value transfer for the choice experiment. This may bias to loss-aversion and result in higher benefit values than a marginal benefit based on industry performance levels.

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

The discussion paper starts with the premise that there are diminishing marginal benefits for customer and environmental ODIs. This may not be the case in practice. There is some evidence to suggest that at higher levels of customer and environmental performance, equity becomes a greater issue and the marginal benefit for the remaining units (e.g. the last few sewer flooding properties to be removed, or areas at risk of supply interruptions for resilience) increases. This may at least in part be due to stated preference survey designs,


'Cabot' Created by Bex Glover

noting the finding from PJM Economics that 59% of the variation in WTP values was due to the scope of service change offered.

A bottom up approach to setting ODIs that includes diminishing marginal benefits (ie lower outperformance rates the higher the levels of performance) would increase the risk of ODI asymmetry. The distinction made in the consultation between customer and environmental ODIs and asset health needs calibration through incentives. The areas where common Price Control Levels (PCLs) were set at PR19 (supply interruptions, CRI, PSR) are a range of customer and asset health elements. The areas where targets were not standardised (mains bursts, leakage) similarly cross categories. Areas where companies set bespoke targets but there were broad expectations of an ODI (water quality contacts, discharge compliance) are similarly distributed across a wide range of incentive types and sources of value used to set incentives.

We are not convinced on the logic set out on pollution incidents as an example of an environmental PC with diminishing marginal benefits. This may have been how societies expectations may have formed in the past and reflected in the cost base for the design of a wastewater system that had an optimal level of pollution, but societies expectations may have shifted. Users of rivers and the increased focus on the long term environmental outcomes may mean that there are factors not historically captured in the benefits, and choices on system design. The costs of removing pollution incidents may be higher than these perceived benefits when traded off against other priorities (e.g. how should compensation be assessed when most do not experience pollution, or swim in rivers etc). A marginal cost approach may be a better incentive, and this could be tested through top down allocation or risk. Particularly if society expects a step change in investment that should be reflected in pollution being a measure of asset health. A better example may be the Bristol Water biodiversity index where there is a baseline which clearly links to biodiversity net gain where they may be some expectation of declining marginal benefits at some point.

Trade-offs can be a reason for underperformance and outperformance rates to be different – the acceptability of this is something we should test in context with customers and stakeholders. The environment we are targeting for long term outcomes should be a good example of this. We can see the case for symmetrical rates beyond legal standards (which is why we do not have outperformance incentives for CRI), but the position on environmental incentives will depend on the metric used.

We agree with the logic that customer and environmental outcomes could have the same outperformance and underperformance rates, but suggest we carry out top-down research to test customer views on this. Similar research at PR19 was carried out on asset health, which generally suggested that when considered in isolation, customers preferred investment incentives for asset health rather than penalty skewed ODIs, but equally there


'Cabot' Created by Bex Glover

was little support for outperformance on asset health – it is a performance baseline for customer and environmental facing ODIs by its description. However, when presented with a package of ODIs, the context of asset health incentives changed to support a range of value based incentives, as long as normal weather variation in performance was not penalised (deadbands) and there was a collar on the total penalty to avoid risk of underinvestment. This suggests that there is value in top down approaches, as a minimum as a cross check, irrespective of what bottom up approach is used.

**Q5: Do you have specific comments on setting ODI rates for asset health-related**

The consultation suggests that you could infer asset health incentive rates from customer-facing metrics, as opposed to direct customer valuation or using marginal costs. This would require research that considered incentive packages as a whole – it would require the top down research.

There is another approach, broadly taken at PR19, that asset health penalties should be of a similar magnitude to previous reviews, unless there are specific reasons to change. We used this at PR19 to consider a multiplier on marginal costs to make sure asset health penalties were c1% of RoRE, a multiplier that could be tweaked with other aspects of ODI design.

A good reason for doing this was that we recognised that risk to asset health changes as services improve e.g. from extreme weather impacts. This can be calibrated through deadbands (as the CMA preferred for mains bursts based on the evidence we presented), but can also be done through estimating base costs (and not necessarily just marginal cost for penalty rates). For asset health, do we really understand what the marginal cost is, having calibrated for all the other incentives that are linked (leakage, supply interruptions etc). Our solution is just to calibrate incentives through top-down research and not to over-complicate this. We know leakage, supply interruptions and mains bursts costs and performance are related but the service cost relationship is not easy to identify. This suggests the marginal cost, separate from other costs, of asset health will also be difficult to identify. We explore in the top down section below our suggestion with regards to calibrating incentives as a whole.

Looking specifically at the link suggested in table 4.1, we observed that the link between unplanned outage and water supply interruptions / restrictions does not usually exist in this way, and depends on the operational resilience of the network as well as treatment works asset health. Linking asset health to other outcome incentives implies double counting of incentives. Ultimately a cost based incentive is better, and perhaps for new investment a price control deliverable. If there are deliverables then there would be a different approach to asset health targets, with deadbands to avoid double counting normal performance.


'Cabot' Created by Bex Glover

Alternatively a top down allocation exercise can help to split the benefit value over customer service (immediate) and long term (asset health) indicators.

The challenge is that the asset health metrics remain backwards rather than forward looking long term measures. Mains repairs as an asset health measure presents short run trade offs, as fixing more leaks can trigger underperformance on this metric. Not making mains repairs may benefit drinking water quality contacts in the short term. A judgement as a proportion of RoRE on asset health, calibrated as part of overall risk and return, is our preferred option.

If we move to forward looking measures of asset health then there is more logic in using marginal costs. We have proposed exploring how Drinking Water Safety Plans and unmitigated hazards (the DWI RARI measure) could be used as a forward looking measure of asset health, because it can be linked to particular asset interventions and what hazards these are resolving. It has the potential to include links to a number of the other aspects of asset health. The challenge with the other suggested measures of asset health (such as Overall Equipment Effectiveness) is that judgement in the assessment is required. They are neither likely to be comparative or consistent forward looking measures of asset health. Whist the RARI measure is not currently ready to be used as a comparative measure, the link to Drinking Water Safety Plans provides for the potential for standardisation.

On diminishing marginal benefits for asset health, this is a question of whether we should incentivise long term asset health beyond targets through outperformance on ODIs. The position historically has been that outperformance incentives are better placed on the customer and environmental outcomes such as leakage. The incentives package can have some metrics with higher reward than penalty scope if the overall package is balanced, if Ofwat were concerned about marginal benefits diminishing for asset health this would be a customer-focused conclusion that can be tested through what customers view on incentives.

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

Ofwat set out a fair description of the advantages and disadvantages of using a top-down approach to setting ODI rates in the consultation paper. Our Future Ideas Lab submission started from the perspective of what alternative approaches were available to simplify incentive setting from the marginal benefit=marginal cost approach. It also considered Ofwat's desire to avoid having to "aim up" the cost of equity because of ODI incentive skews, something that Ofwat's risk and return consultation suggested should be avoided at source.

Achieving these two aims requires a simpler approach to either setting and a way of calibrating ODI incentive rates, as the range of issues set out in the consultation suggests. In answer to the other consultation questions, there is clearly a need for cross checks and top


'Cabot' Created by Bex Glover

down calibration in order to inform some of the questions raised, such as the extent to which there should be asymmetric outperformance and underperformance rates.

A top down approach informed by customer research has the potential to explore what we may have to do, as happened at PR19, that the individual incentives of cost and ODIs require some calibration so they are aligned with the risk buffer available in the cost of equity. The top-down approach in part may be a pragmatic solution to the challenges that arise from standardising performance commitments and greater common ODIs (possibly with common service levels), without retaining the complex analysis that Ofwat stated would be a key benefit from this standardisation. We explained earlier in the consultation the role we see for there to be a number of scenarios for RoRE calibration that could apply in practice.

We agree there is a key challenge in deciding the appropriate performance increment over which to allocate top-down payments. This challenge exists equally for other incentive valuation research, as PJM economics identified in their PR24 Future Ideas Lab contribution that scope of change in WTP surveys helps to explain variation in incentive rates. Ofwat's work to define "what base buys" and the common performance commitment assumptions may reduce this challenge, and the top-down allocation research may still be needed to inform calibration. As our Ideas Lab contribution explored, some of the company top-down research approaches were developed because of the need for this calibration when there were ODI challenges based on standardised comparisons during PR19.

In our view companies should understand the performance increments in their plan and test ODI incentive rates top-down against this increment. If there are standard Ofwat approaches, such as what base buys, then this can be used in this top-down research. If this is not certain and a number of scenarios exist, this can be designed as part of the research.

Whilst it is the case that a top down approach could result in ODI rates that differ between companies, this assumes that the ODI rates from a top down RoRE/RCV allocation exercise are taken mechanistically at a company level. Whilst that is one possible conclusion from this approach, alternatively they could be calculated at an industry level and the incentive rates standardised. However, where for whatever reason (including a low RCV per customer) these standard incentive rates and performance levels result in a much wider ODI RoRE range than expected or result in an ODI asymmetry/skew, the cause and potential options for calibration may be observed from the research and have some reference back to customers' views.

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


'Cabot' Created by Bex Glover

Ofwat observe that a top down approach could be appropriate for a subset of PCs, such as asset-health, or could be used to inform how caps and collars are set. We concur that this can help to explore how incentive packages align with customer priorities in aggregate and for individual PCs.

Ofwat are correct that performance increments for individual PCs need to protect customers. One approach is to compare incentive rates to those that have applied historically, an approach that was used as a cross check by many companies at PR19 in particular for asset health. Incentive rates inferred from a top down allocation approach can also be compared to other research approaches, including companies own WTP surveys being used for cost benefit analysis and any marginal cost information, given both of these depend on the performance increments proposed. Our paper suggests assigning different RoRE top down ODI assumptions to different baskets of incentives (e.g. asset health illustrated at 1% of RoRE) so customers are protected in each broad PC basket, before allocating to individual PCs within that basket. As we set out in the scenarios suggestion above, where there are adjustments to asset health base expenditure, there may be trade-offs on the overall quantum of ODIs and the allocation to baskets of incentives (such as asset health).

Ultimately a simpler approach to setting incentives has trade-offs and the challenges of ensuring performance commitments for individual PCs work individually as incentives but also contribute to a fair risk and return balance applies to all incentive setting methodologies.

We are happy to work with Ofwat and others to develop the top-down approach, particularly if there is broad consensus to do so, including exploring whether a common methodology could emerge. Our paper was based on collaborative conversations as part of the PR24 methodology development.

**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?**
**Q10: For water companies: how have enhanced ODIs influenced your company's decision making around achieving high performance?**

We found no customer support for enhanced ODIs at PR19 – there may be a role for tiered incentives (such as for leakage as at PR19), which could be tested through top down ODI research. We did not use enhanced ODIs where it could have applied (e.g. leakage), because of the triangulation approach we had taken to the incentive rates we calculated, and because our selection of leakage performance was based on what we could economically (and risk based) deliver. This was based on our draft business plan options used to calibrate our incentive rates (by presenting service levels that varied with the marginal cost and


'Cabot' Created by Bex Glover

marginal [redacted] the range of benefit values). Further leakage reductions were not justified and showed an exponential increase in marginal cost and delivery risk.

Therefore, enhanced ODIs would not have influenced our behaviour – the targets were chosen through our innovative bill options research which affected our incentive rates, because we tested the point at which marginal benefits equals marginal costs by exploring how customer views varied at different cost / benefit propositions. At the frontier of leakage the plan itself was challenging enough, a point recognised by the CMA that ODI asymmetry could not be removed by increasing outperformance potential, such as the cap on leakage ODI performance, which was suggested by Ofwat as an alternative way of balancing ODIs. We plan to undertake the same research at PR24 to justify our targeted service levels, because it reflects timing in PR24 period compared to the longer-term (our draft business plan consultation at PR19 focused on this and the adaptive pathway to the long-term targets we set out in ourBristol Water…Clearly long term ambition document). In the context of our proposed simpler approach to top down ODIs, we suggest tiered and enhanced ODIs could be considered where there are beyond P10/P90 levels of performance that require incentivisation, where this isn't achieved through PCDs or bespoke ODIs.

However, we are not quite sure how the use of an enhanced ODI rate will fit with the base cost level of service proposals. If a company's performance is better than the standard base cost level of performance, what is the baseline for their incentives? Is an ODI reward likely to be earned for their current level of performance which therefore already provides an enhanced incentive, or are additional cost allowances being made, or are we not standardising after all? This is a very important question before considering enhanced ODIs. There will clearly be a need for enhanced ODIs, if Ofwat do not answer these questions on how the base cost and standard service levels will be reflected in an ODI framework. We refer back to our scenarios approach as a way of calibrating packages of incentives without having what always results in bespoke calibration for water regulation by the end of a price review process.