ST Classification: OFFICIAL PERSONAL

Discussion paper on outcome delivery incentives

Hafren Dyfrdwy response

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Discussion paper on outcome delivery incentives

Overview of our response

We welcome the opportunity to comment on Ofwat's discussion paper on Outcome Delivery Incentives. Hafren Dyfrdwy is a supporter of ODIs and we believe that, with an equitable approach, they can deliver better outcomes for customers and encourage better performance from companies of all sizes. It is clear that the incentives for the industry as a whole has resulted in a far greater improvement than would have been accomplished under the old penalty-based system that operated before PR14.

While the concept of ODIs is right, we believe that a "one-size-fits all" approach will not always be right for HD. We are by far the smallest and most rural company in the industry. Looking at the next smallest companies, our water service is one third the size of Portsmouth and our wastewater service less than one fortieth the size of South West's. This means that we can face very tight performance constraints with penalties from a handful of incidents, particularly for wastewater operations. This was recognised to some extent at PR19, for example Ofwat "considered it inappropriate to set Hafren Dyfrdwy's target at the forecast upper quartile level because this would require the company to have very low numbers of category 3 incidents"[1]. The target is normalised per 10,000km of sewers; since the total length of our legacy and adopted sewers is under 500km we'd actually need zero incidents to hit or exceed an UQ target. We feel it is only right for small companies such as ourselves to be considered differently.

It is critical that there is a balanced package of ODIs at PR24 that works for all companies. Any scenario with higher penalties and lower rewards would be likely to discourage any innovation and reduce the appetite for risk in the industry, rather than motivating companies to find solutions to problems. It could also increase the true cost of capital in the sector – in the long run, this would not benefit customers in terms of the cost or quality of their service.

We believe that ODIs should continue to be the way forward for the industry, as long as there is a balanced approach that is suitable for all stakeholders. Even when companies outperform, customers receive most of the benefits from this approach as they receive at least half of the benefits in-period and all benefits from higher targets in future. With this in mind, it is important that targets are set at a realistic level since any outperformance will ultimately deliver greater benefits to customers than companies.

Given that it is difficult to estimate the marginal cost of improvement in a reliable and consistent way, we support the removal of the cost element from the ODI formula. However, Ofwat should not lose sight of the linkage between cost and service – it does require investment to improve performance, even if it is difficult to see from high-level company data that covers total company expenditure. If some companies deliver low cost and better performance at the same time, this does not mean that the improvement came at no cost; timing will play a role and the company might well have saved more cost if not for improving service.

In principle, it is right to assess the benefits that customers derive from each unit of improvement (a "bottom-up" approach). In practice, this could be an issue for a company with a very low Regulatory Capital Value per person such as HD, particularly if values are set based on national research. Even if

[1] Ofwat service delivery report, p23

a top-down method is not used, Ofwat should take account of company characteristics and the overall level of risk each company faces. If central values are applied, then other measures such as caps, collars and sharing rates may need to be considered in order to provide a package that is acceptable to customers and other stakeholders.

We were encouraged to see that one of the key themes of PR24 was a focus on the longer term. The paper appears to express a concern that ODIs for asset health could give companies an incentive to over-invest. We believe that it is best to invest in long-term maintenance and if companies are responding to incentives by improving asset health then we would suggest this is a positive sign – indicating that the incentive package is working for our customers and the industry as a whole. On the evidence from AMP7 so far, it does not look like companies are "gold plating" maintenance expenditure.

We set out our responses to the specific consultation questions below.

Response on specific questions

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

We agree with the aims set out in the consultation. In our view, the key way in which the ODI regime improved on the penalty-only system from before PR14 is that it encourages companies to stretch themselves and innovate. By going beyond target performance levels, companies deliver greater benefit to their customers. ODIs have also encouraged innovation in terms of *what* is delivered, engaging with stakeholders to develop bespoke Performance Commitments (PCs). Successful measures can be adopted by other companies or as common PCs at future reviews.

As we note in the overview, customers always receive most of the benefits from ODI outperformance. The rewards are calibrated so that companies receive at most half the value that customers place on improvement during the first review period. Following that, all benefits flow to customers.

Even where companies have outperformed targets, it is important that the cost of delivery is not overlooked. Rewards as reported reflect a gross position, not a net gain. And where companies have under-performed, this is not necessarily because they have not invested in order to hit their Performance Commitment Levels. There are many reasons why companies might not hit stretching PCLs – for example, with the most rural area of any company, our colleagues need to travel large distances on slow country roads to address customer issues, thereby significantly impacting the time it takes us to address the customer's issue. Separately, there can be a significant lag between investing in improved performance and those improvements actually materialising. In addition, some of the existing ODI payments reflect the recovery of costs, so the introduction of Price Control Deliverables (PCDs) will help distinguish revenue and cost to some extent.

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

There are problems with obtaining accurate and consistent data on marginal costs, so we support removing this element from the formula. However, this does not indicate that there is no cost associated with delivering service improvements.

Although customers do receive the vast majority of benefits from ODIs, we do not think that it would be realistic to apply a sharing factor of zero to rewards or penalties when working to an overall RoRE cap of 3%. As we note above, sharing rates could be varied to help achieve a balanced package of risk and reward for companies of different sizes.

Any sharing factor should probably take account of the cost sharing rate for the company because service improvement should be balanced against the benefit customers would get from reduced expenditure, even if the actual marginal cost is difficult to establish. Whatever rates are used, these should be simple to explain to customers and other stakeholders.

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

Removing marginal cost from the approach could mean that ODI rates have no regard to the implications for costs and customers' share of those costs. We understand Ofwat's concerns about the consistency of marginal cost information but this is not just an issue of information asymmetry. between companies and Ofwat – the link between undertaking or stopping an activity and its impact on performance is not easy to estimate. There is often a time delay between the input and outcome; there are also continuing consequences from a reduction in activity that will take time to rectify (and the same can apply when resources are increased).

As we note above, Ofwat should not lose sight of the link between performance and costs. Just because this is difficult to understand does not mean that changes in service do not affect expenditure.

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

In principle, a bottom-up approach is reasonable but – as we note in our overview – the results need to be tempered to take account of the impact on companies. If based on common willingness-to-pay research, there should be a consistent value for common PCs but this could have very different effects on companies depending on their size and particularly the level of RCV per customer.

A customer-centric view has some logic when looking at the value of a service improvement or reduction. But without cross-checks or limits there could be a large impact on customer bills and investor risk, as measured by RoRE. Without any other safeguards, HD would face a very high exposure from small changes in service.

For example, if Dŵr Cymru's incentive rates for internal sewer flooding was applied to Hafren Dyfrdwy the results at the performance collar would be:

Potential effect of a common sewer ODI unit rate for internal sewer flooding

	RCV/customer 17/18 prices 2025, £	Penalty rate 17/18 prices £ incident	Collar Per 10,000 connections	Properties affected at collar	Under-Performance (Properties)	RoRE impact at collar
WSH	£2,730	£427	3.350	462	230	-0.007%
HDD	£591			6	3	-0.030%

If three extra properties were flooded, HD would hit the collar and see a RoRE impact over four-times-greater than Dŵr Cymru. If a bottom-up approach is used, we think there is a case for the use of caps, collars and possibly a variation in the sharing rate. In our view, this is better applied as an overall limit on RoRE impacts, or a tapering of ODI impacts for each service outside a given level (such as 3%). When caps and collars are applied to individual PCs, a company can face the position where it could deliver more benefit on one measure – which could move the industry frontier – but has no incentive to do so. For us this is the case with lead pipe replacement where we have reached the cap on this measure, even though the company is in penalty overall.

In general, we think that ODI rates should be symmetrical unless there are compelling reasons for a different approach. A system with both rewards and penalties can drive more improvement than a penalty-only approach, because companies will only ever strive to meet rather than exceed a target; they will not reveal new information. A bias towards penalties also discourages innovation and risk-taking, as the focus will be on tried and tested methods to avoid penalties. At the same time, we recognise that there are some PCs which relate to statutory requirements and are therefore penalty-only – importantly these introduce a negative skew to the overall ODI package even before we consider the effect of setting higher penalty rates.

If Ofwat then sets higher rates on individual PCs for companies with below-average performance on a specific measure, the effect would be to exacerbate the negative skew. This risk is true across all companies, as even companies that are performing well overall will have some measures where they are below-average. Overall, this would not lead to a balanced package of ODIs – there is no perfect company. As we see it, the upshot is that asymmetric risk is counter-productive and will (in time) feed investor expectations for a higher base return – to the cost of customers. The CMA's decision on the cost of capital was partly driven by expected underperformance against PCLs.

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

Asset health is a key outcome and should be part of the incentive package – particularly if Ofwat is aiming to take a longer-term approach at this review. As the CCW Blue Marble report notes, there are limits to the topics that customers can meaningfully engage on – for example we are not sure that customers can give constructive feedback on issues around financeability or the design of price controls. But multiple pieces of research across the industry show that customers do believe that we should take care of assets and are concerned about the long-term.

We have used an inferred marginal benefits approach before, and revealed preference also shows customers are concerned with asset health – for example, customer contacts often relate to the nuisance from blockages. While the paper identifies concerns with the risk of over-investment and "gold plating" on asset health, these concerns need to be balanced against the long-term approach that Ofwat is seeking to adopt at PR24. We would suggest that, if companies are responding to incentives and improving asset health, then this is a positive sign that the incentive package is working – particularly so if companies are able to do this with efficient levels of expenditure. To date, we see no pattern of over-investment in AMP7.

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

As we note in response to Q4, the bottom-up approach (with common benefit values) could give rise to a very high RoRE risk for a company like HD. By contrast, a top-down approach would allow Ofwat to target the appropriate level of risk, although it would lead to customers paying different rates for a unit of improvement. There may be a stronger case for using top-down approach where customer benefits are more difficult to value, such as asset health, where it might be reasonable for Ofwat to decide the level of risk companies should face on asset maintenance. More broadly, a mixed approach could help Ofwat to calibrate the overall ODI package.

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

If a top-down approach is applied, there will be a degree of disconnect between the value of the reward or penalty and the benefit value that customers would attribute to it. It will be possible to prioritise between service elements but there would be some scaling. This could then further the disconnect between the incentive value and the marginal cost of delivery.

In theory, a company with a high RCV-per-customer could have an incentive to pursue improvements that customers do not value. Conversely, a company with a low RCV-per-customer might have an incentive to save cost by sacrificing service. In practice, we would not expect companies to do this given Ofwat has other regulatory tools to protect against this – such as, comparative reporting and monitoring of performance.

Q8: Should we retain enhanced ODIs at PR24? If we do, should they apply to all companies? And which PCs should have enhanced ODIs?

We support the concept of enhanced ODIs although we have none at present. While no company has yet earned these, we are only one year into AMP7 and so it would seem premature to abandon them this early. In principle, all companies should have the ability to earn enhanced rewards, even if they are unlikely to do so in practice.

On the penalty side, we think there is potential for a significant risk to emerge if enhanced rates were to apply to all companies that are in the Lower Quartile and extreme events are not excluded from performance. Achieving frontier-shifting performance will take time, but one extreme event could easily trigger enhanced penalties. Where performance is measured on a comparable basis, this risk would be particularly acute for small companies given the impact single events can have when converted into the comparative metric. It also much more likely that one or more companies will be in the lower-quartile than achieving a target for enhanced rewards that lies beyond upper-quartile. If enhanced ODIs are extended, the expected range of reward and penalty needs to be balanced.

Q9: How should we approach assessing and setting enhanced ODIs at PR24?

The theory behind enhanced ODIs – rates based upon the benefit from moving sector benchmarks – is reasonable. At the same time, realistic targets for enhanced ODIs are needed to avoid an increase in the existing negative skew on common PCs. At present, the industry as whole is under-performing on common PCs, which, at least in part, is likely stem from targets that were based on optimistic forecasts of upper-quartile performance.

The companies that had enhanced ODIs at PR19 chose which PCs would have them and so naturally selected areas where enhanced penalties are less likely to be triggered. If Ofwat applied enhanced ODIs to a number of common PCs for all companies, then targets would need to be proportionate.

The logic for enhanced rewards is that great company performance will move the UQ upwards for the benefit of all customers – the same cannot be said of unusually poor performance which has little or no effect on benchmarks unless the company had previously been an upper quartile performer. With this in mind, we think there is a strong case for either lowering the threshold for enhanced penalties or removing it entirely.

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

We do not have any enhanced ODIs so we are unable to comment.