

**OFWAT PR24 DISCUSSION PAPER  
ON OUTCOME DELIVERY  
INCENTIVES**

**NWL Response**

**March 2022**

## Northumbrian Water response to PR24 discussion paper on outcome delivery incentives

Thank you for the opportunity to provide our feedback on the development of Outcome Delivery Incentives (ODIs) for PR24.

Our responses below align to the questions in the consultation but we wanted to firstly make some broader overarching points.

**We support incentive-based regulation, which we consider has driven significant improvements for customers.** High-powered financial, reputational and procedural incentives have been very effective in driving service improvement for customers in the water sector and pushing forward frontier levels of performance. **For these incentives to be effective they need to be:**

- **Clear and certain-** in a previous PR24 consultation document, Ofwat signalled an intention to set incentives over multiple price control periods and this appeared to be a significant part of its thinking in the recent consultation on Performance Commitments (where those PCs were proposed based on service levels that were expected to be core and enduring for customers). We consider that the same rules should apply to Outcome Delivery Incentives (ODIs) perhaps with uplifts reflecting inflation over time and any adjustments reflecting changes in customers' preferences. The service incentive area has changed materially at each of the last three price reviews – at PR09 companies were incentivised via the SIM and company specific service targets, at PR14 Ofwat introduced the PC and ODI concepts but all metrics were almost entirely bespoke and at PR19 Ofwat drove more consistency and commonality in the service metrics, target setting and ODI rates. This uncertainty makes it difficult for companies and their board to take longer-term multi-AMP choices. It would be helpful if Ofwat could set both PC targets and ODI rates on a consistent long-term basis.
- **Appropriately calibrated-** ODIs need to drive the right behaviours that incentivise companies to make improvements that are beneficial to customers, i.e. where the benefits exceed the costs. This can only be achieved if the ODI rates are set equal to the marginal benefits multiplied by the cost sharing rate applicable to totex. We therefore support the removal of marginal costs from the calculation of the underperformance rate as we consider that this will promote more efficient and welfare maximising behaviour by companies. We note that Ofwat takes the position that there will not be good marginal cost information in time for PR24 and so there is no opportunity to use it. We emphasised this gap to Ofwat in 2021 in response to its very first consultation on PR24 and requested that Ofwat require companies to report this information in their APRs according to common definitions, just as it has done for Greenhouse Gas emissions, for example. In large part the absence of this information is because Ofwat has failed to take that step. We, alongside other companies in the sector, have commissioned a study into levels of productivity across the sector and as part of that study asked an independent consultant to establish more robust efficient marginal cost curve information for the common performance commitments that Ofwat set out in its previous consultation this study will be available in the summer and so will close the information gap that Ofwat highlights in any event. Whilst we agree that this marginal cost information is not needed to set ODI rates, we do think it is important for calibrating cost adjustments where performance commitment levels go beyond base service and introduce a degree of stretch.

**We support bottom-up approaches on ODIs as top down caps can create distortions which we explained at the CMA.** These also align incentives between customers and companies to improve overall outcomes. At PR19 Ofwat set an indicative expectation of the RoRE 'range' that it considered was appropriate for a company, this wasn't a hard constraint but provided a useful guide to companies in developing their plans and could be provided again indicatively. Top-down approaches could be more beneficial for asset health metrics where there is a strong case for penalty only metrics but where there are lots of challenges with the framework as it currently stands.

**For asset health related PCs we consider that much more fundamental change is needed.** Asset health is a critical area where the consequences of failure could be very significant for customers. Currently the proposed asset health PCs are very partial, covering a tiny sample of our assets and are lagging indicators, focussing entirely on failures after they occur. None of the PCs look at replacement rates or investment levels versus asset lives, for example, and they sit alongside evidence that suggest, for instance, that we are expecting our sewers to last over 1000 years on average across the sector (which clearly is not achievable). At the same time the challenges of the future make it highly likely that different and additional investment will be required to maintain and replace existing assets, for example the shift to net zero may require more rapid replacement of assets and delivering more stretching service levels, e.g. lower leakage, may require much more significant replacement of assets than we have historically undertaken. Developing a consistent framework for assessing and reflecting these costs in price control allowances will take time and we will not reasonably be in the right place for PR24. However, by taking steps now to develop consistent assessment frameworks and piloting approaches in PR24 through the ‘enhancement’ cost allowance mechanism that was used at PR19 companies can make cases where they have a strong evidence base and new approaches can be piloted ahead of PR29. This could be supported by the development of independent assurance of companies’ asset health outside of the price review and Ofwat, potentially by the National Infrastructure Commission or some other independent organisation.

**Figure 1: Potential future plan for understanding and addressing asset health issues**

2020-25	2025-30	2030-35
<ul style="list-style-type: none"> <li>Ofwat and companies take steps to establish a comprehensive and complete framework for assessing asset health and develop consistency in reporting of broad asset health metrics.</li> <li>Companies can seek to assess and prove that they are managing their assets effectively through conducting assessments against the AMMA framework established by Ofwat with independent assurance of their progress with that framework.</li> <li>For PR24 companies can seek cost adjustment claims/enhancement cases where they can provide evidence of a need to increase investment to address asset health issues. This can be assessed by Ofwat and suitable protections put in place to protect customers.</li> </ul>	<ul style="list-style-type: none"> <li>The framework for assessing asset health across the sector is more mature and consistent given the progress made in AMP 7.</li> <li>With some time-series information available on a consistent basis Ofwat can begin to explore alternative approaches to setting capital maintenance funding. Ofwat can also learn from the PR24 experience around what does and doesn't work. A new cost assessment approach that reflects the challenges around asset health and capital maintenance/ replacement investment can be put in place and trialled for PR29.</li> <li>Early steps can be taken to explore an independent, expert body that could undertake an assessment of each company's asset health.</li> </ul>	<ul style="list-style-type: none"> <li>Mature frameworks are in place for assessing asset health and allowing efficient costs.</li> <li>Independent assessment is in place giving Ofwat confidence that companies are managing their asset bases efficiently and effectively.</li> </ul>

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

As stated above we support incentive-based regulation and agree with the continued use of ODIs at PR24. This aligns the incentives of shareholders with the requirements and valuations of customers very effectively and has driven material service improvement in the past.

The objectives set out in the consultation appear broadly sensible. In particular we support the objective that ODIs should '*incentivise companies to go beyond their PCLs where there are clear benefits for customers (i.e. where the costs of delivering better service levels are less than or equal to the benefits from such an improvement)*'. We note that the proposals set out to rely solely on evidence of marginal benefits rather than marginal costs which we think will better achieve this objective as set out in our response to Question 2.

We also note that the objective around balancing competing incentives suggests a trade-off between companies pursuing cost efficiency (which is shared with customers) versus service improvement. There is also a key trade-off between different service levels that companies may focus on based on the incentive rates which can encourage companies to focus on service areas that are the biggest priority for customers.

Whilst the objectives appear relatively clear and sensible the paper doesn't describe the scope and role of incentives in regulation or the 'art of the possible' which might widen the debate considerably. The consultation starts from the premise of limited change which we broadly support.

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

As stated above, the objective for ODIs should promote the maximisation of welfare and this is best achieved by aligning the incentives of customers and companies so that:

- Companies are incentivised to take forward initiatives to improve service where the benefits outweigh the costs.
- Companies are not incentivised to take forward initiatives where the costs outweigh the benefits.

The ODI rates therefore need to be set to deliver this objective. This can only be achieved if the ODI rate is set equal to the marginal benefit multiplied by the cost sharing rate (i.e.  $MC \times S$  using the notation from the discussion paper). This ensures that companies will be incentivised to act efficiently in line with the customer interest. If the ODI rate is set above this level then there will be a bias to additional spend on improvements where the costs outweigh the benefits (as companies would be rewarded in excess of the benefits they are creating). Conversely, if set below this optimal level then there would be a bias towards not making beneficial improvements as companies would not be remunerated up to the level that customers value the service improvement.

Two key points fall out from this:

- First, we agree with Ofwat's proposal to remove the marginal cost component from the calculation of the ODI rate. Its inclusion as at PR19 misaligns incentives between customers and companies on ODI improvements could result in welfare losses compared to the optimal rate ( $MB \times S$ ).
- Second, the sharing rates set out in box 4.1 of the consultation (Xout and Xunder), need to be set equal to the cost sharing rates to promote efficient behaviour and align incentives. Therefore, we do not think that there should be different sharing rates for out and underperformance of the ODI as these could diverge from the cost sharing rates and promote the inefficient behaviour discussed above. We consider these should be replaced by the prevailing cost sharing rate on totex. We also consider that a symmetrical sharing factor is appropriate as this balances creating a strong incentive for companies whilst also ensuring that customers share in any benefits. This was also the finding of the

CMA in the recent Water sector appeals which adjusted cost sharing rates to be more symmetrical. The importance of aligning these sharing rates with cost sharing is shown in the example below.

**Figure 2: Illustration of differences between sharing factors on costs and ODIs**

Sharing factors	Assumed	Outcomes
ODI sharing rate lower than cost sharing for totex	Assume cost sharing is 55%, and the ODI sharing is 50%	In this situation, companies fund 55% of any spend in relation to performance, whilst only receiving 50% of the benefit that customers obtain. Companies will more likely underperform against customers desired levels of performance as they do not see enough benefit.
ODI sharing rate higher than the cost sharing rate for totex	Assume cost sharing is 45% and the ODI sharing rate is 50%.	This situation is sub-optimal as is situation, with companies only funding 45% of any overspend but receiving half of the customer benefit. This may lead to companies over-performing the desired level of performance set by customers.
ODI sharing rate equal to the cost sharing rate in the totex models	Cost and ODI sharing at 50%	Setting both the totex cost sharing rate and the ODI rate at the same level should create the environment for companies to perform at the customers desired level of performance. Both customers and companies get the level of benefit that they fund for service improvements.

Ofwat has indicated that both the marginal benefit and marginal cost data were not of a suitable quality and consistency across the industry<sup>1</sup>. Whilst Ofwat has sought to address the issue of marginal benefit valuations through centralised research, we outlined a number of concerns in our previous response to the PR24 and beyond – ODI Research Paper. For example, we highlighted the obvious weaknesses of using a single source of evidence to attain the levels of customer valuations rather than triangulating with a broader evidence base.

Whilst we agree that marginal cost data should not be used to set ODI rates, we still think it has a strong role to play in PR24 and agree that it needs to be of sound quality. There may have been a missed opportunity in Ofwat not requesting marginal cost data within APRs as we have suggested in the past. We are appointing an independent third party to work with a group of companies across the industry to collate, challenge and assess the level of marginal costs for each of the common PCs. This will hopefully move the industry to better quality data and remove the concern about this information. Since this will be undertaken across a very large sample of the industry it ought to provide a sensible view of the efficient marginal cost of service improvement. We plan to use this data to help cost our business plan and think it would be useful evidence for Ofwat to use for any cost adjustment where the performance commitment levels for PR24 exceed base performance.

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

If the sharing rates are set differently from the prevailing totex cost sharing rate there is a risk that inefficient behaviour will be incentivised as there will no longer be an alignment of incentives between customers and companies. This could result in beneficial improvements not being made (if the ODI rate is too low) or non-beneficial improvements going ahead (if the ODI rate is too high). Either outcome would not be in customers best

<sup>1</sup> Marginal Benefit: Ofwat PR24 and Beyond Creating Tomorrow Together Page 58, Marginal Costs issues acknowledged in Ofwat PR24 and Beyond a discussion paper on outcome delivery incentives page 8.

interests and would not promote welfare maximisation which we think should be the overarching objective of the approach to setting ODIs.

As set out above, the appropriate mitigation is to ensure that the sharing rates are equal to the totex cost sharing rate(s). This will mean that the rate will not depend on whether there is out/under-performance of the ODI itself. The consultation considers whether it might be appropriate to have different rates for out- and under performance of the ODIs but for the reasons above, this conflicts with the objective of promoting economic efficiency and welfare maximisation. We therefore think the incentives should be symmetric to avoid misaligning incentives between customers and companies as this is key to delivering better overall (cost and service) outcomes for customers.

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

For customer facing and environmental PCs the bottom-up approach using marginal benefits multiplied by the totex cost sharing rate should be used to set ODI rates as set out above.

For Asset Health related PCs we do not think that these should be incentivised in the same way as customer or environmental PCs through the framework.

- Firstly, these are long-term obligations that companies should meet and so it does not feel appropriate for these obligations to be rewarded through in-period out or under performance incentives. These requirements are best addressed through the cost assessment process which needs to consider whether the right amount of funding is being provided for an efficient company to maintain and replace its assets in line with a healthy asset base. This could for instance be combined with Price Control Deliverables or another suitable mechanism to ensure that companies deliver in line with the funding provided.
- Secondly, the incentive rates are very unlikely to be of a sufficient scale to either reflect the marginal costs of driving improvements in these asset health metrics, which will often require significant capital investment to address, and certainly won't reflect the consequential impact on customers if asset health were to deteriorate and lead to significant service failures. There is also a significant lag between investment and overall asset performance due to the long-lived nature of the assets.
- Finally, customer valuation of these areas is likely to be inherently very challenging because the ability of customers to engage credibly and effectively on these long-term topics is notoriously difficult. This is particularly difficult for the asset health metrics as customers often do not experience any impact in service from some of the metrics (e.g. unplanned outage). This suggests that any valuations from Ofwat's single piece of customer research evidence could be flawed. During PR19 we ran preliminary customer research sessions to understand best how our customers understood risk<sup>2</sup>. This research aided our development of our Resilience, Asset Health and Long-Term Affordability customer research, which saw our customers demonstrate an understanding in relation to risk and a led to their support for investment to maintain the company's resilience<sup>3</sup> through their indication that water companies should be "mid-ground to proactive" with regards to investment for maintenance and asset health. Effectively customers did not support a policy of replacing assets when they fail but wanted us to take a proactive approach to maintain and replace assets to maintain stable and predictable service levels.

These points suggest to us that these metrics are simply not well suited to ODIs and are better addressed through the cost assessment process.

The consultation raises a concern about the potential for 'diminishing marginal benefits in asset health' suggesting that beyond a certain level of performance an additional

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<sup>2</sup> NWL PR19 Communicating Risk page 97-99, Appendix 2.2 Compendium of customer engagement.

<sup>3</sup> NWL PR19 Resilience, Asset Health and Long-Term Affordability page 13-137, Appendix 2.2 Compendium of customer engagement.

investment could have a declining marginal impact on service performance. It asserts that this creates a risk that companies could 'gold plate' or overinvest. We find this suggestion highly unlikely in a context where the regulatory framework currently funds replacement rates on wastewater networks, for example, that mean each asset is expected to last over 1000 years on average. Furthermore, we note that in Scotland the Scottish Water regulator, WICS is undertaking a programme of work with Scottish Water that is delivering a material uplift in the amount of capital maintenance and replacement investment precisely because that regulator was convinced that insufficient investment was being made in the existing asset base. Far from 'gold plating' this implies a risk of structural underfunding. No specific evidence is provided by Ofwat to suggest that there is a particular risk of 'gold plating' on asset health ODIs or indeed that customers' are willing to take greater risks in this area to keep bills down.

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

For the reasons set out above we do not consider that ODIs are appropriate for asset health-related performance. The only exception to this is for CRI. This is because we consider it is more of a water quality measure, and therefore important to customers, rather than an asset health metric.

Water companies should be focussed on managing the long-term risk of the health of their assets as a minimum standard and the cost assessment process should consider issues like age and asset condition through consistent reporting requirements. To deliver this will require some long-term steps.

A much more comprehensive suite of asset health indicators is needed that would provide more complete coverage of the asset base and include both lagging indicators and leading ones. We believe that Ofwat needs to work with the water industry to develop a common framework to understand assets and assessing the health of these assets as highlighted by the UKWIR<sup>4</sup>. This project could be further expanded to include an assessment of criticality to create an overall risk score. Best practice advice could be considered from other industries already employing this method, such as high hazards in the oil and gas industry, HSE, or the network output measures 'NOMs' in Ofgem's energy regulation, or WICS:

- The Oil and Gas Industry has a well-established approach to asset health as a critical part of delivering a safe and reliable approach to delivering their product to customers. The OGA (Oil and Gas Authority) set up the Asset Stewardship Strategy to work alongside the industry, providing clear stewardship expectations and ensuring asset owners are consistently undertaking the right activities with regards to their assets.<sup>5</sup> The stewardship approach includes:
  - **Asset Integrity:** Demonstrate understanding of the asset's integrity framework over the entire field life, including capacity for extension of field life, reviewed on a regular basis; evaluation and critical appraisal of asset integrity; review and assessment of potential obsolescence over field life; Facilities investment review to support and optimise production from the asset.<sup>6</sup>
  - **Maintenance:** Facilities surveillance and ongoing maintenance programme for all areas of the infrastructure and status reviewed on an annual basis; a mechanism for identifying, maintaining and monitoring critical production equipment; Implementation of scheduled planned maintenance routines.<sup>7</sup>
  - **Asset and Infrastructure threats and opportunities:** Maintain a production threats and opportunities register, accompanied by evidence of an action plan for each, reviewed and actioned on a regular basis; review and assess

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<sup>4</sup> UKWIR Future Asset Planning

<sup>5</sup> OGA; [asset\\_stewardship\\_strategy\\_2016.pdf \(ogauthority.co.uk\)](https://ogauthority.co.uk/asset-stewardship-strategy-2016.pdf)

<sup>6</sup> OGA; [oga\\_se\\_overview\\_july\\_2019.pdf \(ogauthority.co.uk\)](https://ogauthority.co.uk/oga-se-overview-july-2019.pdf)

<sup>7</sup> OGA; [oga\\_se\\_overview\\_july\\_2019.pdf \(ogauthority.co.uk\)](https://ogauthority.co.uk/oga-se-overview-july-2019.pdf)

facilities constraints and opportunities for debottlenecking (e.g. asset life, name-plate capacities) impacting recovery and resource maturation.<sup>8</sup>

- The Health and Safety Executive (HSE) also published a number of recommendations for businesses on asset life extension, obsolescence, data and content management, preparation for life extension and workforce involvement and training.<sup>9</sup> (This report was created in relation to the challenges facing the oil and gas industry).

The cost assessment framework will need to adapt to better recognise asset health. If the current CPIH-X model of seeking efficiency and outperformance through totex cost sharing is to be retained then the cost assessment framework will need to take some greater consideration of asset health indicators such as age, condition etc. At the same time more work will be needed to understand what the efficient level of asset replacement and capital maintenance is or should be rather than simply what has been spent in the past. We are already undertaking work to replicate the WICS framework on our own asset base and that is suggesting significant structural underfunding in asset maintenance and replacement.

Finally, we consider that there is a potential role for an independent body to assess and consider asset health similar to the role adopted by the rating agencies in assessing financial resilience. This allows Ofwat to focus on the core areas of its expertise and would provide some independent confidence that companies are managing their assets effectively.

Partial, in-period short term incentives are unlikely to be significantly improving the issue which is fundamentally long-term and multi-AMP. They will simply divert attention onto the particular PC area that is being incentivised in the short term rather than the asset base as a whole for the long term.

Making the above changes will take time and it will require a multi-AMP approach. Companies should be required to deliver a minimum level of asset health risk funded through an efficient level of totex to do so. There should be an expectation by companies that if they do not deliver the safe minimum level of risk then significant penalties could be imposed. If companies are funded to invest in asset maintenance, this funding should be ring-fenced and could be re-funded if not spent either by linking that funding to Price Control Deliverables (PCDs) or by introducing separate cost sharing arrangements which return either all or a greater proportion of that investment to customers if it is not spent.

For PR24, we consider that companies should be able to use the enhancement or cost adjustment claim process with associated price control deliverables to allow for additional investment in asset health if they can make a strong case that this is needed over and above the base allowances. As with enhancement business cases, companies would be expected to demonstrate a clear need that funding is required for particular asset health risks. This business case should indicate the impact on customers should the asset fail; alongside the efficient level of cost required to improve assets risk of failure that is not funded from base allowances.

**Figure 3: Potential future plan for understanding and addressing asset health issues**

2020-25	2025-30	2030-35
<ul style="list-style-type: none"> <li>• Ofwat and companies take steps to establish a comprehensive and complete framework for assessing asset health and develop consistency</li> </ul>	<ul style="list-style-type: none"> <li>• The framework for assessing asset health across the sector is more mature and consistent given the</li> </ul>	<ul style="list-style-type: none"> <li>• Mature frameworks are in place for assessing asset health and allowing efficient costs.</li> <li>• Independent assessment is in place</li> </ul>

<sup>8</sup> OGA; [oga\\_se\\_overview\\_july\\_2019.pdf](https://www.ogauthority.co.uk/oga-se-overview-july-2019.pdf) (ogauthority.co.uk)

<sup>9</sup> HSE; [Key Programme 4 \(KP4\): Ageing and life extension programme \[KP4 final report\]](https://www.hse.gov.uk/key-programme-4/kp4-ageing-and-life-extension-programme/kp4-final-report/) (hse.gov.uk)

<p>in reporting of broad asset health metrics.</p> <ul style="list-style-type: none"> <li>• Companies can seek to assess and prove that they are managing their assets effectively through conducting assessments against the AMMA framework established by Ofwat with independent assurance of their progress with that framework.</li> <li>• For PR24 companies can seek cost adjustment claims/enhancement cases where they can provide evidence of a need to increase investment to address asset health issues. This can be assessed by Ofwat and suitable protections put in place to protect customers.</li> </ul>	<p>progress made in AMP 7.</p> <ul style="list-style-type: none"> <li>• With some time-series information available on a consistent basis Ofwat can begin to explore alternative approaches to setting capital maintenance funding. Ofwat can also learn from the PR24 experience around what does and doesn't work. A new cost assessment approach that reflects the challenges around asset health and capital maintenance/ replacement investment can be put in place and trialled for PR29.</li> <li>• Early steps can be taken to explore an independent, expert body that could undertake an assessment of each company's asset health.</li> </ul>	<p>giving Ofwat confidence that companies are managing their asset bases efficiently and effectively.</p>
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**Q6: What are your views on using top-down allocation approaches for setting ODI rates or other uses?**

A top-down approach could work as an alternative for a subset of PCs such as Asset Health where customer valuations or costs for improvement may be difficult to ascertain or where the use of short-term incentives just seems inappropriate. However, we still consider that asset health is fundamentally not well suited to the ODI regime.

For the customer of environmental measures we believe the bottom-up process is more appropriate, ensuring that customer willingness to pay is directed to the measures of greatest importance to them and based on a direct comparison to the marginal cost of service improvement.

A top-down approach could also be utilised in creating maximum net rewards and penalties to ensure that company's performance does not create too volatile bill fluctuations for customers and /or overly damage the financial resilience of the businesses by creating large swings in revenue. However, it is also important that such an approach does not create the wrong incentives when aligned with the overall package as a whole.

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

We agree the use of historical industry performance extrapolated out could drive stretching PC targets. However, in setting these targets Ofwat must consider the levels of cost or investment required to achieve these historical targets. Normalising the performance levels through the use of cost will allow an understanding of what can be achieved with future funding.

In developing future targets Ofwat also needs to consider the interventions needed to improve performance alongside the role for innovation. For some PCs, the rates of improvement achieved in the past might reasonably be retained into the future because

the marginal costs are not rising. However, for other PCs delivering increased service will carry a cost and, most likely, those marginal costs will be rising at higher levels of service. The work being undertaken across the industry on marginal costs of service improvement we hope will help to illustrate this for individual PCs.

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

Going back to the objectives set out earlier for ODIs to promote efficient behaviour and alignment of incentives between companies and customers, it is important that ODIs are set in a way that only promote value enhancing improvements (i.e. where the benefits exceed the costs). Enhanced ODIs, by moving the ODI rates away from the optimal rate (MB\*S), remove that alignment of incentives and can encourage companies to spend more on improvements than the benefits created for customers. We do not think this is beneficial for customers of the company concerned to promote such behaviour.

We also do not think that it appropriate for the service improvements from an enhanced ODI to be applied to other companies in the sector. This is because the other companies will not have had access to the same funding provided by the enhanced ODI rate and therefore cannot deliver the same improvements. Moreover, if the improvements by the company with the enhanced ODI were only possible because the rewards were in excess of the customer benefits, then it is questionable over whether requiring other companies to implement a similar strategy is optimal as it would make customers worse off overall.

We therefore do not think there is a strong rationale for enhanced ODIs for PR24.

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

For the reasons set out in our response to Question 8, we do not think there is merit in setting enhanced ODIs for PR24. By increasing the ODI rates it can promote inefficient behaviour by companies to make improvements where the cost-benefit case does not stack up and we do not think this is in the interests of customers.

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

Our approach to improving performance is rigorous and takes direct account of ODI incentives including enhanced ODI rates. We set ambitious annual targets for service improvement at levels that are in line with our vision of being an 'industry leading' company. Achievement of these targets are incentivised through staff and executive reward structures directly where rewards are not paid if targets are not achieved.

In setting targets we develop 'Service Delivery Strategies' which consider the costs and associated benefits of different interventions that we can make to improve our performance. These interventions are optimised annually through the target setting process to optimise ODI rewards and minimise penalties and regularly reviewed through the year as part of our 'tactical planning'. Where an ODI reward can be achieved through an intervention that is lower cost than the ODI it would be taken forward, even if this resulted in a cost overrun for the business against the allowances set, for example taking account of the cost sharing impacts.

We have a mature approach to innovation including a dedicated innovation team, a clear pipeline of innovation projects from development through to trials and implementation and an annual festival to refresh and improve that pipeline of projects. Where innovative ideas are developed these then become part of our Service Delivery Strategies.

ODI incentive rates, including enhanced ODIs, are therefore a key part of our decision making and directly drive the decisions we make to improve our performance. However, a key constraint is the uncertainty created by the lack of clarity in the regulatory regime for the future. Since we cannot say with certainty what the PC targets will be in future years or the ODI incentive rates this limits the extent to which we can optimise performance over the long-term.