south east water

Outcome Delivery Incentives

South East Water response

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South East Water

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1. Introduction

This paper sets out South East Water's (SEW) response to Ofwat's "Discussion paper on Outcome Delivery Incentives".

Any queries in relation to this document should be sent to
[redacted]

2. Executive Summary and key points

We are fully supportive of the use of outcomes. We also support the use of incentives associated with these outcomes where appropriate. Outcome Delivery Incentives, however, need to be understood as part of an overall package. At a periodic review, Ofwat sets the levels of spend that it expects companies to deliver their services for, and the standards, or PCs that it expects them to meet. Combined with the ODIs, these factors set out the financial and performance challenges that the company faces over the following five years. If the challenge is not a credible one, the company is forced to seek the view of the CMA. PC setting and cost assessment are not the subject of this paper, but the subjects cannot be completely disentangled.

ODIs have two particular aspects, which affect the balance of the package against which a company may perform.

The balance of risk and reward

The first aspect is the balance of rewards that are likely to be achieved compared to the balance of penalties. PR19 was significantly skewed towards penalties, particularly in the water service, and this increased the level of risk that companies were exposed to. The CMA recognised this problem when considering the cost of equity. Whilst this discussion paper does not set out detailed proposals for ODIs, it suggests in several places a preference for penalties over rewards. (such as the discussion of diminishing returns on page 9)

To the extent that this reflects the preferences of customers, where customers find the concept of penalties much easier to understand than rewards, this makes sense. However, if we end up with a package which makes penalties much more likely than rewards, that risk needs to be reflected in the cost of capital.

The level of risk

The second aspect to consider, is the overall level of risk. If ODI penalty rates are high and companies are not protected by collars, the overall exposure of companies can be significant. Some ODIs are very heavily affected by weather, and when companies have high ODI penalty rates, unprotected by collars, and correlated with each other, those ODIs can expose a company to a large corporate risk. The most obvious example of this is a prolonged spell of cold weather. Such weather is likely to damage a water company's distribution network and result in mains repairs, an increase in leakage, and possibly also supply interruptions with a further, knock-on impact, to C-Mex and operating costs. Ofwat has suggested that the top down method might be used to control the overall level of risk that companies are exposed to. We discuss this option in response to specific questions below, but we think this is a good idea, and can help maintain the appropriate risk and return balance, if well implemented.

Finally it is important to note that there should be an equitable balance between ODIs in water and wastewater. We have previously submitted evidence to Ofwat that this was not the case in AMP6, and will not repeat it here, however we have yet to see Ofwat recognise this issue adequately and suggest a solution as part of the PR24 consultation process. It should be noted that year 1 of AMP7 suggests that the same bias in favour of wastewater services may have been present at PR19, with wastewater services continuing to outperform water services. Even if the evidence of WoCs is discarded, the evidence that wastewater services within WaSCs are outperforming water services is clear. Whilst this is not the subject of the paper at hand, it is worth noting that this is a major obstacle for Ofwat to clear if it is to come up with a credible set of ODIs at PR24.

3. Answers to consultation questions

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

   We are generally supportive of the principles which are set out. However we believe positing any ODI underperformance payments as compensation is incorrect – particularly when research with customers is being undertaken on this subject. Compensation covers a far broader financial element to an individual customer, for the loss of service and any associated cost of disruption or incidental costs. Whereas, ODI underperformance payments are to reflect a lower level of service and payments are spread across a company's total customer base rather than 'paid' to any customers directly impacted.

   Ofwat should also consider that GSS payments are in place that compensate customers individually for service failure. Ofwat should not therefore be trying to set ODIs at levels which equate to compensation, but should be seeking both financial incentive and reputational effects from ODIs.

   When considering whether the research focuses on compensation required, or willingness to pay less or more for a service change, it is important to consider the relationship between cost and value. Compensation seems, to us, to be more closely linked to how customers value water, whereas a price change assessment is more linked to the price they pay. We are all aware that the value of water to customers and society far exceeds the cost they pay, and therefore there is a real risk that compensation assessments based on value will create unsustainable rewards and penalties. Following interruption events we have seen real examples of this, where customers' expectation of compensation for a short interruption often exceed their annual water bill. We expect therefore to see sound triangulation of the compensation approach with previous WTP methodologies to examine what is driving the range of derived penalties and rewards.

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

   We don't have any major objections to what is being proposed. We accept Ofwat's concern about marginal costs. It is certainly true that they can be inconsistent, both because of realities on the ground and because of methodological differences between companies.

   However, we also recognise that there are methodological problems in estimating marginal benefits. This is discussed briefly at the bottom of page 8 and top of page 9. The paper very confidently predicts that: 'we are expecting the collaborative customer research to provide more accurate and consistent estimates'. However Ofwat should approach this with caution, as there are genuine methodological difficulties involved in estimating marginal benefits to a non-homogenous group of customers. We are concerned that the findings from the research will not necessarily be more accurate, but will await the results.

   Overall it is not clear to us that the problems associated with marginal cost estimation are any greater than those associated with marginal benefit estimation. As such, we believe Ofwat should further consider the use of both where appropriate and to look to improve the approach to the understanding of marginal costs, which should in theory not be difficult to derive. Adopting an approach because of a data issue on the preferred approach seems to us to be inappropriate at this relatively early stage in the Price Review process.

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

   We are particularly concerned about the concept of diminishing marginal benefits. This is certainly a valid concept, and we don't dispute that for most PCs, benefits do diminish. However, we should not overlook the fact that there are also diminishing returns to expenditure. It costs much more to reduce supply interruptions, for example, from three minutes to two minutes (a reduction of 33%) than it does to reduce it from 20 to 19 (a 5% reduction). This is particularly true as we approach 0. The example used in the paper contends that "the marginal benefit of an avoided internal sewer flooding incident in a property should not decrease based on the aggregate number of preceding sewer incidents that were avoided for other customers" this is true however it is clear that the marginal costs will increase if you assume the company has acted rationally and rectified flooding risk by prioritising schemes with the best cost benefit first. We reiterate it is really important to improve the consistency of marginal cost assessments in this area.

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

   As discussed above, we have reservations about an over reliance on marginal benefits research. We also have concerns (also discussed above) that this methodology might lead to a set of ODIs that is unbalanced between penalties and rewards.

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

   Trying to calculate marginal benefits for asset health related PCs is both complex and imprecise. On top of the general problems associated with marginal benefit customer research, we are also faced with the prospect that a customer cannot meaningfully estimate the effect of an asset health ODI on themselves or their community.

   However, we do believe that these ODIs are an important part of regulation regime that is committed to intergenerational equity, as set out in section 4.1.3. It seems that the case for using the top-down methodology is overwhelming for these ODIs, as suggested on page 17 (section 4.2). We think that marginal costs should also have a role in this methodology.

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

   We think that the top-down approach has a lot of merit. It can be used to limit risk to appropriate levels and we think there is much more chance of reliably reflecting customers' opinions using this methodology and the question of 'how much money?' is much more meaningful than 'what is your marginal disutility for a megalitre of leakage?'. We do not believe that a technocratic approach to ODI setting that accepts any outcome of customer research as giving the 'right' answer, with no regard to the potential consequences that the answer might have, is appropriate. A top-down approach can ameliorate this problem, or even eliminate it altogether, by focusing on the parameters of possible outcomes and ensuring that they are sensible and intuitive, as well as reflecting customer preferences.

   We would be content if Ofwat used this as its primary methodology. However, if it does not, we think that the methodology is particularly well suited to:

   - Setting caps and collars
   - Setting aggregate penalty and reward limits (or aggregate caps and collars)
   - Calculating ODI rates for asset health PCs

   An interesting question arises as to who should decide the overall level of risk that companies should be exposed to. The paper assumes (bottom of page 16) that this should be decided by customers, and in principle this seems like an obvious choice. However, the overall level of risk is also a technical question, as it has implications for the cost of capital, that customers can only be expected to have a limited perspective on. There is a danger that customers might choose a level of risk that led to an increase in the cost of capital, which might not be in the general customer interest. It seems that there is, at the very least, a role for Ofwat in moderating the results of customer research on this subject. This should consider all elements of risk, not least the multiple jeopardy risk, as described above, in a cold weather event, where a single weather event creates a wide and disproportionate risk via the ODI and cost framework within the price review.

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

   As discussed above, we do not think that compensation is the right objective to seek in setting ODI rates. It is right that ODIs should be used to deliver financial incentives which reflect customer priorities, and that non-financial PCs should deliver reputational incentives. However, companies in competitive markets are not obliged to, and generally do not seek to, perfectly compensate customers for the consequences of using their products and services.

   The marginal benefits (and disbenefits) that are obtained from the research are a good indication of customers' relative priorities. If the overall ODI envelope is set with a top-down process, as we believe it should be, then the research can be used to allocate that envelope between the ODIs, in line with the customers' preferences. In this way, the performance increments would reflect customer preferences.

   This data could then be triangulated, using the range of historical achievement, and the costs associated with improving performance. Ofwat might also consider an assessment of the level of management control over performance when allocating the overall value of each ODI, as some ODIs are more subject to management control than others.

   Service outcomes are the result of multiple factors, some of which are within management control, and others are not. In the water industry, particular factors which affect outcomes, but are beyond management control include: weather; topography; design choices made in the nineteenth century; geology; soil types etc. It is neither desirable, nor equitable, that the full consequences of ODI outcomes should be borne by water companies via ODI rates.

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

   We don't have a strong view on this. We don't have any enhanced ODIs for 2020-25. We note that none have, thus far, been activated in AMP7 across the industry. However, we noted the discussion at the outcomes working group, where most companies were in favour of retention, and we think it is too early to judge the effectiveness of them. The idea that enhanced ODIs could drive innovation which delivers value to the whole industry, is certainly a valid and potentially important one. However, we would expect to see some evidence, by year 3 at least, that these incentives are having some effect, if Ofwat is to retain them into PR24. Currently it would suggest that, due to the skew in the risk reward balance, companies are concentrating more on avoiding penalty, and the enhanced ODI incentive is not featuring as an incentive that lands. In a more balanced future frame work the incentive power of enhanced ODIs is likely to be more relevant.

9. *How should we approach assessing and setting enhanced ODIs at PR24?*

   We think it is too early to draw any conclusions from the PR19 methodology other than to observe that achieveability is a highly relevant factor in the design of enhanced ODIs. Low achievability equals low engagement with the incentive.

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

    The risk reward skew has meant that, as a business, we are needing to be highly innovative and focus significant extra resource in order to avoid penalties, so the enhanced ODI has not been a major consideration.

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