PR24 and beyond: a discussion paper on outcome delivery incentives

Response from Southern Water

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Introduction

Thank you for the opportunity to respond to this discussion paper on outcome delivery incentives (ODIs).

We are generally supportive of the direction of travel on performance commitments (PCs) and ODIs and support the simplification of both the overall number of PCs and the setting of ODI rewards and penalties.

In PR19 the most significant concern was the skew of the incentives arising from the assumptions that the performance commitment levels (PCLs) are set at P50 level. When the PCLs are set at upper quartile level, they are unlikely to represent a P50 estimate for the whole industry, meaning that incentives will be skewed to the downside.

In addition, companies do not start at the same level of service and with the same incentives; some companies have a head start and others are only ever trying to catch-up to the industry average. Ofwat needs to consider how to level the playing field in order to achieve a greater level of service throughout the whole industry, reducing the opportunity for companies with a head start to take advantage of this through their customers' bills and increasing the opportunity for companies to catch up to the average level of service. An analogous approach has been Ofwat's setting of cost catch up rates applied in previous price controls allowing differential cost trajectories depending on where companies are performing relative to upper quartile (UQ) cost levels.

In considering how to best incentivise catch up from companies not yet meeting the UQ, we would like to discuss the option of customer re-investment. We believe there is merit in offering customers the choice as to whether such penalties are used to reduce customer bills, potentially leading to bill volatility, or reinvested in improving services. This still penalises management and shareholders but provides improvement for current and future customers. Such an approach would have a number of potential benefits, and in particular reduces the risk that the ODI regime entrenches differences in service levels between companies, rather than acting as a stimulus for improvements across the whole sector. Our ongoing discussion with our customers indicates this as a plausible alternative to be explored.

Consultation questions

Purpose of ODIs

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

ODIs are an incentive mechanism to further encourage innovation and stretching performance within the industry, as well as ensuring that there is a balance between incentives for cost reduction and performance. They should not be seen principally as a means to compensate all customers given that, in most cases, service failures will only impact a small number of customers (e.g. sewer flooding or interruptions) or will not have any direct customer impact (e.g. pollution or leakage).

Nor should they be considered as a funding mechanism. The determination should fund the core deliverables within it; ODIs should act as an incentive to outperform those deliverables.

Options for standard ODI rates

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

We support simplification of the ODI formula. The revised formula looks sensible given the complexity and issues that arise when trying to calculate marginal costs for each outcome. We agree that the link between costs and performance is not straightforward, though it will be rare for significant improvements to be made in core service areas without incremental investment/ expenditure. We do not believe it would be appropriate to set asymmetric rewards and penalties even if this does align to customers' loss aversion bias. The point of biases is that they are irrational and regulation should not be based on irrational biases.

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

Aligning the ODI sharing rate to the (asymmetric) totex cost sharing rate would lead to greater rewards and larger penalties, but it may encourage companies to underspend, accepting a poor level of performance and an ODI penalty, but benefitting from underspending through the totex sharing mechanism. For this reason, we feel it would be most appropriate to set the level of sharing rate at 50%. While, in some cases this may lead to customers paying more than the estimated marginal benefit for improvements (and vice versa), the margin of error around the marginal benefit estimates is such that this should not outweigh the benefits of simplicity and transparency.

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

We think that the use of marginal benefit estimates remains the most appropriate method for setting rewards and penalties. We agree marginal benefits should be more consistent in PR24 given the collaborative customer research on most of the PCs. However, there is a need to cross-reference the values derived from this research with other sources of evidence, including companies' own benefits valuations.

If 'bottom-up' marginal benefits are used to set the ODI rewards and penalties it will be important to give consideration of the whole risk and reward package for each company, which needs to be consistent with a 'fair bet' – that is, rewards and penalties are equally likely.

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

Asset health PCs are not fully understood by customers so any marginal benefit values derived from customers would not be reliable. A top-down approach here could be appropriate, to understand what the maximum ODI payments should be. The level of maximum ODI payment for asset health should be derived from a sensible proportion of the Botex programme. This would be consistent with the historic serviceability approach. The level of funding at risk would be very transparent and ensure Boards were suitably focused on asset health outcomes. Because the RCV is not explicitly linked to the underlying asset base we think that a % of RORE approach would be more arbitrary than one based on funded expenditure.

Finally, there is still insufficient clarity on the asset health metrics Ofwat is proposing to use in the ODI package. There is a risk that any inconsistent definition of the metrics compared to past reported data, and no clear baseline of industry performance against the metrics could result in ODI rewards and penalties being driven simply by changes in definition rather than genuine underlying asset condition. We have observed this in the past from metrics such as sewer flooding where changes in the metric definition (e.g. from severe weather events) led to a reranking of company performance simply on the change in definition rather than underlying performance.

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

With the exception of asset health PCs (as noted above) the bottom-up approach for setting ODI rates should be used where possible. The top-down approach does not work for individual ODIs because customers can’t understand the significance of changes in levels of service – this is the principal reason why the willingness to pay (WtP) values are not consistent within the industry and within each company. A top-down approach should be used as a cross-check to ensure that the overall package of ODIs is balanced.

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

Under a top-down approach it is relatively straightforward to elicit customer preferences between PCs through prioritisation exercises. This would provide a good allocation of at-risk funding to each PC. However, as noted above, the principal reason for the differences seen in willingness to pay values at previous price reviews is the difficulty customers have in assessing performance increments, especially where these are small and relate to service failures that the customer will have experienced only infrequently, or not at all.

It would therefore be necessary to make informed judgements, perhaps guided by the relative costs of service improvements in each area, to determine the performance increments over which to spread the incentive payments.

The performance increments should also take into consideration the P90 and P10 levels for each ODI and for the package as a whole. In AMP6, some companies secured very large ODI rewards from a small number of often bespoke ODIs, despite poor performance on many other ODIs in the package. For customers the service ‘in the round’ ultimately matters as service failure often impacts a relatively small portion of the customer base and its about ensuring the generality of customers receive the service they’ve paid for. A symmetric package-wide cap and floor could be good mechanisms to avoid companies being overly rewarded or penalised on a small number of ODIs. These need to be developed using a consistent methodology, agreed upon early in the process to ensure the industry and Ofwat are happy with the approach.

Enhanced ODIs

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 do not believe Ofwat should retain enhanced ODIs as they run counter to diminishing marginal utility – as customers' valuations fall, they must pay more. They may also lead to an excessive focus on individual PCs at the expense of overall service levels, as described above.

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

n/a

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

The only enhanced ODI we have is per capita consumption (PCC) which, due to Covid has shifted to a worse level. Therefore, to be able to reach the enhanced level of performance we would need to shift our performance by over 10%, despite being at or near the industry frontier. This is unachievable and therefore the enhanced ODI has not influenced our company's decision making.