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By email: [redacted]

25 March 2022

Dear Ofwat,

ODI rates at PR24

Thank you for the opportunity to respond on outcome delivery incentives, as part of the wider outcomes strategy for PR24. We are supportive of the collaborative approach to the outcomes framework at this price review.

Our detailed response to the consultation questions is below. Overall, our main concern at this stage is the apparent shift in policy towards an outcomes framework biased towards penalty incentives. Whilst we acknowledge that penalty incentives used correctly can incentivise companies to prevent deterioration in service, it is important that driving service forward is incentivised positively, through strong and fair outperformance incentives. This will facilitate a culture which is more innovative and seeks out proactive improvements to service, rather than one which only seeks to avoid penalties reactively.

Yours sincerely

[redacted]
Director of Regulation

ODI rates at PR24

South Staffs Water and Cambridge Water consultation response

Purpose of ODIs

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

We recognise the role of ODIs in incentivising companies to work to prevent service level deterioration, and to drive service levels forward including developing new frontier performance. Performance commitments have been a broadly successful mechanism since their implementation in PR14 to improve transparency of reporting, consistency in reporting across the sector, and to improve service levels overall. There are a number of success stories within South Staffs and Cambridge Water, and also across the sector, where service levels have improved over time for the benefit of customers and these are to be commended.

Overall though in PR24, we are concerned at the interactions that may be developing between common service levels ('what base buys') and incentives. Without careful design we believe there is a risk that incentives become more focussed on the penalty mechanism to drive service forward (i.e a larger stick) rather than a more positively focussed outperformance mechanism (i.e a larger or more focussed carrot). This concern is supported by some of the language that Ofwat has used in this consultation, where Ofwat has begun referring to underperformance incentives as 'compensation' for customers.

When ODIs were first introduced at PR14, Ofwat was clear that there was a distinction between incentives on the business and compensation for customers. Performance commitment incentives are intended to be broad incentives on high level service measures which are intended to be broadly symmetrical – they are not intended to act as direct compensation for customers who have suffered a direct loss from a specific event that has impacted them. We believe that the term 'compensation' should be avoided in the ODI context because it reinforces an idea that customers are incurring a direct loss when this is generally not the case – customers are typically not directly impacted by these performance commitments or they are impacts which are imperceptible to individual customers.

Broadly speaking – and we understand there may be exceptions – we believe that penalty incentives (the 'stick') should be used to discourage companies from deteriorating from their existing service levels that have been achieved through continued investment funded by customers over time and that represent the baseline for improving service in the next period. It is important that these incentives are not punitive when unprecedented events occur that cannot be reasonably mitigated against. Driving service improvement forward should then be the realm of outperformance incentives (the 'carrot'), and it is important that these are targeted to drive positive and innovative thinking, encourage best practice sharing across sector, and allow companies to take reasonable risks in trying new ideas which may not always be successful.

Without this balance there is a real risk the incentive mechanism becomes one-sided which may restrict innovation in companies as they focus on only short term avoidance of increasingly punitive penalty incentives, and we therefore want to encourage Ofwat to think about the role of outperformance incentives at least equally to the role of penalty incentives and how the two can be balanced to drive the desired behaviours going forward.

Options for standard ODI rates

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

We do agree that the assessment of marginal costs has proved problematic in some areas at previous price reviews. It is difficult to determine marginal costs for activity that is embedded deeply within the core activity of a company, such as water quality, supply interruptions or asset health.

We also agree that a positive cost relationship to service is not always true in practice, a case we have made in past price reviews. Without external factors, service will tend to naturally settle at an economic level where reactive costs (to deal with a problem after it occurs) are balanced with proactive costs (to try and prevent the problem occurring and having an impact). Therefore any movement away from the economic level, either to improve or deteriorate, can increase costs overall. This would be visualised as a U-shaped cost curve. ODIs and stretching performance commitments add an external intervention which is intended to shift this balance to drive service improvement forward.

There is precedent for removing marginal costs from the ODI rate formula. In PR14 and PR19 we successfully made the case that we could not effectively determine a marginal cost for supply interruptions because this area of service is so deeply embedded in our operations. Other ODIs may have had easier to determine marginal costs in the past, for example leakage had an established SELL methodology which was underpinned by a marginal cost assessment. This is another example of a U-shaped marginal cost curve. However, recent policy decisions on leakage now make this approach less useful as targets move considerably away from the legacy SELL method, which means marginal costs are in a region of new discovery as leakage is driven to improve significantly against historic norms.

In terms of marginal benefits, again we agree with Ofwat's observations. We have made the case in the past that marginal benefits are sensitive to the range of service level that the customer is asked about in the willingness to pay survey, and the resultant transformations that need to occur to convert the willingness to pay value to the units of measure used for the performance commitment.

All this considered, we strongly support Ofwat's preference for a pragmatic approach to incentive setting and support the removal of marginal costs from the calculation. As noted in our response to Q1, we specifically encourage Ofwat to consider how it can make more effective use of outperformance incentives rather than relying on the more negative approach of increasingly punitive underperformance penalties.

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

We generally agree with Ofwat on the environmental PCs – that there is sufficient scope remaining for improvement that we have not yet reached the area of diminishing marginal benefit. We can therefore broadly support symmetrical incentives.

However we do not agree with Ofwat that the same applies to supply interruptions, especially for South Staffs and Cambridge Water as we are near to the frontier performance level, meaning that performance improvement will be more difficult to achieve and difficulty is likely to increase rapidly the closer we get to a zero level. We will need to pursue an increasing level of network monitoring, and innovative approaches to managing network incidents such as bursts, in order to continue to drive this service level forward and so we are concerned about biasing incentives towards penalty on this measure.

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

We experienced the challenges that Ofwat describes when setting our asset health incentive proposals for our PR19 business plan. It did involve a wide range of mapping assumptions as Ofwat correctly identifies.

Overall we have concerns that the current performance commitment used for infrastructure asset health, burst mains, is not suitable for incentives. The measure has a long lag to the underlying activity, or lack of, and is also subject to significant externally driven factors that mask the short term trend. Over the long term, as means of monitoring the burst trend (as a proxy for asset health), it works well and so could be retained as a reporting measure for that purpose. However, given the lag and external factors, we believe applying measures or incentives on the mains renewal activity itself would work better as a means of incentivising companies to deliver their business plan proposals in this area and allowing the sector and regulator to take a judgement on what the right level of renewal actually is, given different companies' specific factors. With difficult to measure assets this ensures that we do not push maintenance issues on to future generations, and that we maintain and enhance the skills and technology in the supply chain through a steady rate of investment over the long term.

The unplanned outage measure used for non-infrastructure assets is far more directly correlated to asset condition, and assets are directly observable, so overall there is a far more direct relationship between short term investment and performance in this measure. On this basis we would consider it a suitable measure to use going forward.

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

At PR19 our first business plan submission used a top down calibration approach to setting ODI rates which Ofwat rejected. We did this precisely because we were experiencing the issues that Ofwat acknowledges in this consultation, and we wanted to be fully transparent about these and how we had triangulated our incentives proposals and reached Ofwat's indicated risk levels.

The approaches used to elicit customer valuations are by their nature estimations, with many contributing factors determining the range of results achieved. This was evident at PR19 and is evident now in the work done to scope the centralised willingness to pay research. Recognition of this fact will help Ofwat and the sector move forward with common and pragmatic approaches to incentivising outcomes, and so we do support top down allocation approaches informed by, but not mechanistically reliant on, willingness to pay and other priorities research.

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

Primarily we think that the performance increments for PCs should reflect a company's plan and subsequent regulatory challenge. It is critically important that PC targets are deliverable, aligned to the cost allowances, and are positively incentivised to encourage innovation and forward thinking.

We recognise that Ofwat wants to ensure there are strong incentives for companies to not allow service to deteriorate, in order to protect customers. However as we mentioned in our response to Q1, we are concerned that this consultation has taken a shift towards a 'compensation' approach which we don't think is the intention of these incentives. The compensatory thinking being employed currently may be preventing Ofwat from designing a two-way incentives package that works in the round and makes most effective use of outperformance incentives which encourage innovation opportunity seeking behaviours in companies.

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 agree that as yet there is no information on the effectiveness of enhanced ODIs. Our responses to the earlier questions show that we have doubts that the current proposals for standard incentives are targeted appropriately given the apparent shift towards stronger penalty incentives in this consultation with limited thought given to the power of outperformance incentives.

We would consider that enhanced ODIs may have a place when service levels are approaching a level that new innovation and some exploratory risk taking is needed to make a movement forward. In this situation they are being used for a specific purpose, to incentivise a next big leap. Assuming that the standard rates are set right, enhanced outperformance ODIs should not be automatically mirrored on the penalty side simply for visual symmetry. A standard underperformance incentive should be sufficient on its own to discourage companies from deteriorating in performance. Enhanced underperformance incentives risk being punitive in extreme scenarios and we believe would have no bearing on a company's drive to push the frontier forward if the outperformance incentive is strong.

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

As we have expressed in our responses to questions 7 and 8, we believe that setting both standard and enhanced ODIs (if they are used), should be based on a strong underlying set of objectives that combine customer priorities with national policy aspirations. The incentive framework, in the round and at individual PC level, should be sufficient to discourage deterioration in performance but provide strong outperformance incentives for driving service forward.

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

We do not have any enhanced ODIs in this period.