Discussion paper on outcome delivery incentives

Severn Trent response

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WONDERFUL ON TAP

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. Severn Trent has been a strong supporter of ODIs and we believe there is compelling evidence to show that they have delivered better outcomes for customers, with much greater improvement than would have been achieved under the penalty-based system that operated before PR14. In its recent review of PR14, Ofwat concluded that "the outcomes regime did have a significant impact on the way companies were managed and significantly heightened their focus on customers."[1]

It is critical that there is a balanced package of ODIs at PR24. There may be a superficial attraction to a skewed regime with higher penalties but this kind of asymmetry will simply discourage innovation and increase the true cost of capital in the sector – this would not benefit customers in the long run either in terms of the cost or quality of their service.

By encouraging companies to stretch themselves, ODIs push forward industry performance in a way that the previous penalty-only regime did not. Customers receive most of the benefits from this approach – they receive a portion (usually half) of any outperformance when it is delivered and also the benefit of higher targets in future, which all flow to customers. This is particularly true where outperformance raises the bar for the industry (the "benchmarking externality"), leading to benefits for customers outside a company's own area.

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. But in doing so, 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 all of a company's performance. The fact that companies can stay within their cost allowances while improving service does not mean that the improvement came without cost or that the company could not have delivered more cost outperformance without this activity.

We favour a bottom-up approach to the assessment of marginal benefits where it can be used. For measures where it is difficult to obtain customer valuations, other techniques are available; we have previously used the inferred benefits approach and we think it is important to consider the evidence on revealed preference (i.e. what customers actually contact us about), particularly when looking at asset health measures.

Top-down approaches could have some advantages in terms of simplicity and in calibrating the overall risk and reward package for companies. There are some issues with bottom-up methods, in that companies with low Regulatory Capital Values per customer can face much higher risk – particularly if ODI rates are set at the same level across the industry through national research. But top-down methods suffer the inverse problems – customers would pay different amounts for the same service improvement; it would also be more difficult to balance the trade-off between cost savings and service improvement.

To us it seems inconsistent with the themes of PR24 that one of the prime concerns of the paper is that asset health incentives might encourage companies to over-invest; at several points the consultation talks about a

[1] https://www.ofwat.gov.uk/wp-content/uploads/2022/01/PR14_Review_Paper_Jan_2022.pdf , January 2022, page 3.

risk of companies "gold plating". One of the over-arching themes in the PR24 publications is the need for the industry to focus on the longer term, which includes maintaining assets for future generations of customers. If companies are responding to incentives by improving asset health, we think this should be taken as a positive sign, showing that the incentive package is working. Based on the evidence from AMP7 so far, it would also appear that companies are doing this by finding more effective approaches rather than over-spending.

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 four aims that are set out in the consultation paper. Clearly an important function of ODIs is to hold companies to account for the delivery of outcomes and provide balance other incentives that might encourage cost savings at the expense of service levels. But for us the last two aims are the key way in which the ODI regime introduced at PR14 differs from the system that existed before it:

- ODIs incentivise companies to stretch themselves and innovate, which the previous penalty-only regime did not. By going beyond target levels, companies can deliver additional benefit to their customers.
- ODIs have encouraged innovation both in the way that performance is measured - through bespoke Performance Commitments (PCs) - and in the delivery of higher service against those PCs. At PR19 the successful bespoke ODIs were applied to more companies and Ofwat was able to set more stretching targets for comparable measures.

The ODI regime applies the approach that Ofwat has always adopted with expenditure to levels of service. By providing an incentive to go beyond targets, companies are encouraged to reveal information which can be used to set tougher targets in future. This benefit extends beyond the company's own customers because they enable targets to be set for all companies - in much the same way as cost savings by each individual company drive forward efficiency assumptions for the industry as a whole.

Customers always receive the lion's share of any benefits from ODI outperformance. The rewards are calibrated so that companies receive only half the value that customers place on incremental improvements and only in the first review period. After that first five years, the benefits of the information that is revealed all flow to customers.

In addition, some of the discussion around ODI rewards has tended to overlook the cost of delivery. Company rewards as reported reflect a gross position – the company will have invested in order to deliver improvement. Ofwat recognises this point in its recent review of PR14 saying "some companies likely efficiently incurred additional expenditure in pursuit of ODI outperformance rewards" (page 71). Indeed, some of the existing ODI payments to companies only reflect the recovery of costs; for this reason we think the introduction of the new Price Control Deliverables (PCDs) will be helpful when reporting the true Return on Regulatory Equity (RORE).

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

We understand that there are challenges in getting accurate data on the marginal cost of improvement and support a simplification of the formula. In doing so, it will be important that Ofwat does not lose sight of the fact that there are costs associated with delivering service improvements. It is worth trying to understand the implications for expenditure even if it is difficult to obtain consistent information on marginal costs.

As the paper notes, if no sharing factor was applied to ODI rewards then customers would pay for part of that improvement through totex sharing. One justification for such an approach could be that customers will receive all of the benefit from tougher targets in future periods (as we note in response to Q1). But full in-period rewards would be difficult to reconcile with an overall RORE cap or taper on rewards above a 3% threshold such as was applied at PR19. Ofwat will need to calibrate the overall level of risk and reward; sharing rates could be varied to help achieve a balanced package.

If there is a sharing factor, then it makes sense for the cost sharing rate of the company to be taken into account. Although the marginal cost of improvement may not be certain, the value of improvement in service should be balanced against the benefit that companies and customers would gain from reduced expenditure – this is one of the overall aims of ODIs that Ofwat sets out in section 2. We also prefer the PR19 approach of applying simple sharing factors to ODIs such as 50%, rather than the spurious accuracy of PR14 rates set involving decimal places. Simple incentives are easier to explain to customers and other stakeholders.

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

The obvious effect of removing marginal cost from the equation would be that reward and penalty rates become divorced from the implications for costs and customers' share of variances in cost. The current policy implicitly sees this as a problem for under-performance alone – the idea being that companies might choose to deliver less service than their target level if the penalty is not strong enough. Where a company chooses to go beyond the committed level, it is probably reasonable to assume that the company knows (or ought to know) whether doing this is cost-beneficial.

We do understand the concerns about the quality of marginal cost information for the purpose of this exercise. This is not just a case 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?

Where it is possible to gain a robust view of marginal benefits, we consider the bottom-up approach should be preferred. Common willingness to pay research should produce a consistent value for common PCs and - if the research is robust - then this should be appropriate for setting ODI rates. However, we do think there would be benefits from cross checks on the results if they rely upon a single study.

A bottom-up approach is a customer-centric view and this has some logic when we're looking at the value of service improvement or reduction. But this approach makes it more difficult to calibrate the overall impact on RORE, and the level of risk faced by investors. Companies have very different levels of Regulatory Capital Values per customer: for companies such as Hafren Dyfrdwy there is very high exposure from small changes in service; at the other end of the scale the RORE risk for companies such as South West and Dŵr Cymru will be muted.

The two Welsh companies represent the extremes of the industry and can be used to illustrate this effect. If Dŵr Cymru's incentive rates and package for internal sewer flooding was applied to Hafren Dyfrdwy the results at the performance collar would be as set out below:

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%

Especially where the exposure to ODI risks is high, there is a case for the use of caps and collars. We think that these limits – or a tapering of rewards above a given level such as 3% - are better applied at the company or service level. 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 be moving the industry frontier, but has no incentive to do so, even though the overall impact on customer bills is not excessive.

In general, we think that ODI rates should be symmetrical unless there are compelling reasons for a different approach. We think there is overwhelming evidence that a system with both rewards and penalties has driven greater improvement in service levels than the penalty-only system which operated before PR14. There are some PCs which relate to statutory requirements and are therefore penalty-only - this introduces a negative skew to the overall ODI package even before we consider the effect of setting higher penalty rates.

The consultation discusses two potential reasons for doing this – one being an interpretation of customer preference for loss aversion, the other setting higher rates for companies whose performance on an individual PC is below the expected level. Even leading companies will have some measures where they are below average because of the number of performance commitments; the implication would be potentially high penalties for underperformance and more limited upside for the measures where the company performs well. This would not lead to a balanced package of ODIs because it would hold companies to a benchmark based on a perfect company that performs well on all measures. There is no perfect company.

Having tough penalties and limited rewards may seem superficially attractive but if it leads to asymmetric risk then it is counter-productive. As the consultation notes, the CMA's decision to increase the cost of capital was partly driven by expected underperformance against PCLs, but a negative skew on ODI rates will also contribute to asymmetry. A bias towards penalties will also discourage innovation; it is important that companies are encouraged to take some risks with new approaches in order to deliver a step-change in customer service.

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

We believe that 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. Our research has found that asset health does matter to customers. It may be more difficult to establish a stated preference value for asset health PCs, but it is not impossible. Our evidence is also backed by customers' revealed preferences – for example, in 2020-21 we received around 30,000 contacts where the initial problem related to a blockage, which was 42% of all the wastewater contacts we received.

The consultation cites research which suggests that customers struggle to value the impact of poor asset health. The Blue Marble report for CCW is interesting and we agree that there can be limits to the topics that customers can meaningfully engage on. We are not sure that customers can give constructive feedback on some of the topics that we have previously been asked to consult them on – financeability, intergenerational fairness, and the design of price controls spring to mind. But this report is quite sceptical of customers' ability to engage on issues around business planning and willingness to pay in general – the scepticism is not limited to asset health alone. The Blue Marble report is one piece of research – multiple studies commissioned at PR19 did manage to establish values for these ODIs.

Inferred marginal benefits can be established, because performance on asset health measures contributes to the resolution of issues that customers experience directly – for example, clearing blockages helps deal with nuisance from odour as well as the direct customer indicators like sewer flooding which are already measured. This is an approach that we used at PR19.

We do think it is inconsistent with the themes of PR24 that one of the prime concerns running through the discussion paper is that asset health incentives might encourage companies to over-invest. At several points the consultation talks about a risk of companies "gold plating" due to incentives. Given that one of the over-arching themes of PR24 has been the need for the industry to focus on the longer term, we would have thought that Ofwat would seek to encourage greater focus on maintaining assets for future generations of customers. The fact that companies are responding to incentives and improving asset health is a positive sign, showing that the incentive package is working – particularly if companies are able to do this by finding more efficient ways of delivering these outcomes. The data from the first year of AMP7 does not appear to suggest a pattern of over-investment.

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, an approach based on direct customer benefits will give rise to different RORE risk depending on the size of the company's RCV. A top-down approach has the inverse benefits and drawbacks – it would enable Ofwat to target the appropriate level of risk more precisely, but would lead to customers across the country paying very different rates for a unit of improvement. Using the same extreme examples, customers of Dŵr Cymru would pay a high premium for marginal benefits, while the customers of Hafren Dyfrdwy would be at the opposite end of the spectrum.

Potential effect of a common RORE impact for internal sewer flooding

	RCV/customer 17/18 prices 2025, £	Collar Per 10,000 connections	Under-Performance (Properties)	RORE impact at collar	Penalty rate 17/18 prices £ per incident
WSH	2,730	3.350	462	-0.007%	£427
HDD	591		6	-0.007%	£92

There may be a stronger case for using top-down approach in relation to asset health, where valuation is more difficult. Conceptually, this would be a regulatory choice about the degree of investor risk that Ofwat wishes to attach to maintenance, and could help Ofwat to calibrate the overall ODI package even if combined with a bottom-up approach for most ODIs.

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 disconnection 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. There could be a further dislocation 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. Ofwat would need to use other regulatory tools to protect against this – for example, enhanced reporting, monitoring of performance and enforcement if there was systematic failure of multiple PCLs.

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 retention of enhanced ODIs. While no company has yet passed the threshold to earn enhanced rewards, we are only one year into AMP7; it would seem odd to conclude that the approach had not worked on such limited evidence. As we have discussed elsewhere in our response, the key benefit of ODIs compared to the previous penalty-only approach has been encouraging companies to stretch themselves. Frontier performance provides benefits beyond the company's own customer base because it enables Ofwat to set more stretching targets for other companies at successive reviews (the "benchmarking externality").

In principle, all companies should have the ability to earn enhanced rewards, even if they are unlikely to do so in practice. In practice, applying enhanced penalty rates to companies that are in the lower quartile may run into problems, particularly if extreme events are not excluded from the results. Achieving frontier-shifting performance on underlying measures is likely to take time, investment and innovation by the companies that are close to boundary; one extreme event could easily trigger enhanced penalties.

To deal with very large rewards or penalties, we favour a cap or taper on the overall company or service rather than on individual measures. This should protect customers against excessive bill impacts and companies against excessive risks. But we also think that Ofwat needs to consider how extreme events are reflected, particularly if enhanced penalties are applied to more PCs.

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

The rationale for enhanced ODIs as developed for PR19 still stands. The value of the rewards should be based upon the benefit to all customers when a company delivers performance which moves sector benchmarks (the benchmarking externality). But the thresholds for achieving enhanced ODIs need to be realistic if they are to drive behaviour and not exacerbate the existing negative skew on common PCs. While it is early in AMP7, no company has yet achieved enhanced performance levels and the industry as a whole under-performed on common measures.

The negative skew may have been driven by the decision to set PCLs based on forecast Upper Quartile performance. We think there may have been an element of optimism bias in these forecasts since companies were competing to achieve fast track status or avoid “significant scrutiny”.

At PR19, companies selected the PCs which would have enhanced ODIs, making it less likely that they were at risk of enhanced penalty payments. If Ofwat applied enhanced ODI rates and penalties to a number of common PCs for all companies then it would need to consider calibration very carefully. In year one of the AMP, no company has yet achieved an enhanced reward; however if we look back across AMP6 several companies would have received enhanced penalties if they had been in place on all common measures. This could easily happen as a result of adverse weather events such as the “Beast from the East” or major flooding events.

If companies do not choose which PCs are enhanced, Ofwat may need to consider whether LQ is the right point at which enhanced penalties should apply, or whether there should be enhanced penalties at all; the thresholds for enhanced rewards sit beyond UQ. Alternatively, the threshold for enhanced rewards should be lowered in order to make the performance range symmetrical.

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

Severn Trent has one enhanced ODI for internal sewer flooding. This is a measure where we made significant improvements during AMP6, and considered that there was scope to push our performance still further. To date in AMP7 we have not managed to achieve our more stretching targets, which tends to illustrate the points above: improving the underlying performance takes time and is very challenging, but headline measures can easily be failed as a result of extreme events which are becoming more common as the climate changes.

Hydraulic flooding performance is very variable, depending on the frequency and intensity of rainfall events in a year – weather factors can drive a difference of 30-40% in total incidents. Addressing properties that are at risk from hydraulic factors requires capital schemes, which are more expensive and difficult to address than flooding from other causes (FOC). While we aspire to drive down the base level of FOC through proactive measures such as CCTV, cleansing, education and repairs there is a diminishing benefit from the measures that were undertaken in previous years. This means that some of the proactive measures are required in order to avoid deterioration before we can drive performance forward.