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Ofwat – FAO Jeevan Jones
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By email

Dear [redacted]

We welcome the opportunity to respond to Ofwat's consultation on outcome delivery incentives (ODIs) for future price reviews.

Since their introduction at PR14, ODIs have helped play a major role in driving improvements in service levels, and compensating customers in instances where company performance falls short of the agreed targets.

The consultation proposes to move away from marginal cost analysis, instead focusing on marginal benefit valuation analysis, and top-down allocations. We believe that marginal costs should continue to form part of the assessment of incentive rates.

We have concerns regarding Ofwat's approach to marginal benefit valuation. Given these concerns, the estimation of marginal costs may provide a more robust set of valuation estimates.

We note that Ofwat has largely dismissed the marginal cost data from PR19 due to there being wide ranges in estimates across the sector. Companies know and understand their costs, a material factor driving differences was differences in the assumptions of joint costs and how those are allocated between services. With standardised reporting guidance, this major area of difference could be removed. We have therefore joined an industry project with a number of other companies to develop a robust and consistent methodology to calculating marginal costs, we believe this will be of benefit both to companies and to Ofwat.

Another factor driving differences is regional variation in costs. This is an important factor to consider, as material variations by companies could mean that setting standardised incentive rates may not lead to the optimum economic outcome for customers and is why it is important for costs to remain within the ODI methodology.

Regardless of the approach taken for PR24, given the successes of the ODI framework to date, we suggest that in instances where any new methodology results in incentive rates that are materially different from those used at previous price reviews, a cross-check against marginal cost data may be appropriate to avoid incentives that do not drive the desired behaviours.

The consultation discusses both a bottom-up and a top-down approach to calibrating incentives. We consider that a combination of the two approaches is likely to be the most appropriate method. A bottom-up approach may help calibrate individual ODIs, but a top-down check may be required to ensure that the overall package 'makes sense in the round' and is symmetrical in terms of risks and opportunities.

The overall balance of the incentive package is a vitally important area to consider. We note that in Ofwat's discussion paper on risk and return, Ofwat justifies its intention not to aim-up on the allowed cost of equity by saying that it will address any asymmetry at source. Therefore, whatever approach is adopted to calibrate incentives, Ofwat needs to model the likely and potential incentive impact on companies, so that asymmetry can be removed at source by adjusting the ODIs.

In addition, the regulatory environment in which companies operate should be considered in the round and the risk of overlap or double jeopardy for penalties avoided.

We also expect that companies will test the package with customers for overall acceptability, rather than solely being determined through regulatory judgement. Comparability is a key pillar of the water sector's regulatory framework, but we greatly value the close relationships with our customers developed over previous prices reviews. Given also that each company manages very different resources, assets and networks, it is important to get the balance right between focusing on comparability and the ability to respond effectively to local priorities and needs.

The consultation heavily focuses on ODIs for common performance commitments. It is important that bespoke measures are not overlooked. A number of bespoke performance commitments have driven environmental and social value across the industry and remain essential to the future; these give us the flexibility to recognise regional variances and ultimately delivering what our customers want, and in a way that reflects public value.

We provide specific responses to the questions raised in the consultation as an appendix to this letter.

We would be happy to discuss further any of the issues raised in this consultation with you and / or your team.

Yours sincerely,

[redacted]

Regulatory Director
D: [redacted]
E: [redacted]

APPENDIX

RESPONSE TO CONSULATION QUESTIONS

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

We agree that the four outcomes that Ofwat has identified are important objectives to be achieved from the use of ODIs (i.e., to balance competing incentives, compensate customers, incentivise companies, and encourage stretch and innovation).

The 'incentivise companies' outcome also covers the use of enhanced rates that go beyond the valuation for a single company's customer base, should the company's performance shift the industry benchmark and deliver wider-benefits across the sector.

The treatment of ODIs on the incentive for companies to seek fast-track status at the price review also needs to be considered. At PR14, there was a clear 'do no harm' principle for the fast-tracked companies. Whereas, at PR19, there were instances of slow-tracked companies getting more beneficial ODI packages. Such an approach runs the risk of disincentivising companies from seeking fast-tracked status – an outcome we expect Ofwat would want to avoid.

In addition to the four outcomes identified by Ofwat, there are some outcomes that the calibration of ODIs need to avoid. These include:

- Creating perverse incentives – for example, having incentive rates encourage levels of service that are not supported by customers (whether this is through unsupported service deterioration, or service levels being improved at an unsupported cost).
- Creating disproportionate risk – the water sector is a capital-intensive sector. As such, companies need to maintain investment-grade credit ratings, and should generally represent a low-risk investment opportunity in order to maintain access to low-cost capital (which benefits customers through lower revenue requirements). As such, the need to provide effective incentives needs to be considered within the context of the overall risk profile, ensuring that benefits of providing meaningful incentives are not lost through increasing the required cost of capital for the sector.

The ODI consultation had no reference to the question of risk. This is an important area to consider. We note that in Ofwat's discussion paper on risk and return, Ofwat justified its intention not to aim-up on the allowed cost of equity by saying that it will address any asymmetry at source.

In the PR19 CMA re-determinations, the CMA found the overall ODI package to be materially negatively asymmetric (for the companies that appealed). If Ofwat wishes to maintain its intention of not aiming up, we would expect it to consider – as an explicit objective – for companies' ODI packages to be symmetrical in terms of risks and opportunities.

We have yet to see any analysis from Ofwat on whether its proposed approach to ODIs (and choice of common PCs) would align to this requirement of symmetric incentives. This will need to be a core consideration in price control calibration.

It should also be noted that the consultation heavily focuses on ODIs for common performance commitments. It is important that bespoke measures are not overlooked. A number of bespoke performance commitments have driven environmental and social value across the industry and remain essential to the future; these give us the flexibility to recognise regional variances and ultimately delivering what our customers want, and in a way that reflects public value.

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

In considering the variations in marginal cost figures at PR19, the consultation identifies two potential explanations for the variations:

- Differences in the quality of the data provided by companies; and
- Differences in efficiency levels across companies.

We consider there to be two additional factors.

- Differences in the assumptions of joint costs; and
- Differences in exogenous factors and historical investment choices.

The first of these could be addressed through standardised reporting guidance.

The final factor it is important consider. This is because, if there are material cost variations across the sector, setting standardised incentive rates may not lead to the optimum economic outcome for customers. If this factor were to be significant, some companies would find it relatively easy to improve service and gain rewards, while others would need to incur materially higher costs to gain the same level of rewards.

While we recognise that gaining robust and comparable marginal cost data across 16 companies can be challenging, it may be appropriate to retain some level of cross-check in the calibration process. This may be particularly appropriate in instances where the marginal benefit analysis were to give rise to materially different ODI rates than those used at previous price reviews.

For setting ODI rates, the consultation proposes two broad approaches:

1) Bottom-up – primarily based on customer benefit analysis.
2) Top-down – based on overall potential payments informed by customer priorities and judgement.

We consider that a combination of the two approaches may be the most appropriate method. A bottom-up approach is more likely to result in ODI rates that meet the four objectives for ODIs that Ofwat describes (see the above response to Q1), while a top-down approach is required to make sure that the overall package ‘makes sense in the round’, and does not result in asymmetric risk (see the above response to Q1).

The consultation discusses the role of sharing factors in calibrating the bottom-up approach. Clearly, stronger incentives are more likely to drive service improvement. It may be appropriate to have higher powered rewards either where further improvement is particularly challenging, or where the improvement may result in industry-wide benefits through the sharing of best practice.

In calibrating penalties, there also needs to be consideration of other non-ODI-related penalties/fines a company may be subject to. The regulatory environment in which companies operate should be considered in the round and the risk of overlap or double jeopardy for penalties avoided.

As a further refinement to the top-down approach, we would expect the package to be tested with customers for overall acceptability, rather than to solely focus on regulatory judgement.

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

The risks from the consultation's proposed approach are two-fold:

1) By departing from a methodology based on marginal costs, there is a risk that incentives are set in such a way that do not relate to the costs of service improvement. This could mean that companies are incentivised to improve service beyond the cost beneficial level, or cut service as the penalties could be smaller than the cost outperformance benefit.
2) As customers often have a preference for loss aversion (i.e., wanting to avoid deterioration more than gain improvement), an approach that heavily focused on customer valuation for incentive calibration could lead to a negatively asymmetric package (something that Ofwat has stated it wishes to avoid, so as not to have to aim up on the allowed cost of equity).

These risks could potentially be mitigated through sensible crosschecks. For example, if the bottom-up approach yields incentive rates that are materially different to previous price reviews, it may be appropriate to consider the marginal cost estimates. And if the package is modelled to be negatively asymmetric, it may be appropriate to reshape the package to ensure symmetrical incentives in the round.

To identify a negatively asymmetric package, it is necessary to carry out risk analysis. It should be noted that for 2020/21, most companies received penalties, suggesting that the existing calibration may be somewhat negatively asymmetric. We will be developing our own risk analysis as part of our PR24 business plan, and would be happy to discuss further with Ofwat how such an analysis could be structured.

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

Whilst we understand that marginal costs can be more difficult to establish given the joint costs of provision: most project deliver multiple benefits across asset health and performance, and the allocation of costs across the full range of metrics requires a clear and robust process, we do not believe they should be removed from the methodology for setting ODI rates. We believe our approach of allocating costs in proportion to benefits in PR14 and PR19 was effective and provided robust valuations, but we recognise that in order to give Ofwat confidence this is an area that would benefit from collaboration so there is consistency of approach around the estimation of marginal costs across the industry. We have therefore joined an industry project with a number of other companies to develop a robust and consistent methodology to calculating marginal costs.

Our valuation approach is strong, and we are able to provide robust marginal benefits in line with HM Treasury Green Book advice. We would be happy to discuss with Ofwat our approach, to help ensure that any marginal benefit valuation that Ofwat undertakes benefits from the experience we have developed over successive price reviews.

We do not agree with the discussion paper, that the collaborative research on ODI rates will deliver more robust marginal benefit estimates. The approach being taken is not proven, in fact its use within the sector has been limited to a single study at PR19. Furthermore, the research approach de-couples the setting of incentive rates from service levels and service improvements. Additionally at this stage of development of the approach it is not clear what additional analysis and interpretation will be applied to the results of the research in order to derive the valuations.

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

The consultation describes a few different approaches to calibrating asset-health PCs (direct customer valuation, inferred marginal benefits, and marginal costs). Each of these approaches have their strengths and weaknesses. As such, an approach that considers evidence from a range of sources, and seeks to triangulate a set of incentive rates may be the most appropriate approach.

We note that the Asset Management Maturity Assessment (AMMA) showed that companies can and should talk to customers about asset health.

We employed a robust approach to setting ODI rates for asset health PCs at PR19 which avoided double counting of benefits and proportioned costs and benefits appropriately. We would be happy to have a conversation with you or your team to discuss our approach and how we engaged with customers.

Response to Q6 & Q7 below

Q6: What are your views on using top-down allocation approaches for setting ODI rates or for other uses?

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

As set out in our response to Q2, the most appropriate approach may be to use a combination of top-down and bottom-up. Top-down may be particularly important in removing asymmetry in the framework.

Performance increments could be defined by what it may be reasonable to expect company performance to vary by. This could align to the P10-P90 ranges that companies have previously produced or be based on a different assessment of what likely performance may be. Such an alternative assessment could be based on historical trends and/or an engineering evaluation.

Response to Q8, Q9 & Q10 below

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

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

Q10: How have enhanced ODIs influenced your company's decision making around achieving high performance?

We support the retention of enhanced ODIs. We believe enhanced rates are an important mechanism to support companies moving to upper quartile performance levels. Enhanced ODIs promote frontier shift incentivising companies to go beyond their PCLs where this is supported by customers, and encourage and support innovation, as such enhanced ODIs have a key role to play in strengthening the ODI framework and meeting the purpose of ODIs as set out in the discussion paper.

Enhanced ODI rates can therefore provide incentives for companies to deliver transformational change which can have broader benefits across the sector. We believe they should be available to all companies, and do not believe it would be appropriate to limit their application, whilst companies may perform poorly in some areas, they may be exemplar in others – not allowing all companies, and customers, to benefit from enhanced ODIs would appear unduly restrictive.

At PR19 we discussed enhanced rates with customers. There was good support for the use of enhanced rates, particularly on wastewater services, and no aspect of service which customers felt should be excluded. In determining how enhanced rates should be set, customers supported the doubling of standard rates, however there was also some suggestion that a greater degree of outperformance could be rewarded with a higher factor.