From:	[redacted]
To:	[redacted]
Subject:	ODIs consultation response
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Attachments:	[redacted]

Dear PR24 team

We appreciate this opportunity to comment on Ofwat's proposals on the design and application of outcome delivery incentives at PR24. This is the latest in a series of discussion papers which have been helpful in preparing the ground for PR24 in a constructive and consultative manner. Please find below the response from Welsh Water.

Ofwat sees ODIs at PR24 playing a significant role in setting an incentive framework that aligns company and customer interests. One of the key challenges in this approach is how to set the ODI rates in a way that is consistent with economic theory but also recognises the limitations of available data in the real world. There are challenges both on the 'benefit' side (deriving valuations from customers) and the cost side (capturing marginal costs for distinct outcomes).

We agree that it is best to recognise these limitations and seek a pragmatic approach that is also consistent across companies, leading to a reasonable and defensible set of values that avoids perverse or extreme outcomes. In order to achieve this goal, given the limitations and inherent weaknesses in the methodology, we believe there will be an important role for 'top down' cross checks and a sense check against historic values or other relevant benchmarks.

Consultation questions

1. **Do you have any comments on what the purpose of ODIs should be at PR24?**
   No comments.
2. **Do you have any comments on our observations on the standard ODI rate formula and how we are considering revising it?**
   We are broadly supportive of the general thrust of the proposals. We agree that there are benefits of simplification that probably outweigh any loss of accuracy, given the wide range of industry values on marginal costs. However, we are also concerned about the robustness of marginal benefit values, because of the number of conceptual 'leaps', estimates and assumptions that underpin the ODI rates research. In addition, the choice of X is highly significant in the proposed formula, but the basis on which an appropriate value can be determined is unclear.Certainly considerabe care will need to be exercised in arriving at a choice of X.
   All the same, the proposed approach is a step forward and is probably the best of the available options. The document correctly identifies many of the risks. We would again emphasise the importance of applying appropriate triangulations or cross checks to the resulting ODI rate values.
3. **What are the risks of unintended consequences from this approach? How can they be mitigated?**
   We concur with the potential for unintended consequences that are identified in the document. Triangulation and cross-checks will again play a role here, and we believe this is also an argument for the use of caps and collars.
4. **Do you have any comments on using a bottom-up approach based on marginal benefits for setting ODI rates?**
   See answers to question 2 and 3 above.
5. **Do you have specific comments on setting ODI rates for asset health-related PCs?**
   This is a highly problematic area. setting ODI rates for asset health PCs based on inferred benefits does not work conceptually. The purpose of asset health PCs is to incentivise the long-term, so falling back on short-term customer-facing PCs for ODIs fundamentally undermines this purpose. We agree that using marginal costs does not work as it is impossible to link costs to specific long-term asset health outcomes. Given these issues, we do not think taking a formulaic approach is likely to be helpful or meaningful. We need to instead take a reasonable approach based on some sensible comparisons with the customer-facing measures.
6. **What are your views on using top-down allocation approaches for setting ODI rates or for other uses?**
   Overall we prefer top down allocation approaches. The findings of CC Water research, confirms that research to produce valuations of benefit across a range of PCs is overly complex for customers, even when simplified, and the results cannot be relied upon as a genuine reflection of preferences. It may be possible however to derive meaningful

customer views on the overall amount of bill variation that they are comfortable with, for the purposes of incentivisation.

7. **How would we ensure that the performance increments for individual PCs are sufficiently robust and protect customers?**
   This is a difficult area and we have no detailed suggestions. We do think it might be useful to have a default of standard performance increments across companies, with the possibility of deviations where justified.
8. **Should we retain enhanced ODIs at PR24? If we do, should they apply to all companies? And which PCs should have enhanced ODIs?**
   Our customers are sceptical of ODIs (as evidenced at PR19), so would not support the use of enhanced ODIs. Our view is that company-specific benign operating conditions go a long way to explaining companies' ability to be frontier performers in the industry. Therefore there is limited industry-wide benefit in incentivising them to deliver enhanced performance in the form of shareable learnings. Enhanced ODIs also increase the risk of unintended levels of net rewards or penalties, and they also increase complexity. We would be in favour of dropping them at PR24.
9. **How should we approach assessing and setting enhanced ODIs at PR24?**
   As above, we do not support the use of enhanced ODIs. However, if they are to be used, perhaps a fixed percentage increase compared to 'standard' rates could be applied. The use of caps and collars would need to be carefully considered, especially in order to deal with the possibility of external shocks outside management control, such as extreme weather.
10. **For water companies: how have enhanced ODIs influenced your company's decision making around achieving high performance?**

    Not applicable.

Regards

[redacted]

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