Wessex Water Response – Outcome Delivery Incentives

Thank you for the opportunity to respond to this consultation. Outcome delivery incentives have formed a key part of the overall risk and return balance in the last two price controls, and we expect them to form an even more material piece of the risk and return balance at PR24.

We have published our opinion on how the outcomes framework should evolve around Outcome Based Environmental Regulation (OBER). This will naturally enable a more customer focused set of incentives, that can provide the correct long-term incentives to deliver exceptional services for customers, communities, and the environment.

The key consideration of the incentive package should be the overall risk and reward position and the impact on the company. ODIs need to be considered holistically, alongside other risks such as totex and financing. Then it should be reflected in the WACC. It is not appropriate to look at incentive rates in isolation.

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

We are very clear that ODIs should be used to provide a meaningful long-term incentive to provide excellent performance against a range of outcome-oriented measures that have targets set at the economically efficient level.

The current framework uses ODIs very differently. In many cases, it uses ODIs to bolster totex sharing, or as a route to fund additional investment. We think that this is a function of other areas of the determination not working as intended; i.e. cost assessment not funding the efficient level of investment.

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

We acknowledge the difficulties in gathering robust marginal costs – this is an area that although there is a clear engineering rationale underlying the relationship that better service is a result of higher costs, the current framework around reporting base and enhancement costs obfuscates this. Alongside this, many investments deliver multiple improvements which raise questions of the allocation to each individual area.

We think that there isn't a fundamental issue with the observed difficulties in calculating the marginal benefits for asset health measures. This just highlights the fact that these measures in themselves do not provide customer benefit and should, in our opinion, not be part of the ODI framework. We discuss this more later.

Therefore, removing this more questionable source of data makes sense on the face of it. However, as we discuss below there are some unintended consequences.

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

Although we can see the benefit in simplifying the standard ODI rate formula, we are nervous that it moves the premise away from the economics that underpin this framework. Improved service comes at greater cost. This is a core principle that needs to be reflected consistently across the PR24 cost assessment, target setting, and incentive setting process. If this is ignored then there is a real risk that companies will be incentivised to achieve levels of service that are not the most economically efficient, either by not having sufficient incentive to undertake improvements that customers are willing to pay for, or vice versa.

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

If we are moving away from the bottom-up economic rationale for this approach (for which we can see the justification) then we believe a top-down methodology would be more appropriate – which we discuss later. This removes some of the potential perverse incentives that would be present in the proposal here of only looking at half the picture.

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

We are very clear that the ODI framework should be focused on the outcomes that matter to customers, communities, and the environment. Asset heath measures, although an important factor that should be at the heart of companies' thinking, should not be part of the ODI framework. We do, however, support reporting and monitoring of asset health metrics

Asset heath measures in themselves bear no commentary on the overall service that a customer receives. For example, if there is an unplanned outage and no customers go out of supply or see any reduction of service, there is certainly no short-term and potentially no long-term harm. This may simply demonstrate that the company in question has found a more efficient way to deliver the outcomes that truly matter to customers.

Rather, correctly calibrated long-term ODIs would provide sufficient incentive to focus on asset health, which is at the heart of delivering the proposed outcomes. This could be done potentially by using incentives linked to the RCV (the mechanism to capture long term value) to provide the immediate cash flow impact and provide a long-term incentive until performance is rectified if a company is performing poorly.

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

We think that if we are moving away from the pure economic rationale that informs the bottom-up setting, then a top-down view of rates makes sense. This can instead look at the prevailing market conditions and calculate what range of returns we would expect a good performer to have compared to a poor performer (as long as the measures are set correctly). This can then calibrate the potential returns so that the range of potential returns match those that you would expect in a competitive market.

However, it is crucial that this is done for the entire ODI suite and looked at holistically across the entire PR24 process. It should take account of the WACC alongside other risks such as financing and totex.

It also needs to consider the underlying skew in potential performance. It is very unlikely that this is symmetric, as where companies have delivered performance to ever higher standards, the downside risks are likely to be much greater than the upside risks.

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

If the ODIs are focused on a common set of outcomes that deliver for customers, communities, and the environment, this provides the first layer of protection for customers. Any incentive payments relate to the outcomes that matter the most to them.

Then the choice of metrics is important, to ensure that they provide a robust independent measure of performance that is materially within the companies' control (to avoid any windfall gains from exogenous improvements).

Finally, it then comes down to the interaction with cost assessment to ensure that targets and funding are set in alignment to minimise any risk of windfall gains or losses.

We set out in our SDS appropriate measures that are robust and provide protection for customers.

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

Enhanced ODIs seem at odds with the expected diminishing returns we would expect through customer preferences, although we think do provide an incentive to push the frontier level of service even higher.

On balance, we think that they can in places provide a useful incentive, particularly if we do not move to a true outcomes position. However, where one will often see performance in one outcome come at the expense of another (i.e. capital works, result in higher carbon emissions), we worry that they could increase the overall risk of perverse incentives.

Therefore, overall, we think that if the incentive piece is looked at holistically then there is no requirement for them.

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

If enhanced ODIs are retained in a bottom-up world, then we think that the most natural, economically justified approach should consider the future improvements in service targets across the industry. Therefore, potentially looking at a decreased marginal benefit over a wider customer base.

However, as we mention before if the overall suite is set correctly, we do not see a need for them.

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

We have responded to enhanced incentives where they have been achievable. However, we have not focused on them at the expense of other measures as we have focused on providing the best overall level of service to customers.

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