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By email: [redacted]

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PR24 and beyond: a discussion paper on outcome delivery incentives. Yorkshire Water response.

Thank you for providing Yorkshire Water with the opportunity to comment on the proposed approaches to outcome delivery incentives at PR24. We welcome the continued engagement with Ofwat through the Outcomes Working Group around the proposed purpose and approach of outcome delivery incentives (ODIs).

We have set out below our main points for consideration and have provided detailed responses to the discussion paper questions in the attached appendix.

Purpose and approach to ODIs: As we set out in our response to the *Assessing base costs at PR24* discussion paper, the effectiveness of any ODI approach will be fundamentally influenced by how performance commitment levels are established and linked to cost allowances. To understand, and in turn be able to fully comment on the ODI approach for PR24, we would need visibility of how these elements link together to form the overall risk and reward potential for companies.

Relating to the purpose of ODIs, it would be prudent to consider how national performance objectives, such as commitments to net zero, are incorporated into the regulatory regime. Where there is customer support, these commitments should be considered equally within the approach to incentives at PR24. In addition, it cannot be assumed that ever increasing needs can be absorbed in to observed historic costs.

Bottom-up marginal costs: We support Ofwat's intention of simplifying the ODI rates formula based on marginal benefits and sharing rates. We are however concerned that marginal benefit estimations are being established via an approach not previously used within the industry, namely the centralised customer research.

Asset health: Incentivising asset health performance commitments (PCs) potentially creates an overlap of the customer-facing metrics; asset health metrics are the outputs and customer-facing PCs are the outcomes. This therefore creates the potential for double reward or double penalty for the asset health measure and the associated outcome. Our response to Question 5 sets out a wider approach to considering asset health as well as a potential use of Price Control Deliverables (PCDs) to resolve the overlap between incentives.

Enhanced ODIs: We recognise enhanced ODI rates can impact company behaviour. We agree that an enhanced reward could help incentivise developing innovative approaches. We however caution that enhanced ODIs potentially act to focus attention of companies' performance in one area at the expense of others. We would challenge the view that enhanced rates are the only way to incentivise exceptional performance.

We disagree with the proposal that ODIs are used as funding mechanisms for service improvements as this could further polarise service levels across the industry where customers from some regions have paid for, and receive, vastly different service. Our detailed response to Question 8 and 9 is covered in the appendix.

Additional considerations: The discussion paper provides insight into Ofwat's proposals for common performance commitment (PC) incentives, and it is implied that any ODI rates for bespoke PCs would ideally follow a similar approach. We would appreciate further clarification on Ofwat's expectations for bespoke PC incentives; namely the approach and evidence requirements for bespoke PC ODI rates, and detail of how Ofwat will assess companies approaches.

We mentioned in our response to Ofwat's discussion paper on *Performance commitments for future price reviews*, the need for clarity from Ofwat around the incentivisation of 'how' performance is achieved, though measures such as partnership working. We believe there still to be merit in incentivising how PCs are delivered and would welcome further consideration of this.

We would also appreciate visibility ahead of the draft methodology of the other components of the incentive mechanism used in the price review; that is, the approach for caps, collars and deadbands.

We welcome Ofwat's ongoing engagement with the industry and stakeholders on the approach to ODIs and the overall balance of risk and return at PR24. Should you have any queries regarding any elements of our response, please come back to me.

Yours faithfully,

[redacted]

Head of Regulation
Yorkshire Water
[redacted]

Appendix – Responses to the discussion paper

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

We generally agree with the principal purpose of ODIs to incentivise the delivery of outcomes of greatest importance to customers and the environment, whilst protecting customers from underperformance.

Ofwat however note that ODI rates based on marginal or average costs can also be used as funding mechanisms for service improvements beyond cost allowances, or to return funding to customers where outcomes have not been delivered. We disagree with this; ODIs should be used to reward outperformance and penalise underperformance, not as a funding mechanism to achieve an agreed level of performance. Enhancement and agreed levels of quality related performance should be appropriately funded via the cost allowance, therefore where an enhanced level of performance is achieved, the ODI acts as the compensation for delivering this increased service at the cost-efficient level, i.e., the unit cost allowance is sufficient to deliver the activity.

In section 9.2.4 of Ofwat's 'Creating tomorrow, together' publication, Ofwat discuss the evolution of the outcomes framework to encourage collaboration on key common issues and drive performance across the sector. We mentioned in our response to Ofwat's discussion paper on *Performance commitments for future price reviews*, the need for clarity from Ofwat around the incentivisation of 'how' performance is achieved, through measures such as partnership working. We are concerned that restricting the application for bespoke PCs may discourage value-adding or innovative approaches from being pursued at PR24. We believe there still to be merit in incentivising how PCs are delivered and would welcome further consideration of this. In development of such an approach, there would have to be a fair balance of risk and benefits between customers and the company, and to ensure innovation is engendered through a fair return to companies even where initiatives may not achieve anticipated benefits.

Transparency on the use of the primary customer valuation evidence in calculating ODIs is also important. Performance Commitment Levels (PCLs) and associated ODIs reflect a 'social contract' between a company and its customers on service improvements as well as ensuring customer protection. This social contract is facilitated by Ofwat as the regulator. Customers need certainty that their preferences, revealed through the collaborative ODI rates research, are properly and consistently reflected in the determination of ODI rates.

A further consideration is that there are circumstances where risks outside of a company's control can impact on the quality of service provided to customers. In the current AMP the closure of Tunstall Beach and Storm Arwen have impacted on the achievement of PCLs leading to ODI penalties, despite these events being out with Yorkshire Water's control. Appropriate PC definitions and the use of collars and caps could help to mitigate this risk exposure to companies and customers.

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

We support Ofwat's intention of simplifying the ODI rates formula based on marginal benefits and sharing rates. We accept that marginal costs have been difficult to accurately quantify in the past, with significant variability between companies which cannot be fully explained by differences in customer views or particular company circumstances.

However, whilst Ofwat has proposed removing marginal costs from the ODI rates calculations, we consider that companies may still need to use marginal costs to inform the sharing rates (X_{under} and X_{over}) in the ODI rates formulae. We also would not wish the removal of marginal costs from the ODI calculations to influence, or lead to, their removal from other areas of the price review (e.g., cost assessment), as we still think there is a place for them.

We would like Ofwat to clarify how much companies have influence over the 'X_{under}' and 'X_{over}' rates. For example, would the default position be that they are both equal to 50%, or in favour of customers or companies? Would they be set by Ofwat, or would companies have the opportunity to influence this?

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

The effectiveness of any ODI approach in influencing company decisions, will be fundamentally influenced by how performance commitment levels are set. As an example, an incentivised performance trajectory that sets step change improvement at the start of the AMP could drive short term activities to deliver improvements straight away that may not be best value. A longer-term view of performance, with the correct balance of incentives, would instead drive more sustainable approaches to service delivery.

We discuss the potential overlap between asset health and customer facing incentives in our response to Question 5. Our response to Question 4 presents an argument for how the incentive rates are set in relation to marginal costs and how this in turn will affect companies' decisions for investment in performance areas.

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

Generally, we agree with the use of marginal benefits for customer-facing PCs as this approach links ODI rates with the equivalent value of the impact on customers. However, eliciting benefit values from customers can be influenced by, for example, survey design and wording on the impacts of a service improvement or failure. This means that consideration and care are also required in the processing of data and interpretation of results, especially as the approach used for estimating marginal benefits from the Collaborative Customer Research ODI rates project has not been applied in the water sector before.

We are concerned that marginal benefit estimations are being established via an approach not previously used within the industry, namely the centralised customer research. As expressed via the PR24 Collaborative Customer Research Working Group, several companies including Yorkshire Water are concerned that marginal benefit estimates are being derived using a single research exercise with a method that is previously untested and untried in the water sector. Additionally, we are concerned about the absence of the triangulation of results with other research, when this was previously endorsed and encouraged by Ofwat and CCWater at PR19. The estimation of ODI rates is the 'first step' in determining the overall ODI package, the process of ensuring customer protection and that the incentives work as intended. This means that it is important to make sure that the first step to developing the ODI package is done thoroughly and can withstand scrutiny. If marginal costs are removed from the ODI formulae, then all that is left is marginal benefits. It is therefore important that these marginal benefits are robust and representative.

We understand the rationale for Ofwat to consider alternative approaches to using marginal costs to determine incentive rates due to variances in marginal costs estimated and reported by companies at PR19. Building on our response to Question 2, whilst Ofwat's approach simplifies calculation of ODI rates, we are of the view that the costs to improve performance still need to be considered when setting the 'X_{under}' and 'X_{over}' sharing rates to ensure that incentives work as intended. Excluding cost information in the setting of ODI rates does not align with company decision-making, where both costs and benefits are taken into account. We can see that adjusting the share of marginal benefits in ODI rates to be in line with the company cost sharing rates is one way of ensuring that incentives do not result in perverse outcomes for customers and companies.

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

An overlap is created when asset health PCs are incentivised in addition to the customer-facing metrics; asset health metrics are the outputs and customer-facing PCs are the outcomes. This therefore creates the potential for double reward or double penalty for the asset health measure and the associated outcome. Consideration is therefore needed around how to incentivise asset health without double counting and creating a double exposure to risks for companies and customers.

We understand the need to incentivise asset health correctly to ensure that companies make decisions that have beneficial impacts on operational resilience, customers, and the environment in the long-term. Asset health and operational resilience need to align with long-term strategies and be supported by adaptive planning as well as other long-term commitments such as carbon reduction and other sustainability commitments. To ensure that assets continue to deliver and maximise value to customers, companies, and society over the long-term, issues beyond the performance and costs of physical assets need to be considered. Consideration also needs to be given to the impact of investment decisions on other assets (e.g., natural, social, and human capital). In our Capitals-Based Incentives[1] ideas lab paper, we highlighted the drivers and opportunities for including a wider understanding of value when developing incentives.

As such, we view PCDs as a potential way forward to resolve this overlap. PCDs as outputs that are coupled with PCs as outcomes could help incentivise a company to select the approach that would ensure 'good' asset health but also ensure long-term outcomes for customers and the environment. This will also help companies consider the relationships between and within PCDs and PCs (e.g., with carbon reduction) when selecting the 'best approach'. Saying this, we also appreciate the balance needed for PCDs, especially the magnitude of investment required relative to the need and expected outputs to require a PCD and appropriate controls and protections for companies and customers.

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

We support the use of a top-down approach as an alternative where it is difficult to determine bottom-up marginal benefits.

This approach could also be used to avoid the double count of customer facing, environmental impacts and asset health bottom-up PCs. A bundled approach to allocating incentives across linked performance commitments might be a helpful simplification. The weighting towards customer-facing PCs might, however, need to be considered given that customers may have a greater preference for improved service in these areas over asset health measures.

We would appreciate further detail on the application of a top-down approach in practice, such as how the ODI rates would be calculated.

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

[1] Capitals-Based Incentives. A contribution to the PR24 Future Ideas Lab: https://www.ofwat.gov.uk/wp-content/uploads/2021/07/Yorkshire-Water-submission-%E2%80%93-Capitals-based-incentives-Future-Ideas-Lab.pdf

The relationship between PCs and ODIs needs to be considered; there must a clear rationale (such company-specific customer priorities) for the PCL set at the start of the AMP and throughout the AMP. Performance must also be supported by an appropriate cost allowance, and outperformance appropriately incentivised. Additionally, the final ODI rates and package in the round should link back to customer priorities and valuation to protect current customers and ensure transparency.

Performance increments can also be informed by customers' preferences and allocated across the whole range of performance levels (between cap and collar). The Ofwat and CCWater common PCs and ODI rates collaborative research projects are expected to provide insight into the importance of customer-facing and environmental outcomes and PCs relative to each other. It is not yet clear however if this research will also feed into the determination of PCLs and the implied challenge for companies at PR24. The exclusion of asset health PCs from this research will mean it is not possible to determining whether the performance increments are sufficiently robust and protect customers.

Additionally, performance increments within the five-year period of an AMP need to consider:

1) the long-term targets for some PCs (e.g., leakage, per capita consumption, carbon reduction) and,

2) the associated investment requirements over time, the funding type for the investment (e.g., opex vs capex) and lag of outcomes after investment. For example, overly stretching leakage targets may necessitate a company to invest opex in increased find and fix activities, whereas the most robust long-term solution may be to replace infrastructure assets.

Consideration of these will provide useful information on service and bill impacts on current and future customers.

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?

We have chosen to provide one response to Question 8 and Question 9.

Overall, we do not have a strong preference for the retention, or removal, of enhanced ODIs provided that the PC targets are set at the right level given the totex allowances and each company's specific circumstances.

We recognise that strong enhanced ODIs can have an impact on company behaviour. If designed correctly, the enhanced ODIs can make companies on the cusp of enhanced penalty or enhanced reward focus more on the PC to avoid further deterioration or drive a frontier shift respectively. In this regard we agree that an enhanced reward could help incentivise developing innovative approaches, however the condition for companies to share such knowledge of how such rates were achieved is perhaps idealistic and may not be immediately transferrable to other companies.

There are however a few potential risks of using enhanced ODIs. If, as Ofwat suggests in Section 2 of the discussion paper, ODIs are used as a funding mechanism for service improvements then companies near the frontier are effectively given an additional allowance for improvements. If the frontier (or the upper quartile) is subsequently shifted, it may be unachievable for companies to catch up to the new benchmark at a lower unit rate. This could lead to a polarisation of service levels across the industry where customers from some regions have paid for, and receive, vastly different service.

Another risk is that enhanced rates may have the unintended consequence of focusing company performance in one area at the expense of others, perhaps removing a balanced, sustainable focus of companies across all areas of service. We would challenge the view that enhanced rates are the only way to incentivise exceptional performance. As an alternative to enhanced rates, Ofwat could instead widen (or even remove) caps and collars on standard incentives, assuming correctly set targets. Removing enhanced rates could also help with simplifying the overall package.

Ultimately, we believe that enhanced incentives should only be used where customers express a strong desire for companies to significantly improve performance and for PCs where there is confidence that the targets being set are demonstrably stretching but achievable within the allowed totex.

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

ODIs in the round are considered strongly when making decisions on allocating our investment programme on a tactical basis. Our current and projected performance, and the associated forecasts of penalty and reward, form a key part of the overall analysis on which performance commitments, and ultimately interventions, need to be targeted.

As described in our response to Question 8/9 the proximity of a forecast performance level to an enhanced reward or penalty would give an additional weighting to investment in those PCs when considered against the overall portfolio in the round.

In the cost benefit analysis of an individual scheme (within our decision-making framework) however, we do not consider enhanced penalty and reward as it is usually very difficult to identify which individual solutions move company level performance from one position to another. Our standard 6-capitals approach is used in this instance informed by customer valuations and monetisation of the wider benefits of our solutions.