# Levelling up water company performance

## 1. Summary


- Outcome Delivery Incentives (ODIs) provide a strong incentive to water companies to drive performance for customers. However, they are not generally popular with customers and can lead to bill volatility for customers as under- and outperformance payments are applied to customer bills each year.
- In reducing the funds available to poorer performers and increasing the funds available to the best performers, there is a risk that ODIs drive ever-widening gaps in company performance, which is not in customers' interests.
- The return of underperformance payments to customers through bill rebates is of limited benefit to most customers – for Southern Water an ODI underperformance payment of £1m equates to a bill reduction of around 1p per week for a wastewater customer.
- A more effective use of ODI underperformance payments would be to hypothecate the funds for specific investment in service improvements, with 100% of costs being borne by shareholders.
- Whether underperformance payments are used to return funds to customers through revenue reductions or re-invested outside of the normal cost sharing mechanisms, the impact on shareholders is identical.
- We propose that customers should be given the opportunity to decide whether outperformance payments are returned to them through bill reductions or re-invested in specific projects to drive performance in the failing area of service
- This would not only help to 'level up' company performance, rather than contribute to growing differences, it would give customers a genuine say in shaping the services they receive.


## 2. Background

At PR14 Ofwat fundamentally shifted its approach to the regulation of service levels in the water sector. Where in previous price reviews it had focused on scrutinising hundreds of individual projects and determining an efficient cost allowance for each, at PR14 it shifted its focus to regulating 'outcomes'. Companies were invited to specify the outcomes that they aimed to deliver, based on in-depth consultation with their customers, and the measures by which they would determine whether they had delivered these customer outcomes.

Having determined through this customer research what was most important to their customers, and made promises to their customers about the level of service they would provide for each outcome, companies were asked to back these promises with hard cash. Based on their customers' valuation of improvements, companies could earn financial rewards for beating their targets, but would suffer penalties for failing to meet their promises – so called Outcome Delivery Incentives (ODIs). Thus, customers only paid more if companies delivered more of what they valued; and they would be compensated where companies fell short of what they had promised to deliver. This regime sought to align the interests of customers and companies by providing strong financial incentives to deliver what customers valued most.

For PR14, with a small number of exceptions, ODI rewards and penalties were calculated at the end of the five-year period and applied as an adjustment to revenues in the subsequent five-year period. This meant there was a significant time gap between the services customers received and the financial consequences of that performance.

For the most part the shift to outcomes and ODIs was regarded as a success. While identifying a number of areas for improvement, in its review of PR14[1], Ofwat concluded that *"Companies embraced the outcomes approach, which has the potential to deliver more for less, benefiting customers, the environment, wider society and investors."*

At PR19, Ofwat retained the general approach to outcomes and ODIs but, rather than leaving companies to define their own outcomes and targets, it introduced a core set of common performance commitments, and a general principle that targets should be aligned to the upper quartile of future performance. Rewards would only be earned for performance that was better than upper quartile, and companies falling behind the upper quartile would receive ODI penalties. In addition, it sought to align the timing of performance and the resulting rewards and penalties more closely, by making the latter 'in-period' by default. That is, rather than waiting for the next price review before adjusting revenues, they would be adjusted at the soonest practical time after the performance to which they relate – in effect a two-year lag.

As shown in the table below, evidence from the first year of the PR19 regulatory period (2020-21) suggests that while some companies continue to earn significant ODI rewards, there are a larger number of companies incurring penalties, which will be reflected in revenues and customer bills in the third year of the period (2022-23).

**Table 1. Total ODI payments to be applied in 2022-23 (2017-18 prices)**

| Company | Total ODI payments to be applied in 2022-23 (£m, 2017-18 FYA CPIH prices) |
|---|---:|
| Affinity Water | -5.887 |
| Anglian Water | 11.681 |
| Bristol Water | -1.582 |
| Dŵr Cymru | -4.524 |
| Hafren Dyfrdwy | -0.750 |
| Northumbrian Water | 6.509 |
| Portsmouth Water | 0.473 |
| SES Water | -1.113 |
| Severn Trent Water | 25.276 |
| South East Water | -4.627 |
| South Staffs Water | 1.321 |
| South West Water | -15.444 |
| Southern Water | -45.995 |
| Thames Water | -53.205 |
| United Utilities | 20.533 |
| Wessex Water | 2.523 |
| Yorkshire Water | -2.262 |
| Industry totals | **-67.074** |

Source: Ofwat

[1] Reflections on the price review - learning from PR14, Ofwat, July 2015

For PR24, Ofwat has signalled its intention to retain outcomes and ODIs but with a narrower set of performance commitments, the majority of which will be common to all companies. In addition, it is looking to address significant differences between companies in the penalty and reward rates, commissioning its own research into customer valuations of service improvements.

In general, the shift to outcomes is widely seen as positive for customers. However, the introduction of financial penalties and rewards has not been universally supported. In principle the ODI regime seeks to mimic what would happen in a competitive market; the better performers increase market share and hence returns, and vice versa. In their customer research for PR14 several companies found that in a monopoly market, where they did not have the chance to switch supplier – and hence higher returns came through charging existing customers more, rather than by growing market share - customers were not supportive of the idea. As CCW, the consumer body for water, report[2]: *"…research often shows that many customers do not support the use of ODIs, especially in areas where companies are perceived to be receiving rewards for 'the day job', or for meeting targets for reductions in the numbers of incidents that customers believe should be avoided altogether. For example, avoiding sewer flooding or pollution incidents."*

In addition to concerns about the level of customer acceptability of the principle of ODI rewards and penalties, we think there are a number of specific issues in relation to the application of ODI penalties. We describe some of these challenges below, before presenting a possible solution to, at least partially, address these issues.

# 3. Problems with the current application of ODI penalties to reducing bills

## 3.1 There is a risk that poorly performing companies fall ever further behind their peers

ODIs are designed to reward companies that are performing better than their peers, by giving them more revenue, while penalising the companies that are poorer performers by taking revenue away.

For those companies that are performing well, there is a choice between returning these additional revenues to shareholders or investing further in service improvements, with the prospect of further ODI rewards in future. From a customer perspective, this is no bad thing, as long as performance is not stretched to levels that exceed their willingness to pay for improvements (and most ODI rewards are subject to a cap). Thus, there is the possibility for creating a virtuous circle for these companies. Good performance provides additional funds which can be re-invested with the prospect of further future rewards for beating regulatory targets.

The performance of Severn Trent might be an example of this phenomena[3]. In AMP6 (2015-20) it earned net ODI outperformance payments totalling £150m, more than any other company. In the first year of AMP7 (2020-25) it is also, by some margin the biggest beneficiary of ODI outperformance payments, earning £25m (see Table 1 above).

[2] Lessons learned from the 2019 price review, CCW, October 2020
[3] See, for example, Severn Trent's 2019 Annual Report where it confirmed that "Over the course of the AMP we will re-invest £220m generated by our [cost and ODI] outperformance back into our business."

In contrast, those companies experiencing significant ODI penalties find themselves with lower revenues. The effect of these revenue reductions will be felt principally by shareholders in the form of lower returns, but it will also mean that there are no surplus funds available to invest in keeping up with the better performers. Thus, in a world of comparator-based targets, these companies find themselves falling increasingly behind the best performers and accruing further penalties. The 'leapfrogging' of companies which would be expected in a dynamic competitive environment is lost and performance gaps become entrenched over time.

What the ODI regime should be driving is a 'levelling up' of performance between companies. While the imposition of meaningful financial penalties will undoubtedly act as a spur to improve performance, the rate of improvement they are able to deliver, without surplus funds available for re-investment, is likely to be lower, meaning the poorer performers find themselves falling behind with little prospect of catching up.

## 3.2 The reduction in revenues delivers a largely negligible benefit to customers; but drives bill volatility for those most sensitive to changes in bills

As noted above, for PR19 Ofwat determined that most ODIs should be 'in-period' – the rewards and penalties should be reflected in bills at the earliest practical opportunity. Thus, performance in year one of the regulatory period results in a revenue reduction in year three.

In practice, the benefit to customers in the form of lower bills will often be negligible. For Southern Water, a £1m ODI penalty would result in a bill reduction of just 1p per week for a wastewater customer. Even a much larger penalty of £20m would only reduce customer bills by 20p per week, or just over £10 a year. For most customers that would not be a significant benefit to the household budget. Indeed, many customers are unlikely to even notice, given the normal fluctuations in bills resulting from consumption patterns. And this reduction is for a single year only. Assuming there are no equivalent ODI penalties the following year, bills go back up by the same amount (all else being equal).

This introduces the prospect of a second issue, one of increased bill volatility. While many customers may not notice the changes in their bills resulting from the application of ODI penalties, those customers with tighter household budgets who may struggle to pay their bills are unlikely to welcome additional fluctuations in their water bills. As CCW note in their report of lessons learned from PR19[4] *"Taking into account evidence that customers prefer bills that are stable, in period ODIs have the potential to cause significant bill volatility for customers."*

In setting price controls Ofwat usually take steps ex-ante to smooth bill fluctuations by moving revenues between years. Ex-post this smoothing can be entirely undone by ODI penalties (and rewards) as well as other in-period adjustments within the price control framework.

[4] Ibid



WATER for LIFE from Southern Water

### 3.3 There is a disconnect between the impact of the service failures and the compensation offered

ODIs cover a wide range of service levels, from company-wide environmental targets such as leakage or treatment works compliance, to specific service failures such as water supply interruptions and sewer flooding.

For some ODIs, the impact of missing a target is more generalised. For example, a failure to meet a leakage target will not usually directly impact any customers. In these cases, it may be appropriate to compensate all customers equally through lower bills.

A significant number of ODIs however, relate to specific service failures which impact customers very differently. To take the most extreme case, internal sewer flooding is a very serious and traumatic service failure, but it is also extremely rare, and the number of customers impacted is very small. For example, in 2020-21 of Southern Water's two million wastewater customers just 393 (0.02%) experienced internal sewer flooding. While individual customers are entitled to direct compensation for internal sewer flooding through the Guaranteed Standards Scheme, it seems inexplicable that every customer should also be compensated through an ODI penalty, even though the vast majority will never experience, or even be aware of sewer flooding.

## 4. A possible solution

So, applying ODI penalties to bill reductions in the current way provides little meaningful benefit for most customers and in a very poorly targeted way, while running a risk of creating a widening divide between high-performing companies and others.

A possible alternative to blanket bill reductions would be to hypothecate the ODI penalty funds for specific investment in service improvements, with 100% of costs being borne by shareholders. These investments would need to be demonstrably over and above a company's business-as-usual expenditure and would, ideally, specifically target improvements in the failing service area. So, a penalty incurred for exceeding pollution incident targets would be directed to additional investment in reducing pollution.

Such re-investment would be conditional on customer agreement. If customers preferred to have a bill reduction to investment in service improvements, then that should be respected. However, if their preference was for re-investment to improve future services then that option should be provided for within the regulatory framework.

Going further, customers and stakeholders could even be given choices as to which investments are made using these funds. This way customers would be genuinely involved in decision-making and shaping the services they receive, building trust and legitimacy through genuine participation.

Whether underperformance payments are used to return funds to customers through revenue reductions or re-invested outside of the usual cost sharing mechanisms the impact on shareholders is identical. They experience the same level of 'pain' for the poor performance. The difference is, re-investment provides the opportunity to drive performance and to set new performance benchmarks, while returning funds through bill reductions risks entrenching performance differentials with little benefit to customers.

# 5. Practical considerations

In principle, there seems to be a good case for allowing customers the choice of re-investment or bill reductions. However, there are undoubtedly some practical challenges to overcome. We describe these challenges and possible solutions below.

## 5.1 Ensuring that the investment is genuinely incremental

There is a clear risk that the re-invested ODI penalties simply replace investment that would have been made anyway, meaning there is no additional benefit to customers. What is more, through the operation of the cost sharing incentives, shareholders would not suffer the same penalty as they would if the underperformance payments were used to reduce bills.[5]

We see this as the biggest challenge. However, there are precedents in both the operation of the Ofwat innovation fund and in the Green Recovery funding determinations. In both cases it is necessary for Ofwat to satisfy itself that the proposed expenditure is genuinely incremental.

The onus must be on companies seeking to re-invest ODI underperformance payments to demonstrate that the expenditure is over and above that which they would otherwise incur in the normal course of business. This could be subject to third party assurance and Board sign off. Ofwat would have the opportunity to reject any proposals where it was not satisfied that the proposed investment was genuinely new. For these purposes Ofwat may wish to set out come clear rules for the types of expenditure that could be included, as it did for the innovation fund and Green Recovery examples.

## 5.2 Ensuring that the investment is efficient

One of Ofwat's principal functions at a price review is to ensure that expenditure allowed for in price controls is efficient. It does this via both modelling and examination of specific investment proposals. In the context of a price review this is critical as companies have a theoretical incentive to convince the regulator to allow more funding than is necessary – allowing for subsequent delivery outperformance.

In the context of re-investing ODI underperformance payments it is less clear that this is an issue. Since they will expect to spend all the underperformance payment on service improvements (and to return any surplus) companies have no equivalent incentive to 'over-bid'. It is in their self-interest, as well as that of their customers, to drive as much performance improvement as possible for the available funds. As a backstop, as part of its review of projects under 4.1, Ofwat could of course reject any proposals it felt were clearly poor value for money.

## 5.3 Assurance that the money is spent as intended

It is important that any re-invested funding is spent as intended. It will therefore be essential to have adequate independent assurance of the expenditure. The water sector is well versed in this area, with third party assurance of expenditure being applied to much of our reported data.

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[5] The cost sharing incentives share a proportion of any cost under/overspend with customers. If ODI penalties simply replace business-as-usual expenditure, then shareholders will be better off as they will retain the benefit of the company share of any resulting underspend.

Where less money is spent than is envisaged, there would need to be a mechanism for returning any surplus to customers. This could be done through the annual in-period determination process. Where expenditure is greater than the value of the underperformance payment, this would be for the company to absorb (subject to the usual cost sharing mechanisms).

### 5.4 Oversight of customer research

Customer support for investment instead of bill reductions is critical. If customers prefer bill reductions (no matter how negligible these may be) to investment in service improvements, then that should be respected. With regards to ensuring the robustness of any research, there is an obvious role for CCW, as the customer representative body, to (a) set out criteria for how the research should be undertaken and, (b) be involved in overseeing the conduct of that research. Only if CCW is satisfied that the research findings fairly represent customer views should the re-investment of ODI underperformance payments be considered.

### 5.5 Timing

The current in-period determination process, which determines what adjustments are made to allowed revenues for ODI performance, requires companies to provide information about their performance by 15 July each year. Ofwat then publish draft decisions for consultation with a final decision by 15 November each year, allowing for incorporation in the following year's charges.

We would envisage that the process described above could be run in parallel with this existing process, with companies submitting proposals for investment in lieu of bill reductions alongside submission of their performance data.

## 6. Conclusions

The introduction of ODIs at PR14 has acted as a strong spur for performance improvements. A small number of companies have secured significant increases in their revenues as a result of outperforming their regulatory targets. These companies have the opportunity to re-invest some or all of these additional revenues in driving further performance improvements. This is good for customers as they enjoy the benefit of continuous improvements in service levels.

However, there is a risk that it effectively 'locks in' performance differentials, as those companies that are underperforming find themselves with lower revenues and less ability to invest in service improvements to catch up with the best performers. The leapfrogging of companies which would be expected in a dynamic competitive environment is lost and performance gaps become entrenched over time.

At the same time the benefit to customers is, in many cases, negligible and often not targeted at those customers who have suffered the service failures to which the penalty relates.

We believe customers should have the option to elect to re-invest the underperformance payments in service improvements – at shareholders expense - rather than reducing bills. The impact of this on shareholders is no different from bill reductions. Exactly the same value of penalty is paid, but it breaks what might otherwise become a vicious cycle of underperformance, followed by a reduction in funds available to address the underperformance, followed by more penalties. The result should be a levelling up of performance over time, with benefits accruing to all water customers through the operation of comparative competition.

There are some practical challenges to address, the most challenging of which is to ensure that the investment is genuinely new money and not simply funding projects that would have been completed in the normal course of business. We do not think that is insurmountable and there are relevant regulatory precedents that could be drawn on.