WaterVoice

Exploring views of Outcome Delivery Incentives and their alternatives

Summary Report

October 2020

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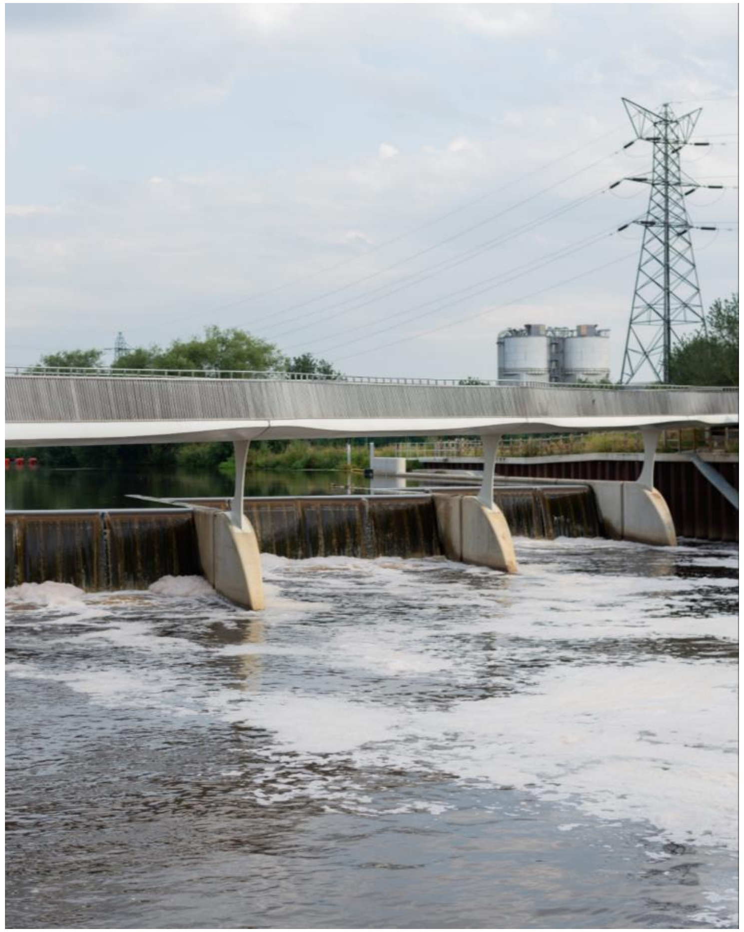
Background

CCW wanted to use the WaterVoice online community of bill payers in England and Wales to explore views of Outcome Delivery Incentives (ODIs). The ODI system is designed to encourage water companies to not only deliver the service levels they have been funded to deliver through customer bills, but to exceed them. CCW also sought to explore what community members think about alternatives to this system.

The research was designed to elicit participants' spontaneous opinions of the broad principle of ODIs, as well as their more considered and informed views. To facilitate this, detailed information and two actual examples were shared with participants in a staged manner, to help explain the ODI system and how it works in practice. Specifically, the research aimed to:

- Gauge participants' **instinctive reactions to ODIs** following an explanation of the concept, including the perceived benefits and drawbacks of this system for customers, water companies and any other parties.
- Understand customers' **detailed and considered views of ODIs** following the presentation of two real examples.
- Explore **reactions to some different incentive mechanisms** as potential alternatives to the current ODI system, and what is driving these views.
- Understand **which of the systems** (ODIs and the alternatives) participants would **most support**, and why.

The findings from this research will help inform CCW's work with the water regulator, Ofwat, in exploring possible developments to the existing ODI system.



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Methodology

Ipsos MORI conducted four online video discussion groups with members of WaterVoice – CCW's online community of water bill payers in England and Wales. The discussion groups were conducted on the 1st and 6th of October 2020.

Each group lasted 90 minutes and involved 4-5 participants. This number of participants is optimal for generating high-quality data, as groups are large enough for creative idea generation which is central to a discussion group approach, while small enough for participants to build rapport with each other remotely and give each individual sufficient 'air time' to contribute.

WaterVoice community members were randomly selected to participate in the groups, using quotas on demographic characteristics (age, gender and tenure) and water company. Groups were mixed (according to these characteristics) in order to hear from a range of customers in each discussion.

Since participants were recruited from the WaterVoice community, they may have seen information in previous research activities which has led them to become more informed; their views may therefore be more considered than those of water bill payers more widely.

This summary report provides the key findings from the research, including factors driving participants' views where this was shared in the groups. A note on the interpretation of qualitative findings and the stimuli used in the discussion groups can be found in the appendix.

Summary findings

Summary findings (1)

Prior knowledge of the system of ODIs was low, though many participants were aware that water and sewerage companies have targets. As such, much of the information presented during the discussion groups was new, and participants considered the benefits and drawbacks of ODIs in detail.

This led to **mixed views of both the current system and the alternatives presented**. While some participants were opposed to ODIs throughout (usually because they objected to the potential for increasing customer bills), some participants oscillated between positive and negative views, pointing to the complexities of a system which delivers rewards and has drawbacks for different parties: customers, water and sewerage companies, Ofwat and shareholders.

Positive views of ODIs focused on:

- the potential financial benefits for customers (such as reduced bills) as well as for water companies (increased profits);
- reassurance that the system challenges water companies to improve and Ofwat holds them to account;
- recognition that some form of incentive to improve performance is necessary in the absence of customers being able to choose their supplier;
- increases in shareholder dividends (with financial benefits for shareholders and more tax paid to the Exchequer), though not everyone agreed this was a positive; and
- recognition that the system can incentivise companies to exceed (and not just meet) targets.

Negative views of ODIs focused on:

- opposition to the principle of increasing customer bills for improved company performance, particularly if a company has moved from ‘poor to average’ and been rewarded, and if individual customers have experienced problems with the service they receive but seen their bills increase;
- concern about the potential for large increases to bills which may be difficult for customers to budget for;
- the relatively small impact on customer bills in the event of a penalty, and the long timescale over which penalties would be ‘paid’ to customers through bill reductions;
- dislike of a system that rewards shareholders, which underpinned some participants’ stronger negative opinions – their preference was for additional revenue to be reinvested in improving services;
- concern that penalising companies financially would reduce their capacity to improve performance in future;
- an expectation that companies would ‘game’ the system – for example by ensuring targets are not exceeded by a large amount, to avoid even more challenging targets being set for the next five year period which may be difficult to achieve (and result in a penalty); and
- frustration at the lack of ability to change water company (when this is possible for business customers) – although this is a feature of the water industry in general and not the system of ODIs, this formed a ‘sticking point’ for some participants and framed their negative views of ODIs throughout the discussions.

Summary findings (2)

Participants suggested that receiving transparent information about the system could **improve their views of ODIs**, including:

- **published information** on water company performance against targets and how this translates to financial rewards and penalties;
- reassurance of the **cap** on the size of rewards; and
- reassurance of the relatively **small percentage increase** which could be applied to customer bills.

There was **no clear preference as to the preferred alternative option:**

- those who preferred a system of penalties and rewards with the additional condition of improved customer satisfaction felt this balances the potential benefits for customers and the company, and is therefore fair, transparent and offers ‘customer inclusivity’;
- those who were more strongly opposed to the principle of rewards (and associated possible increases to customer bills) tended to prefer the options of no rewards (only penalties) or replacing penalties with fines. Many felt that avoiding a penalty or fine would be a powerful enough incentive without the reward;
- suggested alternative incentive mechanisms included published benchmarks on company performance, and a ‘reputational reward’ of awarding accreditations to recognise good and improved company performance.

Detailed findings

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Initial reactions to the principle of ODIs

There was **low prior awareness** among participants about the ODI system of financial rewards and penalties, although some had heard of target setting more generally. After being introduced to the way the system works, **participants shared their immediate reactions** and thoughts:

- Many were **pleased to see such a system** to hold companies to account for their performance, and to ensure performance against targets is measured.
- However, some **opposed the principle of customers paying more** to increase companies' profits, especially in the context of 'average' performance.
- Some argued that companies' motivation to improve may be limited by the **threat of more challenging targets** set in future, and the **long timescale** over which penalties are paid (which may lessen their impact).
- They wondered whether **water companies share information about their targets**, their performance and changes to bills as a result. Some did not recall ever seeing this kind of information from their company, but were keen to. They felt it important that this information is accessible to digitally excluded groups.

Key questions raised by participants before seeing examples:

- Are there caps to the amount customers bills can be increased or decreased?
- Are penalty amounts a token gesture or substantial enough to incentivise companies? How would this impact a typical bill?
- Are customers informed about performance against targets?

I'm pleasantly surprised... It can help [companies] adjust what they fail to do or give them help to improve. Glad there is someone to check on them and see what they've done or need to do."

If the water company is efficient and exceeds their aim then the customer pays the price with increased bills…I'm not very keen – if you were dealing with any other business, you would expect it to do its best anyway. You wouldn't expect to pay more for that privilege."

Maybe they don't want to beat their target too much? If they do something really well, then the following year when they put their expected targets to Ofwat, Ofwat will say 'Well you can do better than that because you did better last year'."

My concern is that you could have a poorly performing water company […] that suddenly increases its performance to an average performance and then charges you more […] You might finish up with higher bills than a company that was doing reasonably well in the first place."

Perceived advantages and drawbacks

What could be the advantages or benefits of this system?

For customers?
- Seen as ‘getting money back’ if a water company has underperformed
- A sense of fairness and inclusion for customers if bills are reduced when a water company underperforms

For water companies?
- Potential to achieve financial rewards
- A motivation to not only achieve, but to improve operations

For anyone else?
- Offers a mechanism for Ofwat to influence companies’ operations and hold them to account
- Shareholders may see dividends increase if targets are met
- Increased shareholder dividends may result in more tax paid to the Exchequer

“*If I did see a reduction (if they hadn't met their target) I would feel included.*”

“*I can see the motivational factor for the company to not only achieve but to improve. But it has to be a fair pricing for the customer as well.*”

Can you see any drawbacks or limitations of this system?

For customers?
- Increased bills if a company meets its targets considered unfair
- Bill reductions may be too small to matter to customers
- Lag time between performance and changes to bills
- Individual customers may have experienced serious problems regardless of overall company performance – a bill reduction may not seem commensurate, and an increase unfair

For water companies?
- Penalties may reduce revenue needed for companies to invest in future improvements, especially if they then lose shareholders

For anyone else/any other parties?
- Concern that failure to exceed targets could lead to job losses at companies, especially among (higher paid) Board members
- Shareholders may see dividends reduce if targets are not met

“*I don’t want my bills to go up if water companies are already making a profit and doing well – [they are] already profiting enough from me.*”

“*If there is a penalty and bills are reduced, why are customers not paid straight away? Why are [water companies] given years to pay?*”

Considering two hypothetical examples: Example A

Example A: The company earned £55 million overall across all its service targets. This added around £2.75 to customers' annual bills.

This example provoked mixed views: some felt strongly that customer bills should never increase to reward companies, while others felt this was reasonable to motivate profit-driven companies, under certain conditions:

- Participants **questioned where the reward money** would go. They hoped some of it would fund investment in infrastructure, tackling climate change, and rewarding company employees at all levels. They **would like to be able to find out** how the reward was used – many were disappointed to learn this usually goes to shareholders, and this shaped their overall views.
- Participants were **concerned about how large the bill increase could be** across 30-40 targets. It was explained that company rewards are capped, and revenue increases beyond this cap would be shared with customers. This was not tangible or reassuring to participants, who **wanted a clear absolute cap on customer bill increases.**
- Some participants were **reassured that Ofwat oversee the process** to ensure targets are sufficiently challenging. Many were sceptical, however, that Ofwat would impose stretching enough targets. A small minority suggested that relationships between water companies and the regulator could be too close for this to work effectively.
- Participants pointed out that **customers directly impacted by a water company fault**, such as sewage flooding their homes, may face a bill increase if the water company has performed well overall. This did not seem fair or balanced, and is unlikely to be deemed acceptable by customers.

> *It'd be nice to have a little breakdown to say 'we've reached our targets but we've got to pay X in the next year to cover staff wages or price of new technology for underground water' if we're gonna pay that extra £2.75, just to know what we're contributing to other than water."*

> *It's respecting that they are a business and ultimately they need to make financial gains from that. I guess as an individual customer you might find that difficult for your personal circumstances but might understand why its happening."*

> *How many members of Ofwat are actually ex-water industry? [... It's] perhaps not as harsh as it could be."*

Considering two hypothetical examples: Example B

Example B: this company incurred a penalty of £279 million overall across all its service targets. This reduced the average customer bill by around £7.80.

Participants held generally more positive views when assessing the example of a reduction in bills (compared with Example A). However, the example generated some questions and concerns:

- The larger change to customer bills in this example led some to **worry that a large increase may also be possible.**
- Some participants suggested that **this penalty seemed very harsh,** and worried about the impact it could have on the company's ability to meet targets during the following five-year period, leading to a 'spiral' of missing targets.
- Some found it difficult to grasp the **significance of this penalty without seeing the profit** made by this company over the same period.
- Despite the high penalty to the company, some participants felt that **the reduction per customer was too small to have a real positive impact** for them.
- Some participants commented that the **system appears very complex and hard to predict or monitor**. They felt that allowing customers to change supplier must be a more straightforward approach to incentivisation than the ODI system, struggling to see how this was not possible.
- Some participants felt strongly that water companies should be motivated to 'do the right thing', and that **customer bills should be linked to company performance**. These opinions tended to be strongly held and did not change after presentation of the examples.

> *I would be concerned if a company overall was ending up paying a penalty figure each year. Either there's something going wrong with the targets or the company's performance."*

> *It's a significant penalty over a period of 5 years. I was just wondering if they are able to show increased performance – in a year or two could that be reviewed again for them or is that fixed?"*

> *It's not too much but that's not really the point… When they wanted to upgrade piping in my area we [already] had to pay towards that. I don't like all of this."*

Overall views of ODIs: support for the system

How supportive are you of having a system of financial rewards and penalties to incentivise companies?

- Overall, there was mixture of support and opposition, and some participants struggled to decide.
- Those who **supported** the system overall believed that in the absence of a competitive market, it would effectively improve company performance by providing an incentive which does not otherwise exist. This would ultimately **benefit both the company and the consumer.** As such, the system seemed **fair and balanced**, even if it could result in increases to customer bills.
- Those who **opposed** the system overall tended to dislike the **principle of potential changes in customer bills**, particularly increases. Many made comparisons to other sectors (not those with monopolies, such as gas and electricity), in which customers are not charged more for an improved service, and some struggled to grasp why choice of company is not possible. This opinion became stronger after learning that rewards are usually delivered to **shareholders** (as opposed to being reinvested in services or new technology, for example). Those who held negative views of the system also **doubted its power as an incentive** for companies to make improvements they would not otherwise make – either because targets are not sufficiently stretching, or because companies will 'game' the system to avoid more challenging targets in the next five year period.
- Some participants suggested they would be supportive **if they received the right information**, particularly on why customer bills were being changed and where increased revenues would go.
- Other factors that shaped participants' overall views over the course of the group were finding out that rewards and penalties could be **capped**, and would be likely to incur relatively **small percentage increases to customer bills.**

"*Without this they wouldn't do anything extra – if they're not being penalised or rewarded they just have no encouragement to improve.*"

"*I think it's terrible that if they're rewarded it all goes to shareholders. I think it should go back to the community.*"

"*These are public limited companies, they have shareholders... the advantage of having this possibility of earning additional revenue is there will be pressure from the shareholders as well as the customer to achieve these targets. A two-pronged approach. I can see why the model will work.*"

Overall views of ODIs: necessity and effectiveness

How much do you think a system of this kind is needed?

- Most participants agreed that the system of targets, rewards and penalties is needed – both to ensure that water companies are **held to account,** and to encourage them to **continuously improve.**
- A small minority struggled to understand the need for such a system as they made comparisons to other part of the utilities sector, where there is **competition** between providers. The wanted to know why choice of provider is possible for business water customers, but not domestic.

And how effective do you think this is likely to be?

- Many of the participants were generally satisfied with their water and sewerage companies overall – as such, they assumed the system *must* be effective as they felt their own company was 'doing a good job'.
- Some pointed out that since the system of incentives has the potential to deliver **financial benefits both to customers** (in the event of penalties, through reduced bills) **and shareholders** (in the event of rewards, through increased revenue), it could be a particularly powerful way to motivate water companies.
- Those who were more sceptical of the effectiveness of the system suggested targets and rewards are a **less powerful incentive than fines.**
- Some participants thought that it would be more effective for **rewards to be shared among direct employees** of water companies (as opposed to shareholders) since this would provide incentives to improve the day-to-day running of the company.

"*Every organisation has to have targets, it doesn't matter what area you work in. I can understand it from that point of view.*"

"*If they've got these checks and balances to work against, it's a road map for them to work against.*"

"*I don't like this idea at all but I can see it might be the best solution at the moment – but still think should be able to change supplier.*"

"*Without this they wouldn't do anything extra – if they're not being penalised or rewarded they just have no encouragement to improve.*"

"*Does [the] employee get a bonus? If it goes to employees directly, that would be more of an incentive, rather than shareholders. Employees are the ones doing the work.*"

Considering alternatives to ODIs

Blue option: No rewards for companies, only penalties

Customer bills are reduced and companies penalised if service levels are not met, but there is no increase in bills if target service levels are exceeded.

- Good for customers that bills cannot be increased via rewards
- Bad for companies losing revenue
- Concern that there would be no motivation to exceed targets, though some thought the risk of penalties would be enough of an incentive
- Would prices increase even with this system, or be frozen?

"In the short term as a customer I'd be happy that there would be nothing added to my bill but in the long term, there's less incentive for the water company to do well so it might result in a worse service."

Yellow option: Replace penalties and rewards system with fines

Performance against targets does not impact bills, but companies are fined if they miss targets. The size of the fine could be larger than a reward or a penalty. The revenue from fines either goes to the Treasury, or is re-invested in services depending on Ofwat's view.

- Significant fines will incentivise water companies to avoid poor performance
- Concern that the cost of fines could difficult for companies to afford
- Positive for customers that their bills are unaffected, but concern that the cost of a fine could in fact be passed on to customers via bills
- Good that fine money could be reinvested in services, but concerns about it going to the Treasury instead

"If the company's performing badly they get a significant fine and it won't affect customer bills and hopefully they'll improve the service."

Green option: Penalties and rewards, but with additional conditions

Customer bills are increased and companies rewarded only if customer satisfaction has also improved and complaints have fallen, in addition to meeting/ exceeding targets. Companies can still incur penalties, regardless of customer satisfaction.

- Positive that the customer voice is considered, not just targets
- Concern that people tend to contact companies with complaints and not praise, so results could be unfair to companies.
- How would satisfaction and complaints be measured? Complaints to the water company, or to Ofwat?
- Concern that high customer satisfaction would mean higher bills

"Like the idea of asking the customers, but would have to ask all customers since people don't necessarily look at the positives of companies – they tend to complain."

Overall preferences and reflections on alternatives to ODIs

- Overall there was **no clear consensus as to which was the preferred alternative** (or whether the existing system is best).
- Those choosing the **green** option did so because they felt it was important to have a system that is '**fair**' (to companies and customers) and therefore one which **balances** the potential benefits for both parties. **Customer 'inclusivity'** and **transparency** were also important themes that framed their views throughout, meaning the customer satisfaction element of this option appealed to them.
- Those who preferred the **blue** option were **strongly opposed to customer bill increases** as an incentive mechanism, and because of this, many also chose the **yellow** option as a joint 'winner'. Their discussion of alternatives also centred on the argument that **water companies should not be rewarded for what they are contracted to do**, even if the targets they have are challenging.
- Similarly, those that chose the **yellow** option did so because they believed **customer bills should not be affected** by rewards or penalties for water companies. While some could see the value of having an incentive to improve which is not limited to penalties, others felt that the threat of a fine was sufficient. Some even felt that the **severity of a fine would be a more effective way of incentivising** good performance from water companies than a change in revenue.
- Publishing **benchmarks** of companies' performance against targets, and creating **accreditations** to reward good performance, were also suggested as alternatives.
- When asked to reflect on the discussion as a whole, several participants explained they had been **surprised to learn that customer bills could be increased** via this system, and some said this had **made them more cynical** about water companies with profit-seeking motives.

"***Green** – because it's as fair a system as you're going to get at the moment. For both customers and company, they have to get their target and provide the right service to the customers and otherwise they incur a penalty."*

"***Green** option – you've got to include customers into those decisions, you've got to take them into account."*

"***[Blue]** – you should never be rewarded for doing what you should have been doing in the first place."*

"*I would go with **yellow** because customer bills are not increased. I don't agree that if rewards are given to a company they increase bills. I still think a bit of incentive to make companies perform better might help, but it shouldn't affect customer bills at all."*

"***[Yellow]** – it'll keep them on their toes knowing that there's a fine hanging over their head – that's an incentive, potentially a better incentive than being able to change how much revenue they get."*

Appendix

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A note on interpretation of qualitative findings

When considering these findings, it is important to bear in mind what qualitative research provides:

- It allows attitudes and opinions of participants to be explored in detail.
- It provides an insight into the key factors and conditions that may be shaping participants' views.
- It allows participants to consider perspectives beyond their immediate experience.

Qualitative findings are descriptive and illustrative, not statistically representative. Messages communicated in this report are based on the themes across the different discussion groups.

Qualitative research also explores the range of participants' views, rather than measuring how many participants hold each view. It is not possible to quantify findings or suggest they represent the distribution of attitudes among water bill payers overall.

Participants were recruited from the WaterVoice community, meaning they may have seen information in previous research activities which has led them to become more informed; their views may therefore be more considered than water bill payers more widely.

Stimuli 1: Information provided to participants about ODIs

- Water customers cannot choose or switch supplier.
- Each water company sets a 5-year business plan which includes targets for service levels, such as:
  - reducing disruption to water supplies,
  - reducing leakage,
  - helping customers reduce their own water consumption,
  - reducing the number of properties at risk from flooding from overloaded sewers,
  - reducing the number of properties that receive low water pressure,
  - reducing greenhouse gases from operational activities.
- Companies consult with their customers on their business plans, and Ofwat checks and challenges them.

Stimuli 2: Information provided to participants about ODIs

- Water companies report to Ofwat each year on how they have performed against their service targets.
- Ofwat monitors how each company performs against its targets.
- For service targets that are exceeded, water companies can increase their customers’ bills and make more revenue.
- Failing to meet a target means companies must reduce their customer bills (and revenue falls).
- Exceeding some targets and failing others may mean any financial rewards companies achieve could be offset by penalties.

Stimuli 3: Example: Company A: Leakage

- Company A has targets to reduce leakage to the following amounts:

Year	2020/21	2021/22	2022/23	2023/24	2024/25
Target volume of leakage in Ml/d	418.2	411.8	399.9	379.6	363.5

- For each megalitre per day (Ml/day) that Company A out-performs or under-performs against these targets, it will earn a reward or pay a penalty of £0.325 million.
- This equates to around +/-£0.09 on customers' annual bills for each Ml/d that Company A's leakage volume is away from the target.

How did service performance over 2015-20 affect 2020-25 bills?

Across **all** of its service targets, Company A earned £55 million in rewards for 2015-20. This added around £2.75 to the average yearly household water bill.

Stimuli 4: Example: Company B – Sewer flooding

- Company B has a target to reduce sewage flooding to the following amounts:

Year	2020/21	2021/22	2022/23	2023/24	2024/25
Approx. number of households flooded	1,018	1,000	979	901	847

- For every 10 properties flooded above or below these targets, Company B will earn a reward or pay a penalty of £0.27 million.
- This equates to around +/-£0.04 on customers' annual bills for every 10 properties that Company B is away from the target.

How did overall performance in 2015-20 affect 2020-25 bills?

Across **all** of its service targets, Company B paid a penalty of £279m for 2015-20. This reduced the average yearly household water and sewerage bill by around £7.80.

Stimuli 5: Considering alternatives to the current system

No rewards for companies, only penalties

Customer bills are reduced and companies penalised if service levels are not met, but there is no increase in bills if target service levels are exceeded.

Penalties and rewards, but with additional conditions

Customer bills are increased and companies rewarded only if customer satisfaction has also improved and complaints have fallen, in addition to meeting/ exceeding targets. Companies can still incur penalties, regardless of customer satisfaction.

Replace penalties and rewards system with fines

Performance against service targets has no impact on customer bills at all, but companies are fined if they do not meet or exceed targets for service levels. The size of the fine could potentially be larger than a reward or a penalty. The revenue from fines either goes to Treasury, or is re-invested in services depending on Ofwat's view.

… Any other options?

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