CCW's response to Consultation:

PR24 and beyond: a discussion paper on outcome delivery incentives

CCW Response **March 2022**

1. Introduction

1.1 CCW is the statutory consumer organisation representing water and sewerage consumers in England and Wales.

1.2 We welcome the opportunity to respond to Ofwat's consultation. We agree that it is sensible that if companies are suggesting bespoke ODIs that they have regard to Ofwat's thinking around ODI rates for common PCs. Ofwat is right to recognise dependencies for other area of ODIs that do not feature in the consultation paper such as caps, collars, sharing rates, etc.

2. Our response

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

The sole reason for ODIs at PR24 should be to incentivise companies to deliver those areas of service/performance that matter most to their customers. In addition, both companies and Ofwat should be able to clearly evidence that the ODIs reflect customer priorities and that they have customer support. However, it is also important that the regime be appropriately calibrated so customers are protected from significant rewards and are protected from failure to deliver.

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

It would be useful to understand the materiality of the change were this to be applied, retrospectively, to the ODIs in place at PR19. Would this have made any difference to the rewards or penalties that companies, and subsequently customers, could expect?

If Ofwat were to pursue an ODI regime where rewards and penalties are predicated on marginal benefit alone we think that there is a definite need to take account of totex sharing rates. As the consultation sets out, the downside for customers of a calculation that is based on 100% of the marginal benefit means that customers could pay over the odds through the ODI and the totex sharing mechanism.

We think there is merit in considering different sharing rates for out and underperformance for the reasons outlined in the paper. From the customer perspective, it may be that the value they attach to failure is significantly higher than it is for performance in excess of target e.g. for sewer flooding.

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

It is unclear how the output of the collaborative research into ODI rates would be used to inform this approach. When the collaborative research results are available and the econometric modelling has been completed, we would welcome Ofwat updating/consulting further on how the outputs of the collaborative research have been taken into account.

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

See response at question 2.

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

As the consultation paper makes clear, there were concerns that companies may not put sufficient weight on the long-term consequences of poor asset health. As a result, Ofwat felt it necessary to directly incentivise asset health through more short-term PCs at PR19. We agree with the continuation of asset health PCs. The joint Ofwat/CCW collaborative qualitative research on common PCs shows that customers view resilience of service delivery as a priority.

Asset health PCs should demonstrate whether a company's stewardship of its assets is adequate and levels of resilience are sufficient. The PCs ought to be consistent measures that track the risk of water and wastewater asset failure to customers, and the level of security and resilience in the service customers receive.

While technical in nature, consideration should be given to how to present these measures in a way that is understandable and meaningful to customers, as it will be important that customers can see clearly how the company's assets are delivering the service they expect, and where companies need to improve. While it may be that the measures companies use to track resilience are technical, it may be appropriate to translate these into a narrative that works for customers.

With regard to ODIs for asset health PCs, the consultation paper references our Blue Marble research which suggests that areas requiring technical expertise may not lend itself to customer engagement. For this reason we are not persuaded that direct customer valuation of asset health will elicit a meaningful response.

We would support a standardised industry approach to quantifying the probability of an asset failure leading to a customer-facing service incident in future price reviews.

We would not support an ODI regime on asset health that incentivised sub-optimal investment where there are diminishing marginal benefits. As Ofwat identifies the ODI rates would need to be calibrated with penalties higher than rewards or no rewards for outcomes subject to diminishing marginal benefits.

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

A top down approach has advantages where there are difficulties in determining customer willingness to pay and/or marginal cost estimates. It is also likely to be simpler conceptually than willingness to pay. As the consultation paper sets out, the difficulties with a top-down approach are determining the appropriate performance increment, variation between companies' reward/penalties as this would be tied in to regulated equity and risk that penalties/rewards do not match willingness to pay.

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

The consultation paper outlines a number of approaches to determining the performance increments and identifies associated problems including that ODI rates do not reflect customer impacts, divergent rates between companies in view of top-down allocation dictated by regulatory equity etc. We would expect the performance increments to be determined using the collaborative research on ODI rates.

Some calibration between individual annual PC targets and the ODI rates may be necessary. For example, a comparatively poor company could have lower ODI rewards attached to its annual targets over the period in which it aims to get on parity with 'average' companies, and then it gets a greater level of reward for achieving targets that push it into the upper tier or beyond. However, there would need to be evidence that customers find this acceptable.

One complication is if good performance is driven by factors outside a company's control e.g. sewer flooding performance is good because of lower rainfall. Ofwat should consider ODIs where external factors are a strong influence being 'end of period'. Customers should not pay rewards when the company have not needed to take actions to the extent expected simply because other factors have worked in their favour.

We think that it is imperative that an approach using performance increments is played back to customers to show them how their valuations have been used to inform the approach to the ODI design.

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

We recognise the enhanced ODIs aim to incentivise companies to improve performance beyond the best level currently achieved by any company. This then moves the bar for other companies to achieve upper quartile performance.

The consultation paper references the outcomes working group where companies provided 'limited examples of how [enhanced ODIs] had led to them targeting high levels of performance'. If there is no evidence that enhanced ODIs have led to such changes in targeting of performance then we would suggest that there is no clear-cut case for them to be continued as part of the regulatory toolkit.

We have some concerns about the overlap of enhanced ODIs with other regulatory mechanisms should customers effectively end up paying twice for the same outcome e.g. the innovation fund and enhanced ODIs.

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

If enhanced ODIs do form part of the regulatory toolkit at PR24 we think there is merit in extending those ODIs to all companies rather than for those companies that have specifically requested them in business plans. Whilst it may be the latter type of company that has a higher likelihood of achieving frontier performance, this would give all companies that same opportunity. A potential consequence of this, however, is to introduce a disjoint between customer preparedness to pay for enhanced performance and the level of that performance.

With regard to the possibility of setting enhanced ODIs for more performance commitments where the data is sufficiently good to set stretching enhanced thresholds, we have some concerns. We think that enhanced ODIs should not exist unless there is clear evidence of customer willingness to pay for that level of performance regardless of the perceived benefits for the industry as a whole.

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

Whilst noting that this is directed at water companies the consultation paper is quite clear whilst companies generally support ODIs, they provided limited examples of how they had led to them targeting high levels of performance. As discussed at question 8 if companies are unable to evidence this then there is not a clear cut case for the continuation of enhanced ODIs.

Enquiries

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