



OUTCOME DELIVERY INCENTIVES

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1. INTRODUCTION AND SUMMARY

Outcome Delivery Incentives (ODIs) were introduced by Ofwat at PR14, and marked a break from the previous approach to service delivery. This had previously been predominantly based on setting a target level for outputs, with penalties for failure to deliver. The framework was changed to move away from delivery of specific outputs to increase focus on what matters for customers and the environment. This included introduction of ODIs, with potential for additional payments for outperformance as well as penalties for underperformance.

This report sets out how ODIs have benefited customers and the environment, and how we consider they should be developed in future in order to provide continuing benefits. We are grateful for comments received from Severn Trent Water on the paper, but the views expressed here are those of Fast Track Squared.

We estimate that ODIs have delivered net benefits of between £850m and £1.3bn to customers and the environment over the six-year period to 2020-21 . This is equivalent to £32-£54 per customer. Gross rewards for the industry during that period have been £30m, which is only just over £1 per customer, and if we consider the cost involved in delivering the improvements in service then the net value would be far lower.

Ofwat's proposals to retain the ODI framework at PR24 are critical to continuing to deliver benefits for customers and the environment going forward. However, the limitation on proposing new ODIs (such as repeat sewer flooding measures or catchment management) at PR24 could reduce the extent to which innovation is encouraged and companies are incentivised to provide further service improvements, particularly where it helps worst served customers or the environment. This could limit net benefit from customer improvements by £270m over the five years to 2030.

The potential for a missed opportunity was highlighted in several responses to Ofwat's PR24 consultation – for example Sustainability First noted:



We have some concerns that the regulator's upfront stated quest for fewer bespoke commitments, combined with its desire for greater regulatory simplicity, and comparability could discourage company-level engagement and innovation and lead to consumer / community needs and wants in practice not being heard or met. Or alternatively innovative bespoke proposals that companies develop with and in response to stakeholder needs / wants will be rejected as they are deemed too numerous.¹



A move towards centrally planning most ODIs may diminish the potential future benefits to customers. In this report we show that a key aspect of the ODI regime to date has been the way that companies have been able to propose new measures and to test these in practice. Successful measures that started as bespoke ODIs for one company have been adopted by others or as common standards for the industry. But Ofwat has now suggested² that companies should only propose new ODIs for circumstances that are unique to them or in areas where their performance is poor. If this approach is followed, it is very unlikely that there will be any innovation that could be adopted by other companies. This would be to the detriment of customers, who would see less improvement.

We have set out below:

- The benefits of ODIs (Section 2).
- How common Performance Commitments (PCs) and ODIs have delivered improvements (Section 3).
- The benefits from bespoke PCs and ODIs (Section 4).
- The value delivered from ODIs (Section 5).
- Analysis of returns earned from ODIs (Section 6).
- Potential improvements to the ODI framework (Section 7).

Our report shows that ODIs have been effective in delivering improvements, encouraged innovation, and have resulted in reasonable returns for companies. There is scope for further development at PR24 but there is also a risk of undermining the benefits that have been achieved.

¹ Sustainability First Consultation Response to PR24 and Beyond: Creating tomorrow Together, July 2021.

² PR24 and beyond: Performance commitments for future price reviews, Ofwat, November 2021.

2. THE BENEFITS OF ODIS

ODIs were introduced by Ofwat at PR14 to increase focus on delivery of the right outcomes for customers and the environment. Ofwat said in its methodology that: “Our view is that companies should be incentivised to meet the needs and aspirations of their customers – and incentives that reflect value are the best way to do this”.³

Ofwat and some companies had argued that the pre-ODIs regulatory framework was encouraging excessive risk aversion and discouraging innovation. For example, Severn Trent, in its publication “Changing Course”, argued that:



The current regulatory regime is not able to incentivise innovation adequately due to:

- An imbalance between rewards and penalties. Companies perceive that the risk of being penalised for service failure is too great to take the risk necessary to innovate...⁴



The introduction of ODIs has addressed this issue. ODIs have provided clear benefits to customers and the environment. The benefits include:

- An incentive to companies similar to that in a competitive market – companies that provide good service earn a higher return, while companies that provide a poor service earn lower returns.
- Clear incentives, with companies’ PC performance and ODI position reported annually, providing a spur to all companies to improve to meet the performance of the best.
- Encouraging a move away from focusing on cost savings against Ofwat’s price determinations to delivering improvements which customers value.
- Discouraging risk aversion – previously companies concentrated on ensuring that they delivered what was required but not trying to achieve better than the minimum.
- Ensuring that where service delivery has fallen short, customers are compensated.
- Encouraging companies to identify wider social and environmental benefits which they can deliver.

³ Setting price controls for 2015-20 – final methodology and expectations for companies’ business plans, Ofwat, July 2013.

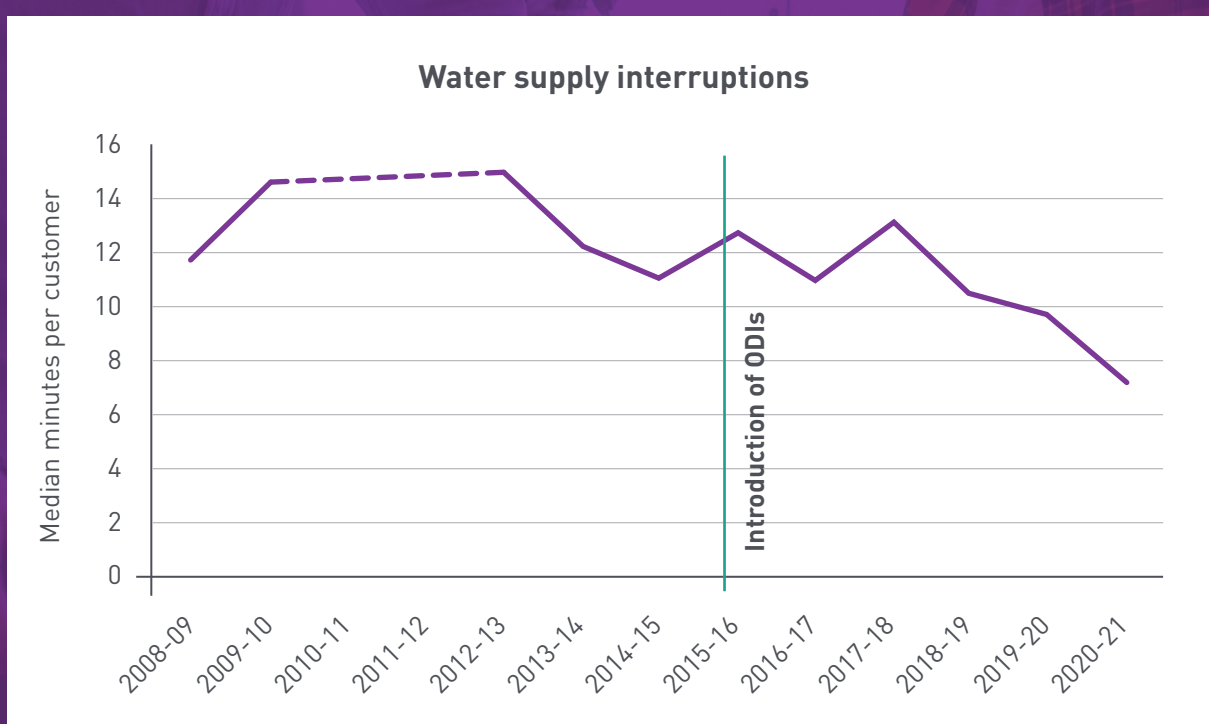
⁴ Changing Course: Delivering a sustainable future for the water industry in England and Wales, Severn Trent Water, April 2010.

3. DELIVERY OF IMPROVEMENTS THROUGH COMMON PCS

We recognise that delivery of core aspects of water and wastewater service should be covered by common PCs. This enables company performance and targets to be compared. Therefore we welcome the increase in the number of common PCs for PR24.

The ODIs for common PCs have led to improved performance on key service measures, sometimes on aspects of service performance where improvements were not previously being achieved. In the past an Overall Performance Assessment was used to incentivise improved performance, but this was discontinued after 2009-10 - it was considered at the time that performance was converging and there might be little scope for further improvement. The new Service Incentive Mechanism therefore focused on qualitative aspects of customer service delivery, reducing the weighting towards older quantitative measures at successive reviews. The introduction of clearer and stronger incentives from 2015-16 onwards, through ODIs, has demonstrated that there was still scope for improved performance, with the right incentives.

The steady improvement (with year-to-year fluctuations caused largely by weather variations) is illustrated below for water supply interruptions. There was no clear trend up to 2015, with the level in 2014-15 similar to 2008-09. Since then there has been continuing improvement, although the cold weather with the “Beast from the East” in 2017-18 caused a temporary increase.



4. THE BENEFITS OF BESPOKE PCS

As noted in Section 2 above, ODIs have provided incentives similar to those in a competitive market. Rather than what is to be delivered and how service delivery is measured being centrally determined, bespoke ODIs enable companies to establish what matters to customers.

Companies can develop new aspects of service delivery as bespoke ODIs, and develop new ways of measuring the benefits to customers. This allows for innovation in service and in measurement of benefits. Where these ODIs would be of clear benefit to customers nationally they can subsequently be converted to common PCs. The use of bespoke ODIs allows for much more experimentation in what works well to measure benefits, and what should be delivered, than is possible with a centrally-determined approach. Ofwat noted in its review of lessons from PR19 that bespoke PCs “could have a role in developing future common performance commitments”⁵.

These bespoke ODIs have:

- Encouraged innovation in defining aspects of service which customers value but companies had not previously targeted.
- Encouraged innovation in measurement to ensure that PCs reflect what matters to customers.
- Delivered wider social value, e.g. on community education and recreational opportunities.
- Delivered environmental benefits beyond the environmental programme requirements, e.g. through catchment management.
- Enabled different ways of measuring performance to be tested, which can lead subsequently to introduction of common PCs.

Ofwat has proposed⁶ for PR24 that it is appropriate to implement bespoke ODIs where:

- A company has a local circumstance that does not apply to most companies; or
- A company provides poor service on a common issue where other companies’ performance is such that it is not a priority for their customers.

⁵ PR24 and beyond: Our reflections on lessons learnt from PR19, Ofwat, December 2020.

⁶ PR24 and beyond: Performance commitments for future price reviews, Ofwat, November 2021.

These limited circumstances for implementation of bespoke ODIs would reduce the extent to which ODIs will promote innovation and delivery of wider social value. Ofwat has suggested that companies should “seek to create further social and environmental value in the course of delivering their core services, beyond the minimum required to meet statutory obligations”⁷. Reducing the scope for bespoke ODIs will work against this objective. We have set out in Section 5 below how much value might be lost from reducing the scope for bespoke ODIs.

Although new common ODIs are being introduced at PR24, these are for aspects of service where a number of companies have already implemented bespoke ODIs. Going forward, the restriction on bespoke ODIs could prevent individual companies introducing ODIs for new aspects of service and new ways of measuring what matters to customers. Under these criteria, it is very unlikely that a company could bring forward any new ODI that could be adopted by the rest of the industry.

A number of consultation responses questioned Ofwat’s approach to bespoke PCs. We have set out some of the comments below. We highlighted Sustainability First’s response in the introduction, and several other respondents made similar points. For example, Jacobs’ response had similar concerns about bespoke PCs:



Moving away from bespoke PCs presents a risk that genuine differences between companies are not fully reflected. Customer preferences may not be represented. There may be potential for better performing companies to be given greater freedom on setting bespoke PCs.⁸



Anglian Water’s response stated that:



We believe there remains an important place for bespoke performance commitments in the PR24 framework and would expect to see these deployed more frequently than by exception. Ofwat should consider the scope for regional priorities... to be reflected in its criteria for bespoke performance commitments. Similarly, there could be localised issues within company areas that an industry-wide performance commitment may not capture... We also believe that bespoke commitments can play an important role in ensuring that all companies face a balanced, well calibrated outcome delivery incentive (ODI) risk and return position.⁹



⁷ Ofwat’s Final Public Value Principles, March 2022.

⁸ PR24 and Beyond: Creating tomorrow together – Jacobs’ consultation response, July 2021.

⁹ PR24 and beyond: Performance commitments for future price reviews, Anglian Water consultation response, January 2022.

4. THE BENEFITS OF BESPOKE PCS cont.

As pointed out in Anglian's response, reducing the number of bespoke ODIs could affect the risk-return balance. If ODIs become biased towards penalties, then there will need to be an adjustment to the allowed rate of return to deliver the right overall return.

Bespoke ODIs have been implemented in areas where measurement is not always straightforward, such as sewer flooding, biodiversity and resilience. We have set out below examples of bespoke ODIs which have enabled delivery of additional benefits to customers and the environment, and allowed testing of different ways of measuring delivery.

BENEFITS OF BESPOKE ODIS – REPEAT FLOODING

There has been a concern that ODIs based solely on sewer flooding incidents have led to a concentration on dealing with flooding caused by blockages. Hydraulic sewer flooding, causing repeat flooding because of lack of sewer capacity, often requires significant capital expenditure to resolve the problem. However, the risk of repeat flooding is a significant problem for customers and customer research – for example, research by Severn Trent and United Utilities shows that it should be given a higher priority than one-off flooding incidents.

Measuring delivery and setting incentive rates is not straightforward because the frequency of such flooding varies with rainfall, schemes take time to implement, and the benefits to customers continue over the life of the increase in capacity. This makes it difficult to measure delivery of improvements within a five-year period. PCs introduced by companies at PR19 to address the problem include:

- Repeat flooding incidents.
- Risk of repeat flooding.
- Number of hydraulic problems addressed.

Bespoke ODIs allow different measurement approaches to be tested and, if appropriate, a common PC could be introduced at a later stage.



BENEFITS OF BESPOKE ODIS – CATCHMENT MANAGEMENT AND BIODIVERSITY

Five companies have financial ODIs for catchment management, and twelve for biodiversity. Catchment management can deliver raw water quality and river quality improvements, while also providing wider environmental benefits and a better carbon impact. It often takes longer than a five-year period for the water quality and environmental benefits to be achieved. ODIs therefore need to be based on some measure other than water quality. Similarly, measurable impacts on biodiversity take some time. Measures used have included:

- For catchment management, number of farmers changing their activities.
- For biodiversity, land achieving a certain standard of management.
- Area of land managed to deliver improvements.

The various measures used will inform the decision on a potential biodiversity common PC at PR24, and demonstrate the benefits of bespoke ODIs. They have led to faster introduction of beneficial activities than would have happened if only common PCs had been permitted, and have enabled testing of different measures before deciding on a common PC.

Although there may be a common PC for biodiversity at PR24, we feel that there will still be some benefit from bespoke ODIs relating to catchment management. Ofwat is proposing that companies should not have catchment management PCs at PR24, as this would duplicate incentives on biodiversity and carbon. We recognise that there is some overlap but these benefits are a by-product rather than the main objective for water companies – the activity delivers a wide range of benefits which will not be fully covered by other ODIs. We consider that, providing overlaps are addressed, bespoke ODIs on catchment management will still be valid.

5. VALUE DELIVERED

Both common and bespoke PCs have delivered significant improvements for customers and the environment. We have estimated the value of these benefits delivered, net of ODI payments made. Issues in estimating these values include:

- What would the trend in service performance have been without ODIs?
- How long does the service improvement continue?
- How much have costs increased to finance improvements, and how much of this is paid for by customers?
- What has the trend been in service performance (bearing in mind that definitions have not always remained the same, and the adoption of private sewers caused some discontinuity)?

In view of these uncertainties, we have estimated a range for the value of ODIs – this is substantial even at the lower end of the range. For the top end of the range we have valued all the service improvement, less ODI payments, and made no allowance for increased costs. For the bottom end of the range, we have assumed:

- Some improvement in service would have happened anyway, based on trends pre-ODIs.
- That there was some increase in costs, which would be partly paid for by customers. We have allowed for costs averaging 25% of the incentive rate being borne by customers, on the basis that customers only bear half the additional costs, and in many cases improvements are delivered through organisational changes rather than additional costs.

This analysis values ODIs with both outperformance and underperformance payments, and excludes asset health measures and ODIs which relate to delivery of specific projects and programmes. As a result of these exclusions, it is an underestimate of total value.

National average ODI reward rates are used to value improvements for common and comparable measures. For other bespoke ODIs companies' incentive rates are used.

For example, for interruptions to water supply:

- The improvement in average minutes interruptions by 2020-21 from the base pre-ODIs is 6.3 minutes.
- Multiplying this by the national valuation (derived from companies' incentive rates) of £18.2m per minute gives a 2020-21 gross value of £115m.
- Allowing for additional costs and for some improvement occurring without ODIs gives a lower range figure of £78m.

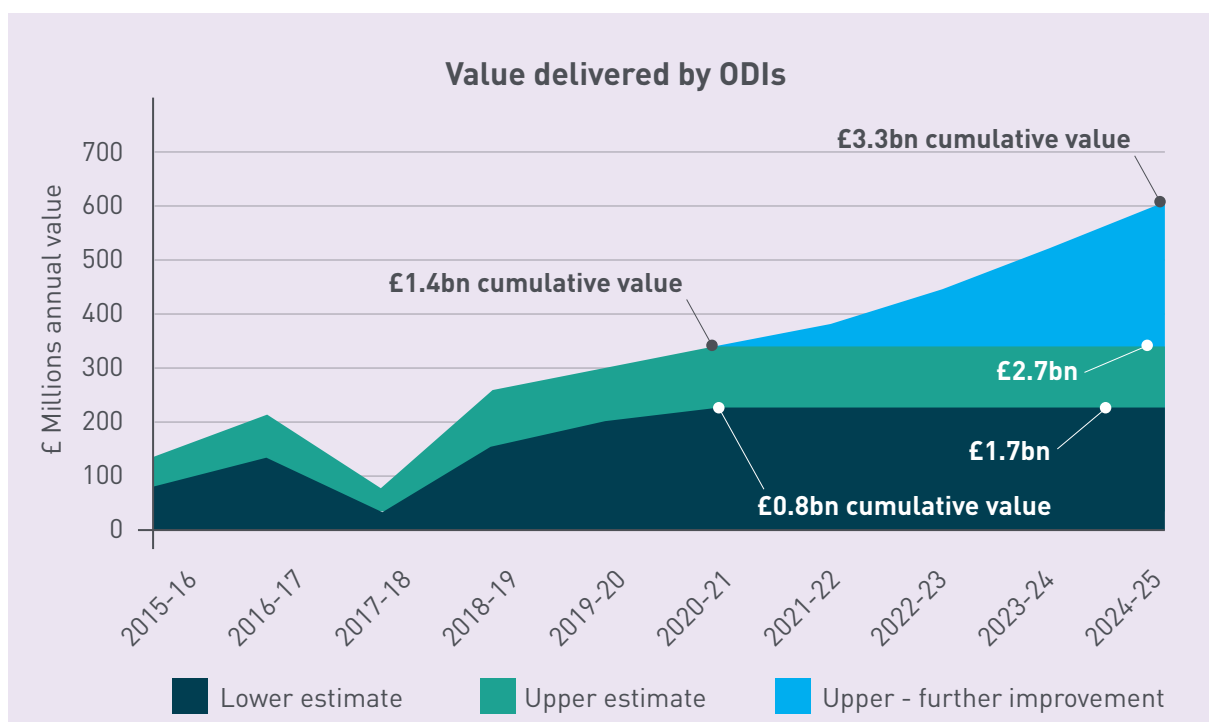
The results are summarised below:

	Upper value	Lower Value
2020-21 annual value (£m)	346	227
Cumulative 2015-16 to 2020-21 value (£m)	1,360	849
2020-21 value - £ per customer	£13.10	£8.60
Cumulative value - £ per customer	£51.40	£32.10

Even at the bottom of the range, ODIs have added substantial value for customers and the environment. Without attributing any further performance improvement beyond that achieved in 2020-21 to ODIs, the total benefit per customer will be around £70 to £100 per customer by the end of AMP7. The benefit per five-year period would be £1.1bn to £1.7bn, continuing as long as improvements already achieved are sustained.

5. VALUE DELIVERED cont.

The graph below shows annual and cumulative benefits from ODIs, and shows how the annual value could continue to increase if performance from 2020-21 to 2024-25 improves at the same rate as projected in Ofwat's PR19 targets.



We have also assessed how much value could be lost if bespoke ODIs were to be largely eliminated. We have calculated this by assessing the value of bespoke ODIs which, on the basis of Ofwat's current proposals, might no longer be accepted at PR24. The calculation therefore excludes bespoke ODIs which will be replaced by common ODIs, such as biodiversity. Bespoke ODIs relating to delivery of specific projects and to asset health are also excluded. We have taken into account actual performance on these ODIs in 2020-21 and the targets for 2021-22 to 2024-25. We have made allowance for some increase in costs to deliver the improved performance and netted off ODI payments.

The calculations show the benefits lost from these bespoke ODIs total £270m over a five-year period.

6. HAVE COMPANIES EARNED EXCESSIVE RETURNS?

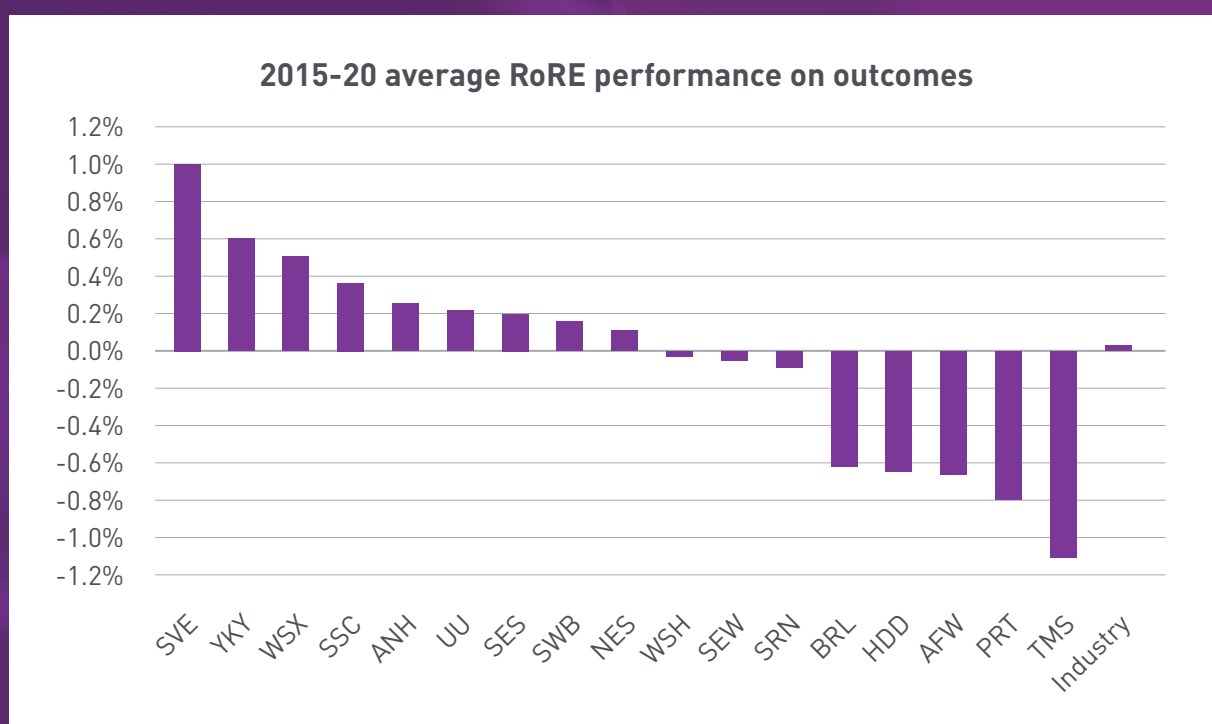
Ofwat noted in its 2019-20 service performance report¹⁰ that over the five-year price control period (2015-16 to 2019-20) the sector achieved net outperformance of £50 million on ODIs. As the graph below shows, this is a very small additional return for the industry as a whole - well under 0.1% additional return on the Regulatory Capital Value. It is only 5% to 7% of the value delivered to customers from ODIs, as estimated above. Taking account of additional costs incurred to outperform, the net gain would be even smaller, or negative. Companies have incurred significant additional costs to meet targets, such as additional work to clear blockages to prevent sewer flooding and additional leakage control activity to reduce leakage.

Ofwat's review of lessons learned from PR19 referred to outperformance of 0.2% of RORE in 2015-16 to 2019-20, on the basis of excluding some underperformance payments by Southern and Thames in areas where Ofwat took enforcement action. We do not consider it appropriate to exclude payments that were part of the PR14 ODI framework - these were not new penalties but a result of missing performance commitments that formed part of the PR19 package - but even with these exclusions the RORE outperformance is small.

The graph below shows there is a range of returns, but if regulation aims to simulate the factors at work in a competitive market then this is something we should expect to see - companies delivering good service outperforming and companies falling short underperforming. Earning rewards does not mean targets have been too easy. Companies often do not know what can be delivered until they focus efforts on outperforming – ODIs give an incentive to discover what is achievable.

¹⁰ Service and delivery, Ofwat, December 2020.

6. HAVE COMPANIES EARNED EXCESSIVE RETURNS? cont.



Ofwat's service delivery report for 2020-21¹¹, the first year of AMP7, referred to an overall underperformance of £19m, i.e. less than 0.1%.

Overall, financial performance on ODIs over the last six years does not suggest that there is a need for major changes to the framework to adjust returns. There is a risk that change will disrupt the balance that has been achieved.

¹¹ Service and delivery 2020-21, Ofwat, November 2021.

7. RESOLVING ODI ISSUES

SETTING TARGETS FOR BESPOKE PCS

Ofwat expressed a concern that bespoke ODIs are “difficult to compare, and so harder to benchmark companies against each other and set appropriate PC levels”¹². We agree that where it is clear that there should be a national PC and there is an appropriate common basis for measurement then bespoke PCs should be replaced by common PCs. However, this does not apply to all current bespoke PCs.

There may be a concern that uncertainty in setting targets for bespoke ODIs could lead to larger rewards on some issues than customers are prepared to pay. Where there is uncertainty, this can be addressed through caps to limit potential returns.

Caps on individual ODIs may be legitimate when there is a new measure, or one where financial rewards have not previously applied. In such cases the scope for improvement may not be clear to Ofwat or to the company. There will also be uncertainty for Ofwat where there is a lack of comparative information and this would also be another reason to apply a cap on the individual ODI.

With established ODIs, there should be less need for caps because the likelihood of outperformance will be more predictable. If the concern is an excessive impact on customer bills then it is better to target the overall level of reward that can be earned. A cap on the individual ODI removes the incentive for further improvement, with a loss of potential benefit to customers and the environment. For example, a company may be earning rewards that are well within Ofwat’s target range (or even in penalty) but need to scale back activity because it has hit the cap on an individual measure. A graduated sharing rate when overall returns exceed a threshold works better because it preserves some incentive for further improvement.

¹² PR24 and beyond – Performance commitments for future price reviews, Ofwat, November 2021.

7. RESOLVING ODI ISSUES

SETTING INCENTIVE RATES

Ofwat has proposed¹³ that incentive rates should be based solely on the valuation of customer benefits, rather than the penalty rates being dependent on marginal cost estimates as well as customer benefits. We support this change, as it provides greater simplicity. There is also uncertainty about estimates of the marginal cost associated with each unit of improvement and whether these are comparable between companies.

We agree with Ofwat that the collaborative approach to customer research should give more consistent and potentially robust results. However, there may still be potential for anomalies, between different PCs and between companies. There needs to be scope for challenge of the results when incentive rates are set, particularly if the challenge is supported by companies' own customer research evidence.

Uncertainty in setting incentive rates for bespoke ODIs can be addressed by relating them to measures where there is more experience in setting rates, e.g. resilience incentive rates may be related to interruptions, or blockage incentive rates can be related to flooding.

ASSET HEALTH MEASURES

Setting incentive rates for asset health measures is problematic because it is difficult to establish what improvement or deterioration on these measures is worth to customers. We agree with Ofwat that a marginal-cost approach is not suitable, as it would not be clear whether the value to customers of maintaining reliable future service would be less than or greater than marginal cost. In addition, as noted above, it is very difficult to derive reliable estimates of marginal cost.

We support basing the rates on future effects on customer service, and think that there is scope for standardising the approach to allowing for overlaps with other ODIs and estimating the link between asset health and future service delivery.

There would still be a need for some top-down checks. We do not, however, support a wholly top-down approach, because of the difficulties referred to by Ofwat in determining what increment of service it is appropriate to apply to the top-down allocation of ODI payments for each ODI.

¹³ PR24 and beyond: a discussion paper on outcome delivery incentives, February 2022



8. CONCLUSIONS

The introduction of ODIs has been a success story for water industry regulation, delivering significant benefits for customers and the environment. This paper has demonstrated that:

- The total net value delivered per customer in the six years up to 2021 is in the range £32 to £51, with further benefits expected each year of this AMP period even if only improvements delivered so far are maintained.
- The mix of bespoke and common PCs has ensured that the core customer service incentives are set on a common basis, while there is still scope for innovation.
- The framework has delivered a reasonable risk-return balance.

There is some scope for further development of ODIs for PR24, and we support the extension of common PCs to more aspects of service. Concerns about excessive rewards and the impact on customer bills can be addressed through targeted use of caps on individual ODIs and graduated sharing rates on overall rewards. However, if the system moves too far towards a centrally-planned approach then this could diminish the future benefits for customers and the environment. There is a need for continuing innovation in ODIs, particularly to ensure that performance commitments will encourage long-term service delivery.



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