WILL IT ALL BE UPPER FUTILE IN THE END?

by ICS Consulting in collaboration with Bristol Water

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"SHOW ME THE INCENTIVE AND I WILL SHOW YOU THE OUTCOME"

Charlie Munger, Vice Chairman Berkshire Hathaway

1 INTRODUCTION

Ask what is important to a water customer about their water services, and the word "incentives" is unlikely to feature as their first response.

What water companies deliver for their customers is their primary focus. How they get there is at best secondary. But as our opening quote testifies, behind the outcomes that water customers experience will lie the set of incentives that link how water companies are operated and managed with how they perform for customers. As Nikita Khruschev also observed "…incentives are what get people to work harder."

For water regulators incentives have always mattered. Since its inception Ofwat as the water regulator has had as its raison d'être the mission of encouraging water companies to work faster, work harder and work better on behalf of water customers. And to do all that for less as in lower water bills.

The how of regulatory incentives has changed and evolved to suit the moods and needs of the times. Post privatisation the approach was to rely on efficiency targets. In a world when water company spending was dominated by "must dos" like meeting the demands of environmental legislation such a focus is easy to understand. The language of regulation was also dominated by "must haves". Namely, water companies must have certainty about their legislation driven plans and have assurances about how they could be paid for.

More recently, the landscape has shifted. Greater emphasis and focus on what water customers want now guides regulatory thinking and in tandem water companies are expected to be increasingly nimble with how those wants are met and also paid for.

These opening remarks provide the backcloth to this think-piece.

Since 2015 the water regulatory framework has included a new system of "Outcome Delivery Incentives". Under this system outcomes – the things that customers want or prioritise – have been linked to a suite of incentives. These incentives where they were financial in nature could see water companies experience over and under performance penalties. In essence beating or not achieving a committed performance target would have financial consequences. Incentives could also be reputational – relying on non-financial carrots and sticks to motivate water company managers. Even more recently – e.g. PR19 – the balance of these incentives has at regulatory behest – tilted even more towards financial incentives.

In this think-piece we wish to ask some basic questions about these water industry incentives. This includes:

- What have they actually done?
- Do they appear to be working?
- Are they working for some companies but not others?
- Do they relate to the things that customers think are important?

We consider these questions at industry level, but also at the level of Bristol Water customers. Bristol Water have asked us to offer an independent perspective on these questions and issues.

Are ODIs making water companies work harder? Are the outcomes now being observed the right outcomes? And does that infer that behind the right outcomes lie the right incentives?

The rest of the paper is organised as follows:

- **We provide a bit more commentary on the actual system of incentives in places. We are particularly interested in what it has meant for water customer bills and hence water company finances;**

- **We then look in a bit more detail at the Bristol Water experience and perspective; and**

- **Finally, where do incentives go from here in the water industry?**

2 HOW DID WE GET HERE?

2.1 THE PRINCIPLES

In some ways the ODI framework that Ofwat introduced back at PR14 had the feeling of "…an idea whose time has come". There was a sense that the previous "armies" of comparative competition, benchmarking and efficiency targets had all but exhausted their regulatory course. To change the regulated mind-sets prevalent in the industry something new and a tad radical was believed to be necessary. At least from Ofwat's perspective.

Set in this context, the idea of rewarding and penalising water companies (as it turned out both financially and reputationally) seems a pretty obvious direction to take. To make people work harder you have to make it worthwhile, Khruschev, if offered the chance, may have said to Ofwat. Dangling some new carrots and adding some sticks would certainly re-focus the minds of water company managers.

Like all new regulatory systems it was recognised that what was introduced at PR14 would never be the finished article. Companies were given mostly latitude to define their own "Outcome Measures" and set the associated "Performance Commitments" with the result that comparisons across companies were inevitably tricky. Importantly as well, they were allowed to decide when and where the new carrots and sticks would be attached to real currency rather than good or bad headlines. And where money was involved the rates underlying any performance payments would be ideally determined by companies and evidence of customer value.

2.2 THE EXPERIENCE OVER THE 2015-2020 PERIOD

Back in 2015 the system of ODIs and associated incentives were a new feature of the regulatory system. How much has this new feature been worth to both companies and customers alike?

The answer to this question is still emerging but the latest data from Ofwat and the water companies offers some clues. The tables below show the value of the outperformance and underpayments that have actually applied so far during the 2015-20 period based on actual company performance.

In the tables below we have combined the payments associated with end of period and in period payments. During this first phase of ODIs end of period performance payments represent the significant proportion of payments due and paid overall (approx. 80% on water for both over and under performance and about 47% on waste over performance and 77% on under-performance). As we note below Ofwat's methodology for PR19 will see these proportions tilt strongly toward in period payments in the 2020-25 period.

Table 1: Water ODI Payments and Bill Impacts over 2015-20

Company	Water Outperformance payment £m	Water Underperformance payment £m	Water Bill Impact of Outperformance[1]- £	Water Bill Impact of Underperformance[1]- £
Anglian	29.0	-0.6	13.00	-0.20
Hafren Dyfrdwy	0.0	0.0	0.00	0.00
Northumbrian	8.3	-5.8	4.00	-2.80
Severn Trent (England)	0.0	0.0	0.00	0.00
Severn Trent	13.0	-54.8	3.50	-15.00
South West	3.8	-2.1	4.50	-2.50
Southern	0.0	-0.3	0.00	-0.30
Thames	6.3	-110.3	1.50	-27.30
United Utilities	21.2	-42.5	6.30	-12.70
Welsh	0.0	-8.4	0.00	-5.80
Wessex	1.9	-0.8	3.10	-1.30
Yorkshire	20.1	-12.7	8.60	-5.50
Affinity	1.3	-11.9	0.90	-8.10
Bristol	0.0	-6.9	0.00	-12.60
Dee Valley	0.1	-0.1	0.50	-1.00
Portsmouth	0.0	-1.0	0.00	-3.20
Bournemouth	0.0	0.0	0.00	0.00
South East	2.0	-3.2	1.90	-3.10
South Staffs & Cambridge	2.9	-1.5	3.80	-2.00
SES	0.7	-0.2	2.50	-0.70
Total Industry	**110.5**	**-263.2**	**4.20**	**-9.90**

Source: Ofwat, Outcome, Performance Commitments and Outcome Delivery Incentives 2017-18 (January 2019) and water company Annual Performance Returns 2018-19

1. Note: the bill impacts are estimated broadly as the total payments divided by the number of customers

For water supply services (Table 1), under performance payments so far have been about 2.5x the level of over performance payments. At first glance this would offer the interpretation that companies have been more likely to deliver less than they promised rather than outperform what customers were promised.

In fairness this under-performance was dominated by only two (albeit larger) companies – Severn Trent Water and Thames Water. At average bill level the industry figures approximate to a bill impact of +£4.20 for over-performance and -£9.90 for under-performance. So, in net terms water customers will be owed just over a fiver.

With average water bills around £195 these impacts represent variability in bills of about +2% to -5%. Small but not insignificant it would be safe to conclude.

The range around the water underperformance bill impacts is more notable with some customers seeing compensation measured in shillings while the larger impacts exceed £10 per customer bill.

Table 2: Waste ODI Payments and Bill Impacts over 2015-20

Company	Waste Outperformance payment £m	Waste Underperformance payment £m	Waste Bill Impact of Outperformance[1] - £	Waste Bill Impact of Underperformance[1] - £
Anglian	12.4	0.0	4.40	0.00
Northumbrian	7.6	0.0	5.95	0.00
Severn Trent	154.7	-1.0	37.35	-0.24
South West	11.0	-5.3	14.49	-7.02
Southern	1.2	-3.0	0.62	-1.52
Thames	4.9	-14.6	0.81	-2.43
United Utilities	44.2	-1.5	13.17	-0.44
Welsh	8.5	0.0	5.77	0.00
Wessex	18.6	0.0	14.69	0.00
Yorkshire	28.6	0.0	12.39	0.00
Total	**291.8**	**-25.4**	**11.5**	**-1.00**

Source: Ofwat, Outcome, Performance Commitments and Outcome Delivery Incentives 2017-18 (January 2019) and water company Annual Performance Returns 2018-19.

1. Note: the bill impacts are estimated broadly as the total payments divided by the number of customers

The impact of ODIs appear quite different for wastewater services. The picture is dominated by payments for outperformance and these in turn are dominated by the position of Severn Trent Water. With average annual sewerage bills of around £225 these impacts translate to a +5% average upside for companies and only 0.4% downside.

One question to pose about this data would be are these impacts big enough to matter? In the case of wastewater is just over a tenner on average a price worth paying for the outperformance that has been delivered, while for water supply is about the same tenner on average sufficient compensation for customers and a big enough stick for companies?

The evidence of much customer research on the issues around incentives in the water industry might suggest that customers themselves would not even take the discussion this far.

During PR14 and PR19 ICS have been involved in a good number of customer research studies with the objective of trying to understand (we will say more about research specific to Bristol Water customers in the next section) the customer perspective.

The balance of evidence we have seen suggests that what customers care about most is stable predictable bills. The principles of incentives are readily understood and supported to varying degrees. If there is a general tendency we have observed it would be that customers are comfortable with the idea of sticks for underperformance but they take more persuading about carrots for outperformance.[1]

[1] This all feels pretty consistent with the idea of loss aversion. The water customer evidence suggests fairly clearly that service losses are valued more highly than service gains. And the findings of neuroscience point towards using punishments as the way to deter "bads" or a negative occurring, whereas rewards are better if you want to promote positive action (Sharot, T. (2017) What motivates employees more: rewards or punishments? *Harvard Business Review*, September 26, 2017.)

They quite enthusiastically debate the merits or otherwise of outperformance rewards, but those merits are less likely to be something they are happy to see translated into their bills. In our experience the customer appetite is for limited variability in bills due to ups and downs in performance.

We have also witnessed secondary concerns about how incentive payments might end up having perverse effects. The most oft mentioned example of this is how compensation for under-performance should be handled. In theory, underperformance payments represent the pay back to customer for a service promise not met. In practice, customers in our experience worry about the future consequences of their water companies giving money back when evidence of under-performance can be an indicator that more money is actually needed. This represents a fairly sophisticated customer perspective that the best solution for something that is failing to deliver is not always to reduce the ability (with less money) to address that failure.

The other perspective is some water customers do react quite strongly and not in a good way to the idea of outperformance rewards. This might be a language thing, compounded by customer fears that any "rewards" find their way into executive bonuses. No surprise then perhaps that terms such as rewards have largely fallen out of favour as part of the ODI nomenclature and superseded by the more benign "outperformance payment".

So, there are clearly important nuances to how customers feel about incentives and how the evidence on the system introduced at PR14 should be interpreted. The experience to date suggests the incentives picture is very variable across companies and good performance in one area (e.g. waste) is not a particularly helpful predictor of good performance in another area (e.g. water).

2.3 PR19 AND THE DRAFT DETERMINATIONS

As early as December 2015[2] Ofwat was setting out its future direction on outcomes for the PR19 price review. This signalled amongst other things ideas about incentives for companies to think longer term along with introducing a significant distinction between common and bespoke performance measures. Common would become in effect an industry wide measure where direct comparisons were felt sensible and feasible. There was also recognition that further thought was needed around the strength and structure of outcome delivery incentives.

These initial signals soon became part of the methodological landscape for ODIs, which in nutshell summary took the form:

- A set of 14 core performance commitments covering customer experience, water supply and wastewater operations and asset health measures (9 of which related to water only companies like Bristol Water). In addition, companies would be at liberty to propose bespoke measures (expected to emerge from consultations with customers about their priorities). To this Ofwat added clear but not always coherent expectations about the levels of performance companies would be expected to attain for these measures. This included the idea that all companies would be expected (at a minimum) to be deliver Upper Quartile performance in key areas of performance. Squeezing 100% into the upper 25% was something Ofwat felt companies should be able to conjure.

- Of more immediate significance for water company Finance Directors, Ofwat provided a clear direction on the balance between financial and reputational incentives. These directions amounted to the straightforward mantra that to see how incentives work best you just have to follow the money. The destination that Ofwat intended would be

[2] Ofwat, Water2020: Regulatory framework for wholesale markets and the 2019 Price Review, December 2015.

that the financial stake for companies on ODIs needed to be higher. And this became codified as an expected +/- 3% range in the Return on Regulated Equity (RORE).

- As a complement to this increased focus on the financials, Ofwat also introduced changes to the detail of how the incentive rates would be structured. The PR19 framework recognised for the first time "standard" and "enhanced" rates. Being really really good would become even more worth the effort, while being really really bad was not somewhere you wanted to go. And as we note immediately below, the actual implementation of this distinction has resulted in Ofwat de-coupling enhanced payments in particular from evidence around customer value, instead linking payments to how other water companies are impacted.

- Enhanced penalties for underperformance by companies is something, in our industry experience, that would find favour with most if not all water customers. More sensitivity would be exhibited around enhanced rewards with water customers readily understanding that a high threshold of performance should be needed before even higher payments for outperformance could be legitimised. A bit like the Sports Promoter offering a Million Dollar Bonus for achieving a personal best time in the 100 metres, it would be necessary to narrow eligibility to the water company equivalent of Usain Bolt. Enhanced rewards would be strictly limited to those already leading water companies pushing the frontiers of performance even higher (with the further contingent of sharing one's training secrets).

- A further development related to the timing of incentive payments. As highlighted above with Table 1 and Table 2, the balance of 2015-20 incentives were largely focused on end of period payments. Customers would not see the impact for their bills until 5 years of pluses and minuses had accumulated. Feeling this weakened the link between performance, incentives and annual bills, Ofwat moved the PR19 approach towards more in-period payments. Customers would as a consequence see more immediately through their bills how their water company was performing.

On 18 July 2019 Ofwat duly delivered its draft determinations. The written appendix on Outcomes published by Ofwat runs to some 218 pages, so capturing the essence of the draft determinations for companies requires a bit of effort to see the wood for the many trees.

There is also a sense that the outcome on ODIs that Ofwat has duly delivered in the Draft Determinations doesn't yet quite match up to its methodological commitments. For a start, ODIs as conceived at the beginning of PR19 represented a top and tail to the overall regulatory framework. A bit of icing on any outperformance cake or a reminder that underperformance would cost companies money and PR19 was about providing a bit of stretch to both.

But the climate that has rained on PR19 suggests ever so subtlety and perhaps unwittingly that the ODIs' carrots and sticks have in reality offered a useful barometer of how tough the regulatory settlement could be. Being tough on water company execs and the returns they can deliver would sit quite comfortably with the Khruschev like message that people running water companies just needed to be made to work harder. A case perhaps of the temptation to side with "could we tweak the ODIs" appearing too great without asking "should we tweak the ODIs".

Further evidence of how the draft determination outcome may be at risk of deviating from the original regulatory intent is the extent to which customer evidence has, or more particularly has not, been reflected in the draft decisions. How the draft incentive rates relate to the customer evidence that companies have collated during PR19 to our observers' eye is at best indirect and at worst tangential. In its published assessment of company business plans back in April 2019 companies were often challenged to explain why the incentive rates developed on the back of consulting *their* customers did not match up to the incentive rates developed elsewhere in the country. So, while it might still be true to say that customer views are mostly at the heart of what ODIs should look like, regulatory discretion has still applied as to *whose* customers.

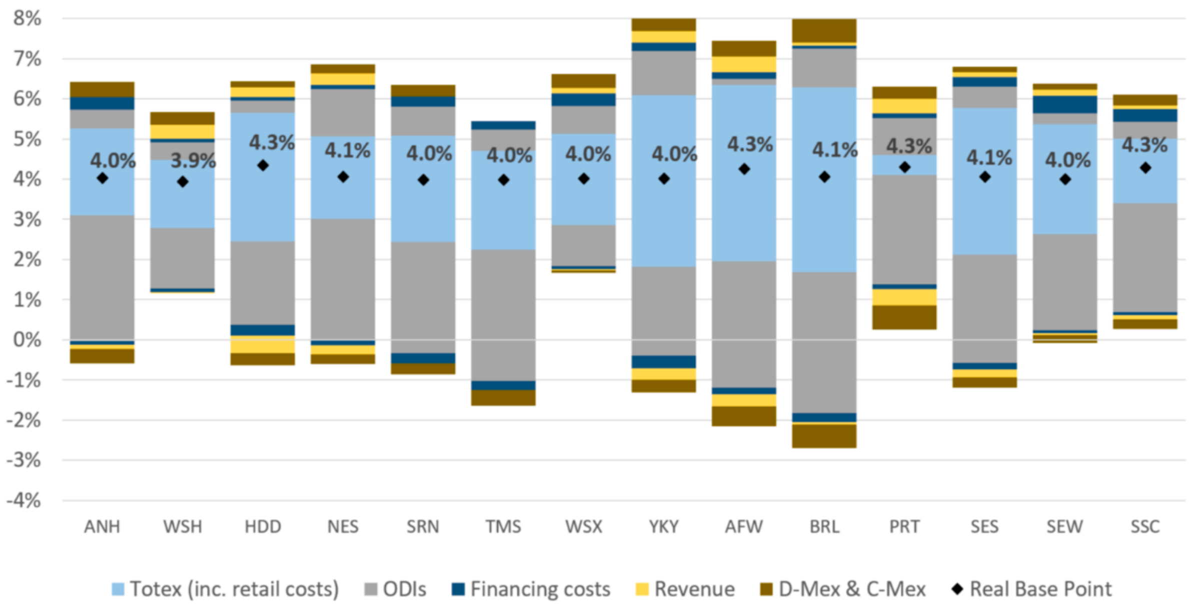
Figure 1 below looks at what it all means through the lens of the equity investor – the people who have put money into owning our water companies.

Figure 1 shows what kind of return on investment equity investors would be signing up to with the draft determinations. More importantly, what this shows are the potential upsides and downsides of investing in today's water companies. The financial incentives with ODIs (which will include the separately identified customer experience measures C-Mex and D-Mex) provide the largest source of variability in expected returns on equity. No longer is the range around the base equity return allowed for these companies simply shaped by how efficiently water companies spend money (totex). Water companies, or more specifically, investors in these water companies have now entered the world where how much their money generates is fundamentally linked to how well their managers deliver on performance.

This of course, as noted above, is precisely what Ofwat has been moving towards. Removing the safe guarantees of a certain cost of capital and with it detaching from water the label of safe money. And in doing so replacing to a degree the idea of water as an investor safe haven with the idea of water as a good bet.

The example of Bristol Water is instructive if only because it is the most stark. And we look at Bristol more closely in the section to follow.

Figure 1: ODIs and Draft Determination RORE ranges for slow track companies



Source: Ofwat, Aligning Risk and Return Webinar, 23rd July 2019.

The RORE range for Bristol is the widest of all the companies shown in Figure 1. From a base equity return of 4.1%, the Ofwat draft determination RORE ranges for Bristol is between +8% and -2.75% and ODIs (including the customer service measures C-Mex and D-Mex) are the biggest component of this range. The chances of a negative return on equity have quite possibly never been so high in the water sector.

This paints a quite different picture to the current 5-year period as well. As Table 1 summarised the current ODIs have delivered a £6.9m bonus to customers (about £12.60 per customer) in return for underperformance but no compensating payments for outperformance. Broadly this equates to Bristol's equity investors foregoing about 3.2% of return.

The PR19 draft determinations for Bristol would push this kind of downside potential for investors even higher. But what would Bristol Water *customers* be getting in return? Is it this new riskier world that Bristolians said they wanted for their water company?

3 THE BRISTOL WATER CUSTOMER EXPERIENCE AND PESPECTIVE

Before delving into how the Bristol Water view on PR19 incentives was shaped first by its customers and then subsequently by the draft determinations, it is worth going back to the start of the ODI journey for Bristol Water.

3.1 HOW HAVE ODIS IMPACTED ON BW CUSTOMERS SO FAR

As for all water companies Bristol Water developed its original PR14 proposals on the back of significant consultations with its customers and stakeholders. There were also the interventions of the Competition and Markets Authority (CMA) who had the task of adjudicating on the PR14 determinations for Bristol Water.

In total 21 performance measures were introduced with 10 of those measures subject to financial incentives. The overall picture was weighted toward penalty incentives or underperformance payments which fitted with the views Bristol had gleaned from its customers with a heavy focus on ensuring resilient water systems and networks. In that respect the views of Bristol customers were very much in keeping with customers in the rest of the country. Bristol Water had also developed innovative *reputational* incentives in areas like biodiversity, raw water quality and water affordability.

The actual experience for customers, as highlighted in the previous sections, was that Bristol Water didn't quite manage to meet all of its service promises. Table 3 below shows where the total underperformance value of £6.9m comes. The biggest contributors have been leakage and supply interruptions.

Table 3: Bristol Water's PR14 Expected ODI performance up to 2019-20

Performance Commitment	ODI Incentive Type	Value of ODI payments up to 2018-19 £m
Unplanned Customer Minutes Lost	Outperformance & Underperformance	-2.2
Asset Reliability - Infrastructure	Underperformance Only	-0.7
Drinking Water Compliance	Underperformance Only	-0.6
Leakage	Outperformance & Underperformance	-2.7
Meter Penetration	Outperformance & Underperformance	-0.7
Total		**-6.9**

Source: Data from Bristol Water

Hindsight is always twenty-twenty and with its benefit the new owners of Bristol Water and management teams would admit that the PR14 plans were inefficiently focused and the observed underperformance has been in part the consequence.[3]

It is arguably a virtue of the ODI framework put in place at PR14 that these missteps by the managers and planners of the time have resulted in Bristol Water customers receiving their ODI rebate. Making it meaningfully painful to under deliver is what the ODI system is designed to do.

But more than this backward-looking recompense the legacy of the current period will be the re-focusing of the minds of the new Executive teams at Bristol Water to do it better next time. That next time opportunity for Bristol Water is what PR19 represents.

3.2 HOW DO BRISTOL WATER CUSTOMERS FEEL ABOUT INCENTIVES?

At the heart of doing it better next time has been an even more extensive programme of consultation with Bristol Water customers. This has covered what matters most to Bristol Water customers along with what that means for the bills they are prepared to pay. All of this is in keeping with the expectations Ofwat laid down for water companies with its PR19 methodologies.

How customers feel about incentives and how these should be designed have featured heavily in this underpinning research. This research is on-going and has also continued post the Draft Determinations.

The following customer quotes provide some direct quotes from customers about various aspects of the ODI framework: from the basic principles to the how they should affect bills and also the details of how they should be designed.

The views expressed here strongly echo in our experience the views that other companies have heard in their cities, towns and villages.

A very basic point of agreement is that customers understand what systems like ODI incentives can offer and why they have a place within the regulatory system. They can see they could do what competition does elsewhere in other sectors and there is comfort in that.

There are also nuances and degrees of sophistication in the customer way of looking at incentives. Motivating companies makes perfect sense but doing that in a way that keeps the consequences for bills comparatively small is also desirable. The benefits of bringing the whole industry up (in terms of performance) are also recognised, but also being sure that the effect is to drive genuine innovation.

Where a Bristol perspective shines through most strongly is with the service areas cited as being particularly important. It should not surprise that environment and community initiatives attracted particular mention in Bristol as the home of the now nationwide water Refill initiative, the UK's first city-wide community currency – the Bristol Pound – and 11 Green councillors. Though this support for environment and community is something customers in Bristol appear to expect from their water company and not necessarily needs prompting through financial incentives.

[3] In 2015 iCON Infrastructure Partners purchased the majority holding in Bristol Water plc.

Bristol Water customer views on incentives

"I think they have to have targets in place like this because they don't have competition like supermarkets do" SEG C2DE, Aged 46+

"We're in this monopoly so increasing bills is a fail, unless I can see something for my money" SEG ABC1, Aged 18-45

"I like the idea it's more about the customer" SEG CD Mixed ages

"If the shareholders have got something to say and they want a return on their investments, Bristol Water have got to do the job they ought to be doing" SEG BC, Mixed ages

"I reckon it's very useful because they need to draw comparisons and see how they can bring up the whole industry, as a whole, rather than having some water companies ahead" SEG C2DE, Aged 18-45

Bristol Water customer views on outperformance

"I think it motivates the company to do a good job and ensures investment in improving the service. (The) amounts for the customer are very small." SEG ABC1, Aged 46+

"It just seems to be small amounts that you would be paying extra - to me it's not a bad thing" SEG C2DE, Aged 18-45

"Is it driving innovation?" SEG ABC1, Age 18-45
"Everything that can be done for the environment needs to be done" SEG C2DE, Aged 46+

"The payments should come from elsewhere" SEG ABC1, Aged 46+

"There should be limits on how much bill payers should pay so not chasing diminishing returns." SEG ABC1 Aged 46+

"I am concerned about the total bill one has to pay" SEG C2DE, Aged 46+

Bristol Water customer views on underperformance

"I think it's good for the company, because for any company you need a benchmark, you need something to strive for and there needs to be a consequence if they don't hit that" SEG BC, Mixed ages

"If they were to miss and then be penalised for that, how is that going to actually help them achieve the target?" SEG C2DE, Aged 18-45

"Leakage is very weather dependent and (its) unfair to penalise on factors that are out of their control" SEG ABC1, Aged 18-45

"Normal building contracts allow for contingencies, so this seems normal" SEG CD Mixed ages

"I disagree, because I don't think there's room for error" SEG CD Mixed ages

Source: ICS, Customer Research for Bristol Water, Outcome Delivery Incentives March 2019

Distilling this body of views and research is what Bristol Water presented in its PR19 business plans. This took account of where Bristol customers felt ODI incentives should apply and also what the overall implications of the incentives would be.

Table 4 presents what it meant for the customer's bottom-line. This table shows the level of incentives customers supported based on the most likely range for underperformance and outperformance.[4]

Broadly, customers supported underperformance penalties that could amount to a bit over 2x the amount of outperformance rewards overall with the potential for outperformance upside primarily focused in areas like customer service, long term asset health, leakage reduction, supply interruptions and water consumptions and network resilience. These ODI payments were set in the context of an expected average bill of £172 by 2024-25 – a 6% reduction in bills from 2019-20.

So, the headline insight from the customer evidence was that the Bristolian appetite for a bit more bill variability through incentives could be pushed a bit further than had been determined at PR14.

[4] This range is based on Ofwat's P10 and P90 thresholds. P90 is the upside performance threshold where it is assessed there is only a 10% chance of doing even better. P10 is the downside threshold, above which there is only a 10% chance of performance being even lower.

Table 4: Proposed ODI payments for 2020-25– Bristol Water Business Plan View

Range of incentives in annual bill	Underperformance Payments	Outperformance Payments
Customer service measure – compared to other companies	-£1.50 (-0.9%)	+£1.50 (+0.9%)
Void properties	-£0.30 (-0.2%)	£0.01
Leakage	-£1.00 (-0.6%)	+£1.00 (+0.6%)
Supply Interruptions	-£1.50 (-0.9%)	+£0.30 (+0.2%)
Water quality	-£1.00 (-0.6%)	+£0.10 (+0.1%)
Long term asset health (water quality at works, mains bursts and pressure)	-£2.50 (-1.5%)	+£0.30 (+0.2%)
Resilience – Population Protected	£0.00	£0.00
Metering & water efficiency	-£1.00 (-0.6%)	+£0.50 (+0.3%)
Community & Environmental	-£0.50 (-0.3%)	+£0.50 (+0.3%)
Total Average Bill (£172)	**-£9.30 (6% of the bill) (Typical performance in a bad year)**	**+£4.10 (2.5% of the bill) (Typical performance in a good year)**

Source: Data from Bristol Water

For Bristol Water's owners the ODI bottom line was expressed through the implied RORE range – estimated as a -2.48% downside and +0.88% upside. Both limits within Ofwat's stated +/- 3% RORE range.

3.3 THE PR19 DRAFT DETERMINATIONS AND BEYOND: FLYING OR FALLING?

There is a well-known scene in Disney's *Toy Story*, where despite a number of mis-fires with Sid's rocker Woody and Buzz manage to launch skyward as they chase in pursuit of their toy comrades who have left with Andy and the removal truck. Woody delighted by these developments exclaims "Hey Buzz, you're flying". To which Buzz responds more accurately ***"This isn't flying, this is falling with style".***

There is a sense in which Ofwat's Draft Determinations give a similarly over-stated impression.

It should always be the job of a regulator to challenge. In the absence of competitive market frictions this is what primarily gives rise to the need for regulators in the first place. But it should also be the job of the regulator to explain and explain clearly the basis for any challenge. Our observation would be that particularly in relation to ODIs there is a feeling of "that's not explaining, it's just stating with style".

Bristol Water's draft determinations included the following firm – see Table 5 - but admittedly stylish statements from Ofwat related to its ODI proposals:

Table 5: Ofwat's Draft Determination interventions on Bristol Water's ODI proposals

Intervention	Detail
We remove the financial incentives on the population at risk from asset failure performance commitments	Removing the financial incentives for the reduction of the population at risk from asset failure (up to £2m outperformance and £6m underperformance over 2020-25) that have been proposed by the company, due to our lack of confidence in the company's benefit calculations and because we have rejected the linked cost claim.
We increase the strength of financial incentives for performance commitments such as leakage and supply interruptions	Increasing underperformance and outperformance rates in relation to leakage to reflect our concerns with the company's approach to setting its rates. Increasing underperformance and outperformance rates in relation to water supply interruptions to reflect our concerns with the company's approach to setting its rates.
We increase underperformance rates in areas where the company is currently a poor performer, such as mains repairs.	Increasing the underperformance rate in relation to main repairs to the upper bound of our reasonable range so that it sufficiently incentivises the company to deliver the significant improvement it has forecast.
Other specific interventions and adjustments	Increasing underperformance and outperformance rates in relation to per capita consumption to reflect our concerns with the company's approach to setting its rates. Increasing underperformance and outperformance rates in relation to customer contacts on water quality to reflect our concerns with the company's approach Increasing the underperformance rate of meter penetration to its PR14 rate, so that it provides strong incentives against delivery failure,

Source: Ofwat, Bristol Water – Draft Determination, 18th July 2019

While we are not privy to all of the correspondence between Bristol Water and Ofwat on these specific challenges, we are aware from Bristol Water that in all cases where an audit trail and rationale behind the Ofwat's imposed ODI rates has been provided this has revealed errors in either data or calculation. That feels like an uncomfortable example of a regulator falling with style onto its target rather than flying smoothly towards it.

These points are worth highlighting only because they matter. They matter for reasons of regulatory credibility as much as for reasons of water company viability. Is it credible to in effect impose incentive rates that over-ride the evidence gleaned from a company's own consultations with its customers and stakeholders? Does that in the end result in a rather futile process?

The draft determinations, as noted already, present in our estimations a tough choice for many water companies including Bristol Water. Under its draft determination, Bristol Water face not only base equity returns which are significantly lower (4.1% versus 4.7%) but a riskier outlook for equity returns with a RORE range of -3.51% on the downside and +0.97% on the upside.[5]

Translated to bills this Ofwat Draft Determination equates to bill range variability of about -11% to +3% against a base average bill of £155 (which is a 15% reduction in the 2019-20 bill).

[5] This is based on the P10-P90 range and compares to Bristol Water proposed range of -2.48% to +0.88%.

The balance of evidence from Bristol Water's customers is that they are supportive of using incentives to improve the performance of their water company. The company had presented ambitious steps in that direction, with the very latest evidence from customers suggesting the magnitude of these steps is looking about right.[6]

And yet that appears to matter little. It ends up feeling as futile as playing harp to the buffalo.

Throughout PR19 Ofwat has stuck proudly to its strapline: *"#deliveringmoreofwhatmatters*". But we worry that in endeavouring to fly toward this objective, the water sector like Woody is left wondering how it can avoid falling with style.

4 MOVING FORWARD WITH ODIS: DO THEY HELP OR HINDER?

The premise of this think-piece has been to ask a simple question: is the direction that Ofwat has taken with the current ODI framework really in tune with what water customers are looking for or even a necessary part of what the evolving landscape for water companies could look like?

The best evidence from Bristol Water customers (see previous section) suggests that the PR19 approach to ODIs may ultimately be headed in a different direction, at least from a Bristolian perspective. We say this for two reasons. First, it is not clear that water customers – in Bristol and elsewhere – have really expressed an appetite for levels of risk and reward implied in the recent draft determinations. And secondly, the relationship between water supplier and water customers may already be changing in ways that obviate the need for arms-length incentives to achieve what customers want.

With its emphasis on financial risk and reward, the system of incentives embodied in the current ODI framework can be looked upon as an elegant solution to a classic principal-agent problem in our privatised water sector.

In this problem the principals of customers and owners are seeking to ensure their agents – the water company managers – are encouraged to make the effort to deliver the outcomes that are in both of their interests. Owners get higher returns paid for by higher customer bills who in turn get higher value from the "extra" services they receive. And on the flip side owners take a hit when customers are entitled to lower bills for outcomes not delivered. Incentives and interests become aligned.

At the heart of this system lies a familiar tension. It is an arms-length contractual tension between suppliers and consumers. This tension between effort and outcome is reconciled through the risks and rewards that stem from sets of obligations on each party.

But how comfortably will this approach chime with the current mood music within the water sector around the need for a social contract in water? Rachel Fletcher, Ofwat CEO, herself observing "It does not chime with people that the relationship between them and their water supplier is transactional".[7]

If there is a desire to move beyond the transactional in water, would that not also limit the need or merit of incentive mechanisms that are rooted in relationships between buyers and sellers that are essentially transactional in nature?

Bristol Water have embarked on an ambitious agenda that seeks to establish a modern social contract between itself and its citizens (consumers). This agenda is principally about building shared connections with wider communities and developing different approaches

[6] This is based on emerging evidence from customer research in August 2019 which is suggesting customers would support underperformance incentives of about -7% on average bills and outperformance incentives of about +5% on average bills.

[7] For more thoughts on these recent debates we would refer you to the recent ICS paper for Bristol Water "Social Contract for Water: Evolution or Revolution?" https://www.bristolwater.co.uk/social-contract-for-water-evolution-or-revolution/

to decision-making in all aspects of how water services are provided and delivered in Bristol. Based less on arms lengths contractual tension and more on engagement, partnership and empowerment as the mechanisms that underpin a public consent for the water company in Bristol that will be enduring.

Ironically perhaps the introduction of ODI incentives may already belong to a short-lived era for the water sector that is already changing. If not quite belonging to the Khruschev age where "…incentives are what get people to work harder", their relevance to a new era of participation and shared decision-making is less easy to see. Things are moving on and the developing focus is about getting people to work smarter together.

5 FINAL REFLECTIONS

If incentives and ODIs were and still are the answer, there is no harm reflecting on what was the question?

We think there are three dimensions to such reflection:

- **First,** what is it customers actually want from their water service providers (and do we know that sufficiently well to structure incentive systems around them)?

  …The processes that have been built around ODIs at face value are very worthy endeavours. Engaging with customers about outcomes and value have been very successful activities in recent years. But are they mis-directed at what is the essentially narrow technical exercise of calibrating incentive payments and is it right that industry comparisons appear to have been restored to take precedence over local views?

- **Second,** do they simplify the task of regulating the water sector and does it make regulation more transparent? We are unsure it does.

  …It would be possible to argue that ODIs have just been one of the levers to allow the historically low cost of capital in the PR19 draft determinations. PR19 has resulted in a trade exchanging relatively certain returns to investors with more tangible upside and downside risks. It makes running a water company a bit more like trading the stock market rather than keeping your money safely tucked up in the bank.

- **Finally,** is the objective still fundamentally about how to make water companies work harder? This we think may end up being too limited an objective.

  …If the evolving landscape for water companies is genuinely to restore public legitimacy and trust in water companies then relying on incentives to make companies work harder might end up being too limiting. And the unintended risk could be to push some water companies too close to the edge. Working smarter together is likely to require approaches that extend way beyond financial risk and reward.

How you motivate an enterprise that is given the job of running one of our core essential industries lies at the heart of the issues explored in this think-piece.

Our chief reflection be would that when you observe a limiting incentive, don't be surprised when you see a limited outcome.

THANK YOU

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