THE FUTURE OF OUTCOME INCENTIVES

How we can move to a better approach

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THE FUTURE OF OUTCOME INCENTIVES

HOW WE CAN MOVE TO A BETTER APPROACH

EXEC SUMMARY

This paper discusses how the design of outcome incentives in the water sector could evolve.[1] We discuss the key issues that need to be addressed, offer suggestions and identify where the approach to outcome incentives needs to be integrated with other parts of the price control. In our view, it is important for companies, regulators, customers and stakeholders to come together and use the next couple of years effectively to develop a new, viable, long-term approach.

THE NEED FOR CHANGE

When Outcome Delivery Incentives (ODIs) were introduced at PR14, one of the overall objectives was to encourage water companies to engage more with their customers and ultimately to mimic the dynamic in competitive markets, where companies that have a better understanding of their customers are more likely to succeed. The framework was therefore designed to encourage companies to find out what their customers want, and to set incentives based on their valuations to ensure corresponding outcomes are achieved efficiently. Another objective was to increase innovation in service delivery. To that end, companies were encouraged to measure customer outcomes instead of using output- or input-based measures.

Performance commitments (PC) and ODIs have since been a key feature of the regulatory framework in England and Wales. There is general consensus that a greater focus on the customer has resulted in material service improvements. However, there is no clear evidence of a step change in innovation, debates continue over the extent to which customer views are truly represented in Ofwat's final determinations, and legitimacy in the sector has fallen not increased in recent years. A number of issues need to be addressed in future, summarised in the diagram below in Figure 1.

In light of these issues, should the PC and ODI framework remain or should we start with a blank piece of paper? Ofwat has signalled in its latest strategy[1] that it wants to retain an "outcomes-based approach with meaningful incentives for outperformance", and ODIs are generally viewed as a valuable element of the price control. In our view, the framework is sufficiently flexible that it can evolve further. Maintaining the existing framework provides regulatory stability, which is particularly important to encourage long-term planning. However,

1 Ofwat, 2019, Time to act together, Available https://www.ofwat.gov.uk/wp-content/uploads/2019/10/Time-to-act-together-Ofwats-strategy-1.pdf

within the PC and ODI setting we need to consider radical change to address the principal issues identified above.

The objective of this paper is to discuss they key questions on PCs and ODIs for the future, offer suggestions and identify where the approach to outcome incentives needs to be integrated with other parts of the price control. In our view, it is important for companies, regulators, customers and stakeholders to cooperate over the next couple of years to formulate a new long-term approach to PCs and ODIs.

FIGURE 1 ISSUES TO ADDRESS IN THE FUTURE FRAMEWORK

STRENGTHEN LEGITIMACY	▪ Legitimacy has fallen not increased over the last few years ▪ How can future ODIs deliver increased legitimacy?
ROBUST AND CREDIBLE TARGETS	▪ PR19 approach to setting targets, including using forecasts of future performance, has been contentious ▪ How can targets be set in a credible and robust way?
EFFECTIVE INCENTIVE RATES	▪ Current basis for determining valuations leads to companies producing very different estimates of appropriate values ▪ How can incentive rates be set in an effective way?
MEANINGFUL AND FOCUSED CUSTOMER RESEARCH	▪ Comprehensive company-specific research is currently carried out but often not reflected in final decisions ▪ Should targets and incentives be based on local or national research/comparisons? ▪ How can future ODIs reflect customer research in a way that creates trust and confidence among all stakeholders?
MORE INNOVATION	▪ How can ODIs foster more innovation?
INCREASED SIMPLICITY	▪ ODIs are complex and not always easy to understand ▪ How can future ODIs be simple and transparent?

Source: Frontier Economics

WHAT ARE WE TRYING TO ACHIEVE WITH ODIS?

ODIs need to be considered in the overall context of the water industry and the regulatory framework. We need to step back and ask ourselves what we are trying to achieve with ODIs.

LEGITIMACY IS KEY

For the long-term viability of the water sector, customer legitimacy is essential as it underpins the regulatory system. Regardless of ownership models or regulatory approaches, natural monopolies need a minimum level of public support to continue to operate. Otherwise the threat of political intervention (e.g.

the potential renationalisation in England), the non-payment of bills (e.g. the Irish Water experience) and the erosion of public trust, which among other things could undermine work on reducing per capita consumption, risk having a significant impact on the whole sector.

Legitimacy has a number of dimensions and can manifest itself in various ways. One of them is whether a person or an institution – in this case the water industry – instils trust and confidence. Fundamentally, it is about the level of customer support for the current model of service delivery. Legitimacy is therefore about satisfaction, value for money and fairness.

It could be argued that ODIs could never have a significant positive impact on the general perception of legitimacy because customers are unlikely to pay a lot of attention to them. But it is clear that ODIs could have a negative impact on legitimacy if:

- Companies are seen to be earning outperformance payments while performing "badly"
- Customers perceive that companies are missing targets even though performance is improving significantly relative to the past (a key risk associated with the PR19 approach)
- ODIs do not incentivise the right investment in resilience, which could lead to significant service failures.

These observations underline that ODI design can have an important impact on customers' perception of legitimacy. If legitimacy were our only objective, the box below identifies some quick wins.

THOUGHT EXPERIMENT: WHAT IF LEGITMACY WERE THE ONLY OBJECTIVE FOR ODIS?

If legitimacy were the only objective for odis, we could:

- Re-brand outcomes, for example as "people's priorities";
- Rename measures as "positive experiences" for customers;
- Get customers to design the framework for odis;
- Make the system as simple as possible;
- Ensure that penalties for failure are designed to increase legitimacy;
- Remove rewards for outperformance where customers expect minimum levels of service, e.g. Sewer flooding and river pollution, as rewards in these areas can reduce trust;
- Limit outperformance payments overall and for individual measures;
- Design achievable targets, as widespread failure may erode trust; and
- Give customers the power to design the final incentives.

However, as legitimacy is not the only objective, this list also highlights how it may conflict with the other goals.

BUT LEGITIMACY IS NOT THE ONLY OBJECTIVE

In reality, ODIs also need to contribute to other objectives. Some of these have clear links to legitimacy and public support. For example, efficiency is tied to value for money. However, some of the other goals also create trade-offs, which means that the system will be unable to fully achieve all the objectives.

The figure below summarises the possible objectives for the outcomes framework.

FIGURE 2 POTENTIAL OBJECTIVES FOR THE FUTURE OUTCOMES FRAMEWORK

Source: Frontier Economics

WHAT ARE WE TRYING TO ACHIEVE IN FUTURE WITH ODIS?

This list of objectives and the potential trade-offs they entail show that we need to be sure about what we want the ODIs to achieve, as this will shape the design of the framework. In particular, developing a new, viable, long-term approach to ODIs requires clarity over the hierarchy or weighting of objectives: arriving at a clear ranking of these goals therefore has to be one of the first steps.

In our view, legitimacy is fundamental and should be a priority, as ODIs are an opportunity to engage customers and increase trust.

WHAT SHOULD WE MEASURE?

There are a number of elements to consider when addressing this question: the scope of measures; how to develop high-level measures; how satisfaction could be included; and the importance of longer-term measures. We discuss each of these in turn below.

WORK IS NEEDED ON HOW SOCIAL VALUE COULD BE INCORPORATED IN THE OUTCOMES FRAMEWORK

As explained in the box below, one of Ofwat's three goals for the future is for water companies to deliver more social value. To this end, firms will be required in coming price control reviews to adapt their decision-making, ways of working and in-house culture accordingly. One way of doing so could be to broaden the set of measures in the outcomes framework to include more service areas and ways to provide public value. But this would not be the only way to achieve Ofwat's goal.

There are pros and cons when it comes to embedding social value in the outcomes framework. If one assumes that social goods have value and are in many ways just the same as other outcomes that water companies deliver, then it could be argued that measures relating to social value should simply be a part of the outcomes framework. This would mean that incentives could be set in a consistent way with other outcome incentives, which should reduce the risk that unbalanced incentives lead to an excessive focus on one area. If water companies are then encouraged to include more social goods in their business plans, there is then a question of who pays for them. If water companies are required to do so, this may reduce the level of ambition included in the plans and this could lead to a missed opportunity for water companies to do more good in their communities. If water companies are instead able to include the costs of delivering social goods in their business plans, this would mean water customers paying for these social goods on behalf of society. This could over the long-run be the most socially optimal solution, as long as water companies are best placed to deliver these social goods. If that is the case, this approach may then also lead to increased legitimacy. However, the risk with this approach is that water companies are encouraged to deliver more social goods, where they might not be best placed to deliver, and this could lead to inefficient outcomes. In particular, it may not be the most efficient solution for society to pay for social goods through water tariffs as opposed to general taxation. In practical terms it may also be difficult to define robust outcome measures relating to social value, which would weaken the corresponding incentives. Another potential downside of incorporating public value measures is that it passes up the opportunity to define a new framework for social value, which may ultimately be more effective in signalling how important this area has become for the industry.

Building on Ofwat's current work on how to evaluate public value, further research should explore whether incorporating social value in the outcomes framework would be an effective way to attain its goal, or whether new regulatory mechanisms are needed.

The box below highlights Ofwat's thinking about generating public value.

OFWAT'S STRATEGY FOR THE FUTURE

In July 2019, Ofwat published its strategy for the future, which included three overarching goals.[2] one of these was for "water companies to provide greater public value, delivering more for customers, society and the environment". To reach this goal, Ofwat envisaged "companies looking for ways to deliver social value through conducting their core activities differently" and gave the following examples of how this could be done.

- Every part of the business and every decision is seen as an opportunity to drive value for society. This should lead to a cultural shift in mindset over time for every water company employee.
- The company places more emphasis on longer-term solutions that are cheaper or cost no more yet provide more public benefits. This could be done through partnerships or new arrangements with communities and local businesses.
- Companies would proactively seek opportunities to remove regulatory barriers to go beyond the norms and do the right thing.

Ofwat is looking for the sector to embed such thinking more deeply and systematically, rather than simply bolting these thought processes onto existing decision-making approaches. Ofwat will develop a framework to understand and evaluate social and environmental value in order to assess how widespread adoption is across the industry.

WORK NEEDS TO START EARLY TO DEFINE MORE HIGH-LEVEL, OUTCOME-BASED MEASURES

Higher-level measures that are more closely linked to the outcome for the consumer (see Figure 1 below for a simple example) have a number of advantages, as they are more likely to spur innovation and efficiency. This is because they give companies more choice about how to meet the respective targets than measures that specify the inputs or outputs to be used. Fewer measures may also make it easier for water companies to manage, and reduces the risk of skewed incentives either through design or unintended consequences.

[2] Ofwat (2019), Time to act, together: Ofwat's strategy

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FIGURE 3 OUTCOME-OUTPUT-INPUT ILLUSTRATION

Outcome	RELIABLE WATER SERVICE			
	Customer satisfaction with number and length of supply interruptions/ communication and support	% of positive / negative sentiment on social media with regard to interruptions	Index of interruptions which captures different aspects such as frequency, duration, planned/unplanned	
	% of households warned of planned interruption	% of households that were sent personalised message to inform of interruption	Total minutes interrupted	Average mins of supply interruptions > 3 hours per property
	Number of real time updates per interruption and % of population reached	Number of households supported with bottled water	Measure of critical asset resilience	Number of mains repairs
Inputs	Number of channels for communicating updates on interruptions	Number of staff dedicated to managing customer experience on supply interruptions	Volume of back-up supplies (bottled water) available	Mains replacement

Source: Frontier Economics
*Note: *PR19 common measure*

However, identifying higher-level outcomes has its challenges. These include:

- **Controllability** – outcomes are often influenced by external factors such as the weather or economic conditions, whereas water companies have more control over outputs and inputs. This makes it tough to measure outcomes. Incentives and targets at the outcome level increase the risk for companies as they are unable to fully control performance.

- **Robustness** – it is challenging to develop robust outcome measures. As an example, the design of a survey can affect satisfaction ratings.

- **Practical issues** – it can be practically taxing to measure the customer outcome closely. Established monitoring processes are often not in place. This can require investment in developing, trialling and refining the measure or taking on performance risk with a new measure. Because of this and the short time available to draw up business plans, the industry often falls back on measuring those things that are already measured.

In light of these obstacles, the water sector has generally moved back towards measuring inputs and outputs. But this approach means companies have limited incentive to devise alternative, innovative ways to deliver improvements inthe customer outcome. A focus on output- or input-based measures leads to more specific, narrowly defined incentives.

To overcome this challenge, we need to:

- Start work on future measures as soon as possible
- Recognise that measuring the right things requires some investment

- Use a collaborative approach, e.g. different companies testing different measures and sharing the results more widely.

SATISFACTION NEEDS TO BE EXPLORED IN MORE DETAIL

An obvious candidate for a measure that is linked to legitimacy and outcomes is customer satisfaction. The PR19 Customer Measure of Experience (C-MeX) was intended to capture overall satisfaction. At issue is whether we can go further. Can satisfaction with a specific service area be a meaningful outcome measure?

This raises a number of questions:

- Can water companies markedly influence satisfaction, or is it affected too much by external events? Can companies influence the impact of these events on satisfaction?

- Would companies still be incentivised to improve in areas that affect only a few customers, e.g. sewer flooding, if they have no impact on overall satisfaction?

- How can satisfaction in relation to the environment be captured when customers may not see the impact of water companies' actions?

- Could increasing the number of satisfaction measures encourage companies to focus more on the short term?

All of these questions have been explored by South East Water, which has used satisfaction measures since PR14. These have the potential to drive positive change as they measure high-level outcomes rather than specific outputs. At the same time, they are not without risks. More work needs to be done on how best to use these measures.

We also need to remember that satisfaction is not the only candidate for more high-level outcomes-based measures. In a recent customer survey, CC Water[3] reported that while satisfaction with water and sewerage services had fallen, trust in companies had increased. Both satisfaction and trust scored higher than value for money and fairness of charges. Only 63% of respondents agreed that charges were fair whereas 72%-75% were satisfied that they got value for money. For the reasons discussed above with regard to satisfaction, it is not clear if a simple value-for-money survey is an appropriate measure, so other measures need to be explored as well.

LONGER-TERM INCENTIVES ARE IMPORTANT

Legitimacy is not the only objective. We also know that customers support the overall outcome of a sustainable, efficient water industry. Water companies should therefore also be incentivised to invest to improve resilience and asset health over the longer term. This has been highlighted in Ofwat's strategy for the future. Another of the regulator's three goals is to "drive water companies to meet long-term challenges through increased collaboration and partnerships".[4] Ofwat is particularly keen that companies address longer-run challenges relating to climate change and population growth.

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[3] CC Water, 2019, Available: https://www.ccwater.org.uk/research/water-matters-householdcustomers-views-of-their-water-and-sewerage-services-2018/

[4] Ofwat (2019), Time to act, together: Ofwat's strategy, p. 28

A challenge with the current outcomes framework is that measures and targets are set only for five years, which encourages companies to adopt short-run solutions. Ofwat has gone some way to address this at PR19 by requiring companies to set out longer-term ambitions on all measures and by signalling that the outcomes framework is likely to remain in place for some time. However, more needs to be done. For example, a small number of targets could be set over a longer time period or a few output-based measures could be developed that sit outside the outcomes framework, as with Ofwat's monitoring of financial resilience.

Including longer-term measures is not without its difficulties. How do you set corresponding targets? Should "reopeners"[5] be included to reflect changing priorities and external shocks? Water companies would also need sufficient confidence that they would continue to receive the necessary cost allowances to deliver those targets efficiently over the long-term. Questions such as these have previously held the industry back from building longer-run measures into the outcomes framework. However, we believe overcoming these issues will be necessary if Ofwat is to achieve its goals of increasing resilience and focusing more on the long term. In our view, the ambition should be at least to trial a small number of longer-term targets at PR24.

WHAT SHOULD WE MEASURE?

Higher-level measures that are linked to outcomes are most effective at delivering legitimacy, innovation and efficiency. Customer satisfaction is clearly a candidate and needs to be explored further. The water industry needs to carry out the following steps.

FIGURE 4 STEPS TO DEVELOPING NEW MEASURES

Source: Frontier Economics

An early start is particularly important as it is risky to set targets when only one year of data is available. So, if we want to have a more meaningful set of measures at PR24, we need to identify, test and refine them starting this year. During trial periods, it must be remembered that some measures can be tracked on a monthly or quarterly basis to create a sufficiently reliable time series.

[5] By reopener we mean a mechanism or framework for amending a long-term target.

HOW SHOULD TARGETS BE SET?

CUSTOMER RESEARCH AND COST ASSESSMENT NEED TO BE ALIGNED WITH THE TARGET-SETTING METHODOLOGY

At PR14 and PR19, the customer research used to inform target-setting was company-specific and carried out independently of the cost assessment. This raises a number of issues.

- Comparative information was often used to set targets and sense-check the level of stretch in the proposed targets. This often meant that final targets were not directly linked to customer views. The methodology in future needs to incorporate a much clearer role for customer research to avoid a potential disconnect between customers' preferences and the final targets.

- By setting costs and targets independently of each other, the regulatory framework fails to recognise that companies are faced with different operating environments that could make it easier or harder to achieve comparative targets. The future methodology for target-setting needs to be integrated with the cost assessment, requiring an analysis of how the operating environment affects both costs and service levels.

- Comparative targets for measures such as asset health or resilience have generally been set without considering customer views and costs in an integrated way. An integrated analysis can also address the question of whether comparative targets are appropriate for such measures in the first place. For example, a 30% reduction in mains repairs or sewer collapses could be analysed in the context of the operating environment and the cost assessment.

The future target-setting methodology needs to be integrated more closely with customer research and the cost assessment so that the final price control is fully reflective of companies' operating environments. In the following section we consider alternative ways in which targets can be set, which could go some way to addressing these concerns.

STANDARDISED OR DYNAMIC TARGETS CAN DELIVER LEGITIMACY BUT NEED TO BE INTEGRATED WITH COST BENCHMARKING

Keeping in mind that legitimacy is a key objective, there are various options for setting targets, as summarised in the figure below.

This highlights that standardised and dynamic targets require a comprehensive approach to be taken. The industry needs to ensure that future work on targets includes considerations on cost benchmarking.

FIGURE 5 POTENTIAL WAYS TO SET TARGETS

STANDARDISED TARGETS

- Targets could be set the same for all companies
- Could involve an adjustment in cost assessment
- Avoids “postcode lottery”
- May be at odds with allocative efficiency
- May increase overall legitimacy

TARGETS BASED ON LOCAL VIEWS

- Reflects local preferences
- Information asymmetry between Ofwat and companies can lead to concerns around the quality of data and level of stretch included in targets
- Need to strike a balance between using local views and comparisons

DYNAMIC TARGETS

- Rewarding ex-post top performers arguably more closely mimics competitive market
- Removes need to forecast performance
- Could drive productive efficiency
- May not work as well for capital-heavy areas

Source: Frontier Economics

THE WATER INDUSTRY SHOULD EXPLORE HOW LONGER TERM TARGETS COULD BE IMPLEMENTED

As discussed above, one potential criticism of the current outcomes framework is that it does not support resilience and asset health as much as it could. This presents an opportunity to adapt the framework to incorporate more longer-term thinking. There are a few ways in which longer-term targets could be set. For example, targets for the current set of measures could be set for, say, 15 years. This could be accompanied by an appropriate “reopener” mechanism allowing for amendments to targets to reflect external shocks or material changes in customer preferences.

A commitment by Ofwat to maintain the same set of measures and to setting dynamic targets for a longer time period may also generate greater incentives for companies to plan for the longer term. However, there are challenges with introducing targets that stretch long into the future: sustained outperformance or underperformance can undermine legitimacy. This is a consideration that to date has limited the introduction of longer-range targets.

In our view, the industry needs to commit to exploring this question further for PR24 and beyond. This should include assessing whether there is a way to set longer- term targets effectively within the outcomes framework. This may be more possible than it has been in the past if alternative target-setting approaches are being considered for PR24 and beyond. Trialling, say, 10-year targets for a small number of measures seems to be a good starting point. However, if a detailed evaluation of long-term targets suggests there are too many risks and drawbacks, alternatives should be considered outside the outcomes framework, which we discuss further below. If resilience and asset health are to be addressed using alternative mechanisms, there is a need to think about what weightings would be appropriate relative to those in the outcomes framework.

THE ALTERNATIVE IS A RISK ASSESSMENT FRAMEWORK

The alternative would be to separate those measures for which long-term targets would be most appropriate and develop a consistent risk assessment framework for them. This could promote long-term thinking and delivery. It would also be an opportunity to include a mix of long-term targets and indicators to be assessed on an integrated basis.

The industry needs to weigh up the pros and cons of long-term targets within the outcomes framework versus a long-term risk assessment. To develop a credible approach for PR24, an early decision on the direction of travel is needed in order to develop a practical, robust approach in time for PR24.

HOW SHOULD TARGETS BE SET?

To develop the best way forward on target- setting, we need to balance allocative efficiency and legitimacy. This means we need to be clear about our overall objectives (see Figure 2). One option would be dynamic five-year targets for customer-facing issues and standardised long-term targets for outcomes such as resilience and asset health.

Any approach to target-setting needs to be integrated with the cost assessment. The industry should investigate further the options for targets and the implications for cost-modelling. In addition, customer views on standardised targets, dynamic targets and the importance of allocative efficiency need to be explored to ensure that the target-setting approach delivers legitimacy.

The way forward is summarised in the diagram below.

FIGURE 6 STEPS FOR DEVELOPING TARGET-SETTING METHODOLOGY

Source: Frontier Economics

HOW SHOULD INCENTIVES BE DESIGNED?

INCENTIVE DESIGN NEEDS TO BE ALIGNED WITH THE OVERALL OBJECTIVES

In order to develop the most effective incentive design, we need to focus on the behaviours that we want to encourage. We need to understand better the impact of current incentives to know if and how they need to be changed. ODIs have now been in place long enough for us to assess how they influence company behaviour.

With legitimacy as a key objective, incentive design really matters. Here we consider four relevant questions.

- Who should receive underperformance payments?
  - Should they be paid to those who experience interruptions and flooding?
  - To date, the argument has been that we jointly pay for an average service so all customers should receive underperformance payments. But that may not be the best approach to increase legitimacy and the acceptability of ODIs.
  - The balance between compensation (guaranteed standard scheme payments, GSS) and ODIs needs to be reviewed.
  - Should companies who continue to deliver strong absolute performance avoid underperformance payments, or should we target incremental improvement for all companies?
- Should we revisit personal versus collective incentives for the company?
  - To what extent is senior management accountable in the current system – should ODIs lead to more personal incentives or is this already the case?
  - Should this be left to companies to decide?
  - A greater understanding of how ODIs work in practice will help shape decisions on this issue in the future.
- How can we introduce longer-term incentives?
  - Longer-term targets go some way to improve decision-making, but longer-term incentives may also be needed. Some level of confidence over future cost allowances may also be required.
  - Should bonuses be tied to long-term performance after people leave the company?
- Can we simplify deadbands, caps and collars[6]?
  - All of these tools reduce the strength of the incentive but limit the risk the company and customers are exposed to.
  - A better approach to target-setting could remove the need for deadbands.

As legitimacy is not the only objective, other approaches need to be considered to encourage innovation and manage affordability. For example, innovation could be fostered by offering large prizes for step changes (the original intent of enhanced ODIs at PR19). This would need to be linked to appropriate targets

[6] Deadbands provide range of performance levels for which no financial incentive is applicable, i.e. a safe band of performance levels between the target and a point at which incentives kick in. Caps and collars refer to limits on financial out and underperformance.

to be effective. To manage affordability and vulnerability, questions about how ODIs should affect the average bill and the bill for those on social tariffs need to be explored.

HOW SHOULD INCENTIVE RATES BE DETERMINED?

In theory, incentive rates that reflect customer valuations seem appropriate to bolster legitimacy. Bottom-up incentive rates that are based on triangulated consumer valuations should be constrained by the overall acceptability of bill increases and customers' views on bill stability and incentives. The existing methodology is based on this approach. However, in practice two important challenges arise.

- **Differences in customer valuations across companies.** A comparison in 2018 of the customer valuations estimated across companies revealed large discrepancies. For example, the implied value of one property affected by a six- to 12-hour interruption ranged from around £160 to around £2,400.[7] While we would not expect identical valuations, such a large divergence is likely to be the result of differences in research design and the context provided. As a consequence, a number of the customer valuations were amended in the course of the price control review. Indeed, in many cases Ofwat decided not to use the companies' customer valuations in setting ODIs as part of its final determinations. This means that in practice the link between customer research and incentives was significantly weakened across the industry, and in many cases entirely removed. The sector therefore needs to find a more pragmatic approach to strengthen the link between customer insights and financial incentives.

- **Link with setting targets.** The original framework had a strong link between the way targets and incentives were set; both were informed by local customer valuations. This meant that, in theory, targets were allocatively efficient (customers were prepared to pay for the costs) and ODIs were incentive- compatible (companies were incentivised to go beyond the target only when costs fell below the willingness to pay for more service improvements). However, at PR19 a number of targets were set on the basis of comparative information rather than companies' customer valuations. This being the case, the logic for requiring incentives to be based on bottom-up, localised valuation data was undermined.

There are some potential options for addressing these challenges and maintaining a link between customers and incentive rates. One is to set standardised targets and to develop a national customer research approach to be used by all companies to inform ODIs. This would ensure that customer research is carried out on relevant targets, taking into account local views, but it should narrow the range of customer valuations across companies. The downside of this approach is that companies would not design their research with their own customers in mind. It would deter innovation in customer research design. And a lack of time might make it infeasible because the research would need to be carried out after targets had been set.

An alternative option is to set incentives on a top-down basis. Ofwat could determine the overall total upside and downside, and it would be up to companies to allocate this across PCs based on customers' relative priorities. This would be a less mechanistic approach, but it may be more pragmatic. And at a

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[7] Accent (2018), Comparative review of PR19 WTP results

qualitative level the way incentives were set would reflect consumers' views. The total overall upside and downside could also be informed by national customer views and affordability.

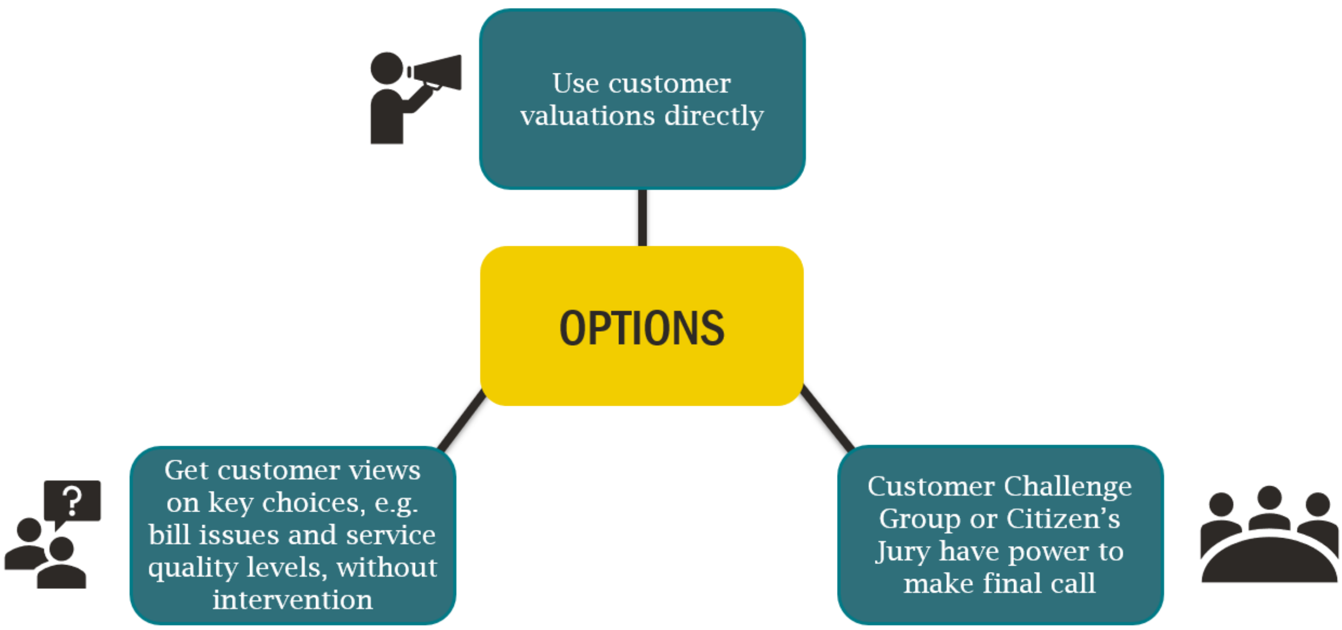
The key decision for the industry, therefore, is whether a bottom-up incentive mechanism should be retained in light of the design challenges. If the industry were to opt for a top-down structure instead, there would still be questions about how it should be designed to ensure that incentives continue to reflect customer views to some extent.

WHO MAKES THE KEY DECISIONS ON INCENTIVE DESIGN AND VALUES?

A potentially more important question centres on who would make the key decisions on incentive design and customer values used to set rates. As legitimacy is crucial, could we envisage a system where customers have more of a direct say without their views being interpreted by companies and by Ofwat?

This requires us, first, to think about those areas where customers can have a direct voice, including incentives. One possibility is to take a set of, say, 25 options in the business plan and ask customers to select their preferences. The important question in all of this is what customer views we could leave unchallenged and take at face value. There are different ways of giving customers the power to set incentives, as shown in the figure below.

FIGURE 7 WAYS TO GIVE CUSTOMER POWER TO SET INCENTIVES



Source: Frontier Economics

The options need to be investigated further so that customers' voices can be heard more clearly in the next price control reviews.

This raises a wider question as the voice of the customer needs to be considered not just in the context of outcomes but with regard to the full price control. The PR19 methodology focuses customer engagement on the overall plan and on specific service quality targets. Most of the customer engagement takes place to inform the initial business plan so that companies can base their plans on customer views. However, the issues with this approach is that the final determination often reflects higher service and lower costs compared to the options initially presented. Detailed views by customers on specific valuations therefore often do not feed into the final determinations. There are a number of ways to address this issue:

- We need an integrated assessment of costs and PCs. This would make the relationship and trade-off between costs and PCs more explicit. More and better data provides great opportunities to achieve this. An integrated assessment would open up a range of options for how customers can feed into the price control. For example, a citizen's jury could be involved in reviewing and assessing companies' overall plans, including to some extent getting their views on companies' proposed costs and the approach for assessing them.

- A sequential approach is another option as there is no reason why the PC and ODI framework could not be agreed ahead of the price control. This could also enrich the debate about how to set incentives for long-term outcomes such as resilience and asset health. It may mean that some customer engagement is carried out early on in the process to identify customers' priorities and high level views on incentives. It would then require more involved and expanded acceptability testing to ensure that customers' views were sought on the final business plans, including the overall bill levels. If this was implemented in a targeted way, it could lead to more meaningful engagement without requiring more resources.

HOW SHOULD INCENTIVES BE DESIGNED?

There are many options for incentive design, and any changes can have a big impact on legitimacy. The Important next steps are to:

- Build a better understanding of how the current ODIs affect company behaviour
- Review the framework of who receives outperformance and underperformance payments, on both the company and the customer sides (personal vs collective incentives) and consider how long-term incentives may work
- Explore the options for using top-down incentives and how these may relate to customer views on legitimacy
- Consider how customers can have more of a direct voice in the price control process
- Integrate the methodology for incentive-setting with other parts of the price control such as the review of risk and reward.

This is summarised in the diagram below.

FIGURE 8 STEPS FOR DEVELOPING INCENTIVES

Source: Frontier Economics

WHAT SHOULD WE DO NOW TO CREATE A BETTER ODI APPROACH?

In this paper we have discussed how ODIs could evolve and we have identified a number of topics that need further investigation. In our view, it is important for companies, regulators, customers and stakeholders to use the next couple of years effectively to develop a new, viable, long-term approach to ODIs. This should include the following.

- **Overall**:
  - Agree the balance of overall objectives. This is essential so we can design a system that delivers what we want and we can shape the framework accordingly.
  - Conduct research on what sort of system customers would regard as supporting the overall objectives, including legitimacy.
  - Build a good understanding of how the current ODIs affect company behaviour.
- **Measures**:
  - Start work on measures as soon as possible – they are more important than they sound.
  - Focus on identifying outcome-based measures.
  - Recognise that measuring the right things requires investment.
  - Use a collaborative approach with companies sharing results from their trials of new measures.
  - Explore how satisfaction measures can be used for specific service areas.
- **Targets**:
  - Decide how to trade off allocative efficiency, productive efficiency and legitimacy in setting targets and incentives.

- Further develop options for target-setting, including
  - dynamic targets for customer-facing measures
  - standardised targets
  - long-term targets or risk assessment framework for resilience and asset health
  - making an early decision on the direction of travel to allow sufficient time to develop the agreed approach.
- Decide who should make the final decision on targets and incentives and the role of the customer voice in the process.
- Integrate the approach to targets with the approach to cost benchmarking.

- **Incentives**:
  - Build a better understanding of how the current ODIs affect company behaviour.
  - Review the framework of who receives outperformance and underperformance payments and consider how long-term incentives may work.
  - Explore the options for using top-down incentives, and how these may relate to customer views on legitimacy.
  - Consider how customers can have more of a direct say in the price control process.
  - Integrate the methodology for incentive-setting with other parts of the price controls such as the review of risk and reward.

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