Oxera

Agenda

Advancing economics in business

Getting the outcome right for water customers

One of the key changes recently introduced by Ofwat to how it regulates UK water companies is the move to outcomes-based regulation. While this may appear to pose some challenges for the industry, it can also be an opportunity to build on experience, deliver what customers want and value, and, potentially, gain greater rewards than in the past. What are the practical implications of this new form of regulation for the water industry?

Ofwat, the economic regulator of the water and sewerage sectors in England and Wales, has carried out a fundamental rethink of how it regulates the industry. In its consultation paper on the approach for the next price control,[1] Ofwat sets out the pillars of its new regulatory framework.

One of the main changes is the move to outcomes-based regulation. A similar approach is being applied in the GB energy sector, where the regulator, Ofgem, has already incorporated regulation into its framework for gas transmission and distribution based on the delivery of high-level 'outputs' (similar to Ofwat's 'outcomes').

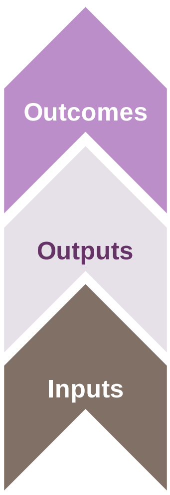
This article discusses the main changes that Ofwat is planning to introduce to the incentive regulation framework, considers some of their key challenges and opportunities for water companies, and compares the approach adopted in the energy sector.

What is outcomes-based regulation?

Traditionally, UK regulators have focused on assessing companies on the amount of money they need to spend (inputs) in order to deliver a particular level of service or improvements to services (outputs). Recently, however, some regulators have suggested that such an approach may miss the 'bigger picture', and have asked whether it really captures what customers or society want and value.

Some regulators are therefore moving away from the regulation of inputs and outputs in pursuit of a regulatory approach with high-level 'outcomes' at the centre. Figure 1 explains what is meant by outcomes, and shows the hierarchy of inputs, outputs and outcomes.

Figure 1 The relationship between inputs, outputs and outcomes



The higher-level objectives that company actions, activities and achievements are intended to help deliver. They represent what customers and society really value

The observable and measurable activities, actions or achievements that a company needs to deliver to bring about the outcomes that customers and broader society value

The resources that a company uses to carry out its activities or to deliver particular outputs. These could be specific resources (such as goods, services, energy, labour or capital), or they could be enablers (such as the skills base)

Source: Oxera, based on Ofwat (2011), 'Inputs, Outputs and Outcomes—What should Price Limits Deliver? A Discussion Paper', March.

Defining and measuring outcomes

In moving the focus of regulation to outcomes, the first challenge is to define target outcomes and decide how these will be measured in order to assess whether companies have delivered their commitments on outcomes.

The approach to setting outcomes differs across industries. In the energy sector, most outcomes and measures of success are set centrally (ie, determined by Ofgem) and are the same for all companies. Ofwat, on the other hand, intends to set only a few industry-wide outcomes, with the remainder being company-specific, reflecting the individual company's and its customers' priorities, as identified from customer research and based on an engagement with each company's Consumer Challenge Group.[2]

Given the high-level nature of outcomes, measuring them may not be straightforward. Indeed, as inputs and outputs tend to be easier to measure than outcomes, there may be a temptation to slip back to focusing on inputs and outputs rather than outcomes.

Outcome delivery incentives

Ofwat has stated that it intends to attach 'incentives' to the delivery of outcomes, with a view to encouraging companies to deliver their promised outcomes in the most efficient way—ie, with penalties for non-delivery and rewards for delivery of outcomes that customers value. There are a number of considerations concerning incentives:

- the choice of financial or non-financial incentives;
- when to grant rewards or issue penalties;
- trade-offs across outcomes, and across time;
- the basis for setting financial incentives;
- the process for determining outcome incentives.

Form of incentives

Ofwat has allowed for the use of a combination of financial and non-financial incentives.[3] The latter could be used as a complement to financial incentives for priority outcomes or as a partial substitute for them if the outcome is considered to be largely outside the company's control. Similarly, in the energy sector, Ofgem noted that financial incentives were not applicable to all outcome ('output') measures, and, in particular, that they should not be applied to outcomes outside the regulated company's control.[4]

Penalty-only or penalties and rewards

Ofwat has allowed for companies to propose incentives that allow for both penalties and rewards for those outcomes where there is evidence that customers are willing to pay for delivery beyond the agreed performance level. If, on the other hand, the evidence suggests that customers will gain no incremental value from over-delivery, the outcome will be incentivised through the implementation of penalties for under-delivery only (eg, for statutory requirements).

Ofgem's approach is similar, with additional rewards for over-delivery only where companies are able to demonstrate that customers value this.[5]

Trade-offs

Trade-offs between performance on different outcomes are intended to allow companies additional flexibility in delivering the outcomes—for example, outperformance on one outcome could be used to compensate for underperformance on another. The intention is that this could encourage (or at least not discourage) the adoption of alternative solutions and innovation, given that the company's performance is assessed 'in the round'. Otherwise, if the company expects to be penalised for not achieving a particular outcome, it might become risk-averse and adopt only tried-and-tested solutions, thereby reducing the scope for innovation.

Ofwat has adopted a flexible approach that allows companies to propose trade-offs among outcomes to best fit with the nature of the outcome. For example, outcomes may be delivered by shared activities and incur joint costs, or customers may be willing to pay for improvements to a group of outcomes. In these cases, outcomes may be grouped and delivery assessed at the group level rather than for single outcomes.

Strength of incentives

Ofwat has confirmed that the size of any potential reward or penalty should be set with reference to the value that customers place on the delivery of the outcome, as opposed to the incremental cost associated with its delivery. By basing financial incentives on the value of the outcomes to customers, companies should be encouraged to focus on the outcomes that customers value most, thereby providing strong incentives for both delivery and innovation in the delivery of those outcomes.

Process

Ofwat has put the onus on companies to propose outcomes and outcome delivery incentives in their business plans. Customer Challenge Groups will be responsible for challenging the companies' proposals. They will also report to Ofwat on the quality of the companies' customer engagement and the extent to which the companies' proposed outcomes and delivery incentives reflect customers' views. Ofwat will then make a final assessment of the companies' proposals. In addition to these company-specific outcomes and incentives, Ofwat will determine some minimum performance levels that will apply to all companies.

Key challenges for industry

Constructing the post-2015 business plan is likely to be one of the key tasks for water companies in 2013. It could be made more challenging by a number of changes to the regulatory framework (such as multiple price caps, and new ways to remunerate expenditure). Perhaps the most critical aspect of the new framework for water companies is to develop a well-evidenced, customer-centric business plan that has the support of the key stakeholders (customers, regulators, and providers of finance). This may present a series of challenges.

- Companies would need to identify outcomes, performance commitments and measures of delivery that their own staff can understand, relate to and deliver. Stakeholders would need to understand what the company is committing to and feel reassured that, using the measures identified by the company, they can monitor progress. Crucially, in defining these outcomes and committing to different levels of service, companies would need to have an understanding of customers' priorities and the values attached to different levels of delivery. This evidence would be required to establish the level of incentives that customers and regulators would support in order to penalise under-delivery and reward over-delivery.

- Companies would need to identify the cost implications of delivering different levels of service for each outcome, to allow them to decide what level is economically efficient. The impact of the package of outcomes would then need to be considered in terms of its affordability to customers.

- Companies would need to understand the implications of outturn performance—for example, on outcomes delivery and costs (and other incentives)—and how these would affect their financial performance.

- Companies would need to consider the risks arising from events not under management control, and how best to allocate them between companies and customers, for example.

- Since outcomes proposed are likely to vary from company to company, this may raise a question about how Ofwat will assess and compare companies. In particular, a shift to outcomes-based regulation may result in like-for-like comparisons being harder to make. Ofgem may have uncovered a similar issue when assessing the comparative efficiency of business plan costs—instead of undertaking comparative analysis over the full eight-year forecast period of the business plans, Ofgem focused on just the first two years, when costs may have been more comparable.

A practical approach to outcomes?

However challenging the move to an outcomes-based regulation may appear, water companies start from a history of collating information on services delivered to customers and publishing it in a way that is accessible to various stakeholders, most notably through the Overall Performance Assessment (OPA).[6]

The framework proposed by Ofwat offers the companies flexibility on how outcomes and related incentives can be developed and implemented.[7] This may help companies to learn from, and build on, their experience in order to take a practical approach to implementing outcomes-based regulation and in proposing appropriate delivery incentives.

One approach might therefore be to use a mechanism similar to an OPA for groups of outcomes. Grouping outcomes would make it easier to assess costs (eg, by overcoming issues around common and joint costs allocations). Similarly, it may be more robust to assess the value of grouped outcomes, since customers may assess the level of service in the round and not at the level of specific outcomes.

In summary, a practical framework for water companies would be made up of the following key elements.

- Listening to their customers. Companies need to understand their customers' priorities, via qualitative and quantitative research (eg, stated-preference studies), and using the Customer Challenge Group to test the results, credibility and interpretation of this empirical evidence.

- Defining outcomes that are measurable and transparent. Companies may want to select measures of delivery success, beginning with the outputs that have been known and reported on thus far.

- Identifying the cost implications, over time, of adopting different solutions/strategies for outcomes delivery.

- Treating outcomes as a group wherever this is appropriate—for example, when costs to deliver the outcomes are joint, customers are willing to pay for a group of outcomes rather than individual ones. Trade-offs and rewards and penalties should be applied to ensure that outcomes are evaluated as customers would evaluate them (ie, in the round), and to ensure that changes in the external environment can be accommodated.

- Recognising that some outcomes, such as minimum quality standards, may not be suitable for certain aspects of the incentive regime (such as trading off statutory water quality standards against other outcomes).

- Building the package of outcomes and delivery commitments, outlining related costs, risks and potential rewards for customers, companies and their providers of finance.

- Communicating clearly with different stakeholders. A key part of this will be to propose mechanisms that clearly link the outcomes that customers want with the remuneration that companies receive under different packages.

In developing an approach to assessing and effectively communicating the implications for stakeholders of different options, companies may consider treating service and satisfaction levels as given points, weighted according to customers' stated priorities. Customers pay over a price control period for an agreed level of points to be delivered by an agreed date. Changes in the points beyond a level of immateriality trigger rewards and penalties for the company. This is illustrated in Figure 2 below.

In this framework, rewards/penalties should be applied at the end of the price control period and not during it, to avoid unnecessary fluctuations for customers and investors in charges and revenues respectively.

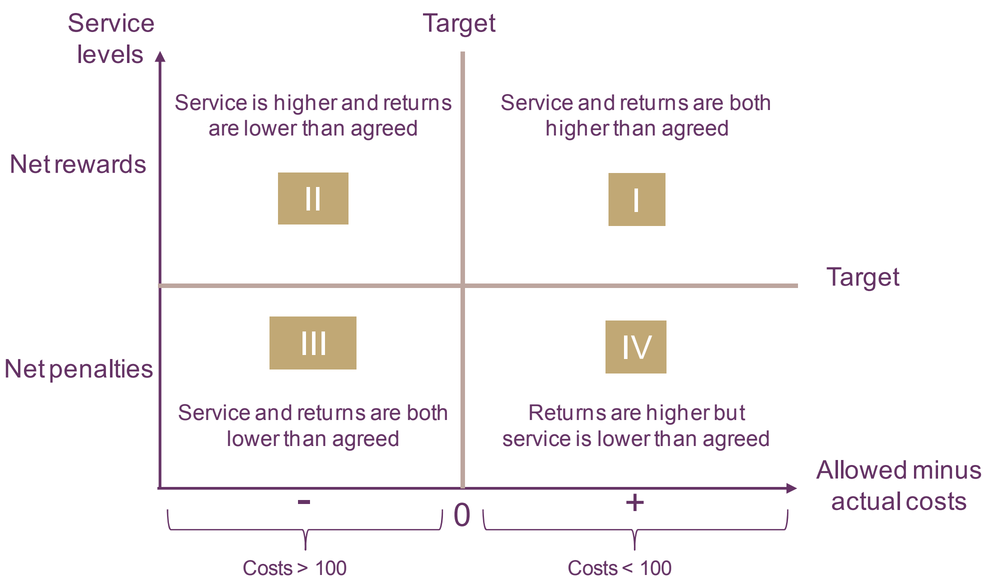
Conclusions

Outcomes-based regulation in the water sector will be a key pillar of the new regulatory framework being introduced by Ofwat for the next price control. While this may appear to pose some challenges for companies taking on the ownership of setting the outcomes and the relative incentives, it can, in fact, represent an opportunity for them to build on their experience and deliver what customers want and value, and potentially gain greater rewards than has been possible under the current regulatory regime.

In order to rise to this challenge, companies may need to build the case for grouping one or more outcomes when appropriate and to be assessed according to their delivery over the group (ie, a sort of mini-OPA). This could reduce computational difficulties and enhance the robustness of the case at the planning stage. It could also facilitate the engagement of customers and their representatives in the Customer Challenge Group, as presenting services grouped together is potentially closer to the way customers consider the services they receive—ie, in the round.

Finally, outcomes-based regulation could reduce the risk of companies being penalised for failing on a single outcome—which, in turn, could lead to companies trying innovative rather than tested solutions in some areas, on the understanding that any failures in those areas could be compensated by delivering services above commitments in other areas.

Figure 2 The relationship between rewards, penalties and targets



Source: Adapted from Oxera (2012), 'Outcome Delivery Incentive—Options in Setting Future Price Limits in the England and Wales Water Industry', August.

[1] Ofwat (2013), 'Setting Price Controls for 2015-20 − Framework and Approach: a Consultation', January.
[2] In the new regulatory regime, Customer Challenge Groups review and challenge companies' business plans. Ofwat (2013), op. cit., pp. 14–5.
[3] A non-financial incentive might take the form of a league table (ie, based on reputation), or could be more procedural (eg, fast-tracking, or additional scrutiny of future outcomes-setting processes).
[4] Ofgem (2010), 'Consultation on Strategy for the Next Transmission and Gas Distribution Price Controls – RIIO-T1 Outputs and Incentives', supplementary annex, December 17th, p. 5.
[5] Ibid., p. 5.
[6] The OPA was an incentive tool used by Ofwat until 2010 that assessed companies' quality of service along a number of metrics, covering security and continuity of supply, compliance with required standards, and customer services (eg, handling complaints). Ofwat would report on companies' performance annually. The companies would be assessed during a regulatory period and then given a financial reward or penalty at the start of following period, depending on their performance.
[7] See Ofwat (2013), op. cit., p. 39.