Can Ofwat's PR19 deliver good consumer outcomes?

The 2014 price review saw one of the biggest changes in the water sector in the last quarter century: a new and relentless focus on good consumer outcomes has driven a fundamental shift in the incentive package on offer to water companies. We ask how far that change has gone, and what more might happen in PR19.

To some in the water sector, Ofwat's new consumer outcome incentive package for PR14 felt like a radical experiment. Giving companies responsibility for finding out what their consumers wanted, and letting them set their own rewards and penalties for delivery of those outcomes, seemed to be fraught with the potential to go badly wrong.

So it is not surprising that Ofwat introduced its final package in a very careful way. PR14 deliberately capped the scale of potential rewards (and penalties) from the outcomes incentives – the Risk Based Review and the companies' Outcome Delivery Incentives. It also retained a strong focus on cost efficiency incentives, albeit with the introduction of new initiatives like the move to totex and the use of menus.

This cautious approach was sensible not only to protect against the potential for unintended consequences, but also to allow the industry to learn how the package works. Water companies needed time to trust, by verifying, that Ofwat would honour the new approach if they in their turn stepped up to the challenge of becoming truly consumer focussed.

Two years on, there is general consensus that Ofwat's new approach is the right one, and that companies do need to change their culture.

To build on this success, Ofwat needs do three things: it must honour the incentive package for those companies that really deliver for their consumers; it should increase the size of the prize in the outcomes incentive package; and it must clarify how the outcomes incentive and cost incentives package work together to deliver the best outcomes for consumers.

At PR14 the regulator challenged water companies and their Boards start to transform their businesses into truly customer-focussed enterprises, concentrating on what their customers want and being accountable to them for the outcomes they deliver.

To make the process even more powerful in PR19 and beyond, the regulator needs to take a strategic step back and address the complexity of the package, in particular the inter-linkage of outcome incentives with the cost assessment incentives.

Only when companies and their Boards can clearly understand, quantify and trust the outcomes incentive package will we see a step change in their ambition to change their businesses and put the consumer, and the outcomes they want, first and foremost.

A major theme of Ofwat's PR14 price review was the regulator's drive to place responsibility with company Boards for business planning decisions that deliver good outcomes for consumers. Today – nearly two years into the five-year price review period – there is widespread agreement that this was the right move for the water sector. But we should not forget too quickly just how seismic a shift this has been.

Historically, the incentive package in water rewarded companies for delivering a long list of 'schemes' that the regulator in its wisdom approved, and customers paid for. In such an environment it is unsurprising that water companies had come to focus more on what the regulator wanted than on what their consumers were experiencing.

A new package was needed, one that got the attention of water company Boards and persuaded them that there were real opportunities to earn rewards from engaging meaningfully with their consumers and then designing their business plans to deliver the outcomes consumers wanted. It also had to give management enough freedom and flexibility to deliver those outcomes without the straightjacket of detailed regulatory approval of operational decisions.

PR14, involving rewards for good consumer engagement through Ofwat's Risk Based Review, cost efficiency incentives through the new totex models and menu approach, and companies' own performance commitments and outcome delivery incentives, has been broadly welcomed.

Anecdotally, companies report a new strengthened Board focus on the business plan and the beginnings of a shift in how companies view their accountability to deliver for their consumers.

Ofwat has signalled that it intends to build on the PR14 approach for the next price review. In particular, the regulator wants more stretching performance commitments and more powerful outcome delivery incentives. This could be mutually beneficial with consumers better served and companies, when they deliver, better rewarded.

But the PR14 process had its limitations: the regulator was developing a novel approach in a fairly compressed timescale, and companies were trying to respond to information that sometimes came late in the process. Some of these limitations are relatively easy to put right for PR19 and Ofwat's existing work programmes are clearly looking to do this through process changes: e.g. developing simpler and more informative guidance and issuing it earlier.

The most critical issue that needs to be addressed if Ofwat truly wants companies to focus on delivering good consumer outcomes, is the coherence of the package of incentives. For example, if outcome delivery incentives are to work, companies have to be clear about the purpose of the outcome delivery incentives and how they interact with other incentives in the price control, particularly those aimed at driving cost efficiency. While these questions and inter-linkages were addressed to some extent in PR14, the overall outcome was a highly complex mixture that made it difficult for companies to assess the opportunity afforded by outcome delivery incentives, and respond with suitably ambitious proposals.

In part, this is matter of presentation and clarity. Incentives work best when they are clear and well understood – the clearer companies and their Boards are the more they can rely on and respond to the incentives. When things are less clear up front, there is a risk of ad hoc interventions later in the process if the regulator sees unexpected outcomes, so firms will be more cautious. Presenting a clearer overall picture of how the outcome delivery incentives fit within the broader price control arrangements is likely to important if Ofwat wants to strengthen the power of the incentive and encourage company Boards to respond with ambitious consumer focussed proposals.

There are also a number of substantive coherence questions to be addressed and these will become even more important if Ofwat fulfils its promise to make outcome incentives stronger in PR19. Given the novelty of the approach in PR14, the value of the outcome delivery incentives, and hence the exposure faced by companies, was kept relative low. This was sensible given the potential for unintended consequences that comes with any new approach. But as the financial exposure increases so too does the potential for unintended consequence.

So now is the right time to take a step back and consider how the PR14 consumer outcomes incentives will fit within the broader price control package for PR19. The key to successfully strengthening these incentives will be to look carefully at where the main tensions might be expected to arise in PR19 and what alternative trajectories would lessen the extent of these tensions and provide for greater clarity, coherence and robustness.

One of the most important tensions is the link between outcome delivery incentives and the cost assessment processes. PR14 treated outcome incentives as a funding mechanism, and developing this mechanism will be a key task for PR19. If the magnitude of the incentives is to increase then interactions with the primary funding mechanism in the price control – critically through the cost assessment process - must be addressed. Ofgem's Interruptions Incentive Mechanism, that is applied to DNOs and has evolved over several price controls, provides one example of where these interactions have been explicitly recognised and addressed.

Another tension will be how to take account of the longer-term sustainability of assets, particularly as Ofwat seeks to meet its new resilience duty.

The development and treatment of longer term outcomes and their linkage to nearer term expenditure allowances, was always going to be one of the most difficult aspects of incentivising companies to focus on consumer outcomes. Success in this area will depend on companies being very clear about the balance of incentives on offer.

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