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PR24: Performance Commitments and ODIs
Prepared for Water UK

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1. Introduction

One of the questions that we have been asking while reviewing Ofwat's PR24 draft determination is: how well centred is Ofwat's calibration of 2025-30 performance targets?

The question arises because, with the benefit of hindsight, we can see that PR19 targets were too challenging. In year 4 of the 2020-25 regulatory period, 16 out of 17 companies in the sector reported net financial under-performance against Ofwat's common[1] PR19 performance measures, despite over-spending by a sizeable margin against Ofwat's PR19 totex allowances in year. It follows that this corner of Ofwat's PR24 framework merits particular attention in order to understand whether companies are being offered a genuine reset on 1 April 2025 or if some of the miscalibration from PR19 is likely to persist.

2. Objective

Ofwat explains that it approached the setting of PR24 performance targets in the following way:[2]

> Our calibration of the draft determinations has led to a package of incentives, cost allowances and uncertainty mechanisms so that the draft determination package is broadly balanced. As well as aiming for efficient companies to have a reasonable prospect of achieving the base allowed return, we have also provided opportunities for outperformance where companies deliver high levels of service to customers and the environment and lower returns where companies deliver poor levels of performance.

We take this to mean it is Ofwat's intention that the better-performing companies that Ofwat regulates ought to have picked up the draft determination and been able to identify definite scope for earning net ODI rewards across the new five-year period. At the same time, there ought to have been a similar-sized group of companies looking at a potential net ODI penalty based on the current trajectory of their performance, with a rump of other companies positioned somewhere in the middle.

In each case, companies should also have seen opportunity to improve their position and/or danger of doing worse than anticipated depending on how well management teams are able to respond to the operational challenges that PR24 requires companies to take on.

[1] 'Common' refers to the subset of targets that Ofwat factored into all companies' price control arrangements.

[2] Ofwat (2024), PR24 draft determinations: aligning risk and return. Ofwat's position is consistent with the approach that Ofwat took in PR19. See, for example, Ofwat (2020), Reference of the PR19 final determinations, cost of capital – final response to working papers: "[I]t is in customers' interests for companies to respond to incentives, and we are supportive of companies earning higher returns than our allowed cost of equity where this is due to genuine service improvements or cost reductions, stemming from good company management, or the result of a "fair bet". This mirrors the effect of a competitive market. We are, for example, pleased that some companies are improving performance in response to the ODIs and recognise this means that they may earn returns above our estimated WACC."

3. Assessment

There's no single way of judging whether Ofwat has produced a draft determination that has these qualities. But we show overleaf the first picture that we drew up as we tried to work out what kind of outlook Ofwat's draft determination produces.

The shading in the chart takes the performance levels that each company targeted in their October 2023 business plans, runs that performance through Ofwat's draft determination, and identifies where there is:

- expected financial reward worth more than 25 bps of RORE = blue
- expected financial reward worth between 10 and 25 bps of RORE = green
- expected financial penalty or reward worth no more than +/- 10 bps of RORE = no shading
- expected financial penalty worth between 10 and 25 bps of RORE = amber
- expected financial penalty worth more than 25 bps of RORE = red

In total, the table contains a total of:

- 4 cells shaded blue;
- 10 cells shaded green;
- 40 cells shaded amber;^ and
- 21 cells shaded red.

(^ not including C-MeX)

Table 1: Expected 2025-30 financial out- and under-performance based on companies' business plan forecasts of performance

	WSI	CRI	WQ	ISF	ESF	BIO	OG W	OG WW	LEA	PCC	NHH	POL	SPL	DPC	BWQ	SOF	MRP	UNO	SCO	C-MeX
ANH																				
WSH																				
HDD																				
NES																				
SVE																				
SWB																				
SRN																				
TMS																				
UUW																				
WSX																				
YKY																				
AFW				-	-			-				-			-	-			-	
BRL				-	-			-				-			-	-			-	
PRT				-	-			-				-			-	-			-	
SEW				-	-			-				-			-	-			-	
SSC				-	-			-				-			-	-			-	
SES				-	-			-				-			-	-			-	

Source: data provided by Water UK. Shading of C-MeX column reflects expectations of sector-wide under-performance.

Our instant reaction when we look at this picture is that it is not immediately obvious how this could be said to constitute a "balanced" package. We would not necessarily expect the number of green/blue cells to exactly equal the number of red/amber cells, but the strong overall tilt that there is towards expected penalty rather than expected reward, along with the high absolute number of companies that have multiple ambers or at least one flashing red on the dashboard, straight away makes us feel very uneasy.

The same story comes through when we calculate companies' expected RORE impacts and overall expected £m ODI performance.

Figure 1: Expected net ODI penalty / reward, average annual RORE, 2025-30

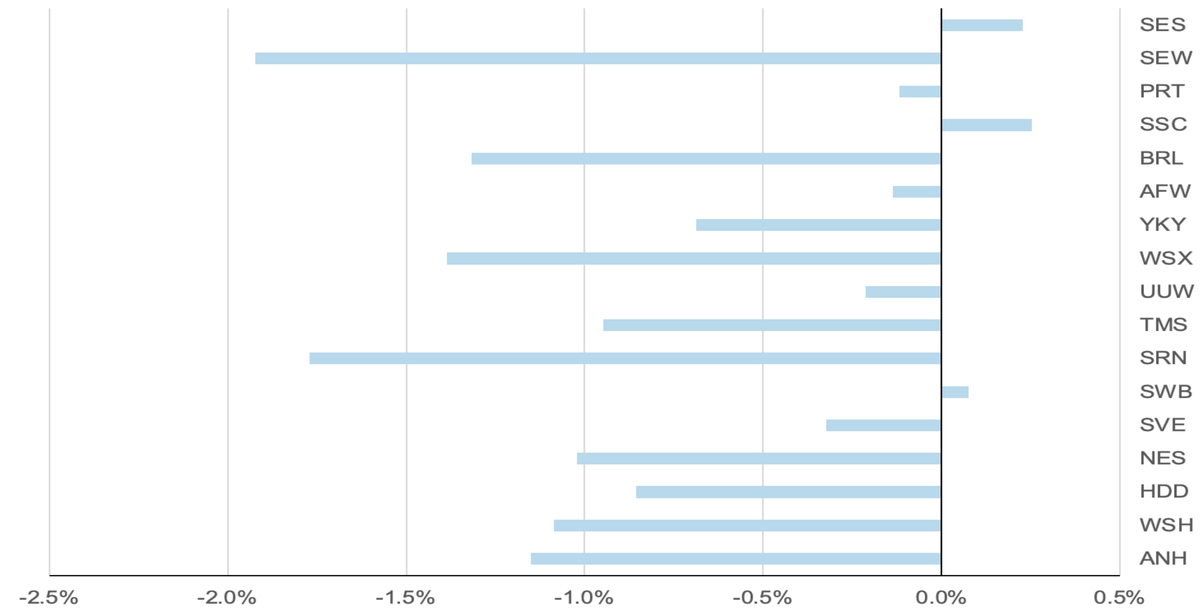
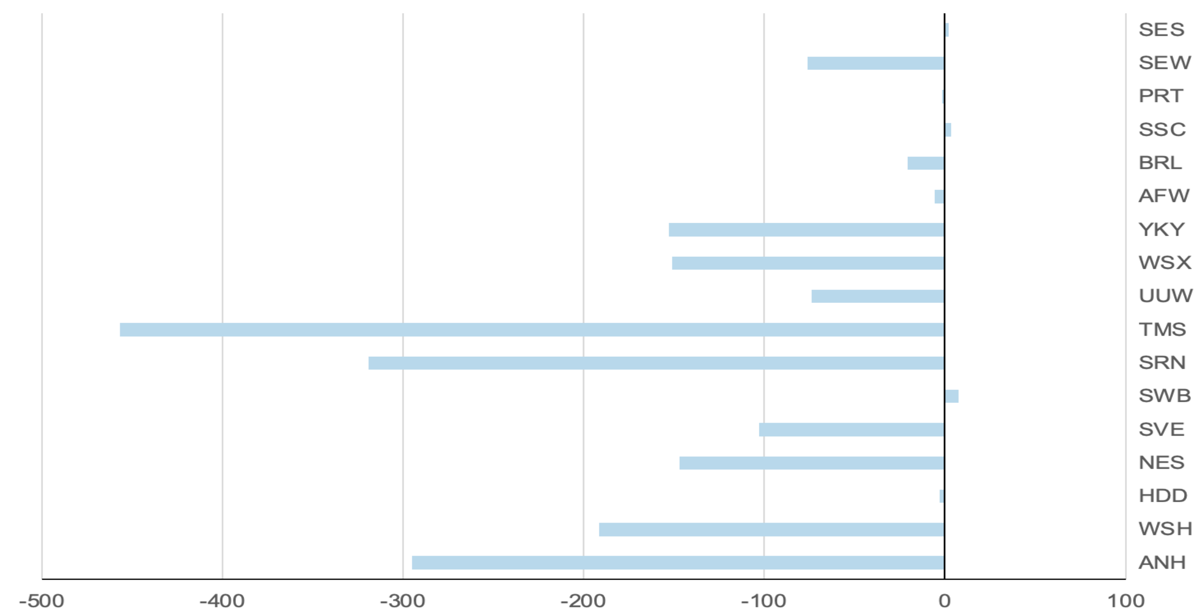


Figure 2: Expected net ODI penalty / reward, £m, 2025-30



Source: First Economics' calculations based on data provided by Water UK. Does not include expected C-MeX penalties or TMS's projected external sewer flooding penalty.

Our interpretation of this chart is that one water and sewerage company and two smaller water-only companies might reasonably be looking at their PR24 draft determinations and thinking that they have a decent chance of earning a net financial reward. There are subsequently two other water and sewerage companies and two smaller water-only companies who might be asking themselves if they can find ways of eliminating expected penalties and getting to a neutral position. And then there are 10 other businesses who can be forgiven for thinking that they are looking at a sure-fire financial penalty (and with those towards the lower quartile of the distribution likely to encounter a very significant loss of return).

In table 2 overleaf we show what looks to us to be the key driver of this picture.

The shading in this table comes from running companies’ performance in the last completed financial year, 2023/24, through the PR24 ODIs. It shows, in effect, how companies are positioned ahead of the new five-year period.

Table 2: Expected 2025-30 financial out- and under-performance if companies maintain 2023/24 performance

	WSI	CRI	WQ	ISF	ESF	BIO	OG W	OG WW	LEA	PCC	NHH	POL	SPL	DPC	BWQ	SOF	MRP	UNO	SCO	C-MeX
ANH																				
WSH																				
HDD																				
NES																				
SVE																				
SWB																				
SRN																				
TMS																				
UUW																				
WSX																				
YKY																				
AFW				-	-			-				-			-	-			-	
BRL				-	-			-				-			-	-			-	
PRT				-	-			-				-			-	-			-	
SEW				-	-			-				-			-	-			-	
SSC				-	-			-				-			-	-			-	
SES				-	-			-				-			-	-			-	

Source: data provided by Water UK.

The shading in this case is dominated by amber and red. In some cases – e.g. leakage – this is because companies have not yet received the funding that they need to deliver significant performance improvements. But the table also helpfully highlights that:

- certain columns in the earlier table 1 – e.g. serious pollution incidents – are either all white or mostly white because companies are targeting full compliance with obligations, even though past experience suggests it will be very hard for the sector to maintain a 100% record across a full five-year period; and
- in other instances, either when looking at specific performance measures or when looking at specific companies, a comparison of table 2 to table 1 indicates that business plans contained genuinely ambitious improvements performance levels.

These two factors imply that, in at least some cases, achieving the 'expected' financial outcomes shown in figure 1 could be very challenging.

We once again have to be clear at this point that there is no single right way of knowing when a package of regulatory proposals goes from being unbalanced to balanced. On the one hand, it is right that the regulator should offer challenge to companies, especially to companies that have a track record of under-promising or under-achieving, rather than take plans at face value. But on the other hand, the stretch that Ofwat tables has to be measured and recognise the dangers of repeating the mistakes of PR19, especially when dealing with companies that have a good track record and have elsewhere in PR24 exhibited a good level of ambition (and, hence, may have consciously strived to position performance commitments at a level that they thought would be acceptable to Ofwat, rather than necessarily a level that they currently expect to achieve).

If we had been sitting around Ofwat's board table during the assembly of the draft determination and had been shown the preceding tables and charts, we would have voiced concerns about Ofwat's proposals. The median position in the charts and the overall tinge of the tables, in particular, just look too skewed to the left and too amber and red in colour, respectively, to be compatible with what we consider as experienced regulatory practitioners to be a fair and appropriate level of challenge.[3]

As a consequence, we are not seeing how Ofwat could have satisfied itself that it has devised a package that 3/4/5/6 companies, including good representation from the water and sewerage companies, are going to look at and think "yes, Ofwat is right, this gives us an opportunity to earn a net ODI reward on the back of high levels of service to customers". We instead see a regulatory framework that says that only a few of the very strongest performers can expect, at best, to just about break even, while anyone that sits further down the industry league table is likely to suffer a loss.

In our opinion, this is not a balanced package.

4. Remedies

The skew that we are identifying can, in principle, be corrected via one or both of: changes to performance targets; and/or changes to ODI design.

[3] We note that the experienced eyes at Moody's offer a similar perspective in their recent sector note 'Ofwat's draft determination increases sector risk'.

Companies will be making company-specific representations on their company-specific performance commitments and their company-specific ODIs at the end of August. We do not wish to cut across any of the arguments that companies will be making. But we would suggest that the response that Ofwat assembles should include some changes that are systemic in nature to address what at least in the first instance is a systemic asymmetry problem.

Our thoughts here – which are not meant to be exhaustive – come in two parts.

First, we do not agree with the logic of rolling over PR19 targets unchanged through to 2025/26 in places where the sector as a whole has generally struggled to meet expectations that were set five years ago (e.g. on pollution, internal sewer flooding, per capita consumption). We view this as a form of extended punishment for a past collective failure to foresee during PR19 what the industry was capable of achieving with the cost allowances it was given, rather than a justifiable ongoing penalty for objectively poor performance. As such, we think that balanced regulatory regime would provide for more of a reset at industry level (but not necessarily at company level) as at 1 April 2025 and so provide for a starting point in which there are no sector-wide carryover penalties at the start of the 2025-30 regulatory period on the back of actual performance improvements delivered during the 2020-25 period.

Second, we noted at the start of the discussion that Ofwat's intention is to provide "opportunities for outperformance where companies deliver high levels of service to customers". We think that this opportunity needs to be made more obvious and more pronounced in places where companies and/or Ofwat are showing real ambition. This includes:

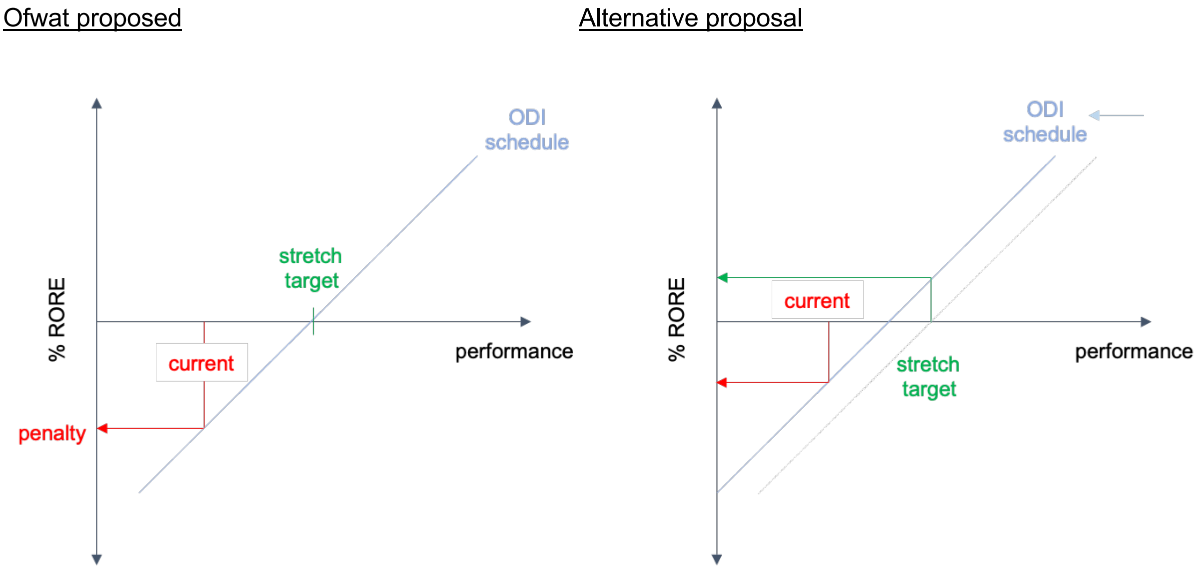
- where companies and Ofwat are targeting a 100% perfect performance level, despite not being funded at a level that will produce faultless performance and despite the historical record showing that there will inevitably be points of failure over a five-year period; and
- where companies and/or Ofwat are pushing for standards of performance that sit far beyond anything that the industry is currently delivering and, hence, if achieved, would represent a hitherto unprecedented step up in the outcomes that the industry is delivering for customers, communities and the environment.

(Examples in the first of these categories might include serious pollution incidents and the two compliance indicators. Examples in the second category might be total pollution, spills from storm overflows or C-MeX.)

What we have in mind here is an ODI design which provides for companies to collect financial rewards if they <u>meet</u> notably stretching performance improvement targets. This contrasts with a current set-up in which meeting such targets confers zero reward. Ofwat would retain a system of continuous marginal reward/penalty for every unit of better/worse performance, but with a lower break-even point than currently envisaged so that a company moves into a net reward position some way prior to meeting a target in full.

Figure 3 overleaf shows how this might work for a hypothetical performance measure. The only modification that above scheme makes to Ofwat's basic ODI design is a parallel shift to the left in the positioning of the diagonal ODI line.

Figure 3: Possible calibration of ODIs for 'stretching' performance targets



5. Conclusion

The likely effect of our two proposals would be to turn some of the cells in table 1 from red/amber/white to amber/white/green and switch the centre of gravity in figure 1 and figure 2 towards the right of the page.

Poorer performers would still face the prospect of a (smaller) financial penalty, but better performers would see a more obvious prospect of financial reward, thus giving the kind of balance that Ofwat has said it is seeking.

(NB: this would not only be a balance in £m financial terms. It would also set regulatory and public expectations for the next five-year period at an appropriate place, and ensure that the wider accountabilities that come from exceeding, meeting or missing targets operate in a proportionate and effective way.)

Again, for the avoidance of doubt, nothing that we say in this paper is intended to cut across other submissions that companies will want to make about specific targets that Ofwat has set. We can also be clear that we have not assessed by exactly how much Ofwat needs to retune performance commitments and ODIs, bearing in mind that the framework of outcomes regulation is just one part of a wider regulatory package and that what ultimately matters is the balance in that package as a whole. We mean only to observe that, whatever results further bilateral engagement produce and however the overall price control comes together, there are steps that Ofwat can take in its outcomes workstream to lift all boats and so contribute a final determination that is simultaneously challenging towards companies and capable of giving investors a fair and competitive prospective return on the monies that they are being asked to put behind the water industry's investment programme.