TOTEX and other Ofwat investment incentives – how could these impact the supply chain in 2015-20?

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What approach to investment should water companies be aiming for?

- Least whole-life cost
- Innovative approaches
- An appropriate approach to risk
- Delivering the right outcomes for customers and the environment
- Taking account of future challenges e.g. changing weather patterns
There is widespread agreement that the previous regulatory framework has led to a capex bias, inhibited innovation and encouraged excessive risk aversion.

• “Innovation tends to be incremental, rather than the kind of step-change innovation the industry needs” (Cave Review of Competition and Innovation, 2009)

• “The present framework of incentives and prescriptive output setting encourages a risk averse approach to meeting standards and can mean that more sustainable solutions are overlooked in favour of capital intensive solutions.” (Severn Trent, Changing Course, 2010)

• “The system of incentives applied by Ofwat may be too focussed on penalties and compliance as opposed to positive incentives for desired changes of behaviour” (Defra review of Ofwat and consumer representation in the water sector, 2011)

• “There is general agreement that a perception exists of an inappropriate capex bias” (Ofwat, Future price limits – a consultation on the framework, 2011)
The framework needed reform

The previous approach has delivered significant improvements in service for customers and the environment, and increased efficiency. But some aspects needed reform:

• Ofwat efficiency targets for operating costs based on comparative efficiency analysis have discouraged opex solutions.

• Emphasis on penalties has encouraged risk aversion, and use of solutions which are certain to achieve the required output.

• Detailed outputs have discouraged innovation.

• Earning a return on capex, through spend being added to the Regulatory Capital Value, has encouraged capex solutions.
Changes for PR14 are addressing shortcomings in the framework

We support the changes Ofwat is proposing to improve the framework

- Emphasis on outcomes rather than detailed outputs, with “measures of success” defined at a higher level than previous outputs.
- Comparing efficiency of total expenditure (totex) rather than opex.
- A balance between rewards and penalties.
- The totex approach means that a proportion of expenditure, to be defined by the company, will be added to the Regulatory Capital Value – this will no longer be limited to capex being added to the RCV.
- Incentives to encourage water trading

These changes will take time to have effect – the full benefits unlikely to be felt in AMP6 (2015-2020)
Outcomes and measures of success – key concepts and definitions

What is a measure of success and how does it relate to outcomes and outputs?

Outcomes
- Long-term customer needs or wants

Outputs
- The results of company actions to deliver outcomes

Inputs
- What firms do to deliver outcomes (means to an end)

Measures of success
- Indicators that capture performance against the outcome

What is the definition of a target?

Target
- Level of outcomes, expressed in terms of the measures of success, that companies aim to achieve by the end of the price control period
Summary – Developing measures of success

1. Develop long list of potential measures of success

2. Assess each measure on the long list against 6 key criteria:
   1. As closely related to outcome as possible and covering a large proportion of the outcome
   2. Informed by stakeholder engagement
   3. Measurable, verifiable and comparable
   4. Easy to understand by stakeholders
   5. At least in part controllable by water company
   6. Future proof

   Select small number of most appropriate measures based on ratings and trade-offs

3. Assess most appropriate measures for individual outcomes against materiality and duplication and identify potential for bundling

Stakeholder engagement with:
- Customers
- CCG
- EA and DWI
Process for determining the incentive structure and strength

1. Assess other financial incentives
2. Determine the structure of the incentive mechanism: One-sided vs. two-sided and symmetric vs. asymmetric
3. Determine the incentive strength
4. Determine the level of discretion
5. Reconsider bundling of measures of success
How this might change what companies do – sewer flooding example

What really matters to customers is best measured by the number of incidents (possibly with allowance for location, severity etc.)

• In the past capex solutions have been encouraged by:
  − focus on the sewer flooding register as an output
  − emphasis on penalties
  − Disincentives to increase opex

• Setting incident numbers / severity as a measure of success will encourage companies to choose the lowest-cost balance of solutions, including:
  − sewer cleansing
  − mitigation measures
  − sustainable approaches to surface water drainage.
  − Education on impact of fats, oils and greases
  − Working in partnership with local authorities
  − Capacity increases where appropriate
The company can choose the activities which reduce flooding at least cost.
How this might change what companies do – leakage example (1)

The previous framework:

• The previous framework incentivises resource development over leakage control:
  - The effect of leakage control measures is uncertain, whereas creating additional resources relatively reliably delivers additional supply capacity.
  - The penalties for missing the leakage target are potentially high, whereas there is no reward for leakage outperformance.
  - Leakage control generally adds to opex, whereas resource development is added to the RCV.
  - Higher opex leads to a company being assessed as less efficient.
How this might change what companies do – leakage example (2)

The new framework:

• Symmetrical rewards / penalties around the leakage target will encourage leakage reduction, with the rewards and penalties based on value to customers of higher / lower security of supply.

• The totex approach means that:
  – Companies will no longer be disadvantaged in comparative efficiency by increasing spending on leakage control.
  – A proportion of leakage expenditure can be added to the Regulatory Capital Value.
How leakage rewards and penalties might work

- A leakage target would be set – possibly as a band rather than a single figure, to allow for the impact of weather fluctuations.
- Performance above the band would incur a penalty.
- Performance below the band would lead to a reward – with possibly a limit on how much reward could be earned.
Incentives for water trading

- It is widely felt that the current framework discourages companies from obtaining new water supplies from other companies.
- Ofwat is creating incentives to encourage water trading.
- This may enable supply-demand deficits to be addressed at lower financial and environmental cost than companies developing their own new resources.
- There will be an incentive on both buyer and seller.
- This may encourage investment in new water mains links between companies – a national water grid is not economic, but investing in smaller scale links may be.
What difference is this making to company business planning?

• We are working with our Water Forum (our Customer Challenge Group) to define outcomes and measures of success – we will be publishing a consultation on these, and our potential plan, in April.

• We will be discussing incentive packages with our Water Forum in spring and summer.

• We aim to produce a plan which delivers service to customers and the environment at least whole-life cost.
  - This was our aim under the old framework and will continue under the new framework.

• The new approach will not have its effect mainly through deliberate policy changes in companies – it is more about changing attitudes.

• This is bound to take time to have an effect,
What difference will this make for the supply chain?

- Water companies will be seeking to be more innovative – and will seek to involve the supply chain, e.g. in improving leakage control.

- There may be fewer capex solutions e.g.
  - More catchment management and fewer treatment solutions
  - More leakage control and water efficiency measures.
  - Fewer capacity increases to address sewer flooding, more sustainable drainage and sewer cleansing.

- But:

- Totex emphasis on total spending in a five-year period may discourage some investment to reduce opex – because it may not pay back in five years.

- The new framework is still not in place – late finalisation of the approach means that smoothing out the five-year cycle is unlikely to be addressed at PR14 – an issue for PR19.
Conclusions

• The new framework – a focus on outcomes, and a balance between rewards and penalties, should encourage more innovation.
• The totex approach should encourage more opex solutions.
• The water trading incentives will incentivise investment in more links between companies.
• But these changes will take time for their full effects to be achieved.