Methodology information paper 8: Rolling incentives

Introduction

In the Strategic Review of Charges 2006-10 we, the Commission indicated our intention to apply rolling incentives in the next regulatory period, whereby gains from outperformance would be retained for a number of years by Scottish Water, reflecting Ofwat's practice in England and Wales. Proceeds would be used to build up a gilts buffer.

This information paper begins by discussing the purpose of rolling incentives. It then considers how outperformance of regulatory settlements can be measured and treated. It summarises Ofwat's approach to rolling incentives and provides a worked example of how Ofwat calculated the rolling incentive allowance for operating costs in its 2004 price review. The paper concludes with a discussion of options that we propose to consider in setting prices for 2010-14, and on which we seek views.

Purpose of rolling incentives

The purpose of rolling incentives is to encourage companies' outperformance of regulatory assumptions. A rolling incentive mechanism allows the regulated company to extend the number of years over which any cash savings that are generated through outperformance are retained, before being passed to customers. In the private sector, the longer retention of savings means higher dividends to shareholders, or higher bonus payments for employees, or both.

If a company outperforms its regulatory settlement, it demonstrates, in effect, that it can deliver the expected services for less cost than assumed by the regulator when prices were set. Using this evidence, the regulator can then assume a lower cost when setting prices for the next regulatory period. In this way, savings are quickly passed to customers through lower bills. Rolling incentives delay the transfer of savings to customers, and mean that reductions in bills are phased gradually. However, customers benefit over the medium term, provided that the strengthened incentive to outperform encourages companies to demonstrate even lower costs.

It follows that the decision to use rolling incentives, and the choice of mechanism to adopt, has a direct impact on the prices that customers pay.

In the case of Scottish Water, there is no shareholder to benefit from higher dividends. Instead, more of the proceeds from outperformance would be available to purchase gilt-edged securities.

Measurement of outperformance

There are two main ways in which we could measure outperformance by Scottish Water. The first is to compare the costs allowed for in the 2006-10 review with the costs that Scottish Water reports in its annual regulatory accounts. This 'accounting approach' is the method used by Ofwat. The second is to record annual payments made by Scottish Water into the gilts buffer, since these would represent the cash savings from outperformance. This 'cash approach' may be preferable, as we explain later in this information paper.

Sharing outperformance gains between companies and customers

Under either of these approaches, prices would need to be set to allow for Scottish Water to retain the benefits of outperformance for a period of time. This delays the transfer of savings to customers.

In Ofwat's framework for rolling incentives, customers receive around 65% to 75% of the overall outperformance[1] of the company that serves them.

To encourage outperformance, we believe that any rolling incentive mechanism should provide Scottish Water and its employees with incentives that are comparable to those that apply in England and Wales. Customers ultimately would benefit from the full value of outperformance less the cost of bonuses to the staff of Scottish Water. If Scottish Water does not outperform the regulatory settlement, then there can be no additional benefit for customers.

Ofwat's approach

Ofwat introduced rolling incentive mechanisms for both capital and operating costs in its 1999 price review.

Ofwat's rolling incentive mechanism for capital costs rewards total outperformance (except for infrastructure renewals expenditure) over a five year period, irrespective of when the savings were made. Companies retain the benefits of outperformance for five years through a rolling adjustment to their RCVs.

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[1] This estimate is based on the net present value of benefits over 25 years, assuming a 5% discount rate. If the company is a leading comparator for the industry, then further benefits accrue to customers generally, as Ofwat can use the new benchmark when it sets prices for all companies. Ofwat recognises this benefit by allowing leading companies to retain 1.5 times the incremental outperformance.

The main characteristics of Ofwat's rolling incentive mechanism for operating costs in the 2004 price review were:

- outperformance is defined as the difference between the allowed for operation costs and the actual operating costs;
- outperformance is measured on a year-by-year basis;
- outperformance is retained for a period of 5 years;
- only the incremental outperformance is allowed for;
- outperformance on each year is capped by the outperformance achieved in the latest available year (base year);.
- underperformance in one year is netted against any outperformance in the remaining years;.
- Ofwat has incorporated 'enhanced mechanisms' so that the best performing companies receive additional benefits; and.
- rolling incentives are assessed on a service level basis (ie separately for water and wastewater).

Table 1 is an example[2] of Ofwat's operating cost rolling incentive.

Table 1: Worked example of Ofwat's operating cost rolling incentive

	AMP2	AMP 3					AMP3				
Financial year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Initial regulatory assumption	275	270	265	265	260	255					
+/-Idoks assumption	0	0	0	0	0	0					
+/- logging up/down	0	0	0	0	0	0					
- less shortfalls	0	0	0	0	0	0					
Revised regulatory expectations	**275**	**270**	**265**	**265**	**260**	**255**					
Actual expenditure	265	255	250	240	238	??					
Less atypical and exceptional costs	0	0	0	0	0	0					
Less any cross subsidy adjustment	0	0	0	0	0	0					
Adjusted actual expenditure	**265**	**255**	**250**	**240**	**238**	**0**					
Outperformance	**NA**	15	15	25	22						
Outperformance (setting negatives to zero)	NA	15	15	25	22						
Outperformance constrained at 2003 level	NA	15	15	22	22						
Incremental outperformance in 2000-01		15	15	15	15	15					
Incremental outperformance in 2001-02			0	0	0	0	0				
Incremental outperformance in 2002-03				7	7	7	7	7			
Incremental outperformance in 2003-04					0	0	0	0	0		
Incremental outperformance in 2004-05											
Final incentive allowance							**7**	**7**	**0**	**0**	**0**

[2] This example is adapted from 'Periodic Review 2004 - A further consultation on incentive mechanisms: Rewarding future out-performance and handling under-performance of regulatory expectations', Ofwat, June 2003.

In this example, the company outperforms by £15m in 2000-01, but as this is the first year of a five year regulatory period (‘AMP 3’), it retains the benefit of its outperformance until 2004-05, ie for five years. Therefore, no rolling incentive allowance is required in ‘AMP 4’. In 2002-03, the company improves its outperformance by an increment of £7m. It retains this for three years until 2004-05. Rolling incentive allowances of £7m are applied in both 2005-06 and 2006-07, so that the company retains the benefit for a total of five years. These allowances are included in prices for the ‘AMP 4’ period.

Under Ofwat’s framework, had the company in this example been assessed as ‘leading’, the total benefits retained by the company would have been multiplied by a factor of 1.5.

Possible options

There are three main approaches to rolling incentives that we could consider:

- adopting Ofwat’s approach to rolling incentives;
- adopting an adjusted approach to rolling incentives; or
- taking the decision not to include rolling incentives.

Ofwat’s approach could, we believe, be difficult to implement. Ofwat’s mechanism rewards annual incremental improvements in operating cost performance, relative to the regulatory settlement. This requires a set of detailed rules that deal with the incremental impact of variations in performance from year to year. For example, it may be necessary to assess whether incremental outperformance in a given year (compared with the previous year) should be adjusted or disallowed if it does not mark an improvement in actual performance over that achieved some years earlier. The complexity of these rules could reduce the effectiveness of the incentive.

Ofwat’s method measures outperformance using cost accounts. This means that the approach also requires scrutiny of the accounting treatment of operating costs, to ensure that factors such as atypical provisions and accruals are not affecting reported performance artificially.

An alternative and simpler approach is to use Ofwat’s framework for sharing the rewards of outperformance between the company and its customers, but to focus on outperformance in the ‘base year’ of each price review. Regulators use the base year to assess the costs that companies

demonstrate can be achieved. Prices depend on the level of outperformance achieved in the base year. An approach that encouraged such outperformance could benefit customers directly, whilst allowing Scottish Water to retain a share. However, the assessment of costs would still require scrutiny of their accounting treatment.

Either approach would become easier to implement, and we believe more effective, if outperformance were measured not through the annual accounts, but rather using actual cash proceeds to the gilts buffer, under the arrangements discussed in information paper 7.

Implications for our approach

We are currently of the view that replicating Ofwat's approach in Scotland may significantly reduce the transparency of our approach to setting prices. This is a function of the complexity of the Ofwat approach to rolling incentives. However, we do see benefit in providing an incentive to Scottish Water (and its management) in order to maintain the pressure to improve efficiency. Our current preferred approach would be to link rolling incentives to additions to the gilts buffer. In doing so we would also expect bonuses for the staff of Scottish Water to be linked partly to growth in the buffer and partly to other indicators of performance such as those measured by the Overall Performance Assessment.

At this stage, our proposals exclude incentives for outperformance on capital expenditure, where we do not believe there is a clear customer interest. In particular, we consider that a rolling incentive allowance for capital expenditure could increase the risk of overscoping or overpricing of capital projects in Scottish Water's business plans.

Related documents

'The Strategic Review of Charges 2006-10: The draft determination', Volume 5, Water Industry Commissioner for Scotland, June 2005.

'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.

'Efficiency incentives for public sector monopolies – the case of Scottish Water', Beesley Lecture, Alan D A Sutherland, London, 16 November 2006.

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