REMOVING OFWAT'S QUALITY AND AMBITION ASSESSMENT (QAA) - WAS IT REALLY THE PROBLEM?

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Introduction and context

The Cunliffe review's recommendations are intended to lead to "a fundamental rebalancing of economic regulation in the sector".[1] Some of these recommendations, if adopted, have direct implications for specific mechanics of future price reviews. This includes a recommendation to remove Ofwat's Quality and Ambition Assessment (QAA).

Through the QAA, Ofwat graded water company business plans following their submission and applied financial adjustments (rewards and penalties) depending on the regulator's assessment.

The Cunliffe review proposes the removal of this process alongside the introduction of a supervisory approach to regulation, making the price review less reliant on benchmarking and taking more account of company specific information.

In this note, we consider the potential unintended consequences of removing the QAA. We suggest that we consider replacing it with a reframed business plan incentive regime that adds value to the supervisory approach.

Was the QAA really the problem?

To protect consumers, economic regulators must always be concerned about the data asymmetry between a regulated company and its regulator. This is because companies hold information about costs and performance that the regulator cannot easily observe.

In our view, the QAA (and its predecessor business plan incentive mechanisms) have been a legitimate way to seek to address information asymmetry in a world where the RPI-X model (which encouraged data revelation by allowing companies to keep all savings in the short-run) was no longer acceptable with stakeholders. Other sector regulators, both in the UK and internationally, continue to use similar business plan incentive regimes.[2]

[1] https://assets.publishing.service.gov.uk/media/687dfcc4312ee8a5f0806be6/Independent_Water_Commission_-_Final_Report_-_21_July.pdf (p.7)

[2] For example, the PREMO used by the Essential Services Commission in Victoria, Australia and the RIIO framework used by Ofgem for UK energy networks.

In hindsight, the key problem with the QAA (and its predecessors) was that it was coupled with an often-transactional regulator-regulated relationship between price reviews that has tended not to expose to the regulator the real issues companies faced. This left the QAA providing financial and reputational incentives to tell the regulator what it thought it wanted to hear at a price review[3] rather than what it needed to hear. In turn, this may have contributed to successive periods of underinvestment and/or an increasing need to seek appeals at the CMA to resolve differences. In our view, the information discovery element of the price control process was therefore compromised by the QAA without sufficiently robust processes elsewhere to fill the gap.

What might be the consequences of removing the QAA?

While jettisoning the business plan incentives without fully considering how to address information asymmetry may feel like an opportunity for companies in the short-run, if it leads to unwarranted levels of financial returns through gaming it will be unlikely to deliver the stable and independent regulatory framework that will benefit companies and their investors in the long-term.

The supervisory approach to regulation might be argued to open new opportunities to address information asymmetry in a more sustainable way, by encouraging a more honest two-way conversation with more openness and reasonable challenge that is ongoing and not completely restricted to a price-review. This may be correct, however at the same time there is an associated risk of regulatory capture – where the company is able over time to educate the supervisor into its own way of thinking by repeated exposure to the same evidence base and the analysis that comes from it.

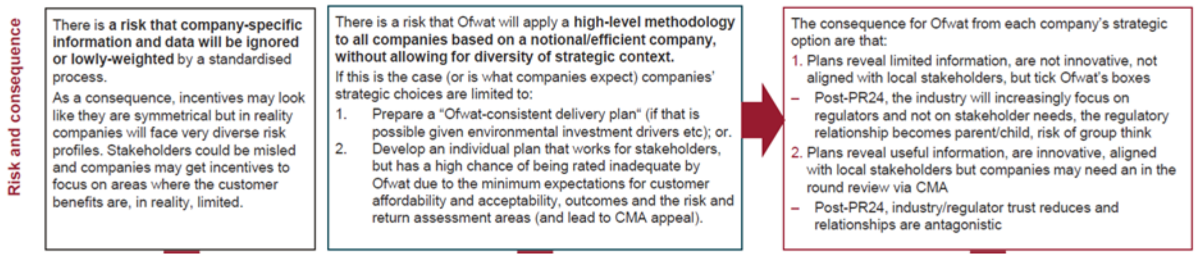
In our view therefore simply removing the QAA without considering the issues of information asymmetry, gaming and / or regulatory capture would be unwise. Under the new model for regulation, a reframed business plan incentive scheme could actually remain a valuable part of the regulatory toolkit that helps make the supervisory approach more effective and reduce regulatory capture risks.

Recalibrating the business plan incentive regime

As the PR24 methodology developed, in work for one company (shared with Ofwat) we predicted that Ofwat's attempts to both standardise and increase incentive rates when coupled with the QAA, risked creating imbalanced price determinations that left companies exposed to an unrealistic risk profile. In turn, this would lead to greater numbers of appealing companies and a further loss of trust between companies and Ofwat.

[3] Ofwat's approach at successive price reviews from PR14 increasingly used the business plan assessment incentives to anchor companies' inputs in advance – initially informally, e.g., through public statements about the WACC or bill profiles and at PR24 by publishing WACC guidance and cost models in advance.

Table 1 Our 2022 hypothesis for outcomes of the PR24 price control



Source: Frontier Economics report prepared for a water company in response to the PR24 Draft Methodology

At that time our suggested solutions to mitigate these risks were achievable within the PR24 framework, but they required more and better processes for taking company information into account and for the QAA incentives to be recalibrated to promote credible plans that do the right thing for stakeholders.

We suggested:

1. Removing the potential for a plan diversity penalty through the quality "Q" assessment - i.e., where companies could potentially be penalised for taking different approaches to balancing competing objectives based on their different starting points. This could be achieved in a number of ways, including by removing the gated quality assessment and considering plan credibility within the overall assessment.
2. Reframing the ambition assessment to be about risk i.e., well-constructed plans have balanced risk and reward appropriately to their individual strategic context, ambitious plans accept more risk and (if credible) gain more reward potential. Plans considered too cautious for their circumstances can be adjusted by Ofwat through tougher outcome targets/efficiency challenges in the usual way.
3. Company Boards to state whether and how they have balanced risk or accepted more risk (for reward).
4. Board/Ofwat meetings to explain plans in advance of submission/reintroduction of initial assessment of plans.

Building on this approach, we think that a revised business plan assessment approach (with some financial incentives attached) could focus on a wider set of dimensions than the existing QAA, encouraging good and truthful plans while avoiding the risk of limiting information discovery.

The simplest approach for a new regulator would be to focus a new regime only on a restricted **Quality** dimension. This would focus on whether the company had submitted a plan that gave the regulator what it needed to make its price determination , rather than marking companies on the use of pre-determined expectations of inputs or outputs. This however would not reduce the risks associated with information asymmetry.

The opportunity of the supervisory approach is that it could enable a much more nuanced assessment of **ambition** and **credibility** to be made, based on a much fuller understanding of the strategic context of the company and the trade-offs being made, including those between current and future customers. A future regulator with a wider and deeper understanding of environmental and drinking water quality issues will likely be better placed to make these judgements holistically.

There will likely in future need to be a much greater understanding from the regulator of risk and its management within each company – see our separate suggestions for how accountability for maintenance investment could be improved through PCDs for base spend could be framed on the basis of risk management. This greater understanding will be the basis from which judgements around credibility and ambition can be made.

Table 2 Dimensions for a future business plan assessment

Dimension of Assessment	**Why is this important?**
Quality	An incentive to meet procedural requirements of a submission will reduce regulatory costs overall. This should be restricted to submissions that are made on-time, complete, without material error and with sufficient clarity rather than an expectation to use certain parameters as was the case at PR24.
Credibility	Plans also need to be credible given the strategic context faced by the company - where there are trade-offs that have been made these need to be clear and they should set-out the consequences of these trade-offs for any legal obligations and in fairness for current and future consumers.
Ambition	Well-constructed plans will balance risk and reward appropriately to their individual strategic context, ambitious plans accept more risk and (if also credible) could gain more reward potential. Plans considered too cautious for their circumstances can be adjusted through tougher outcome targets/efficiency challenges in the usual way.

Cross-company cost, and performance benchmarking will remain an important part of a balanced evidence base in making assessments around ambition, but they will not be the only source of the initial assessment. Company supervisory teams will instead need however to actively qualitatively benchmark companies' approaches to risk and from this their approaches to credibility and ambition.

A future regulator will need to create processes that enable individual supervisory teams to see across companies, to learn from best practice and to enable them to target their actions and assessments. The credibility of this process will be key in ensuring that the incentive regime acts to further reduce information asymmetry by reducing the risk of regulatory capture.

Next steps

Under an incentive-based regime, if the QAA is to be removed entirely, the new regulator will need to consider how it will maintain incentives for "truth-telling" in future price reviews as well as avoiding regulatory capture under the new supervisory approach.

Early thinking about how a recalibrated business plan incentive regime could fit within and add value to the supervisory framework being developed will be important. The detailed mechanics and timing of a recalibrated process (as well as any financial incentives) will all impact on how companies engage with it and therefore the likelihood of it improving outcomes and increasing trust within the sector over time.

To be successful, the design of any business plan incentive regime will need to be sufficiently aligned to the institutional framework created to deliver the supervisory approach.

It should also in our view consider and develop the tools to qualitatively benchmark a much more detailed understanding of companies' risk position and their approaches to managing risk.

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