

Company monitoring framework – further consultation

Northumbrian Water Limited response

1 INTRODUCTION

1.1 This consultation response

Assurance is extremely important in building trust and confidence in public water and wastewater services. Anything that can be achieved to enhance our customers' and stakeholders' trust is worthwhile.

We fully supported Ofwat's initiative, started prior to PR14, to transfer the responsibility for robust assurance fairly and squarely onto companies and their Boards. In response to this we redesigned the way we manage our assurance, moving away from the traditional Reporter model, and introducing an innovative risk-based approach using best fit assurance providers. Together with our transparent and constructive approach to communications with Ofwat and other stakeholders we feel that the assurance approach we have adopted over the last few years for performance reporting, and for PR14, is one of the best in the industry.

We consider the principles of the 'Company Monitoring Framework' to be appropriate and welcome the opportunity to respond to the consultation. Demonstrating good performance alongside: transparency; stakeholder involvement in processes; existence of checks and balances; and existence of credible challenge should build trust and confidence with all concerned.

The Ofwat workshop on 25 March in Birmingham helped us understand Ofwat's approach, including its alignment to the wider factors that build trust and confidence rather than only the formal assurance provided by Financial and Technical Auditors.

Whilst we support the principles of the proposed framework, we do have some important points to make about how it should operate in practice. Our comments in this respect are made in response to the specific questions in the consultation document.

In addition to the material covered in the consultation, we raise two further important areas regarding the monitoring framework:

- the evolution of the performance monitoring and Outcome Delivery Incentive (ODI) regime going forwards; and
- the need for clarity regarding Ofwat contact points considering the recent and ongoing changes in personnel.

These are addressed in more detail overleaf.

1.2 Performance monitoring and ODI regime going forwards

Our view is that comparative performance measures have an important part to play going forwards. In this respect we supported Ofwat's horizontal review of PCs and ODIs for PR14.

We also agree there is a case for introducing dynamic ODIs at PR19, though there are a number of important issues that would need to be addressed in terms of how this should be implemented. These include:

- Ensuring rewards are sufficient: rewards based on a dynamic threshold (e.g. annual upper quartile performance) would potentially result in rewards being harder to achieve year on year and, therefore, the magnitude of rewards would need to reflect this in order for the incentive to be meaningful; and
- Ensuring inappropriate penalties are not levied: it might not be appropriate to base penalties on a dynamic threshold (such as annual upper quartile performance) because the target for acceptable performance would be unknown in advance and this approach would likely result in a majority of companies attracting penalties for what might be levels of performance that are acceptable to their customers.

Such a regime would result in some companies' customers paying more for ever increasing service levels. It is important that customers are consulted to be clear that this is what they actually want. This is a question of ensuring that the fundamental concept of a dynamic ODI regime, and its application, is acceptable to customers. It is separate from customers' valuation of service increments through willingness to pay research.

For any monitoring and incentive regime relying on comparative performance, it is extremely important that companies collect the data using consistent definitions. It is also important that the data is robust. We believe that Ofwat has a role to identify the measures that will form the dynamic ODI regime and companies should then work together to ensure reporting on a consistent basis.

1.3 Contact with Ofwat

The new framework requires good communication with all of our stakeholders, including Ofwat. There have been significant changes in personnel in Ofwat over recent years and the changes continue.

It would be really helpful if Ofwat provided companies with the names and details of contacts and technical leads. We will then know who to contact depending on the issue in question. We have had a similar conversation with the Environment Agency following its recent and significant changes in organisation.

2 RESPONSES TO CONSULTATION QUESTIONS

Q1 Do you agree that companies in the self assurance category should provide explicit sign off on the assurance that has been provided?

We agree that explicit Board sign off of assurance should be provided by all companies, in all assurance categories, each year.

Q2 Do you agree that the assurance process, and the outcome of that assurance process, should be transparent? Do you have any suggestions of how this could be accomplished?

We agree that the assurance process and its outcomes should be transparent. This means that the:

- process and criteria for the assessments to be undertaken by Ofwat should be clear and published well in advance;
- the outcome of the assessments should be published, including clarity regarding the areas each company would need to address to improve its classification, where relevant.

Q3 Do you agree that a company in the prescribed category should consult on its assurance plans with stakeholders? If not, what approach to prescribing assurance would you suggest?

Ofwat needs to satisfy itself that the companies it has identified as 'prescribed' are addressing the pertinent issues. However, where issues have been identified that are associated with other stakeholders' responsibilities (e.g. Environment Agency, DWI), companies should also liaise with those organisation.

We believe that it is best practice for all companies to share their assurance approaches and outcomes with their Customer Challenge Groups (CCGs), including any actions to remedy shortfalls. This will help engender confidence regarding the quality of annual performance data and business plans. For example, for 2015 we plan to share our assurance outcomes for annual regulatory reporting with our Water Forums. We also plan to share our autumn statement on assurance with our Water Forums.

Q4 Do you consider the outline approach that we have set out to be practicable, or can you suggest improvements?

We believe the outline approach is reasonable subject to our response to the other consultation questions and the points we set out below regarding its application.

- Ofwat's assessment should take the materiality of any risks or shortfalls in assurance into account. It is very important that companies' trustworthiness is not called into question publically, e.g. by a 'targeted assurance' assessment, when the issues identified are non-material. Assessments must recognise that, given the vast amount of information in business plans and annual reporting, it is impossible to identify an assurance process that will guarantee zero errors on an ongoing basis.
- Companies attracting a 'targeted assurance' assessment must understand from Ofwat exactly what must be addressed in order to be 'promoted' to 'self assurance'. Given that Ofwat must be confident in its assessment before a company is classified as falling

short in assurance terms, it seems reasonable that the reasons for the assessment are clearly identified.

- Ofwat's annual assessment, to be practicable, could be based on two areas:
 - the information Ofwat has gleaned during the preceding year through its normal dealings with companies and other stakeholders; and
 - the information provided by companies in autumn assurance statements.

Q5 Do you think that our guidance could be minimal or do you think that it is necessary for us to define a high level of prescription to protect customers?

As mentioned earlier, it is important that the process and considerations for assessing companies should be clear and published in advance. The autumn statement produced by companies is also very important and it would be helpful if minimum requirements are set out by Ofwat in advance. Each company would be able to decide the emphasis of its statement taking into account its own position. This approach would not preclude companies from offering more information to support its case, in addition to the minimum requirements.

Q6 Do you think that companies in the targeted category should publish an assessment of risks, strengths and weaknesses, to be used to target more prescriptive assurance requirements? If not please suggest how we should target the areas that require more prescriptive assurance.

We see this risk assessment as something that should be carried out by all companies, regardless of their status. We think that companies in the targeted category should be allowed to propose their own assurance requirements to address the areas identified as needing attention. Ofwat would only intervene to prescribe assurance if the company's proposals were unsatisfactory.

Q7 Do you think that the prescription for targeted areas should be the same as for the prescribed assurance category? If not please suggest how assurance should be prescribed.

The level of prescription should be risk based. Ofwat, other stakeholders and the individual companies could work together to define the appropriate assurance.

Q8 Do you think that for areas that are not targeted that the prescription for these areas should be the same as the self assurance category? If not please suggest how assurance should be prescribed.

We agree that areas that are not targeted should be the same as the self assurance category. On a risk based approach Ofwat should target the most rigour to the areas identified as requiring improvement.

Q9. Do you think that companies should move to a tighter assurance category immediately an issue that reduces trust and confidence comes to light, rather than wait for an annual review? Do you think that the examples which we have provided are appropriate?

We do not support an instant reaction unless there is a major event that cannot wait for action to be taken (e.g. premeditated misreporting). We think that Ofwat should generally make its public assessment on an annual basis but signal to companies immediately should

it have concerns. This will allow companies to make plans to address the issues as soon as possible.

Q10. Do you think it is appropriate that companies can move up from the prescribed to targeted category or targeted to self assurance category without the need for a positive relative assessment?

Yes, please see Q11 below.

Q11. Do you think that an annual relative review is unnecessary? If you think Ofwat should undertake an annual relative assessment, do you consider it necessary for moving companies both up and down or only in one direction?

A full annual relative review would take up a significant resource commitment, unnecessarily in our view. It would tend to distract both Ofwat and companies.

We believe that the approach should be risk based:

- changes would be made ‘upwards’ when companies present evidence of their improvements (and no further issues arise);
- changes would be made ‘downwards’ when companies report issues or Ofwat detects issues; and
- in addition Ofwat could select (on a risk basis) a small number of companies to assess in detail, if necessary.

This would ensure the most scrutiny is applied to the areas with most risk. See also our response to Q4.

Q12. Do you think that it is appropriate for companies to spend at least two years in the prescribed assurance category?

We think this is appropriate. The level of failure required to be in the 'Prescribed' category would suggest systemic failure and would therefore require considerable remedial actions.

Q13. Do you agree that the overall package of proposals leads to appropriate incentives for companies? Are there ways you consider that these incentives could be improved?

There are considerable reputational incentives for companies not to be classified in the targeted or prescribed assurance categories.

The assurance categorisations could be used in the future as one of a number of factors in deciding if a company’s business plan is ‘enhanced’ at the next periodic review if such an approach is retained.

As already mentioned, the fact that a company is categorised as ‘targeted’ or ‘prescribed’ assurance can itself lead to a loss of trust and confidence in the company by customers and other stakeholders. It is, therefore, it is very important that Ofwat gets the assessment right and is transparent and clear about the reasons.

In this respect, we have some concerns regarding the initial assurance categorisation for Northumbrian Water, as outlined below.

It would appear that Ofwat has decided that having an 'enhanced' business plan was a pre-requisite for being classified in the 'self assurance' category. We are not convinced that this is appropriate. The degree to which a company's business plan proposals were deemed acceptable by Ofwat, or judgements about the amount of evidence to provide in business plans, are not in themselves a measure of assurance effectiveness. Nor do these factors affect customers' trust and confidence in the company. We believe that Ofwat is confusing achieving a case that Ofwat accepts with having good assurance.

We were also disappointed that Ofwat's comments in its assessment in relation to our business plan and data submissions did not appear to accurately reflect the feedback we received at the time.

For the company monitoring framework to operate effectively and provide appropriate incentives, the assessments must be seen to be demonstrably correct. If this is not the case, the process will harm, rather than enhance, trust and confidence.