Ofwat Consultation on the outcomes framework for PR19

Dŵr Cymru Response

31 January 2017

Q1: What is your view on the use of improved information, including comparative performance information, to make performance commitments more stretching?

Overall we are in support of Ofwat's proposals to use improved information to ensure that companies' performance commitments are stretching. We have been fully involved in the development and launch of the Discover Water dashboard which is a major step in the right direction. There are a number of associated challenges, however, that need to be overcome. First among these is ensuring that the performance data being used is gathered on a consistent basis and hence genuinely comparable across companies. We are involved in the cross-industry efforts to reach agreement on a common basis of measurement for the relevant measures, but there are a number of outstanding issues.

We believe that the ten performance commitments proposed as common measures for the industry are the right ones, subject to the details of how they are defined and measured. Further details are provided under Question 2 below. We would like to see all of these included in Discover Water as soon as possible.

With regard to common targets for the industry, again we have no problem with this in principle, and four of the six measures proposed as candidates for common performance commitments are suitable. (As explained below, we do not believe there should be common targets for asset health measures.) However, there needs to be recognition of the tension between having customers drive individual companies' performance commitments and strict horizontal benchmarking. In particular, we would appreciate clarification from Ofwat on how they would expect a company to respond should its customers be unwilling to support the level of investment required to meet a centrally imposed target.

We welcome the proposal to assess companies' provision and use of information as part of the Risk Based Review.

With regard to Outcome Delivery Incentives (ODIs), we do not believe in-period ODIs should be mandated for all of these measures. It seems appropriate to leave this to individual companies to decide based upon customer views. We see no advantage in a common approach to the application of ODIs. For customers it is the comparability of outcome information that is of value to customers, not the comparability of rewards and penalties.

In terms of how the comparative assessments are carried out, a more detailed answer is provided under question 3. We would note here that performance across the industry has improved enormously over the last 20 years. Given this, a point will be reached where prescribing further service improvements, requiring disproportionate investment, will no longer be in the interests of customers. This should be taken into account when applying common measures across companies that may have different 'cost curves' for the various measures.

We do not think there are any other common areas that should be covered by bespoke commitments.

With regard to the application of performance commitments and ODIs at the price control level, on the whole we believe they should apply at the aggregate level. Certain of the proposed measures relate only to one or two of the price controls (e.g. wastewater rather than water for sewer flooding), but we see no advantage in making this explicit. Customers do not see the separate price controls. This should be kept under review as competition and the form of control evolves for bioresources and water resources in particular.

Q2: What is your view on the common performance commitments we are suggesting for PR19?

We are content in general with the common performance commitments proposed, but we are concerned that a number remain undefined. This needs to be resolved quickly so that detailed customer engagement can take place in time to inform the development of investment plans. Ofwat may need to be flexible in how some of the common targets are applied should issues remain outstanding in terms of common definitions.

Our views on each of the measures are set out in the table below.

Performance commitment	Comment
1. Future customer experience measure.	We are pleased to see that the current SIM measure is being reviewed, as we believe it does not capture accurately the customer experience. See our answer to question 6 for a more detailed response.
2. Water quality	Ofwat will be aware that we believe the current measure of water quality, Mean Zonal Compliance (MZC), is not suitable as a common performance commitment as the measure applied to companies with a higher number of very small zones (such as Welsh Water) can be badly affected when there are failures in those zones. We would wish to see this measure for water quality changed at PR19. Our preferred measure is the Compliance Risk Index measure being developed by the DWI. This has not yet been finalised but it appears to capture the right elements and could be applied in an unbiased way across all companies.
3. Supply interruptions	This is an important measure for our customers and the Discover Water measure is a good starting point, but the working group has not yet addressed all of the issues to reach a sound and common definition.
4. Water efficiency (DI, leakage, PCC)	We have carried out a number of engagement exercises with our customers where Water Demand and Efficiency has been a key topic. We find that customers relate better to Leakage as the measure because it is easier to understand and relate to for consumers. We do feel that as meter penetration grows, a more individual measure such as Per Household consumption may be more appropriate, however with current constraints Leakage is the most appropriate option.

	However, reaching a common definition and reporting basis for leakage is far from straightforward. We are involved in ongoing work on this.
5. Abstraction incentive mechanism	We have no objection to this being included, but we anticipate that this will again not apply to Welsh Water in AMP7.
6. Internal sewer flooding	We are content with the inclusion of this measure. A cross-industry working group is developing a detailed definition and this will have implications for the way we measure and report this outcome.
7. Pollution incidents	We are content with the inclusion of this measure. A cross-industry working group is developing a detailed definition.
8. Water mains bursts (asset health water)	We are happy to include this as a measure of asset health. However, we have reservations about using this as a comparative measure with common targets, as many incidents occur without any service impact. Customer service in this area is covered by supply interruptions and water quality measures. Driving all companies to frontier performance on this measure may lead to uneconomic investment with no customer service improvement. If such a measure is included, there needs to be clarity on whether incidents are included where a company undertakes work proactively to address a potential burst. We are aware that different companies have different approaches to this. Further, company specific factors would need to be taken into consideration in any comparative assessment, as bursts are related to operating pressure.
9. Sewer collapses (asset health wastewater)	There is not yet a consistent definition for sewer collapses. This will need to be resolved before stretching targets are developed. If such a measure is included, there needs to be clarity on whether incidents are included where a company undertakes work proactively to address a potential collapse. We are aware that different companies have different approaches to this. As with to mains bursts we feel it is not appropriate to use this as a comparative measure, as it does not link directly to customer service.
10. Possible new common measure of resilience.	We are in agreement with this measure being included. Further details are provided in our answer to question 10.

Q3. What is your view on how we might apply comparative assessments at PR19?

There are a number of sub-issues here.

i. Should we propose common commitment levels to 6 of the 10?

As noted above, we have no objection in principle to this proposal, and believe the four of the six measures selected for common commitment levels are appropriate – the two that are not being 8 and 9. However, we seek to understand how Ofwat would expect companies to respond if customers were not ‘willing to pay’ for the extra investment required to meet the prescribed targets.

ii. How should the comparative assessment be applied?

We do not think it is reasonable to expect all companies to move to frontier performance, unless some account is taken of differing company circumstances and costs, and different customer preferences.

Use of data: For some measures it may be useful to use forecasts, but generally this will be overly complex to manage and of limited value to customers. Historical data remains the best guide.

The use of glide paths would appear appropriate, depending on the improvement in performance expected. Some performance improvements depend on costly schemes, the benefits of which can take time to implement and then the benefits to feed through.

Average or individual data: We agree that the use of 3-year average data would be appropriate for some measures.

Basket of measures: We believe there is merit in exploring the proposal set out in the United Utilities paper to use a “basket” approach to setting performance targets. It would allow flexibility to move away from strict benchmarking where local factors, including customer views, mean that upper quartile targets are inappropriate for individual measures.

Company-specific factors: We support the use of a set of criteria to be used when evaluating company applications for company-specific factors.

Q4: To what extent do you agree with our proposed approach to leakage performance commitments at PR19?

Overall we are in agreement with these proposals to enhance the leakage measure.

One area of potential concern is that the requirement to consider the future value of water in the context of the water trading agenda will require us to assess the potential that short run marginal reductions in leakage and more importantly ongoing maintenance costs could have on the abstraction of treated water sharing or transfer. A series of definitions would be required to perform this assessment, such as what our long-term expectations of the future value of water are. This is subject to a high degree of uncertainty and hence would cause some difficulty in reaching a firm position.

Q5: What factors should we take into account in our guidance on setting performance levels for <u>bespoke</u> performance commitments at PR19?

We believe that performance levels should be based on information on customer preferences including customer research and information from day-to-day operations such as customer contacts. Other factors would include company comparisons (as far as they are relevant) and historical data.

Q6: What is your view on our development of a new customer experience measure for PR19?

See Annex 1 for our answer to this question.

Q7: What is your view on the options for increasing the power of reputational and financial ODIs at PR19?

See Annex 2 for our answer to this question.

Q8: What is your view on our proposals for better reflecting resilience within the outcomes framework?

We support the proposed resilience planning principles. They give a structured approach to tackling resilience and appear to cover all relevant aspects.

We agree with the discussion on long term performance commitments, which emphasises that resilience is largely about maintaining customer service (as measured through the standard outcomes) in the face of multiple challenges.

Concerning the two options on resilience metrics, we recognise the work being carried out to develop common metrics for resilience but are concerned with the timing. Once these are clear there will be a period of data collection to understand the baseline performance position, some investment planning work to understand the costs associated with making improvements and customer engagement to identify the speed and appetite for future improvement targets. It will be challenging to complete all of these in a fully robust manner prior to submission of the plan. If these metrics are only made visible very late in the day we would advocate some reflection of the level of uncertainty in the associated incentive mechanisms to protect companies and customers from incentive payments arising from uncertainty rather than changes in service.

Q9: What is your view on the options and our preferred approach to asset health outcomes?

We support the proposed approach to asset health. We are pleased to see that this outcome is maintaining a central position within the price review process.

We would prefer to use the measures that are most appropriate to our business but would be happy to work with a standardised approach if required. We believe that the guidelines set out here give sufficient protection to customers in ensuring transparency in this area.

We would be content for ODIs for asset health to continue at PR19, as long as these are not linked to standardised targets, as explained above.

Q10: To what extent do you agree with our proposals for making performance commitments more transparent for customers?

We agree with the proposals set out here and have no further comments.

Appendix 1: Comments customer service measure

Please find below our answers to the questions addressed in Appendix 5 of the consultation document.

1. The Ultimate outcome?

The current SIM approach has been effective in bringing the customer to the forefront of water and sewerage companies focus but we think that a different approach is needed for the future of a customer experience measure.

The current approach obtains a sample of the views of customers who have contacted water companies. We think that this is an important customer experience measure as it measures how satisfied the customer was with how their contact was handled. However, this only captures the views of customers who have contacted us and not customers in general. As a result our view is that a wider customer experience measure is also needed that covers the full service provision.

One of our current Measures of Success asks a sample of customers if they trust us: “MOS D5 Earning the Trust of Customers”. We consider an approach similar to this would be a true measure for the customer experience and options around this should be explored.

2.2 Wholesale to retail?

We consider that it is important to measure the customer experience provided by the retail and wholesale company taken together. A significant proportion of household and non-household customers will not appreciate the difference between the retail and the wholesale elements, and that difference will not be important to them.

Hence, we would propose to do a single survey that covers both the retail and the wholesale service, and that samples all customers, not just those that contact us. Customers could also be asked if they have views on wider services issues such as the impact of our capital works and how we communicate about them with customers.

2.3 Beyond Water?

We agree that it is appropriate for the customer experience provided by water companies to be compared against other companies. As things stand, we do not believe the current UKCSI measure is the most appropriate way to do this because they only survey a small number of customers. Also, if they do not have a sufficient number of responses per company they do not publish the responses. However, there is scope for change the UKCSI current approach.

We consider that the companies that we should be benchmarked against are the best providers of other essential services, such as the post and emergency services, and possibly also phone/broadband providers, councils, mobile phone companies, and gas and electric companies.

We also suggest that consideration is given regarding targeting companies to achieve top quartile position. As companies improve the customer experience the variance between company scores is likely to decrease. In this situation it may not be fair to penalise companies which are ranked lower than the very top performers, but who are nonetheless providing excellent services. We also suggest that the option of rewarding improvement rather than absolute position in a table is explored, as this would incentivise innovation and dynamism.

2.4 Beyond contacts and complaints?

To date the quantitative element of SIM has been successful in focusing companies to reduce written complaints and unwanted telephone calls. However, as customers are contacting us via different methods for example e-mails, social media, live chat, this measure is becoming outdated. Telephone calls will decrease and customer contacts via digital methods will continue to increase. It could be that a quantitative measure in the next AMP might encourage companies to provide a poorer service to customers. For example, pro-actively contacting a customer by e-mail might result in a written complaint if the customer replies with dissatisfaction.

Our priority is to ensure that all companies are being measured on the same basis. At present, companies have to interpret which of their contacts are classified as unwanted telephone calls and written complaints. Some companies are taking a more a cautious approach which could result in them reporting a higher number than other companies.

2.5 A multi-channel approach

We agree that other options for completing surveys should be explored, for instance mirroring how the customer contacted the water company. During 2015/16, 79.4% of contacts were by telephone, 13.9% were by e-mail/web form, 4.5% were by letter and 2.1% were by live chat. The number of customers contacting us by digital channels is increasing year on year.

We are looking at ways of measuring customer sentiment as expressed through social media. This could become a useful contributory measure as part of SIM. However, social media sentiment can be influenced by a wide range of factors, so a cautious approach is required at this stage.

Water companies' online account functions are likely to improve by 2020 and the number of customers going online to self-serve will increase. We agree that these customers should be included in the satisfaction survey. Customers could be asked to complete an online satisfaction survey following their online session. However, this would need further consideration to avoid customers being exposed to too many survey requests, and to ensure consistency of reporting across companies.

2.6 The role of complaints?

We suggest that the quantitative element needs to be carefully reviewed to ensure it is appropriate and consistent across companies. Our reason for this is:

- As more customers are contacting us via different methods for example e-mails, social media, live chat, this measure becomes outdated. Telephone calls will decrease and customer contacts via digital methods will continue to increase. If poorly designed, the quantitative measure in the next AMP might encourage companies to provide a poorer service to customers. For example, pro-actively contacting a customer by e-mail might result in a written complaint if the customer replies with dissatisfaction.
- As mentioned earlier companies have to interpret which of their contacts are classified as written complaints. This is open to different interpretation. Some companies may take a cautious approach which could result in them reporting a higher number than other companies. This would lead to an impact on the company's score.
- The definition of a complaint does not always match with customer views of what constitutes a complaint. We have had occasions where we have responded to a written contact as a complaint and the customer has then complained that their contact was not a complaint.

- The current definition of written complaints with regard to the quantitative measure includes customer complaints of actions we are taking unavoidably to enforce regulations or legislation. These complaints are often about the regulations or legislation themselves, and hence are totally outside our control, and yet these are counted against us in the measure which could be our household or non-household SIM. This is inconsistent with a measure intended to penalise companies when they make a genuine mistake. Another example may be where we have a running correspondence with a customer on a technical issue, and if a customer 'does not accept' a Health and Safety recommendation this is considered a written complaint. We would like to see these definitions revised to avoid perverse incentives and to more accurately capture good customer service.

2.7 Incorporate vulnerability?

As we are fully committed to support vulnerable customers and have a number of support mechanisms available in our contact centres. We think it is important to try to capture this, but would suggest a separate measure outside of SIM, because of the difficulties of identifying relevant callers correctly. This would require a consistent definition of vulnerable customers.

2.8 Beyond end user?

We agree it is important that customers receive excellent customer service, regardless of which part of the company the customer contacts. We are currently trialling a new app where customers can provide on-site feedback on how satisfied they are with the inspectors visit. This gives valuable feedback on how satisfied the customer is with any operational visits. However, it focuses only on a small element of the overall service and would be difficult to standardise across companies. It therefore would not be fit for purpose as a wholesale customer service measure.

With regard to Developer Services, we have participated in industry discussions on the issue of an industry-wide qualitative measure for developer customers. The principal challenge here is that there are many different types of customers (small and large developers, Self-lay Operators, contractors, builders, consultants, landowners, Local Authorities etc.) who have different needs and expectations. Any system to measure the qualitative performance would have to be split into these customer groups for benchmarking purposes across companies. We are therefore not convinced that seeking an industry-wide measure is appropriate or achievable at this time.

Additional comments

We found that the SIM workshops arranged by OFWAT as part of the SIM 2015-2020 development were useful and beneficial and would support a similar approach in the development of a future customer experience measure.

Annex 2: Reputational and financial ODIs

Please find below our answers to the questions addressed in Appendix 2 of the consultation document.

1. How to enhance the reputational impact of ODIs?

    The challenge is that a company's announcement of a 'reward' is a double-edged sword for customers. We believe that a comparison of performance outcomes, rather than of rewards and penalties, has a more powerful reputational impact and this is where the focus should remain. If and when a standard "at-a-glance" summary of company performance is developed, this could be sent to every customer in England and Wales together with water bills.

2. Section 13 licence modification on in-period ODIs

    We have some concerns about the growing complexity associated with more and more in-period and end of period adjustments. However, we have no objection to the use of in-period ODIs in principle, although we think that companies should have the discretion whether or not to apply them in-period, at least for rewards if not penalties as well.

    In particular, given the lag between the year in which performance occurs, year *t*, and the first opportunity to apply the reward or penalty, year *t+2*, there may be circumstances where a company has incurred a penalty, but knows that a compensating reward if in the pipeline, or via versa. It is important that companies have the flexibility to avoid see-saw changes in customer bills.

3. Link end-of-period ODIs to revenue rather than RCV

    Strictly speaking, under Ofwat's current price review methodology, we query the extent to which this is a true "either/or" choice. Since companies can increase pay-as-you-go and "run-off" rates to increase revenue over a price control period at the expense of end-period RCV, an ODI applied to the RCV can be translated into revenue and *vice versa*, within limits.

    That said, we consider that it is undesirable if ODIs are seen to apply only over a long period of time, so we agree that they should be reflected in adjustments to revenue, in the first instance.

4. Removal of 2% cap and collar

    We acknowledge the arguments for removing the aggregate cap and collar of 2%.

    However, we do not support complete removal at this stage. The ODI regime is still very much in its infancy, and it will be many years before there is sufficient experience of the variety of circumstances necessary to form definitive conclusions. In particular, we think that there is a need to see how the regime deals with exceptionally adverse, and exceptionally benign circumstances before moving to complete removal.

We would therefore support an increase in the cap and collar from +/- 2% at PR14 to +/- 3% at PR19, but no more at this stage.

5. Use of indicative range for ODIs

We have no objection in principle to the provision of indicative guidance on RORE ranges for ODIs, provided Ofwat addresses the following inter-related observations.

First, there appears to be a tension between various of the statements made in this consultation, which require reconciliation, namely:

- the suggestion that Ofwat could allow a lower overall cost of capital because companies have an opportunity to earn higher returns;
- the statement that rewards should only be applied for truly "stretching" performance; and
- the suggestion that RORE ranges could be symmetrical, or weighted towards the upside.

It appears that these can be made to be consistent only if the "run rate" for rewards is significantly higher than that for penalties. However, this might violate the principles underpinning the calibration of rewards and penalties set out on page 18 of Appendix 2 – penalties would be insufficient to compensate companies for poorer service, and rewards would be higher than customers were willing to pay for better service.

We consider that it is essential that Ofwat sets out its position on the inter-relationship between these issues, otherwise the apparent contradictions will undermine the process of development of ODIs throughout the PR19 process.

Second, if indicative guidance is to be provided it is important that there is sufficient flexibility to allow for the different appetites to the performance/rewards amongst customers in different areas to be reflected in the final decisions. It is entirely possible that customers in some areas would like to see company performance incentivised much more strongly, whilst others may be more concerned with steadier performance and more stable bills. This is an area where an Ofwat-imposed "one-size-fits-all" approach may be inappropriate.

6. Alternative approaches to setting ODI rewards and penalties

We agree that there should be an open mind as to how rewards and penalties are calibrated for the purposes of PR19. We believe that the PR14 approach should be retained as an acceptable "default", especially given the importance of continuity from one AMP period to another, but other approaches should be permitted as well. At present we do not have a view on what approach we would look to adopt at PR19.

7. Standard powerful ODIs for common performance commitments

We would not be in favour of industry standard ODIs as we cannot see a case for this. In particular

- there is a risk of distorting behaviours to concentrate on the small number of "super-commitments" to the detriment of others; and
- one-size-fits-all is not consistent with customer driven plans and targets.

8. Increasing the proportion of performance commitments with financial ODIs

We do not support the view that a financial ODI is necessarily more powerful or otherwise superior to reputational ODIs. Rather, we believe that each performance commitment has to be considered on its merits and the pros and cons of having financial ODIs duly evaluated.

For example, during AMP6 one of the most important performance commitments for our customers has proved to be the aim of keeping average bill increases at least 1% below the rate of inflation. It would not be appropriate for us to reward ourselves financially for achieving this aim.

Therefore, we consider that a crude requirement to increase the proportion of financial ODIs risks arbitrary results and we would not support it. That said, we believe that it is for companies to explain the individual choices that they make, especially to customers and CCGs, and if they are not objectively justifiable then we think it is fair that they are subject to regulatory adjustment.

9. Detailed design of ODIs

We feel that it is important to continue with deadbands to acknowledge that there is some natural variation in performance, for example in relation to the weather. Without these companies may be incentivised to make inefficient investments to meet short term objectives and jeopardise long term sustainable investments.

In any event, it is important not to overplay the incentive effects of the deadbands. The nature of the vast majority of performance commitments is such that "real time fine tuning" of performance is simply not possible. For example, mean zonal compliance is the result of a long list of factors and decisions, many of which will have been made a long time before a sample is taken. So there is a degree to which companies are "flying blind" in the shorter term, which means that they will have an incentive to behave as though rewards and penalties are at stake, even if it turns out "after the event" that they were actually in the deadband.

10. How the variable cost of equity might interact with ODIs

We set out our views on this issue in our response to the "Cost of Debt" consultation in October 2016. In summary, we do not support the idea of a variable cost of equity determined through a "game" as devised by the Essential Services Commission in Victoria. We believe that Ofwat should continue to estimate the cost of equity as part of its core functions of arriving at a baseline allowed weighted average cost of capital. Deviations in the allowed return on equity, e.g. because of the impact of ODIs, can be made from there, but it is important that the common reference point for the whole industry is established.

11. Implications of more powerful ODIs for performance commitments

As set out elsewhere, we believe that caution has to be exercised in making ODIs more "powerful". In particular, Ofwat needs to be sure that it is not sanctioning a framework that encourages "gold plating" – i.e. improvements in service that go beyond what customers want.

In addition, we agree that affordability is a crucial consideration, and that undue volatility in bills caused by powerful ODIs is to be avoided.

Finally, we share Ofwat's concern regarding the effect that strong ODIs could have on definition, measurement, and choosing the right targets. There is a risk that a major "turbo-charging" of the ODI regime could lead to unforeseen distortions in company behaviours. For this reason we would advocate proceeding cautiously at PR19.

12. 'Gated' ODIs

We do not support the use of gated ODIs, mainly for the reasons already set out in Appendix 2.

We do agree that the payment of rewards may not always be appropriate if performance on some other measure has fallen short, but this should be for companies to manage in the light of the individual circumstances of the successes and failures. At attempt to "hard-wire" gating rules in advance is likely to produce unintended consequence both ways.