

## Response to Ofwat consultation

### Outcomes Framework for Price Review 2019

#### Summary

The Environment Agency welcomes the opportunity to comment on Ofwat's proposed outcomes framework for the next price review (PR19). We support the move to a more transparent, principle based approach that actively involves customers and stakeholders in water company decision making on outcomes and performance commitments.

As the environmental regulator of the water industry in England we have been working with Ofwat and the water industry since privatisation to ensure that companies deliver outcomes that protect and enhance the environment. We plan to continue this work in PR19 by supporting the development of affordable water company business plans. These should ensure companies are able to meet their regulatory obligations and go beyond the statutory minimum and maximise environmental outcomes where there is customer support. Recognising the future challenges that the water sector faces we would like to see water companies taking a longer term view of investment, sharing best practice, adopting new technology and working in partnership with customers and regulators.

The main points are:

- We strongly support the outcome-based approach.
- Outcomes, performance commitments (PCs) and outcome delivery incentives (ODIs) should cover the water companies' environmental and flood risk obligations. We see outcomes-based regulation as an opportunity for companies' to be more open and transparent with customers about their environmental and flood risk obligations and how they intend to meet them in the future.
- PCs should always be at least equal to companies' regulatory requirements but preferably more stretching. PCs/ODIs should not be used as a tool to challenge or undermine regulatory regimes.
- We strongly support the use of comparative information to improve customer engagement and help improve company performance and legal compliance.
- We expect to see leakage, per capita consumption, wastewater compliance, and sewer blockages included in the list of common PCs.
- Where it encourages innovation and ambition we agree that linking revenue to service improvements would be advantageous.
- We believe that developing a common set of resilience measures is essential to understand and consistently compare levels of resilience across the industry. We would like work to with you, and the industry to develop an agreed common set of metrics. We also encourage Ofwat to look at whether more consistent use of ODI's could drive improved resilience.

- Annual assessments and payment of penalties/rewards makes the process much more transparent and makes companies more accountable to their customers.
- Greater transparency is required to reassure customers and regulators that company PCs and ODIs are justifiable, realistic and achievable.

In making this response we have limited the comments to specific issues that we feel are relevant our role in protecting people and the environment.

**1.0 Question 1: What is your view on the use of improved information including comparative information to make performance commitments more stretching?**

1.1 We strongly support the use of comparative information by companies to engage with their customers, stakeholders and Customer Challenge Groups (CCGs). At PR14, it was often difficult to judge how stretching or ambitious an individual company's performance commitments were when compared to similar commitments made by other companies.

1.2 We expect the use of comparative information to improve the quality of companies' engagement and the level of discussion at CCGs. This should in turn lead to a greater level of challenge and potentially more stretching performance commitments.

1.3 For comparative information to be useful it is vital that it is made available early in the process; that comparators have standard definitions and performance is judged over similar time periods.

1.4 Discover Water ([www.discoverwater.co.uk](http://www.discoverwater.co.uk)) is a valuable source of comparative information and as a member of the working group we will continue to support this initiative. We also however, expect companies to use other sources of comparative information where available, for example, the Environment Performance Assessment (EPA), Climate Change Adaptation reports and Water Resource Management Plans.

**2.0 Question 2. What is your view on the common performance commitments we are suggesting for PR19?**

2.1 We support the use of common performance commitments as the basis for ensuring that each company has sufficiently stretching targets and aims to fully comply with its legal environmental obligations.

2.2 We believe that common performance commitments should be applied to the services which are most important to customers and where companies' activities have the potential to significantly impact the environment. The use of common commitments should not prevent companies from being able to set further bespoke commitments based on local priorities and customer preference.

2.3 The environment is usually a high priority for customers and we would expect to see the list of common commitments to additionally include wastewater permit compliance and sewer blockages.

- 2.4 We strongly support the use of common commitments covering pollution incidents as these can have significant effects on the environment and impact on customer's future use and enjoyment of the environment. The priority should be a serious pollution incidents commitment (category 1 and 2 incidents) but we would also expect companies to include a total pollution incidents commitment covering category 1, 2 and 3 pollution incidents<sup>1</sup>. Pollution incident commitments should be normalised by total length of sewers.
- 2.5 We believe that sewer blockage is a better measure than the suggested sewer collapse. Sewer blockages can drive long term operational activity, are more representative of the reporting period over which they were collected and have proven links to key outcomes for the environment and customers. Blockages are the primary reason for pollution incidents with a significant 92% (3,653) of sewage flooding incidents occurring as a result of physical restrictions in the pipe (such as a blockage caused by physical objects or the collapse of the pipe) or mechanical failure of pumps. Including blockages as a common measure provides the opportunity to directly influence:
- long term asset condition management
  - companies' operational activity
  - customer and manufacturer/retailer behaviours.
- 2.6 Measuring sewer collapse would be useful as part of a long term measure of resilience. The consequence of collapse might be high, but the likelihood is often low.
- 2.7 We support the use of leakage and per capita consumption as common PCs. Leakage and per capita consumption would be significantly better than distribution input given that the former enable performance comparisons to be made whilst the latter doesn't. There is considerable overlap between the interruptions, pipe burst and leakage common commitments. We would question whether a common commitment for pipe bursts is necessary alongside interruptions and leakage. Customers care about their supply being interrupted, but not about the number of bursts (only in so far as its impact on leakage).
- 3.0 Question 3. What is your view on how we might apply comparative assessments at PR19?**
- 3.1 We expect the wider availability and use of comparative performance information to reduce the need for comparative assessment.
- 3.2 There are strong similarities between Ofwats use of common performance commitments and comparative assessment and the EPA. We would like to explore whether there is an opportunity for greater collaboration and whether the EPA can perform a wider role that supports Ofwat and the price review process. We would be happy to meet and discuss how the EPA could be further developed to meet Ofwat's needs.

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<sup>1</sup> Pollution incidents are categorised as category 1 – major, serious, persistent and/or extensive impact or effect on the environment, people and/or property; category 2 – significant impact or effect on the environment, people and/or property; category 3 – minor or minimal impact or effect on the environment, people and/or property.

3.3 The use of comparative assessment should not be restricted to common performance commitments. Where companies are proposing similar bespoke commitments it may be helpful to compare relative targets to make sure that companies are setting challenging commitments across their services.

3.4 Comparative assessment should be forward looking but also take account of historic 'best' performance and recent trends in performance.

**4.0 Question 4. To what extent do you agree with our proposed approach to leakage performance commitments for PR19?**

4.1 We broadly support the proposals for making leakage commitments more stretching. Leakage may not be subject to comparative assessment but it is important that customers can compare company performance, especially between neighbouring companies and where water only companies are within water and sewerage company boundaries. This requires consistency of data and definitions. At PR14, the measures were not comparable with companies choosing different periods and total volume of leakage in MI/day to illustrate their performance.

4.2 We believe that there should be less emphasis placed on the sustainable economic level of leakage as it does not offer a reliable or verifiable basis for setting stretching targets. Setting more ambitious targets should however, enable innovation and ultimately greater efficiency. We believe that a frontier or upper quartile approach would drive most companies to better leakage performance.

4.3 In comparing leakage targets one option would be to categorise companies in to three graduations of resource position (high, medium, low) and set commensurate targets.

4.4 Research shows a close correlation between leakage and the number of connections. This is because most leakage occurs on the service pipe; either on the communication pipe (water company responsibility) or on the supply pipe (customer responsibility), the best comparator would therefore be litres/connection/day. As the number of connections is not always known the number of properties is a good proxy and would be acceptable.

**5.0 Question 5. What factors should we take into account in our guidance on setting performance levels for bespoke performance commitments at PR19?**

5.1 We expect water companies to take account of a range of factors when setting bespoke PCs, including local pressures on the environment, current and recent performance and existing regulatory obligations or expectations. Companies should provide evidence to Ofwat, CCGs and stakeholders that they have benchmarked their performance levels against current performance, and the scale of the overall improvement required.

5.2 We would like to see companies factor in and communicate where additional wider benefits might be secured for both customers and the environment. To achieve this Ofwat should encourage companies to consider setting

performance commitments that embed best practice and innovation such as improved self-reporting, adopting natural flood management and catchment based approaches.

- 5.3 We support companies using a wider evidence base for customer preferences to help them understand what outcomes customers' value and how they can best deliver those outcomes. We would like to see companies gather customer's preferences and values across all the wider outcomes and benefits that the companies help to deliver.

**6.0 Question 6. What is your view on our development of a new customer experience measure for PR19?**

- 6.1 We support the proposal to look beyond customer service and base the new measure on the full service that customers' experience. South East Water's PR14 customer outcome measure is an example that could be built upon. There needs to be some caution in measuring customer satisfaction for all customer-facing activities. Customer satisfaction can be genuinely improved by better customer service or customer expectations can be lowered by company 'explanations/awareness raising'. We want the former not the latter.

- 6.2 The role of companies is changing and the activities and services provided are expanding. Any future customer satisfaction measure should take account of the relationship that companies have with all those they deliver services to, be they with developers, land-owners, risk management authorities or catchment partners.

**7.0 Question 7. What is your view on the options for increasing the power of reputational and financial ODIs in PR19?**

- 7.1 Financial ODI's are a powerful tool for encouraging good performance. We support their use in situations where companies are looking to go beyond their statutory duties or are delivering quicker or achieving additional outcomes beyond those intended. We do not however, support the use of ODI's to reward companies for complying with existing regulatory requirements. We believe that water companies have already been funded to achieve 100% compliance with existing permits.

- 7.2 ODIs as indicators of systemic performance are useful in driving better performance but are separate from any enforcement action that we take in relation to specific incidents on non-compliance or where we suspect an offense has occurred.

- 7.3 Financial ODIs should be transparent, proportionate and effective. If penalties can be postponed, hidden (linked to the Regulatory Capital Value (RCV) or are limited to incidents of extreme service failure they are unlikely to be as effective. For this reason we would support proposals including using in-period ODI's, applying end-of-period ODIs to revenue rather than the RCV and reviewing the use of deadbands.

- 7.4 We agree with linking more revenue to service improvements but only if it encourages innovation and ambition. For instance, more cost-effective natural/catchment based solutions, or control at source options, over more costly and carbon intensive treatment options. We would also like to see Ofwat

reconsider how revenue foregone due to poor performance is allocated. While we agree that customers should be compensated for not receiving expected improvements in service we also expect companies to offset any environmental benefits not secured as a result of poor performance. This could include compensating measures funded by ODI penalties, for example habitat restoration/recovery projects for water bodies subject to serious pollution incidents or non-compliance.

- 7.5 We believe that financial ODIs should be based on a wider outcome valuation evidence base. This is possible provided water company customer surveys are designed correctly.
- 7.6 There needs to be a continued focus on reputational as well as financial incentives. Reputational incentives can be effective in other ways, for example, we know that our Environmental Performance Assessment (EPA) has an influence on water company credit ratings.
- 7.7 Open reporting of performance is extremely important so that water companies can be held to account by CCGs, other regulators and stakeholders and we would support the use of comparative tables for reputational ODIs where appropriate.
- 7.8 In-period ODI penalties and rewards would increase the focus of companies to achieve the targets and make the process more transparent and accountable to customers.
- 7.9 Evidence to date indicates that there has been significant improvements in some areas of service but not in others. It is difficult to establish if service failures in the first year of AMP6 could have been mitigated by additional rewards and if so by how much. We would encourage Ofwat to investigate this further ahead of the PR19 methodology being released. Ofwat should also consider the likelihood of higher rewards in some areas putting other services at risk.

#### **8.0 Question 8. What is your view on our proposals for better reflecting resilience within the outcomes framework?**

- 8.1 Improving the level of resilience within the water industry is essential if we are to respond effectively to future growth and climate change pressures. The recent national flood resilience review and the water resources long-term planning framework both highlighted the exposure of assets and services to extremes of flooding and drought and the need to plan for a range of extreme events.
- 8.2 Resilience will be an important theme during the next price review and we strongly support the proposal to better reflect resilience within the outcomes framework. We support introducing resilience planning principles and in particular the need for a clear line of sight between a companies' understanding of risk and its choices and options. Companies need to be able to clearly articulate future risks to services and the long-term costs and benefits of potential solutions.

- 8.3 We believe that a common set of resilience measures is essential as this will allow water companies, regulators and customers alike to have a shared understanding of the risks and inform resilience improvements. We support option 2 which introduces a common set of resilience measures, but also allows water companies to consider their individual company risks and adopt additional metrics to focus on these. It is important that any metric developed demonstrates the industries resilience to natural hazards, environmental disasters and water and wastewater system risks.
- 8.4 We are aware that there are a number of groups currently involved in developing future resilience metrics, including a group chaired by us that is considering a resilience metric for the EPA. We suggest that Ofwat take on an overview role to make sure there is join-up across these groups and agreement on any future common measure of resilience.
- 8.5 We support the proposal that long-term performance commitments should be looking at least a further ten years after the five year duration of the performance commitments as this will help companies plan longer term. Where appropriate we believe that companies should be encouraged to provide long-term commitments that go beyond ten years. These commitments should be informed by existing strategic plans including Water Resource Management Plans, River Basin Management Plans and Flood Risk Strategies.
- 8.6 Water companies should develop willingness to pay approaches that take proper account of resilience considerations.
- 9.0 Question 9. What is your view on the options and our preferred approach to asset health outcomes?**
- 9.1 The partial standardisation approach to asset health seems sensible. We would like to be involved in future discussions about the sub measures that are to be standardised for all the water companies
- 9.2 We support the introduction of asset health expectations, but question whether it is appropriate to include water mains bursts and sewer collapses as part of the asset health measures, having already identified these two as common performance commitments. The same information should not be both a measure in itself and a sub-measure of a composite. In addition, to expectations listed we would expect asset health to include both natural and built assets. Companies could do this for example via Corporate Natural Capital Accounts.
- 9.3 We would question how realistic it is to expect customers and CCGs to challenge companies on their asset health proposals. This is a complicated area and while the asset health outcomes expectations will help, Ofwat needs to be realistic in terms of the contributions that customers can make in this area.
- 10.0 Question 10. To what extent do you agree with our proposals for making performance commitments more transparent for customers?**
- 10.1 We agree with the principles that Ofwat has outlined for making performance commitments more transparent. In particular we are pleased that Ofwat has

recognised the challenges around sub measures and proposed an approach for these. Where sub measures combine into an overarching matrix or index it is fundamental that the method of overall compilation is made clearer.

- 10.2 The decision making process from risk assessment to option choices and commitments should be transparent. For each PC we think it would be helpful for companies to provide a supporting commentary that describes how companies plan to meet their commitments. Greater transparency would reassure customers and regulators that company PCs were realistic and achievable.

### **Further information**

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