

## **Ofwat Consultation on the Outcomes Framework for PR19**

### **Ofwat Consultation on the evolution of the framework for Outcomes, Performance Commitments (PCs) and Outcome Delivery Incentives (ODIs) introduced at PR14**

#### **Response from the Northumbrian and Essex and Suffolk Water Forum**

##### **Introduction**

The Northumbrian and Essex and Suffolk Water Forum represents a wide range of people, organisations and sectors, from consumers, to business and communities to industry regulators. It meets frequently, seeking to establish a strong connection between its members' expertise and the role it plays as a crucial friend. Northumbrian Water Group (NWG) operates in the north east of England, where it trades as Northumbrian Water, and in the south east of England, where it trades as Essex & Suffolk Water.

NWG supplies water and sewerage services to just under 4.4 million people. Water is supplied to 794,000 properties in Essex & Suffolk, with water and sewerage services provided to 1.3 million properties in the North. NWG employs just under 3,000 people and operates 1,097 water and sewerage assets and 25,678.3 km of water mains and 29,923.1 km of sewers.

Northumbrian and Essex and Suffolk Water is a well-run company adept at providing water supply and wastewater services and doing so to over 4.4 million customers. However, it is also a company that seeks to achieve improvements in all that it does. The Water Forum is both a means towards aiding that, by being a critical friend, but also it is a means of assurance that the company is taking its responsibilities to customers seriously: listening, engaging and acting accordingly.

The Water Forum brings together people from the wide range of different organisations relevant to water and sewerage planning. They help ensure NWG decisions reflect customers' views, particularly on issues that may impact on standards of service or the level of customers' bills. The Water Forum also recognises and takes into account the legal obligations faced by the company such as new drinking water quality and environmental standards.

The Forum offers structured, informed and rigorous challenge to help NWG maintain its resilience, accountability and focus on the needs of its customers.

##### **Ofwat Consultation on Outcomes**

As a general rule, The Water Forum prefers to be consulted by Ofwat and prefers that such consultations should be of value to both sides, allowing time for the Forum to engage and ensuring Ofwat has the time and willingness to consider fully the Forum, and indeed, other views. The Forum has, however, found this consultation to be rather onerous in terms of its length and the fairly tight timetable. Possibly Ofwat could consider a separate process for a more effective engagement with Customer Challenge Groups (CCGs).

Our summary of the rather long document, the full version of which can be viewed [here](#), is that Ofwat has issued a consultation on the evolution of the framework for Outcomes, Performance Commitments (PCs) and Outcome Delivery Incentives (ODIs) introduced at PR14. Ofwat's aim is to create a step change in the framework to help ensure companies remain focussed on delivering the outcomes that matter to current customers, future customers and to the environment, and that customers and stakeholders have trust and confidence in the sector.

Ofwat's consultation has four interrelated themes on how the framework can be developed and strengthened for PR19:

1. How companies' PCs can be made more stretching to deliver higher service levels to customers.
2. How ODIs can be strengthened to encourage companies to deliver on their PCs.
3. How resilience can be better reflected in outcomes to ensure the interests of future customers are taken into account.
4. How PCs can be made more transparent to make it easier for customers to hold companies to account.

The consultation asks ten questions covering these four themes. In answering these questions, we draw on the company's own response and add commentary to that.

### **Responses to Ofwat's questions**

#### **1. Making performance commitments more stretching**

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

Summary of NWG response:

*We strongly support the use of comparative information to drive improvements in performance. Indeed, we already scrutinise benchmarking data when setting our own performance targets. This approach has driven significant service improvements for both our customers and the environment.*

*We agree that giving more information to customers provides the evidence they need to challenge their companies. In this regard we have engaged extensively with Water UK on the development of the Discover Water dashboard. We have also started to share more detailed information on our own comparative performance by placing Discover Water specific 'landing pages' on our website. These have been well received by both Water UK and Ofwat as a way of providing even greater transparency to customers.*

*For comparative assessments to be credible, they must be based on information that is genuinely capable of comparison. To be certain that this is the case, each measure must be clearly defined and these definitions must then be applied in a robust way. These processes should be underpinned by a programme of proportionate but rigorous and independent ex-post horizontal audits where checks for consistency are made. We view this as essential to maintaining trust and confidence.*

*We have played a key role in work to date to establish robust and consistent definitions for metrics such as leakage, interruptions and flooding. We are on the steering group for the UKWIR project on the consistency of performance measures, for example. We would welcome an approach that builds further on this work.*

*We strongly support the use of comparative information when engaging with customers. We agree that such comparative information needs to be framed appropriately if it is to result in meaningful engagement. Again, we welcome the opportunity to work with our CCG on this.*

*We are supportive of incentivising the use of better information in business planning.*

#### **Commentary from The Water Forum**

We support moves towards better comparative information and believe that NWG's response is a sound one that reflects a strong culture that believes in the use of credible and verified data for exposing performance variability between companies. We would like to see NWG and Ofwat continue to develop ways of using more data and more innovative ways of using such data in ways of engaging customers.

There remains a concern that some companies have yet to commit fully to changes to measurement systems and data definitions necessary for the data to become truly comparable. Customers and CCGs need to be able to see truly comparable information to form a view about a company's plans, in little over a year from now. Whilst Discover Water is a good initiative and as a Water Forum we note supportively NWG's commitment to it, not all companies have the same commitment seemingly. Therefore data may not be sufficient and sufficiently comparable for the dashboard to be credible with the public.

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

Summary of the NWG Response

*We are very supportive of a limited set of core measures of success that apply to all companies, whilst still leaving scope for companies to innovate.*

*As we noted in our response to Q1, it is imperative that all companies measure their performance against these common measures of success in a consistent way.*

*We are broadly supportive of the common measures of success that are proposed in section 2.5, subject to the following specific comments:*

- We consider that sewage treatment works discharge compliance is a significant omission. The quality of continuous discharges has the potential to have a significant long-term impact on the quality of rivers and bathing waters. All companies already report performance against this measure under the Environment Agency's current monitoring regime.*
- We agree with the observation that the Abstraction Incentive Mechanism may not meet the 'applicable to all companies' test for a common performance commitment.*
- While we are very supportive of resilience being reflected in the outcomes framework, it is important when selecting specific measures to make sure they drive the right behaviour and do not undermine outcomes-based thinking. We consider this further in our answer to Q8/9.*

*We are supportive of the approach whereby ODIs are attached to common measures of success. We think that incentive rates should be set in a consistent way across the industry and should not be based on local results of willingness to pay (WTP) surveys. While these surveys can be helpful to determine relative customer priorities, the results are not sufficiently consistent or accurate to be used for calculating incentive rates. We consider this further in our response to Q7.*

*We agree that ODIs should be specific to price controls, on the basis that it should be possible to attach all ODIs to an individual price control on a 'primary driver' basis. The need for ODIs to be price control specific, however, should not detract from the requirement to make outcomes and performance commitments meaningful and transparent to customers.*

#### **Commentary from The Water Forum**

We agree with NWG that the adoption by Ofwat of a small, targeted number of common performance commitments is a step forward and one that will improve transparency and accountability. However, we are a little concerned that Ofwat may be taking a quite prescriptive approach and that this may result in companies not putting sufficient weight on the performance measures that they may adopt in their own strategies. We would suggest that Ofwat should retain an element of flexibility in measuring the performance of a company to reflect the diversity of approach that is needed for true customer focus. We would be particularly keen to see measures that reflect a proper balance between the need to serve vulnerable customers with overall good levels of profitability and debt recovery.

### **Q3: What is your view on how we might apply comparative assessments at PR19?**

#### Summary of NWG Response

*We welcome the introduction of common commitment levels for a core set of performance commitments. At PR14 the introduction of ODIs and performance commitments that were set by companies in consultation with their own customers was a substantial and positive innovation. It has, however, resulted in some companies earning rewards for a level of comparative performance that would see a different company incur a penalty. This is difficult to explain to customers and does not seem fair, nor does it appear to drive incentives for frontier companies. For selected performance commitments, setting common commitment levels has the potential to resolve this issue.*

*We are broadly supportive of the measures proposed for comparative assessments.*

*In our view, comparative assessments work best in relation to performance commitments that relate to mandatory standards, where robust common definitions already exist. It would be beneficial for sewage treatment works compliance to be included alongside drinking water quality.*

*We support the inclusion of bursts and collapses in the list of common performance commitments as measures of asset health. We do not agree that they are comparative service measures.*

*We support setting common commitment levels for individual measures, based on achieving at least upper quartile performance. Rewarding the performance of leading companies is important as it sets the benchmark and provides incentives for all companies to catch up. This also reflects competitive markets where leading companies earn higher returns until competitors are able to match their performance.*

*Further sense checks should be applied. In each case it should be established that the proposed level of performance is likely to be acceptable to customers. In addition there will be cases where the industry is already performing at, or close to, zero failures or 100% compliance on a given measure. In such cases there is a risk that making further improvements (or indeed maintaining the current high level but with a greater degree of certainty) can require significant investment with no meaningful change in outcome from a customer's perspective.*

*While we strongly support a comparative approach, there is obviously the potential that performance commitments that are set comparatively across the industry might conflict with the results of local engagement with customers.*

*A simple solution would be to consult customers on the acceptability of the proposed framework for those core measures that are subject to common commitment levels. In other words, to seek customers' views about setting performance commitments on a comparative basis using upper quartile assessments. This would enable a more genuine and meaningful conversation with customers than if companies consulted in detail on targets for these measures, the results of which could be overridden by independent horizontal assessments.*

*Companies should also be free to engage on bespoke measures that have strong customer support. We would also expect companies to engage with customers more broadly on subjects such as trust, transparency and loyalty.*

*Consideration would need to be given on whether customer consultation on the proposed framework for common commitment levels should be carried out locally or on a national basis.*

#### **Commentary from The Water Forum**

We support the introduction of a common format and ten common PCs and clear definitions and methodologies for reporting. We agree that the NWG response is both positive and pragmatic and would support the company's requests for some flexibility. Most importantly, we are strongly of the view that true customer focus means that when an effective approach to customer engagement has been taken, moderating objectives and managing expectations, that the company's performance should not be 'marked down' or 'marked up' for following the lead set by customer engagement. This is particularly the case where companies can evidence sustained and multi-stakeholder engagement leading to defined performance levels - if a company can evidence true customer engagement then Ofwat must have the flexibility to acknowledge that.

We also support the company's view that the proposed framework for common commitment levels should be shared with customers through a consultation exercise, which could be conducted on a national basis, but with a sufficiently large sample drawn from the customers of each company to enable any important differences of customer perspective to be surfaced.

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

##### Summary of NWG Response

*We strongly support proposals to increase the consistency and transparency of leakage reporting. This is critically important to maintaining trust and confidence in the water industry.*

*We believe that leakage commitments should be derived as part of a company's overall plan and should not be set in a simplistic way based on comparative data (although comparative data provides helpful context and should be referred to in justifying commitments).*

*We agree that targets should be expressed in megalitres although we would support these targets being set on the basis of a three-year rolling average, which we discuss further below.*

*We believe that robust calculation of the sustainable economic level of leakage (SELL) is key to setting appropriate targets. We would support incentives for companies to drive the SELL down over time. There is a balance to be struck, however, between maintaining customer trust, and incurring unnecessary expenditure that has an upwards impact on bills. We do not support forcing companies to operate below the SELL.*

#### **Commentary from The Water Forums**

This is an important area and one where we would encourage NWG and Ofwat to continue to recognise customer concerns over the costs and scale of leakage. We would also encourage NWG and Ofwat to ensure that, when striking a balance over investment and leakage levels, that such analyses are informed by customer engagement as much as by cost-benefit analysis. Overall, we support the clarity of Ofwat's proposals in this area and would want certainty that these measures will be retained amongst all such future measures.

#### **Q5: What factors should we take into account in our guidance on setting performance levels for bespoke performance commitments at PR19?**

##### Summary of NWG Response

*We agree with the observations, outlined in the consultation document, about the way that WTP research was used at PR14. We welcome the opportunity to use a wider and richer evidence base so that bespoke performance commitments more fully reflect customer priorities. We welcome the opportunity to work with our CCG on this aspect. We also agree that comparative information has a role to play in this area.*

*In our view this approach is likely to require a higher degree of judgement than simply relying on a numerical equation that balances marginal costs with incremental WTP. However, if company proposals are subject to robust challenge from their CCGs, this approach should result in more meaningful commitments.*

*We remain open minded about the results of our customer engagement, and whether it will result in all cases in more stretching performance commitments.*

*As regards the proposal to set a profile for performance commitments, we recognise that seeking year-on-year improvement can drive a continuous focus from companies. It can also, however, reduce the scope for innovation in that it could encourage companies to focus on initiatives that deliver smaller incremental improvements rather than more transformational activity.*

### **Commentary from The Water Forum**

There are several parts of the relationship between customers and NWG where a distinctive and bespoke measure would be advantageous, reflecting particular circumstances and so, overall, it's welcomed that this is a key part of the Ofwat consultation. Such measures can reflect particular needs, local circumstances and the local environment and they can lead to stretching performance targets for an organisation. We would encourage Ofwat to agree such bespoke measures when they can be evidenced by good customer engagement techniques.

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

#### Summary of NWG Response

*Our customers are at the heart of everything we do and they tell us that providing excellent service is important to them. We therefore welcome the continued focus on this area, and the opportunity to review and potentially enhance SIM by creating a new customer experience measure.*

*We wholeheartedly agree that customers should be given the opportunity to participate in the co-creation and co-delivery of solutions and we live by this principle. For example, we co-created our Unrivalled Customer Experience Strategy by working with our customers, our employees and our supply chain partners. We would welcome the opportunity to co-create a customer experience measure in this way, one that is fit for the future with customers and other stakeholders. We would therefore encourage and support such an approach.*

### **Commentary from The Water Forum**

The relationship between the company and a customer is not an abstract and uniform one, rather it is personal, particular and diverse – when viewed from the customer's perspective or reflecting it. Therefore, a performance commitment that goes beyond the narrow limits of SIM (but retains its simplicity) would be welcome. We support the NWG approach that SIM and any other regulatory measure must be seen alongside the other actions and systems that a company uses to manage relations with its customers. We would also ask that Ofwat recognise the skills and expertise needed in companies to handle relationship management on this level.

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

Summary of the NWG Response

*We aim to deliver leading company performance in both totex efficiency and outcome delivery. We believe that ambitious companies should be able to earn higher returns for delivering high performance. For common financial ODIs, powerful incentives for leading companies are particularly important to encourage stretching performance targets to be set for the industry.*

*We note that the 2015-16 industry ODI performance generates RoRE impacts that range from +0.6% to -0.7% across the industry. These are all below the desired minimum range of +/-1% in the PR14 guidance. We suggest that this is due to a combination of incentive dampening factors, which we consider below.*

*We welcome the commitment to common financial ODIs. As is proposed, these must be based on performance relative to other companies, not on a change in company performance over time. This ensures that rewards most closely match those of a competitive market, where the companies that provide the best service to customers make the highest returns.*

*This would also avoid any scenario where, for example, a poorly performing company earns a reward merely for improving its own performance to an industry average level. Such scenarios could well damage customer confidence in the ODI regime.*

*The standard definition of common performance measures is of critical importance. Any suggestion that comparative data is not equivalent immediately undermines customer confidence in the comparative regime. We are currently leading the drive for standard definitions and measurements in these areas. As noted earlier, we have supported the development of the Discover Water website and are active participants on the steering group for the Water UK & UKWIR project to develop consistent measures.*

*We have set out our views on each of the nine proposals for increasing the power of reputational and financial ODIs. We are generally supportive of these proposals and have made suggestions as to how they might be applied.*

*We believe that there is a different approach to the variable cost of equity proposal that merits further consideration and we believe that this revised approach would allow companies to demonstrate their appetite for outcome delivery risk without the need for regulatory judgement.*

### Commentary from The Water Forum

The measurements required to justify financial rewards need to be robust and stretching so that customers, consumers generally and regulators can be confident that the payments reflect reward for very high performance, rather than fostering safe and relatively undemanding levels of performance. Enhanced payments may be welcomed by some consumers and may help achieve some specific outcomes, but customers will be very wary of such payments. High transparency, high levels of customer engagement and precision defining the criteria for such awards are important alongside sensible arrangements that protect companies' performance from factors outside their control.

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

#### Summary of NWG Response

*We see resilient services as a cross-cutting issue, and one that is fundamental to our business. It is our intention that resilience will underpin our own business planning at PR19. We are therefore fully supportive of the drive to better reflect resilience in the outcomes framework, as set out in the consultation document. We set out below our views on the more detailed proposals in this area.*

*We are supportive of the proposed resilience planning principles. We think it particularly important that companies consider a broad range of intervention options (including response and recovery) to arrive at cost-effective solutions, as detailed in principles 4 and 5.*

*We are also supportive of the increased emphasis on engaging with customers on resilience, and for the quality of this engagement to feed directly into the risk based review. This is important to maintain the trust that our customers already have in us to deliver resilient services.*

*We welcome the introduction of longer term performance commitments, as long as these are set in a way that reflects the degree of uncertainty associated with longer term projections.*

*We are supportive of a review of common performance commitments, to understand the degree to which they take account of resilience issues. It will be important that, in line with resilience planning principle 4, this review considers all aspects of resilience including recovery. The definition of performance commitments is important in this regard, simply removing all exclusions for severe events, for example, may encourage companies to focus disproportionately on prevention, rather than on recovery. This course of action may be neither efficient nor consistent with customer views.*

*We have reservations about the merits of introducing common resilience measures. Based on the examples seen so far, there is a risk that these measures will dictate the method, not the outcome, which could potentially undermine the resilience planning principles 4 and 5. It is also likely that different companies will have different resilience challenges, which means that bespoke measures will be more appropriate.*

*If the aim is to strengthen trust and confidence that companies are meeting their resilience obligations then this could be addressed through the assurance framework. Companies could highlight resilience risks in the 'risks, strengths and weaknesses' section of their assurance plans, for example. Ofwat's assurance assessments could reflect, in a consistent and evidence based way, the extent to which companies have identified and mitigated these risks.*

#### **Commentary from The Water Forum**

We strongly support measures and targets for outcomes related to resilience and believe these will be most valuable when grounded in long-term forecasts, research and strategic plans. These should be measured and assessed and paid in the life of a PR but should reflect longer term risks and opportunities and reflect large regional sustainability themes, such as soil, water and carbon balances, economic development and community outcomes, as well as those solely within the purview of the NWG operations. We support NWG locating this work in its assurance framework and look forward to working closely on the development of the customer engagement dimension of the assurance plan.

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

##### Summary of NWG Response

*Our preferred approach to introducing more standardisation on asset health performance commitments is option 1.*

*Partial standardisation addresses our concerns for industry-wide comparative information and for making performance commitments more transparent. We agree that partial standardisation will still allow scope for companies to innovate, which is key, and to address any circumstances that may be specific to them.*

*By contrast, full standardisation – in the form of a standard list of asset health measures with standard aggregation rules from the sub-measures – has the potential to stifle innovation. This approach could also restrict companies' abilities to reflect their engagement with customers and stakeholders in their business planning.*

### Commentary from The Water Forum

The Water Forum supports the company's response. Asset health is of general concern to customers who would accept that managing such assets for long-term sustainability is a legitimate component of price and profitability. They would also understand the need to invest and for such investments to be carefully assessed. Asset health is also an integral component of many other of the proposed indicators and the potential scope of bespoke measures too.

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

#### Summary of NWG Response

*We welcome the suggested principles for defining performance commitments, and the suggestion of common definitions for common performance commitments. It is important that these common definitions are sufficiently detailed to ensure consistency, and are supported by a programme of independent horizontal checks.*

*The proposals outline a sensible way to improve clarity. The need for sub-measures should be kept to a minimum by careful selection and design of performance commitments, and by minimising the use of baskets (see response to section 3.4.4).*

*We welcome the opportunity to build on the way in which we have disseminated our recent assurance plan and the comparative information that is provided through the Discover Water website. We support the proposal for companies to explain in their business plans their approach to disseminating information, and for this to form part of the risk based review – as long as this does not constrain companies from innovating further in-period.*

*We support the proposals. Company activity and performance should be judged according to what customers expect them to deliver. It is therefore logical that outcomes that have been shaped by genuine and open customer engagement should provide a focus for company performance.*

### Commentary from The Water Forum

This question lies at the heart of the regulatory process, the relationship between companies and their customers and the role of the Water Forum. Clarity, transparency and a commitment to engaging with stakeholders in many and varied ways are essential to the development, measurement and accountability of a company's performance. NWG has a good story to tell about the way that it gathers intelligence and ideas from the public and customers, engages them in its work and disseminates this information. It has also been an active supporter of national efforts, especially Water UK, to do this at a comparator level for all water companies. It therefore follows that the more effective customer engagement is, the more reliable can the regulators and other stakeholders judge the plans, measures and outcomes to be. As a Forum, we look forward to continuing to work with the company as it develops its strategic plan, Assurance Plan and its response to the Ofwat outcomes consultation.



Jim Dixon

Chairman

Northumbrian and Essex and Suffolk Water Forum

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