

November 2016

# **A consultation on the outcomes framework for PR19**

## **Appendix 4 – Making performance commitments more transparent for customers**

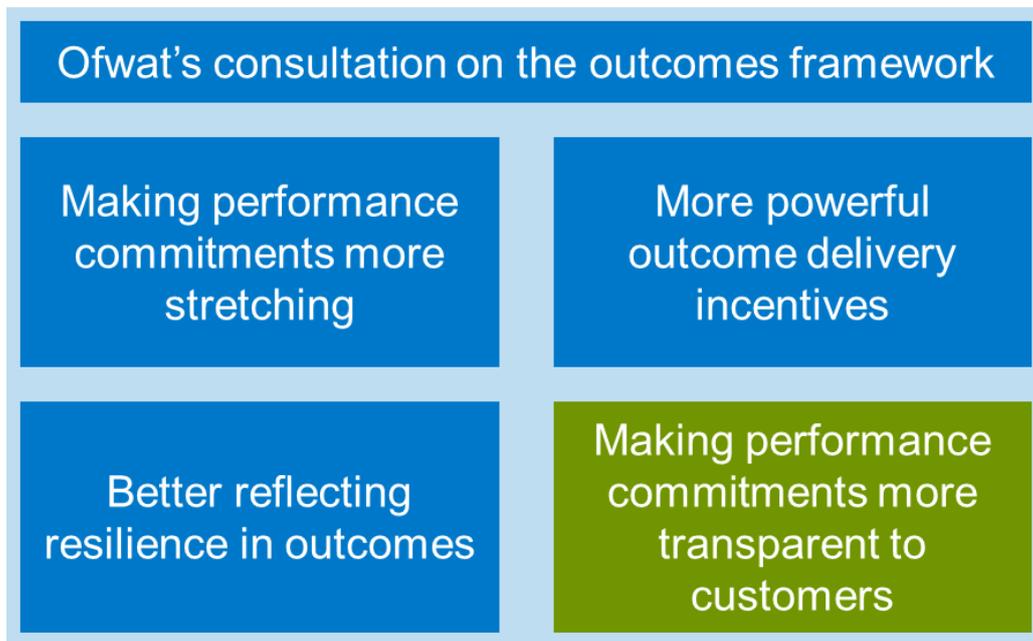
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## Appendix 4 - Making performance commitments more transparent for customers

This is appendix 4 to the consultation on the outcomes framework for PR19. It considers how we can make performance commitments more transparent for customers.

**Figure 1 – Appendix 4 relates to the fourth theme of the outcomes consultation**



**Table 1 – Our proposals for more transparent performance commitments for customers**

<b>Proposals for more transparent performance commitments for customers</b>	<b>Status</b>
1. We propose a set of principles which can help companies make their performance commitments easier to understand (their performance commitments should be clear, unambiguous, complete and concise)	We are consulting on our proposed principles for making performance commitments easier to understand. We expect to confirm our approach alongside the methodology consultation.
2. We are proposing reporting requirements for all performance commitment sub-measures that companies use at PR19, including	We are already introducing reporting requirements for all existing performance commitment sub-measures for the 2017 annual performance reports.

<p>clarity on what the sub-measures are, their definitions and the targets that relate to them.</p>	<p>We are consulting on our proposed reporting requirements for performance commitment sub-measures at PR19. We expect to confirm our approach alongside the methodology consultation.</p>
<p>3. We are encouraging companies to explain in their business plans how they will disseminate their performance information during the next price control period to ensure it is visible to customers, CCGs and other stakeholders. We propose to assess this in the risk based review.</p>	<p>We are inviting early views on this issue. We expect to consult on our risk based review tests in the methodology consultation.</p>
<p>4. We propose circumstances in which scheme-specific performance commitments might and might not be appropriate.</p>	<p>We invite early views on the issue of in which circumstances scheme-specific performance commitments might and might not be appropriate. We expect to consult on a preferred approach in the methodology consultation.</p>
<p>5. We propose some process improvements for the development of the scheme-specific performance commitments and ODIs, including early engagement with customers and CCGs on any scheme-specific performance commitments.</p>	<p>We invite early views on the process for the development of scheme-specific performance commitments. We expect to consult on a preferred approach in the methodology consultation.</p>

## Introduction

The outcomes framework and its associated performance commitments are one of the most customer-facing elements of the price review. For the engagement process to be effective it is important that outcomes, and the performance commitments that support them, should be easy for customers and other stakeholders to understand and that the performance commitments relate clearly to the outcomes companies are pursuing. To do this, we want to ensure performance commitments are more transparent at PR19.

More transparent performance commitments will increase the reputational incentive on companies (see the consultation document chapter 2 and appendix 2) to improve their performance, as customers and CCGs can more easily hold companies to account for their performance when their performance commitments are easy to

understand. Effective dissemination of companies' performance information will also increase the reputational impact of performance commitments. We propose to assess the transparency of companies' performance commitments and their approaches to disseminating information on their performance in their business plans as part of our risk based review.

We are consulting on a range of proposals to promote more transparent performance commitments at PR19:

- principles to make performance commitments easier to understand
- making performance commitments easier to understand through reporting requirements on the sub-measures that underlie some performance commitments
- encouraging companies to explain in their business plans how they will disseminate their performance information to ensure it is visible to customers, CCGs and other stakeholders
- making performance commitments more focussed on customers' preferred outcomes, through reviewing the approach to scheme-specific performance commitments

## 1 Principles to make performance commitments easier to understand

It will be easier for customers, CCGs and other stakeholders to engage with companies on their performance commitments and to hold companies to account for their delivery if they are clear and easy to understand. In addition, clear and easy-to-understand performance commitments are likely to be more effective at incentivising companies to deliver for their customers.

We strongly encourage companies to make their performance commitment definitions as clear and easy to understand as possible. We recognise that it can be difficult for customers to understand the detailed definitions of some performance commitments and for CCGs to challenge them. Examples might include the detailed exemptions for weather events or third-party actions that are included in the definitions of some performance commitments. However, it is important for CCGs to understand and be able to challenge these detailed exemptions, since they can allow performance to be excluded, diluting the strength of the performance commitments and weakening the incentive on companies to deliver a resilient service.

We confirmed in our [Water 2020 decision document](#) that we expect companies to submit their performance commitment definitions ahead of business plans. This will allow us time to review the definitions and provide any feedback to companies ahead of them submitting their business plans. We also stated that, by exception, a company can choose not to submit a definition early if a performance commitment is new, innovative or requires extensive customer engagement. These definitions will be scrutinised more closely during the risk based review at PR19 as a result of not being seen early.

One way in which companies could submit their performance commitment definitions early would be by us requiring companies to provide a document similar to appendix 4 of the [PR14 final determination company-specific appendices](#). By reviewing these documents in advance of the submission of business plans it will enable the discussions during the price review to focus on what matters to customers rather than looking at the detail of performance commitment definitions. We will confirm in our June 2017 methodology statement when exactly companies should submit their definitions.

We also recognise that some performance commitments are more complex than others and that if companies want to develop new, innovative measures these could be more complex or unfamiliar to customers and CCGs than well-established existing measures. In this context, companies should still strive to make their

performance commitments clear and easy to understand even if they might require more explanation than more familiar performance commitments.

We suggest some principles which can help guide companies when defining their performance commitments:

- **Clear** – use plain English as much as possible, avoid jargon, and use technical terms only if they are well explained.
- **Unambiguous** – definitions should leave no room for doubt about what is being proposed or measured.
- **Complete** – the definitions should describe any material points of relevance which a company might later rely on when reporting its performance.
- **Concise** – the definitions should be as short as reasonably possible to enable customers, CCGs and us to engage effectively with the definitions.

We invite stakeholders' views on the above principles, including any that we might have missed.

In chapter 1 and appendix 1 we propose ten common performance commitments with standard definitions. We would expect the definitions of the common performance commitments to be agreed during 2017 abiding by the draft principles outlined above (and any changes to them).

## **2 Making performance commitments easier to understand through reporting requirements on sub-measures**

One way in which performance commitments can be less transparent to customers, CCGs and other stakeholders is through the use of sub-measures i.e. measures which directly contribute to the performance on a companies' performance commitment, but are not themselves performance commitments. We recognise that good presentation of composite measures, perhaps using digital presentations to allow customers to click through to the sub-measures, can make them more accessible.

Sub-measures were mainly associated with asset health and environmental performance commitments at PR14. We have discussed asset health in the resilience section of this consultation and our preferred approach included improved reporting requirements on the sub-measures for PR19.

The use of sub-measures creates a number of challenges:

1. Sub-measures have their own targets that contribute to an overall matrix, index or score. In many cases these targets are not transparent to stakeholders.
2. The aggregation methods from performance on the sub-measures can be complicated and difficult to understand, even though they are important to calculate when rewards and penalties are due.
3. To understand performance on the overall performance commitment you need information on sub-measure definitions. If there are several sub-measures with detailed definitions it is more difficult for customers, CCGs and other stakeholders to engage on them.
4. Monitoring and assurance is likely to be more time-consuming for performance commitments with several sub-measures. For example, indices may need unpacking in order to understand individual performance levels.

We are already taking forward several initiatives to improve the transparency of sub-measures. First, we are including a new table in the Annual Performance Reports for 2017 in which companies will have to report performance on their sub-measures. We propose to continue this after PR19. Second, the greater emphasis we are proposing on performance commitments being clear and easy to understand should encourage companies to be more transparent about their sub-measures and how they aggregate into the overall performance commitment at PR19. Third, our requirement for companies to submit their performance commitment definitions ahead of business plans so that we can review them means that we will be able to feedback

on the transparency of any sub-measures used. However, it would be much better if companies had reviewed their performance commitments and sub-measures for transparency and addressed any issues before our review ahead of PR19.

We are proposing to adopt similar reporting requirements for all sub-measures at PR19 as we discussed under the options for asset health in chapter.

**Box 1 - Proposed reporting requirements for sub-measures at PR19**

- clarity on what the sub-measures are
- clarity on the sub-measure definitions
- a clear statement of the targets for the sub-measures and the justifications for them
- information on any past targets to compare with those proposed for AMP7
- data on sub-measure past performance for the five most recent years to compare with the proposals for AMP7
- clarity on the weighting / scoring / aggregation rules to be used to aggregate performance from the sub-measures to the performance commitment (the rules need to be automatic rather than involving company discretion)
- clarity on what mitigation rules apply to the sub-measures and why any mitigation rules are appropriate

We are not proposing to rule out the use of composite performance commitments with sub-measures for PR19. We recognise that they can be a useful way of measuring multi-faceted issues or summarising performance over a range of measures into a single performance commitment. We consider that with the proposed improvements on reporting above and a greater emphasis on ease of understanding we can collectively mitigate the challenges posed by the use of sub-measures in terms of transparency.

We propose to assess the transparency of companies' performance commitments in their business plans as part of our risk based review.

### **3 Disseminating performance information effectively**

An important way of making performance commitments more transparent to customers is to disseminate the information effectively. We strongly encourage companies to explain in their business plans how they will disseminate their performance information during the next price control period to ensure it is visible to customers, CCGs and other stakeholders.

We would expect companies' proposed approaches to take account of new communication channels and tools, a recent example being the [Discover Water](#) dashboard.

We propose to assess companies' approaches to disseminating information on their performance in their business plans as part of our risk based review.

## **4 Increasing the focus of performance commitments on outcomes**

The outcomes adopted by companies at PR14 reflect the objectives that customers and society value. Many of the supporting performance commitments, however, are relatively narrow commitments based on traditional industry measures of performance.

Now that the sector has had more time to adapt to the outcomes philosophy we want to see companies developing more forward-looking performance commitments that are more connected with the outcomes that companies are trying to achieve on behalf of their customers. The development of a new customer satisfaction measure and new resilience measures are examples of trying to make performance commitments more outcomes-focussed.

At PR19 we will expect companies to provide a clear explanation of why the performance commitments they have chosen are good indicators of success and appropriate for the outcome they are trying to measure.

### **4.1 Making performance commitments more transparent by reviewing the approach to scheme-specific performance commitments**

We introduced scheme-specific performance commitments at PR14 to protect customers from the non-delivery of major schemes for which companies had received additional allowed totex due to a successful special cost factor claim. Some examples are Northumbrian Water's Whitburn wastewater scheme and Wessex Water's North Bristol sewer scheme. A full list of the scheme-specific performance commitments is available in [the outcomes chapter of our PR14 final determinations](#).

Typically a company received additional allowed totex for a scheme at PR14 and the performance commitment involves a judgment on whether it meets specific project milestones. If a company does not meet the specified milestones an ODI penalty applies. There are penalties for non-delivery or delay or both for the different scheme-specific performance commitments. The penalties relate to full recovery of costs and, depending on circumstances, up to 50% of the whole-life benefits of the scheme in question. We developed many of the scheme-specific performance commitments relatively late in the PR14 process while our approach to companies' special cost factor claims was finalised.

The final determination policy chapter on outcomes explains that we will undertake an additional assessment of incentives regarding scheme-specific non-delivery penalties when they are due to be applied. This will determine the circumstances and the extent of any non-delivery. Penalties for non-delivery will apply unless a company can demonstrate that it has delivered an alternative outcome that delivers greater benefit to customers, or that the statutory requirement driving the scheme has been removed. Policy chapter A2 also sets out the approach for scheme-specific incentives regarding delay.

## **4.2 Reviewing the use of scheme-specific performance commitments**

There are two main reasons why we want to review the use of scheme-specific ODIs:

- During the PR14 lessons learnt review some stakeholders questioned whether scheme-specific performance commitments were in the spirit of outcomes, as customers care about the outcomes companies deliver rather than the delivery of specific schemes.
- Some stakeholders also questioned the late development of the scheme-specific performance commitments and ODIs and would have preferred more engagement on them during the price review process.

We want to see companies focusing on delivering what really matters to their customers, rather than the delivery of certain outputs and schemes. We think at least some of the existing scheme-specific performance commitments could be accommodated within more outcome-related performance commitments and still ensure customers are fully protected against the risks of under-delivery.

For example, at PR14 United Utilities was successful in its special cost factor claims for 'Davyhulme', 'Oldham and Royton' and 'NEP 3 and 4 Biodiversity' among others. Instead of developing scheme-specific performance commitments, United Utilities proposed increases to penalties through related outcomes-focussed ODIs to ensure that the penalties would recover the additional totex customers had paid and a proportion of the benefits foregone in the event of delay and/or non-delivery. In the case of the Davyhulme wastewater treatment works United Utilities made changes to its existing ODIs on rivers improved and maintaining Wastewater Treatment Works.

The table below shows the number of allowances made for successful special cost factor claims, which were incentivised through scheme-specific performance commitment/ODIs, more customer-focussed performance commitment/ODIs and

through both. The balance at PR14 was towards scheme-specific performance commitment/ODIs.

**Table 2 - Breakdown of PR14 allowances for successful special cost factor claims and their associated performance commitments and ODIs**

<b>Price control</b>	<b>Total number of allowances for successful special cost factor claims</b>	<b>Number of allowances incentivised through a scheme-specific performance commitment/ODI</b>	<b>Number of allowances incentivised through a customer-focused performance commitment/ODI</b>	<b>Number of allowance incentivised through both customer focussed and scheme-specific ODIs</b>
Water	7	6	1	0
Wastewater	17	9	7	1
Retail	4	3	1	0
<b>Total</b>	<b>28</b>	<b>18</b>	<b>9</b>	<b>1</b>

### **4.3 When scheme-specific performance commitments can be appropriate**

For PR19 we want companies to retain the option of using scheme-specific performance commitments, but we want to be clearer about when they should be used. We accept there may be circumstances where scheme-specific performance commitments might be appropriate as the best way of protecting customers even if they focus on the delivery of specific schemes rather than the outcomes that customers value. We explain the process for developing scheme-specific performance commitments in the next section.

We propose below the circumstances in which scheme-specific performance commitments might not be appropriate and when they might be appropriate. We invite views on our suggested approach.

We propose that companies could use more customer and environment-focused performance commitments than scheme-specific performance commitments in most circumstances including:

- Schemes where the companies' existing performance commitments cover, or can be adjusted to cover, the benefits of the schemes and therefore would compensate customers sufficiently for delay and/or non-delivery. In such cases any adjustments would need to be discussed through companies' engagement with their customers and CCGs or would need to be sufficiently small not to

represent a distortion on the company's original customer engagement in which case engagement with the CCG only might suffice.

- Schemes where the company can develop a new outcomes-focussed performance commitment or performance commitment which captures the customer benefits the scheme is intended to deliver.

Situations where we propose it might be appropriate to set scheme-specific performance commitments include:

- Schemes with extended delivery times, beyond 2025, or that deliver inter-generational benefits to customers which would be hard to capture in the companies' existing customer- or environmentally-focussed performance commitments.
- Schemes where the companies' existing performance commitments do not sufficiently cover the benefits of the schemes and therefore would not compensate customers sufficiently for delay and/or non-delivery. In such cases the company should consider whether it is appropriate that its existing performance commitments do not cover the benefits delivered by the scheme.
- Schemes where the companies' existing performance commitments could be adjusted to sufficiently cover the benefits of the scheme, but doing so would distort the existing performance commitments too far away from the original engagement with customers. However, if the company had engaged with its customers and CCGs on the adjustments as part of its outcomes package, or re-engaged on the adjustments, a scheme-specific performance commitment would not be necessary.
- Schemes where there is a high degree of uncertainty (legal or technical) associated with completion.

Our Water 2020 proposal for direct procurement for customers involves a company procuring services, particularly capital projects, on behalf of customers, including the project's financing. It promotes the use of markets for projects which would otherwise be delivered by the water company. Direct procurement for customers can generate savings from project costs and cheaper financing – under our approach, these savings are shared with customers. It can also encourage companies to take a long-term view of projects, bringing long-term savings.

Our proposal on direct procurement for customers might involve the use of scheme-specific performance commitments. However, it would be better for customers if the performance commitments could be more customer-focussed following the suggested approach to scheme-specific performance commitments discussed above.

## 4.4 Improving the process for scheme-specific performance commitments

We recognise that we developed scheme-specific performance commitments and their associated ODIs relatively late in the PR14 process. We suggest that this process could be improved if companies accompanied applications for special cost factor claims with their proposed approach to protect customers in the event of delay or non-delivery of the scheme subject to the special factor cost claim. As mentioned above, the approach could involve protecting customers through more outcome-based performance commitments rather than scheme-specific ones.

If a company considered a scheme-specific performance commitment was necessary to protect customers we propose the following approach should apply:

- A company would engage with its customers and CCGs on any scheme-specific performance commitments as part of its engagement process on all its outcomes, performance commitments and ODIs.
- A company would submit the details of scheme-specific performance commitments alongside any special cost factor claims. This should include an explanation of how their performance commitments and ODIs will ensure customers will be compensated in the event of non-delivery or delay relative to the costs they would be paying should the special cost factor claim be accepted, and relative to the benefits of the scheme the customers would be foregoing.
- A company would explain what alternatives to scheme-specific performance commitments and ODIs it has considered, including how it engaged with customers and the CCG on the alternatives, and why the company did not consider these were appropriate.

These process improvements would enable us to scrutinise any scheme-specific performance commitments and ODIs as part of the assessment of companies' special cost factor claims and to do so earlier in the price review process. We invite views on our proposed approach to the process for scheme-specific performance commitments.

### **Consultation question: making performance commitments more transparent for customers**

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

## **5 Impact assessment for making performance commitments more transparent**

We are proposing a range of measures to improve the transparency of performance commitments at PR19: principles for making performance commitments easier to understand; reporting requirements for sub-measures to performance commitments; encouraging companies to disseminate their performance information effectively; providing advice on when scheme-specific performance commitments might and might not be appropriate; and proposing process improvements for scheme-specific performance commitments.

The main benefit of these proposals is that they should make it easier for customers and CCGs to hold companies to account for their performance. This in turn should increase the reputational incentive on companies to deliver their performance commitments to customers. Companies improving their performance will generate benefits for customers in terms of better service quality. Clearer performance commitments will also benefit companies whose staff will have more clarity over precisely what they are aiming for. The proposals in relation to scheme-specific performance commitments should improve the quality of them by allowing for more engagement with customers and CCGs.

These proposals have a negligible cost. The principles for easy-to-understand performance commitments might reduce companies' costs for engaging with their customers if this engagement becomes easier. We are already introducing reporting requirements for sub-measures in the 2017 annual performance reports so applying these at PR19 will not increase costs. Companies could incur some costs from disseminating their performance information more effectively, although the availability of digital communication channels will mean any such costs are likely to be low. The proposals in relation to scheme-specific performance commitments should reduce the costs for companies and Ofwat of developing them relatively late in the price review process as happened at the last price review.