A consultation on the outcomes framework for PR19

Severn Trent response

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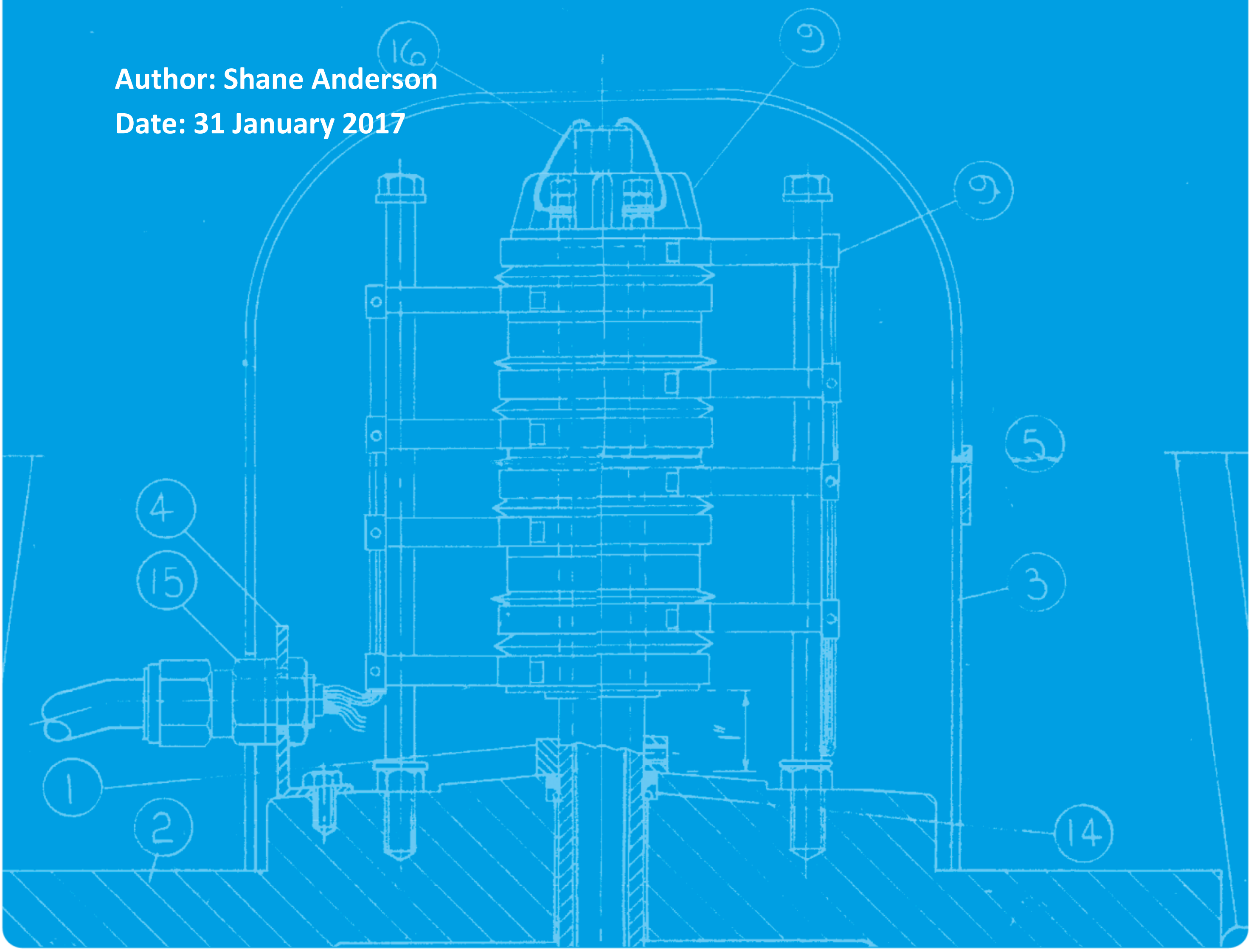

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Executive Summary

Our package of ODIs were introduced at the start of 2015 based on the outcomes our customers cared about most. The greater focus that ODIs create has helped drive a step change in performance and we are delivering the highest level of service in 30 years – bills are affordable and importantly, the quality of services are rising. Today more customers turning on their tap will have wholesome water when they need it, as reflected by supply interruptions of 11 minutes and a 62% reduction in coliform incidents; and less homes flooded, as seen by a 28% reduction in sewer flooding incidents.

A key driver for this improved performance are the financial rewards and penalties associated with ODIs which have helped drive additional investment. If we look at just sewer flooding – in one year we invested £13m on capital schemes to protect 168 homes, in one year we educated 68,000 customers on sewer misuse and in one year we invested in developing fat busting chemicals to deliver an improvement in performance. We've applied this approach to all 27 ODIs.[1]

The strength of the current framework is that it creates much greater focus on the outcomes our customers care about. This is because they have a direct impact on our profits each year. This impact creates more focused effort, with business cases targeting improvements where customers value it most. We therefore strongly support the retention of financial ODIs. We also think that the credibility of ODIs and future legitimacy of the sector requires that ODIs remain stretching.

We are therefore very supportive of Ofwat's proposals to create more powerful incentives at PR19. Having strongly embraced the ODI framework, we believe we are well placed to help shape its design ahead of PR19 so that it can deliver even better outcomes for customers.

Our response to the consultation is guided by our desire to ensure that the ODI framework continues to create effective incentives. There are many important interactions across the design components and it is critical that these operate effectively otherwise it could undermine the incentives and generate poorer customer outcomes in the future.

A framework for effective incentives

The precise design of the ODI framework is critical to delivering better customer and environmental outcomes. We have identified a number of principles that we think should underpin effective incentives.

Challenging	ODIs must be challenging to be credible not only with customers but also those delivering them. Our people are genuinely motivated by delivering stretching improvements for customers.
Realistic	ODIs, both individually and as a package, must offer the potential for rewards to be achieved by the upper quartile performers. Unrealistic targets at a sector level will not

[1] We also have 6 ODIs relating to the delivery of the Birmingham scheme.

	incentivise improvements.
Certainty	Certainty about targets and rewards/penalties teams enables companies to develop business cases to deliver the desired outcome. Conversely if there is uncertainty about the parameters then it reduces the robustness of proposals to improve performance and leads to poorer outcomes.
Simplicity	Customers and companies must be able to understand how incentives work and affect them. Complex mechanisms will reduce transparency and undermine credibility.

A workable overall package

It is important that ODIs are not considered in isolation and that the package of rewards and penalties, totex and cost of capital are aligned. This should ensure that the overall price control package:

- is calibrated in ways that offer the opportunity of meaningful rewards for companies that develop and deliver on ambitious plans;
- offers upside possibilities that are sufficient to incentivise the development of more innovative cultures in the sector; and
- provides a basis for companies to seek out and deliver step change improvements in service for customers.

We believe an effective overall ODI package should include (i) strong financial ODIs; (ii) comparative measures set on the basis of historical UQ with targets potentially getting harder however the increment must be realistic (eg 1% per year); (iii) rewards and penalties impact profits and are trued-up in-period whilst generating a net balance when added together; (iv) rewards are paid for above UQ performance; dead-band for the second quartile and penalties for the bottom two quartiles.

We believe this type of incentive package would drive more innovative cultures, delivers higher service levels, better environmental outcomes and ultimately higher customer satisfaction and trust in the services they receive.

Summary of our position on the key questions

Throughout our response to the consultation questions we have emboldened our position on the key issues and summarised them here:

- we are broadly supportive that the 10 common performance commitments proposed cover the most appropriate service areas, although we have some reservations about applying a comparative performance assessment and harmonised ODI against the two asset health measures;
- targets for comparative ODIs should be based on historical UQ performance, with a realistic annual improvement thereafter (eg 1% per annum);
- no special adjustments to targets should be made by companies or Ofwat;
- if companies are already delivering services at UQ or higher they should start the period in reward as this enhances the incentive for companies to shift the frontier;
- the customer experience measure should be split into two, one for Wholesale and one for Retail;
- ODIs should be strengthened by targeting revenue and applying in-period;
- the original rationale for including a cap and collar at PR14 is less relevant and there is logic in widening or abolishing it but potentially retaining individual cap and collars;
- gated ODIs should not be applied as they could undermine the ODI framework and deliver poorer outcomes to customers in the long run; and
- companies are best placed to engage with their customers to develop ODIs and manage the resulting impact on bills.

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?

We are supportive of the principle of using comparative information to make performance commitments more stretching. Comparative information could be used to this effect in two ways:

a. to inform assessments to set industry wide commitments; and
b. to provide context to strengthen CCG challenge, decision making, customer engagement and customer research.

We provide our views on (a) in response to questions 2 and 3 below.

With regards to (b) we agree that providing clear and comprehensible comparative information can help to create credibility and in turn legitimacy. The provision of comparative information will be an important part of our CCG discussions, decision making and broader engagement.

Where comparative information is used in research, it needs to be carefully applied to ensure that it makes research more meaningful. This means:

- It is used in circumstances where the information is genuinely reflective of the companies' performance (e.g. as opposed to different investment levels or approach to asset management).
- How and when it is presented does not have the perverse effect of making research less comprehensible – for example, risking 'cognitive overload'. The form of research could be important in this regard depending on the nature of comparative information being provided.
- It is used in appropriate circumstances, depending on the aim of the engagement that is being carried out. For example, there may be circumstances in which a company wishes to understand:
  - the absolute value customers place on a service improvement in isolation of other considerations and constraints (for example, to inform cost-benefit analysis), as opposed to
  - the extent to which customers value and would be prepared to pay for a service improvement when they see it in the context of other products/service on offer and actual bills impacts (which would be more akin to the choices an actual market and might be used to set an ODI or performance commitment).

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

We are very supportive of the use of common performance commitments.

The number of common performance commitments that the industry uses needs to strike a careful balance between:

- ensuring companies have the freedom to develop performance commitments that reflect their customers' specific preferences (bespoke commitments); and
- recognising that customers might, as they do in a market, want to make comparisons between the service levels and product quality they receive from their company, against others.

In the case of the latter, where common performance commitments are used it is important that the measure:

- reflects an area of service that is important to customers;
- is an appropriate measure for that area of service; and
- is consistently applied by every company.

In the light of this, **we are broadly supportive that the 10 common performance commitments proposed cover the most appropriate *service areas***, but believe there is further work needed to ensure all companies report against a common definition.

We set out further views on:

- an appropriate SIM replacement in question 6;
- options for resilience measures in response to question 7; and
- options for asset health measures in response to questions 3 and 10.

We would question whether the abstraction incentive mechanism (AIM) should be a common AMP7 performance measure, due to the very different abstraction regimes that exist across water companies which means it would not be directly comparable. We have previously explained that we do not have any abstraction sites included in the AMP6 AIM. Because our region is dominated by sandstone aquifers and regulated rivers, there are few obvious candidate sites where a short term reduction in abstraction would lead to an immediate improvement in river flow. When Ofwat first proposed the AIM approach in 2013, we reviewed the potential sites with the Environment Agency but due to the nature of our sources we found few abstractions where short term changes would have a measurable effect on any associated surface water bodies.

For this reason, we think common measures should be underpinned by some degree of comparability. This ensures that customers can provide informed challenge without the need for significant explanations which would undermine the simplicity of the incentives. Where measures do not support direct comparison, such as AIM, then it's important that companies have the ability to propose bespoke measures.

For example, we strongly support having a performance measure that addresses unsustainable levels of abstraction. For AMP6, instead of AIM we adopted an ODI incentive measure that is more reflective of the water resources in our region. Our ODI measure commits us to reducing harmful abstractions and improving WFD water bodies and aquatic ecology at a number of sensitive sites across our region. In AMP6 we will be delivering our largest ever water environment improvement programme, and we expect to improve 29 surface water bodies with a further potential 7 groundwater bodies.

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

As set out in the executive summary when designing ODIs we think there are four principles that need to be reflected to ensure that the resulting incentives deliver the best result for customers. We have applied these principles where appropriate to inform our position below.

Coverage

We are supportive of the concept of using a comparative assessment to set commitments in all of the areas proposed except the two asset health measures.

For four of the six (water quality compliance, supply interruptions, sewer flooding, and pollution incidents) we think it's reasonable to assume that:

- all customers would consider these service areas important;
- the measures proposed appropriately capture the service delivered to customers; and
- they can be consistently reported.

We have some reservations, however, about applying a comparative performance assessment and harmonised ODI in relation to the two asset health measures. This is principally because, whilst they represent a pragmatic and accessible way to signal asset health to customers, they are not a complete and representative measure of asset health. In addition, whilst all companies have been required to maintain stable service at a stable level of risk, the definition of this stable level has not been uniform across the industry. As such we do not believe that an industry-wide single level of performance against one measure is appropriate.

We therefore think bespoke performance assessment should be applied to asset health measures.

Common performance commitments and in period ODIs

See response to question 7.

Setting the target

In areas that we know are consistently important to customers, companies should be challenged to improve in comparison to each other. An appropriate target for these measures would consist of:

- **cross company comparison using historic data**
- **setting targets on the basis of the projected UQ at 2020**
- **companies should continue to improve, however the increment needs to be realistic (eg 1% tougher year on year)**
- **rewards are paid for UQ performance and above; dead-band for the second quartile and penalties for the bottom two quartiles.**

This would help ensure that the targets are stretching and so legitimate in the eyes of customers and stakeholders. It would also ensure that investors view incentives as credible enable them to hold management teams to account (as they would be able to contend that failure to deliver is reflective of poor performance as opposed to unrealistic targets).

Historic, forecast or dynamic

One of our key learnings this AMP is that ODIs empower teams to develop business cases that deliver service improvements to our customers. This is principally because teams can more readily quantify the benefit of a specific investment over the AMP and so produce more robust business cases.

To ensure that ODIs continue to deliver great customer outcomes it is crucial that management teams have visibility about the improvement that they need to deliver over an extend period. This means targets must be set on the basis of historic or forecast performance.

Resetting ODI targets each year, as would occur under a dynamic regime, weakens the incentives as any rewards beyond a year would need to be discounted due to the inherent uncertainty. In effect a dynamic ODI policy would replace the 5-year price control with a 1-year control.

<u>Special factors</u>
The price review and resulting determination represents a package that companies and stakeholders need to consider in the round. Specific adjustments have the potential to undermine the price review process – for example by introducing added complications, or reducing the power of the incentives.

We strongly believe that if Ofwat is setting UQ target for comparative ODIs, then no special adjustments should be made by companies or Ofwat**.** This means:

- companies should not apply for targets to be weakened on account of special factors; and
- **Ofwat should not reduce the reward or increase the target if companies are already delivering services at UQ or higher – instead they should start in outperformance as this enhances the incentive for companies to deliver higher service levels.**

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

Leakage is consistently found to be a key concern for our customers and stakeholders. PR14 feedback was that our draft WRMP leakage target was not ambitious enough, even though we demonstrated that it was the Economic Level of Leakage (ELL). Therefore, we responded to feedback by setting a more ambitious target that went beyond the ELL.

Ofwat's performance measure challenge for PR19 recognises that leakage will continue to be a priority measure.

The leakage calculation is complex, uncertain and relies on data that is not directly measurable or relies on statistical sampling techniques. Changes in data assumptions and accuracy can have a material impact on reported leakage (e.g. population, unmeasured pcc, night usage).
Further, a significant and growing proportion of total leakage comes from customer supply pipes, over which we have very little control. We have to work harder on our network to offset the contribution from customer supply pipes.

Finally, day to day leakage performance can be impacted by factors outside of company control (eg extreme weather).

The uncertainties around absolute leakage measurement, and the variety of factors that can impact on it mean that total leakage should not be taken as a performance measure in isolation. We agree that the importance of the issue means that it should remain as a performance measure, but **it should be part of a suite of indicators** showing demand management and / or infrastructure resilience.

At PR14 we proposed Resource Efficiency as an alternative way of measuring how effective we are with making use of the water we abstract. The Resource Efficiency measure was an attempt to disentangle the uncertainties around estimating unmeasured consumption from the measurement of absolute leakage performance.

In the light of this:

- we broadly agree with Ofwat's recommendations of how leakage performance should be measured and that total company leakage Ml/d should be retained as a measure;
- we welcome the commitment to improve the definition and calculation of leakage so as to reduce variability between companies' approaches;
- we recommend companies express the uncertainty around their Ml/d leakage calculation and give an indication of whether year on year changes are statistically significant;
- uncertainty should be expressed either as +/- Ml/d or the size of the MLE adjustment made to the water balance calculation; and
- accompany leakage performance metric with another measure of water efficiency (eg DI per connected customer, DI per household, DI per person) to address the uncertainties between leakage and unmeasured consumption measurement.

If leakage per km or leakage per property is to be used as a comparative measure, it should be accompanied by a measure that shows the context of overall distribution input per km or per property. Without understanding how companies compare on the accuracy of water consumption, it is difficult to use leakage as comparative measure across companies.

While we agree that leakage performance should be presented in the context of the SELL assessment for the current AMP and the long term WRMP, it is important to recognise that Defra's WRMP Guiding Principles for leakage will inevitably push companies beyond the SELL. The expectation that leakage can never be allowed to rise means that we will be committing to ever tighter targets that drive leakage down incrementally, even when new resource capacity could reduce the short and medium run marginal costs of water supply. A true SELL would allow leakage to fluctuate if new or surplus capacity comes on line.

Leakage performance should be compared at a company level and not at a water resource zone level. Different water companies will have different numbers of water resource zones, depending on the configuration of the supply networks. Because of the variable number of water resource zones, reporting at a zonal level will not be an effective inter-company comparison. Furthermore, from a customer engagement point of view it would be preferable to report leakage at a company level as water resource zones are a planning tool only and do not correspond to administrative boundaries that customers would recognise.

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

As we note above in response to question 2, the number and range of performance commitments that each company uses needs to strike a careful balance between:

- ensuring companies have the freedom to develop innovative performance commitments that reflect their customers' specific preferences (bespoke commitments); and
- recognising that customers might, as they do in a market, want to make comparisons between the service levels and product quality they receive from their company, against others.

Where companies choose to develop bespoke commitments, we agree that:

- they must be able to demonstrate that they are stretching; but

- would caution against creating guidance for bespoke commitments that is too prescriptive (and effectively diminishes the extent to which they are bespoke to each companies' customers).

Rather than too much prescription, we believe that:

- **bespoke commitments should be founded on strong evidence; and**
- **as with common performance commitments, they work within an agreed range and set of parameters that takes into account the views of customers (see response to question 7).**

Common areas for bespoke performance commitments

Where companies undertake effective engagement with their customers then, in theory, there should not be any need for Ofwat to prescribe common areas that bespoke performance commitments should consider. They should be revealed by the process.

However, during PR14 it became clear that there were a number of areas that were consistently important across all companies, including vulnerable customers, and in these circumstances, it would not be unreasonable for Ofwat to require a performance commitment from companies in these areas.

However, we do not believe that the prescription should extend any further than that - if they are to remain genuinely bespoke and founded on each company's customers' preferences.

For example, our research revealed the extent to which our customers were prepared to support a social tariff and other forms of support for vulnerable customers was heavily related to specific issues around what form that support took, how it would be administered and in what circumstances.

We would also question the rationale for introducing requirements for companies to report against common metrics in addition to their bespoke commitments as:

- this would suggest that they should be one of the 10 common performance commitments proposed;
- it introduces a second tier of reporting that could be confusing for customers and creates a further reporting and assurance burden for companies; and
- risks duplication as companies already report performance on a range of other metrics to other statutory bodies (for example, companies provide quarterly information to CCWater on their performance on a range of metrics relating to support for vulnerable customers that may not already be captured by their performance commitments in these areas).

Making bespoke performance commitments stretching

We are supportive of Ofwat issuing proportionate guidance about its expectations for how companies can demonstrate that performance commitments are stretching. Not least because high level guidelines should provide reassurance to CCGs and help them to focus their challenge (particularly for members who may not have a background in the water industry).

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

SIM has made a significant difference in driving forwards improvement in customer experience in the water sector. It has given the focus and incentive required but we feel now is a good time to review and change, learning from the last few years, learning from other sectors and future proofing the measure in terms of changing customer behaviour and attitudes.

We have worked with a number of experts and organisations over the last two years to further evolve our own customer experience measures to drive further insight and improvement on top of that driven by SIM. We have also undertaken a number of focussed research areas to understand what is important to customers now and in the future to ensure we have a future proofed understanding of customer experience and can set up measures accordingly.

We believe that the customer experience measure is split into two, one for Wholesale and one for Retail. This will ensure that the measures drive improvement in the areas customers feel are important and relate more to the reasons for contact. Both the Wholesale and Retail SIM should be made up of a basket of measures. The measures should take into account multiple contact channels as customers want choice and have a right to a great experience no matter what channel they choose to use.

<u>Retail measure</u>

For retail we propose a basket of four which will help us understand the driving factors of loyalty and switching linked to satisfaction and experience.

Element	Measure	Method	Detail
Qualitative SIM (75% weighting)	Customer contacting water company customer satisfaction	Survey	Survey asking one question, then asking for verbatim comments: - Overall how satisfied with the handling of this matter are you?
	Proactive contact satisfaction	Survey	Survey undertaken at the point a problem is resolved asking one scored question then asking for verbatim comments: You recently received communication from Severn Trent about an issue in your area. Overall how satisfied were you with how this issue was handled?
Net Promoter Score (5%)	NPS	Survey	A second question as part of the customer contacting water company satisfaction survey asking: - How likely is it you would recommend us to a friend?
Quantitative SIM (20% weighting)	Points incurred through complaints	Count	Social media – 1 point Phone – 5 points Written – 10 points Escalated – 100 points

			CCW investigation – 1000 points

Wholesale SIM

For wholesale we propose a basket of four measures; three of these will be in the form of qualitative surveys. The fourth element is the same quantitative measure around complaints across multiple channels. These measures will drive improvement in ease of dealing with the company around service failure and also take into account the impact that service failure has had on the customers' day to day life so help prioritise improvement in the failings that are having most impact on them. It aligns to the OFGEM approach to how Energy Wholesalers are measured with a different survey for different products/services.

Element	Measure	Method	Detail
Qualitative SIM (75% weighting)	Reactive contact Effort score x Impact score	Survey	Survey undertaken at the point a problem is resolved using 2 questions then asking for verbatim comments: - Severn Trent Water made it ***easy*** for me to handle my issue - The issue have a significant ***impact*** on my day to day life
	Proactive contact Satisfaction	Survey	Survey undertaken at the point a problem is resolved asking one scored question then asking for verbatim comments: - You recently received communication from Severn Trent about an issue in your area. Overall how satisfied were you with how this issue was handled?
	Planned work Satisfaction score	Survey	Survey undertaken at the point the work is complete asking one scored question then asking for verbatim comments: Severn Trent recently undertook work in your area. Overall how satisfied were you with how this was managed?
Quantitative SIM (25% weighting)	Points incurred through complaints	Count	Social media – 1 point Phone – 5 points Written – 10 points Escalated – 100 points CCW investigation – 1000 points

We propose that the customer experience surveys are undertaken by the water companies themselves with central assurance. This will drive more customer voices to be heard and drive further insight and improvement.

We would welcome a face to face discussion on the future measurement of customer experience to further share our thinking and discuss OFWATs thoughts.

More powerful outcome delivery incentives

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

We are very supportive of creating more powerful ODIs. Our experience demonstrates that ODIs are really effective at driving service improvements where customers value it most.

It is important that ODIs are not considered in isolation and that the broader context of totex and the cost of capital are aligned so that:

- the overall price control package should be calibrated in ways that offer the opportunity of meaningful rewards for companies that develop and deliver on ambitious plans;
- the potential for these upside possibilities is sufficient to incentivise the development of more innovative cultures in the sector; and
- it can provide a basis for companies to seek out and deliver step change improvements in service for customers.

In-period ODIs

We support the greater use of in-period ODIs. They create a much stronger and more transparent link between performance and remuneration. This is something our investors have recognised and provide strong challenge on us to ensure we deliver for our customers. And this annual scrutiny serves to strengthen the impact of our reputational ODIs too by drawing further public attention to our performance in the round.

Linking end of period ODIs to revenue rather than RCV

We agree that revenue has a more direct impact and will serve to further strengthen incentives. However, there will be circumstances in which the benefit accrued from outperformance will be realised by customers over the longer term (eg % of customers with dual supplies). In these instances, it might be more appropriate to retain an adjustment to the RCV.

Removing the overall aggregate cap and collar

We agree that **the original rationale for including a cap and collar at PR14 is less relevant** – this is because for existing ODIs companies have been able to better understand the performance range. As such **there is logic in widening or abolishing the aggregate cap and collar**.

There could, however, be benefits in allowing companies to propose caps and collars on individual ODIs. For example, this could apply to new measures which do not have the same historical data as other measures and hence there is more risk of volatility which is not driven by performance. This would be consistent with Ofwat's rationale for employing an aggregate cap at PR14.

Hitting an overall RoRE range

The use of ODIs (or performance payments) has the potential to deliver significant benefits to customers through higher service levels. It follows that more powerful ODIs can help to deliver even greater benefits. It could:

- encourage more companies to embrace ODIs and so deliver benefits to customers;
- promote more targeted challenge from the Water Forum; and
- support alternative methods to setting rewards and penalties (see below).

Alternative approaches to setting rewards and penalties

As noted in the consultation document, the current ‘bottom-up’ approach to setting rewards and penalties places a high level of focus on precise estimates of marginal willingness to pay (WTP) and marginal costs. And whilst greater use of a range of sources to validate WTP results can help to provide greater certainty, it will not negate the risk of ‘spurious accuracy’ entirely.

In the light of this, alternative, ‘top-down’ approaches which recognise the difficulty of placing too great a reliance of obtaining highly accurate WTP results, whilst ensuring companies are being incentivised to deliver the improvements that customers value the most, warrant further consideration. Such approaches could effectively allocate the RoRE range based on a weighting derived from WTP research. This would still require cross-checking with other forms research, but has the advantage of being more transparent and enable more effective challenge from CCGs.

Industry standard ODIs

We support the use of industry standard ODIs where they are applied to the small number of comparative measures Ofwat is considering.

We recognise that from a purist perspective if an industry standard ODI is to be applied then it must be the case that:

- customers place the same valuation on the improvement; and
- differences in costs between companies are substantially due to inefficiency.

However, in reality it would be very difficult to find a cross industry example where this is the case. This needs to be balanced with the fact that comparability, used proportionately, can help to create legitimacy with customers. It would therefore seem logical that if common measures, with common targets are to be used then incentive rates should also be harmonised for pragmatism - but only in a small number of cases (and noting our comments in relation to asset health measures in response to question 3). It would also follow that these ODIs should be ‘in-period’.

More fundamentally, further consideration would need to be given as to how consistent this approach would be with the proposal to set ODI ranges based on a percentage of each companies’ RoRE. In these circumstances using a harmonised ODI rate for some performance commitments would create more or less scope for each company to develop other financial ODIs depending on their RoRE.

Increasing the proportion of ODIs with financial rewards attached

We are fully supportive of financial ODIs to drive better customer outcomes – this is why we have amongst the highest proportion of ODIs in the sector (at 33 of 45 are financial).

At a sector level we think there is benefit in having more ODIs with financial rewards. This will better align the incentives of investors and customers and so drive more innovative behaviour and ultimately deliver better outcomes. Given the reluctance of some companies to embrace the ODI framework there may be merit in mandating a minimum level, at least initially, to overcome some of the cultural resistance to performance payments.

Gated ODIs

We are strongly opposed to the use of gated ODIs as it has the potential to undermine the ODI framework and deliver a poorer result for customers. This is because a framework in which rewards are conditional on no penalties being incurred could:

- reduce business case investments targeting performance improvements as the rewards would need to be discounted to reflect the uncertainty associated with other ODIs;
- dis-incentivise companies from improving if performance on one metric was poor (as could occur due to an incident);
- incentivise companies to minimise the number of PC/ODIs that they have; and
- incentivise companies to set less stretching targets to avoid the downside risk.

Overall **we do not agree that it is appropriate to use gated ODIs as customers would experience lower levels of service in the long run**.

We recognise that some stakeholders might be concerned that companies would focus on those measures that have the most revenue at risk. Our experience is that this hasn't happened – for example our performance on social tariffs started slowly reflecting the uniqueness of the programme however through significant effort and management focus we have shown enormous improvement and are on track to deliver our commitment.

We also note that where customers place a high value on a particular service, then it is appropriate that the ODI is strong and it receives significant investment and management focus. This is a feature of an effective incentive framework.

We also think that there are other tools that could be used to mitigate companies from disregarding poor performing ODIs. For example, in our present suite of ODIs, our overall environmental performance commitment, which captures our combined performance against four separate performance commitments incentivises us to focus on all areas of environmental performance, not just the one with the biggest potential upside.

Cost of capital

We agree with the principle that higher levels of risk should be remunerated, but how that can be achieved is more complicated.

Our initial view is that increasing company exposure to ODIs would put upward pressure on the cost of capital (other things equal). This is likely to follow because:

- increased exposure may make companies more exposed to systematic risk and thus justify some increase in the cost of equity; and
- an increase in the total risk faced by companies may make a lower gearing assumption appropriate (and/or an increase in the assumed cost of debt).

This is an area where we are developing evolving our thinking as part of a broader piece of work on how to incentivise frontier shifting performance, which we will share later this year. Overall we expect that under the incentive framework a high performing company delivering higher levels of services where customers value it most should be able to earn a higher return on equity.

Bill smoothing

We recognise the concerns of stakeholders such as CCWater about the impact of ODIs on bills. However we think it's important that ODIs and the resulting impact on bills are not conflated with affordability concerns.

We seek to ensure our bills are affordable for all our customers by:

- driving efficiencies to ensure that our bills remain the lowest in the UK;
- adopting the most ambitious social tariff programme across England; and
- introducing extra support for customers in vulnerable circumstances, including a dedicated team at our call centres.

The topic of bill smoothing is quite different. We note that some commentators have suggested that more powerful incentives could create greater bill volatility. However, this needs to be viewed in the context of:

- the counterfactual – whereby making changes at the end of the AMP also creates bill volatility and defers the impact onto future customers;
- other factors impact bills, notably inflation and the new true-up being introduced for the cost of new debt. Focusing solely on ODIs will not reveal the impact on bills and instead consideration needs to be given to all the factors in the round; and
- incentives, are more effective when there is a transparent link between performance and remuneration (ie, not wrapped up in a midnight adjustment).

We therefore think **companies are best placed to engage with their customers to develop ODIs and manage the resulting impact on bills.**

Better reflecting resilience in outcomes

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

We welcome the discussion around resilience and how this should be reflected in the regulatory framework. We recognise this is particularly challenging given the need to define near term measures, such as blockages, and longer term measures that allow long term risk to be assessed and targeted. Ultimately no single measure adequately captures a company's resilience. This is because no single measure can represent the different resilience challenges and the different asset bases that each company has.

We have therefore been developing, consistent with Defra's long term planning horizon, core resilience measures that we believe could be included as the resilience common performance measures (box 10 in Figure 6 in the consultation document). This is illustrated in the figure below:

Resilience challenge	Indicator	Current Performance	AMP7 view	AMP8 view	AMP9 view	Long-term target
1.Flooding	% of customers with water service at risk from flooding	%	%	%	%	%
2.Drought	Size of drought that we can sustain without restrictions	Drought definition	Drought definition	Drought definition	Drought definition	Drought definition
3.Environmental	Natural capital change due to our waste water activities	Baseline	£	£	£	£
4. Long duration interruptions	% of customers with alternative water supplies	%	%	%	%	%
5. Hydraulic sewer capacity	Additional capacity availability	Baseline	Ml	Ml	Ml	Ml

Definitions:

- Flooding: % of customers with their water service at risk from flooding using the extreme flood outline. This builds on the work carried out for the National Flood Resilience Review.
- Drought: Size of drought that we can cope with. This would be the size of drought that we can withstand without placing any restrictions on use for our customers.
- Environment: Natural capital change due to our waste water activities. This new measure uses the natural capital approach to value the positive (or negative) impact on the environment from our waste water activities. This innovative approach would allow us to work more broadly than using WFD indicators and is aligned to the thinking in the upcoming 25-year plan for the natural environment from Defra. It would be appropriate to treat this as a pilot measure.

- Long duration interruptions: % of customers with alternative water supplies. This improves on the existing ODI measure (% of customers with two sources of supply) by considering customers' wider resilience to long-duration interruptions. This would include customers who can get their water from other sources, or from treatment works with dual streams, and also includes customers who are in smaller communities that have sustainable tankering plans in place.
- Hydraulic sewer capacity: Additional capacity availability. This additional capacity could come from traditional solutions such as storm tanks and bigger sewers, but would also include capacity that is generated from keeping surface water out of sewers from approaches such as SUDS, permeable surfaces or upstream catchment management.

We think companies should be responsible for setting their own target levels for each resilience measure and for asset health measures in conjunction with their customers and stakeholders. The only exception to this should be where clear national standards have been set by government and recognised by Ofwat. Note that last year's National Flood Resilience Review, initiated by the Cabinet Office, asked companies to use the extreme flood outline as the baseline for measuring flood resilience.

The difference between a company's current performance and their target is their "resilience deficit" for each measure. We think that exposing the deficits across the range of resilience challenges would be very positive step forward. It would highlight where companies have different resilience issues and priorities, provide a baseline for a conversation with customers, help shape investment plans and would be trackable over time.

We do not think that combining the core resilience metrics to form a single resilience deficit score would be sensible, as we do not think this would be meaningful to customers or act as a representative comparative measure.

Companies would invest to address their resilience deficits in order to meet the expectations of their customers. It is essential that Ofwat's cost assessment methodology takes this into account as this would represent a legitimate step change in service.

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

We consider it is a very positive step to include asset health outcomes within common performance commitments given the critical role of our assets in providing reliable water and sewerage services. We fully support Ofwat's intention to adopt asset health expectations and reporting requirements.

In relation to Ofwat's two options - we favour Option 1 which includes suggestions for partial standardisation.

Specifically, we agree that companies should include additional asset health metrics in their company bespoke commitments. We are content for bursts and collapses to be common measures representing asset health but we recognise that this is a pragmatic approach rather than the best leading measures of the services that customers care most about. Providing the incentives are harmonised between the two common measures and against the company bespoke measures, we think the proposal would achieve the right balance between comparability, simplicity and allowing us to focus on what matters to our customers.

We think there should be an additional expectation covering the scope and design of company bespoke asset health measures and the relationship between them and the common measures.

Option 2 sets out proposals for a fully standardised approach. We do not think option 2 is in customers' best interests as it would prevent companies from tailoring their asset health measures to be the best indicators of future service for their given asset base and system configuration.

Although we are in favour of the direction of travel set out in Option 1, the following points on the development of asset health measures should be considered:

- A too narrow focus on bursts and collapses has the potential to drive the wrong behaviours. This risk can be mitigated by ensuring the overall size of rewards and penalties for burst and collapses are carefully calibrated with the wider set of company bespoke asset health measures.
- Related to the previous bullet, we think it is possible to standardise the overall size of the penalties and rewards relating to asset health without standardising the measures used to describe asset health.
- We believe the proposals for the reporting requirements are overly prescriptive in the expected use of historical data sets to set performance targets [Appendix3, Box4, fifth bullet]. This prevents the development of new measures. Companies should be required to explain how they have established the targets where data history is not available or sufficiently reliable.
- There is a need to include a reporting requirement for companies to explain to customers their approach and basis for their ambition regarding the +15 year targets. Companies should also set out mechanisms for future adjustments to these long-term targets.

The consultation includes the suggestion of setting common targets for the common measures (some or all). We don't think common asset health targets is appropriate because:

- it moves away from companies owning a plan that represents what matters to their customers; and
- All companies have been funded to explicitly maintain different service levels in relation to asset health (i.e., the definition of "stable" under the old serviceability metric was not uniform across the industry).

We have been building on the existing basket of serviceability metrics to identify the most meaningful and representative set of asset health measures that will allow us to make fully informed investment decisions that balance short and long term service. At this stage we are not proposing these as common measures because:

- they are tailored for our company's assets and risks; and
- they are not fully mature.

However, we would welcome an opportunity to discuss our development of asset health measures with Ofwat.

Making performance commitments more transparent

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

We are supportive of the four principles proposed to make performance commitments more transparent to customers – clear, unambiguous, complete and concise. There will be sometimes where trade-offs will be required, for example:

- ensuring definitions are unambiguous and complete does not always mean that they can be concise (or at least brief)
- there may be some potential tension between ensuring performance commitments are comprehensible to customers whilst ensuring they adequately drive changes in company behaviour, or meet a statutory or regulatory requirement

We also support Ofwat's views that companies should seek to disseminate performance information more effectively. We recently undertook focus groups to explore how customers responded to our customer summary of the Annual Performance Report we produced this year. These suggested that typically customers would not proactively seek out information on our performance – particularly where they were satisfied with the service they were receiving – but understanding that we had commitments to further improve did engender trust or a least a degree of comfort/confidence.

However, how companies can disseminate performance information more effectively and to what extent they proactively promote this information needs to be considered in the context of their wider communications plans and be proportionate customers' other communications needs and priorities – including for example, how can I save money from my bill, how can I save water, how can I contact you etc.

Scheme specific performance commitments

We are supportive of Ofwat's proposed direction of travel that, where large investment schemes are proposed, performance commitments should be on the benefit/outcome delivered to customers.

However, we note that some stakeholders and customers - particularly where significant sums are involved, and where the benefit may take a long period to be realised – make take reassurance by a form of interim milestone reporting. Rather than Ofwat mandating these types of measures, the onus should be placed on companies to discuss with customers and stakeholders the extent to which, and what type of reassurance they may seek.