Consultation on the outcomes framework for PR19

31st January 2017

This paper sets out South East Water's views in response to Ofwat's consultation on the outcomes framework for PR19.

1 INTRODUCTION

This document provides South East Water's (SEW) response to the consultation on the outcomes framework for PR19.

2 GENERAL COMMENTS ON THE CONSULTATION

Overall we support the approach Ofwat is taking in relation to setting out it's thoughts on the outcomes framework for PR19. There are many aspects of the consultation document that we agree with, however there are specific areas where we believe more consideration and discussion is required with the industry to ensure the right outcomes are achieved for customers.

As an overarching observation the prescribed outcomes and associated ODIs focus largely on the activity of companies and whilst there is a cause and effect link to customers, we believe there is an insufficient link to how customers perceive the service they receive. We would welcome further consideration across customers' priority areas to measure how customers believe water companies are performing either using satisfaction or alternative approaches.

At PR14 South East Water introduced a range of new, innovative customer satisfaction outcomes, PCs and ODIs and we have found that this has changed the way the business thinks and behaves – providing a refreshed and invigorated approach to customer service delivery across all aspects of the business, and moves from counting activities and issues to a focus on how the customer feels about the service they receive. We believe this type of approach could be used as a blueprint for a strong service focused foundation for the industry.

An additional concern is that the list and range of the prescribed outcomes doesn't leave companies much room to include further innovation focused on customer perception.

We have included answers to the specific questions raised in the consultation document however also make a series of overall comments below.

Stretching performance commitments (PCs)

We are not convinced that the overriding premise repeated throughout the consultation that companies should be incentivised to achieve better and better service across a range of measures is justifiable or indeed in the customers' interest.

We believe that the level each performance commitment should be set at, and incentivised around thorough customer engagement. This should also take into consideration the costs of achieving this level of performance and the expectations of customers in terms any bill/price impact of this.

We support the concept of applying stretching PCs to ensure customers get a level of service that they want and are willing to pay for, and this should include catch up for poor performing companies, however there is a question whether high performing or even broadly average performing companies should be stretched beyond what customers are willing to pay for and expect. It should be noted that it is unrealistic that such companies could be expected to deliver better performance at no extra cost.

Stretching PCs should be set at a level that is economic to achieve and matches customers' expectations. Where there is clear support from customers we support the idea that a frontier shift in performance should attract the appropriate level of reward/incentive.

We believe that customer research at an industry level would be helpful to understand this issue further.

Fundamentally we don't support an incentive regime where customers are paying for a service level they don't want.

Consideration should also be given to better understanding regional factors that may affect a company's level of performance against the common PCs. For example the geology of a region influences the likely level of discolouration and water quality contacts. This may mean a company is unable to achieve an upper quartile level of performance unless a disproportionate amount of investment is incurred meaning customers might be paying more than they want to for a given service level.

Stretching performance – setting the target

In the consultation document it discusses options for setting the PCs based on a historic or dynamic basis. It is essential to make sure that PCs are set at a level that is achievable for companies. We therefore strongly believe that these should mainly be set using a historic basis (with a potential for increasing due to efficiency/innovation where appropriate). Setting targets on a dynamic basis will result in only a small number of companies ever achieving the target, and the majority of companies failing. We do not believe this will be constructive in building trust and confidence in the industry from the customer's perspective.

We do however believe that in some circumstances dynamic targets are appropriate when there is the ability to react quickly to the market/environment – for example in retail. Dynamic targets on asset and investment heavy activities, such as might be required to reduce burst rates, would be inappropriate and potentially lead to a seesawing of investment priorities leading to inefficient procurement and delivery. In these types of areas certainty of targets is essential to achieving efficiency and driving innovation over the life of the investment.

Stretching performance – achieving the target

The consultation document questions the use of glide paths and deadbands at PR19. Our view is that both of these elements of the ODI design are still appropriate for PR19.

Glide paths should be used where appropriate – for example when the PC is linked to longer term investment that will inevitably result in a longer trajectory to achieve a given target (eg bursts, sewer flooding). The removal of the glide paths will drive companies to short term solutions that may achieve the initial target but are not the right long term solution.
For new PCs a glide path allows companies to build some history in terms of performance and effectiveness of solutions and also reduces the risk to companies of introducing new PCs encouraging more innovation in this important area.

The rationale of deadbands is that they allow for 'normal' volatility within a particular PC i.e. where the actual performance is not statistically different from the target. Applying small penalties or rewards for very small changes in performance will also be confusing to customers and we should seek to create a regime where the use of penalties and rewards are applied for meaningful deviations from the targets.

Removing deadbands also means that every ODI will either pass or fail and will therefore require a determination either in period or at the next Price Review and increases the regulatory burden on both the companies and the regulator unnecessarily.

Therefore it seems entirely sensible that the use of these should continue for PR19. Where deadbands are used they should be done in a consistent way across the industry, particularly for any common PCs that are set. The use of caps and collars is a way of mitigating risk to customers and companies and should be set proportionally to the PC involved.

Earning 'return' through the ODI mechanism

The consultation document outlines that Ofwat is seeking to change the balance of how companies earn their return towards service delivery and away from other sources of return such as outperforming the cost of capital.

A key premise of the regulatory regime in the water industry is that an efficient company can expect to earn a fair cost of capital on its asset base (RCV). Looking at this statement we believe that there are three key areas that interact with the consideration of ODIs and the balance of risk and reward that ensues.

- Efficient company – this is very dependent on the specific measure adopted
- Expectations – given a range of outcomes the expected outcome should have a probability of occurrence of around 50%

- Cost of capital (the focus in this consultation is on the cost of equity and the return on equity – RORE)

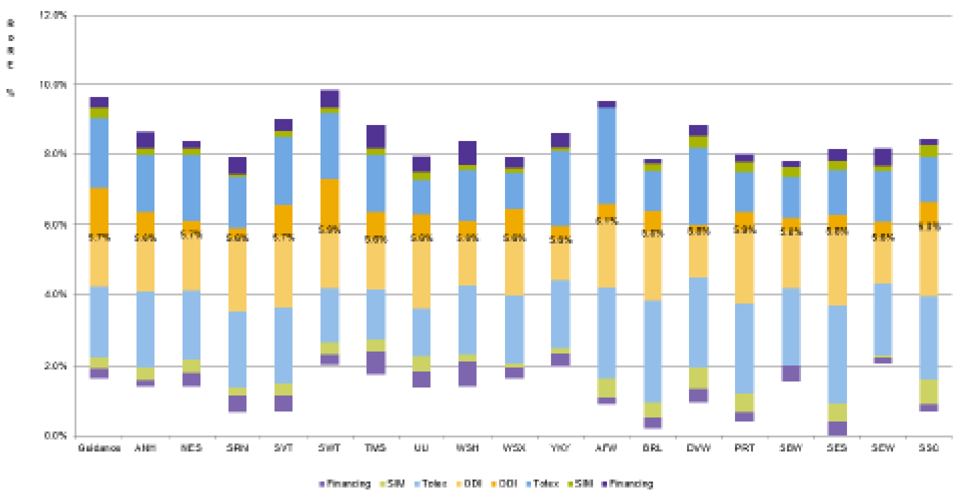
At PR14 we saw the first signs of a move away from basic WACC x RCV returns. Ofwat introduced ODIs – with the intention that companies could have the opportunity to earn additional returns if they exhibited a high level of performance against a range of PCs.

This framework clearly aligns the interests of investors with the interests of customers – companies are rewarded for doing more of what customers want and penalised where they fall short.

At the same time the allowed base return or cost of capital was the lowest set in the history of water regulation.

The following chart shows companies' estimated ranges for RORE with the central yellow/orange being attributable to ODI risk. Across the industry the average ODI risk range is -1.7 percentage points to +0.6 percentage points. The overall ODI range was capped at +/- 2 percentage points.

Figure 3 - Estimated ranges for the return on regulated equity at PR14



At the heart of this framework is that the ODI range represents a P10 and P90 for each individual ODI. This is important in the context of the proposals included in the consultation document.

It is clear from the consultation document that Ofwat is considering setting PCs and ODIs that will likely see a reduction on any upside outcomes with potentially fewer companies being able to achieve rewards – this is particularly the case if dynamic targets are set.

We believe that this will result in a reassessment of likely outcomes and would likely result in a further narrowing of the p90 upside – but not necessarily give a corresponding narrowing of the p10 downside. This will lead to a greater level of reward/penalty asymmetry than was seen at PR14.

We do not see this as consistent with being able to earn an expected return on equity.

Central to the regulatory framework is the premise that an efficient company should be able to earn a return on equity similar to what investors in other low-risk regulated businesses require when they invest their money – i.e an economically derived cost of equity, usually via accepted methods like the capital asset pricing model (CAPM).

We believe that Ofwat should set out what it means by an 'efficient company' - particularly in terms of ODI performance. Some of the proposals in the consultation risk defining an efficient company in such a way that it is only ever possible for one company to achieve its target (for example if the frontier: best performer is selected or 25% of the industry if upper quartile is used). Whilst this approach may be appropriate for achieving an 'incentivised return' – i.e above and beyond a base expected return – we do not believe that it is appropriate for making up the base return.

Further clarity is needed on the proposals contained in the consultation document and in particular the interaction between the cost of equity and expected outcomes from ODIs. The risk is that without this clarification it will be difficult for companies (and Ofwat, and investors) to assess financeability which could inevitably be perceived as increased 'regulatory risk' and therefore result in a higher expectation of the overall cost of equity.

Menu based approach to the cost of equity

The consultation document refers to a potential menu based approach to the cost of equity based on a model seen in Australia. Our response to this consultation should be read in conjunction with our response to Ofwat's cost of debt consultation which also discussed this potential new mechanism.

Our main concern with the use of such a mechanism in the UK water industry is that its use in Australia was mainly done so to drive an improvement in the quality of business plans. As Ofwat has acknowledged the business plans submitted in PR14 were generally regarded as good quality, and therefore we believe the introduction of a mechanism as outlined in the consultation would be trying to fix a problem that does not exist.

We do however believe that a differing level of cost of equity could be introduced to allow for higher returns for companies that adopt a higher level of innovation in its plans or where more return is placed 'at risk' in the ODI framework.

We believe this could be achieved by introduced a central cost of equity for all companies but then allowing a menu framework to reduce or enhance this allowed figure dependent on the proposed RORE range from the ODIs as shown in the following table. The adjustment to the central cost of equity has been termed an 'innovation incentive premium' to encourage companies to place more return based on service delivery to customers.

	Proposed RORE range from ODIs			
	0%	+/- 1%	+/- 2%	+/- 3%
Cost of equity in WACC (ie base case)	6%	6%	6%	6%
'Innovation incentive premium'	-1%	0%	+1%	+2%

**note figures are for illustration only*

Other comments

We also make the following comments on other aspects of the consultation document:

- Multiyear or annual ODIs – the use of multiyear ODIs should be investigated further as they may be appropriate for PCs where performance in any one year may not be representative of performance overall - eg for measures that are highly influenced by weather related events. We believe there is still the place for both but it will be ODI dependent. The trade-off is between 5 year flexibility on delivery, allowing more innovation and the ability to absorb shocks and certainty to customers of achieving the outcome year by year.

- Basket of measures – we believe that this should only be used where there is no subjectivity in the basket and the relationship of the components in the basket are clearly understood and articulated. Any subjectivity creates risk and uncertainty and this should be avoided for clarity to customers and companies. The challenge with the basket approach is communication to customers and should only be used if the basket lends itself to improved communication compared to communication of the individual sub measures.

- Company specific factors – if appropriate these would need to be strongly justified as it would create a different target for some companies and we would support that these be two way to prevent a bidding approach to special factors.

- ODIs across price controls – the consultation document suggests that ODIs should be discrete to each price control. We do not agree with this point and strongly believe that some PCs will span multiple price controls – particularly where the measure is based on customer satisfaction (as customers do not segment the different parts of the service). The whole supply chain should be jointly accountable to customers and therefore having ODIs that span the price controls seems a very pragmatic way of achieving this. It may create some tension between each party responsible for each element of the service however this will lead to better and more formalised service level agreements or contracts (where appropriate) between each party – resulting in a better level of service for customers. For example water quality contacts are managed by better information from the retailer to customers as well as reduced discolouration in the network. Therefore both retail and wholesale should share in any reward or penalty. SEW adopted this approach at PR14 and have found it produces the appropriate challenge to all those involved in the delivery of the service.

- Gated ODIs – we do not support the use of gated ODIs as this will inevitably lead to a disproportionate amount of management time and expense on some ODIs that may not reflect customer's priorities. We believe it is preferable to make the incentive proportionate to the value customers place on that measure to ensure the right measures are focussed on. In addition a gated approach means if the gated ODI fails the incentive to improve the performance of other ODIs related to the gate is significantly reduced and this is not a desirable outcome.

3 SPECIFIC CONSULTATION QUESTIONS

3.1 WHAT IS YOUR VIEW ON THE USE OF IMPROVED INFORMATION, INCLUDING COMPARATIVE PERFORMANCE INFORMATION, TO MAKE PERFORMANCE COMMITMENTS MORE STRETCHING?

We support the principle of providing comparative information to customers, stakeholders and CCGs. We believe that Discover Water can play a critical role in this, providing a place for all of the industry to use in their engagement programmes. As an active participant in the industry's Steering Group we are keen to see how we can help shape the development of Discover Water for use by all companies at PR19.

A critical element of providing comparative information, especially if it is being used to make PCs more stretching, is to ensure it is truly comparable with clear definitions for each measure and all detailed context provided to ensure the reader is fully informed of the potential reasons for any justified difference in performance levels.

We do believe that using comparative information in the right way can only help better inform customers enabling any engagement with them to be more rounded, however we also believe that focusing a wide range of PCs on customer satisfaction achieves a better result overall. When asked about their satisfaction level customers will naturally compare their water company's performance to a wider range of experiences rather than a comparison to a service they don't receive i.e. from another water company. This is what we believe will drive an improvements in service delivery to customers.

3.2 WHAT IS YOUR VIEW ON THE COMMON PERFORMANCE COMMITMENTS WE ARE SUGGESTING FOR PR19?

Overall the range looks reasonable, with coverage of the majority of areas customers feel are important. We do however think there could be opportunity to introduce some environmental measures and statutory measures (eg discharge consents, abstraction licence compliance etc) to complement the list, and further consideration should be given to whether AIM should be included as there are already legislative incentives in place to achieve sustainable abstraction and AIM isn't relevant for all companies.

Once it is agreed that common PCs should be set then it seems unjustifiable to use anything other than common penalties or rewards (in proportion to the company size) so that they retain similar incentive properties across the industry. Creating unbalanced incentives will drive a further mismatch of service standards across the UK. This may be an area for sector wide engagement to understand this further with customers.

In relation to engagement on the common PCs we believe further thought is needed by Ofwat to understand how they can be tested with customers to ensure they are still priority areas, and to consider how a company can include these mandated measures if the results from the company's engagement do not support all of these measures.

Whilst we agree with Ofwat setting a range of common PCs, we also believe there should be sufficient freedom for companies to propose a full set of bespoke PCs and ODIs – not just for circumstances where their customers differ from the mandated set of measures but also where they feel new PCs and ODIs should be introduced to drive a behavioural change in the company and/or drive service improvements not just for their customers but the industry as a whole.

At PR14 South East Water introduced a range of new, innovative customer satisfaction outcomes, PCs and ODIs. This covered each main priority area of service identified by customers. This has driven a refreshed and invigorated approach to customer service delivery across all aspects of the business and we believe it can be used as a blueprint for a strong service focused foundation for the industry. Ofwat must ensure that companies are not discouraged from implementing new, sometimes unproven, measures that can help drive a better service for customers.

3.3 WHAT IS YOUR VIEW ON HOW WE MIGHT APPLY COMPARATIVE ASSESSMENTS AT PR19?

At discussed in our 'overall comments' section above we believe that PCs should be set at a level that is economic to achieve and matches customers' expectations – ie upper quartile or frontier should depend on customer expectations of service improvement needed.

Where there is clear support from customers we support the idea that a frontier shift in performance should attract the appropriate level of reward/incentive.

We believe that customer research at an industry level would be helpful to understand this issue further.

3.4 TO WHAT EXTENT DO YOU AGREE WITH OUR PROPOSED APPROACH TO LEAKAGE PERFORMANCE COMMITMENTS FOR PR19?

We support the use of a leakage PC and believe this to be better that using a combination of PCC and distribution input, where they are many variables that can affect the latter driving differences in company 'performance' in this area (for example customer demographics, level and type of non-household activity, housing stock, levels of discretional use etc).

Driving performance pass the SELL is a difficult balance as it effectively means that it would mean companies performing at a level that is lower than the 'optimum' economic level. However, where customer support for this is strong we believe this should be encouraged through the use of PCs and an appropriate level of rewards/penalties.

Any leakage PC should logically be set against a leakage target like SELL however we believe the most element of leakage is in the expectations and experience of the customer and this is what should be tested in a satisfaction based measure (similar to the measure we introduced at PR14).

We believe the industry should be tackling this issue head on and set a long term leakage level that our customers think is appropriate and acceptable. This should be tested with customers in the same way we have suggested above against both an upper quartile and frontier position.

We don't advocate the use of more complex economic approach to leakage as discussed in the consultation document as this is likely to lead to more customer confusion and potential mistrust.

3.5 WHAT FACTORS SHOULD WE TAKE INTO ACCOUNT IN OUR GUIDANCE ON SETTING PERFORMANCE LEVELS FOR BESPOKE PERFORMANCE COMMITMENTS AT PR19?

As set out in our response to question two it is important that Ofwat encourage companies to develop new, innovative measures that help drive a better service to customers. Key criteria in any guidance or assessment of these should be:

- Is the measure 'bespoke' to the customer base for the company in question or could it be used by a wider range of companies?
- Is the measure implementing a new approach not seen in the industry before?
- Will the new measure generate an incentive to truly change behaviours in the company/industry in delivering service improvements to customers?
- Is the new measure covering an aspect of service not currently measured by the common PCs?
- Is the new measure covering an aspect of service not currently measured by other companies?

- How have the targets and ODIs been developed?
- Is the measure dynamically testing customer's expectations such that a stable 'score' is actually an improving service level?

3.6 WHAT IS YOUR VIEW ON OUR DEVELOPMENT OF A NEW CUSTOMER EXPERIENCE MEASURE FOR PR19?

We support the principles and idea of a new customer experience measure and support that this should cover customers that contact the company and those that do not. It is essential that any customer experience measure covers the 'silent majority' who receive a good level of service with very little interaction with the company but also adequately reflects the importance of service from the company when things go wrong.

As outlined above we introduced a range of new, innovative customer satisfaction measures at PR14 and have since learned a lot about customer perceptions and interactions with the company and how this can affect satisfaction.

We would welcome the opportunity to discuss this further with Ofwat as we believe the approach we introduced at PR14 can be further enhanced to benefit not only our customers at PR19 but the wider industry.

We believe that targets should be set against customer expectations rather than necessarily comparing to other industries. This is because customers, when defining their expectation level, will pull on the experiences of a far wider set of industries and interactions than a simple comparison could make. Customers will also set their expectations on different aspects of service delivery from a range of suppliers – effectively creating the 'best' combination of service from a mix of suppliers.

3.7 WHAT IS YOUR VIEW ON THE OPTIONS FOR INCREASING THE POWER OF REPUTATIONAL AND FINANCIAL ODIS AT PR19?

We agree that reputational ODIs area strong driver of performance and that they do not necessarily always have to be financial. Visibility of performance against reputational targets is important and we believe the introduction of our new Performance, People and Planet report last year was essential to show customers and stakeholder how we are performing across all of our ODIs. Simple red/amber/green assessments can be used to show customers where performance is at, above or below target.

Where measures can be viewed across the industry on a truly comparable basis there could be an enhancement of reputational ODIs through the use of 'league tables' in Discover Water. This is an area that we will be discussing further with Water UK in the industry steering group.

3.8 WHAT IS YOUR VIEW ON OUR PROPOSALS FOR BETTER REFLECTING RESILIENCE WITHIN THE OUTCOMES FRAMEWORK?

We support the development of resilience metrics across the industry and believe these should include a suite of new 'potential to fail' measures as well as the traditional lag measures (eg bursts).

These measures should be developed using customer research to inform their design however we believe there will always be a need for an element of 'central development' of resilience measures as it is a difficult area for customers to understand and value – especially when this can often be using service level descriptions that extend a long period of time – eg "1 in 100 years".

There should also be consideration to the fact that customers quite often expect these type of measures to be set centrally by "trusted experts" rather than taking their view as the prime basis. We have carried our research which showed customers were split 53%/47% between those who thought resilience metrics should be set locally by the company vs those that thought it should be set centrally by a regulator or equivalent body.

If metrics and standards are set centrally, we do however, believe there is a place for customer engagement by every company how they go about achieving the required standards. Our experience is that customers can more easily engage with this concept and can see why their view is important in this regard.

Consideration for this Price Review might centre on evolution, collection and publication of resilience measures using a wide suite of indicators in the knowledge that this will lead to the right debate on what changes the UK industry needs to make to improve resilience. We are concerned that if the industry moves to an ODI arrangement too early we may supress this important sharing and development step and produce ineffective incentives aimed at the wrong thing.

3.9 WHAT IS YOUR VIEW ON THE OPTIONS AND OUR PREFERRED APPROACH TO ASSET HEALTH OUTCOMES?

We support the standardisation of asset health measures, however the definition of them needs to ensure they are about the assets themselves not about the response or the resilience of a system – these should be covered in the common resilience measures.

We believe the current set of measures could be improved as they are too focused on water quality and not on sufficiency. We support the use of a limited number of failure focused asset health metrics such as burst mains and unplanned treatment works outage. In addition, the measures and mechanism needs to deal with the ability to cope in different weather situations so that the measure is truly capturing a change in the health of the assets as opposed to the assets ability to cope with a changing environment – the latter being more of a resilience measure.

3.10 TO WHAT EXTENT DO YOU AGREE WITH OUR PROPOSALS FOR MAKING PERFORMANCE COMMITMENTS MORE TRANSPARENT FOR CUSTOMERS?

Transparency of PCs, their measurement and the nature of the ODI associated with them is essential to the outcomes framework.

We support the principles outlined in the consultation document and have strived to ensure our performance, the measures and their definitions is clear to customers and stakeholders. The introduction of our new Performance, People and Planet report supplements the formal Annual Performance Report in a format that is more visual, easy to understand and tailored to the audience.

We strongly support increased transparency of performance information for CCGs. It is something we already do through regular reporting of our PC performance, the use of 'Deep Dives' to drill into more detail against our PCs and ODIs and promotion of the Discover Water industry dashboard. We are actively discussing with our CCG how we can build on this and increase the frequency and visibility of performance reporting to all our customers.