South West Water

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Outcomes consultation
Water 2020
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

By email: water2020@ofwat.gsi.gov.uk

Dear Sir,

A CONSULTATION ON THE OUTCOMES FRAMEWORK FOR PR19

We are delighted to have the opportunity to respond to Ofwat's consultation on the outcomes framework for PR19.

We are pleased that Ofwat is considering the approach to outcomes and outcome delivery incentives (ODIs) at this time to give the opportunity to companies to fully engage in these developments.

The introduction of the outcome framework in PR14 represented a significant step forward in the regulation of the water sector. While it is only in its second year, we believe that the framework is already starting to deliver substantial benefits to customers and investors, including:

- enhancing the accountability of the companies to their customers;
- encouraging companies to develop a strong, innovative and balanced business plan (based on the priorities of their customers); and
- rewarding companies for delivering against this plan.

In light of this, we support the further evolution of the outcome framework for PR19. We consider that the evolution of this framework should take on board the following two considerations.

- the lessons from PR14 (e.g. what worked well and what could be improved); [1]
- interactions with the other aspects of Ofwat's methodology for PR19 (e.g. cost of equity menu) [2] and implications on the overall balance of incentives (e.g. considering ODIs in the round with other price review incentives).

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[1] Ofwat (2015), 'Reflections on the price review – learning from PR14', July.

On the first point, we are pleased to see that Ofwat has indeed taken on board the lessons from PR14 in developing its consultation on the outcomes framework.

On the second point, we note that this consultation will help to define the overall balance of incentives. We look forward to the opportunity to comment on the overall package of incentives once Ofwat presents all of its proposals together in its consultation on the methodology for PR19.

There are many of Ofwat's new proposals that we agree with (further details on our views regarding each question are provided below).

However, as a general point, there appears to be a number of areas where Ofwat is seeking standardisation and comparison based target setting – in particular in setting common ODIs. We believe that outcomes, performance commitments (PCs) and ODIs should be grounded in the priorities that our customers value. As these priorities will differ by company, we are concerned that the proposal to move to common outcomes will result in outcomes, PCs and ODIs that do not reflect our customer's priorities, or service improvements that our customers are not willing to pay for. Furthermore, such an approach may not be consistent with the principle of ensuring that companies have full ownership of their business plans.

As an alternative to this Ofwat could provide comparative information to water company consumer challenge groups (CCGs). This information would enable CCGs to challenge the proposals put forward by the company in preparing the business plan, while at the same time allowing the company to develop a business plan based on the outcomes that are most important to customers in the water company area.

Such an approach would enable CCGs to decide to challenge the company to reach a national benchmark, or instead decide against such an approach in favour of challenging the company to improve performance in another service area where there is a greater willingness to pay for improvements. If the CCG opts for the latter approach of challenging the company to improve performance in another service area, we would expect Ofwat to respect the CCGs decision. The important distinction under this alternative is that common outcomes, PCs and ODIs would not be mandated.

There are two main attractions of this approach.

- It allows for companies to tailor their plans to deliver the outcomes that their customers value most highly; and
- By having CCGs draw on information on other companies, it further strengthens the incentive for companies to justify their plans to customers.

Furthermore, we understand that Ofwat is considering the appropriate balance between the allowed return that companies earn ex-ante through the weighted average cost of capital (WACC), versus the return that companies can earn through ODIs. In determining the appropriate balance we suggest that Ofwat has regard to the following principles:

- companies are able to finance their functions in the first place – otherwise the proposals may risk loading too much risk onto companies and ultimately customers;
- any change should not increase the level of risk facing companies and investors (e.g. the risk profile of cash flows) to the detriment of investors' confidence in the regulatory regime;

[2] For example, as set out in Ofwat (2016), 'Water 2020: consultation on the approach to the cost of debt for PR19', September.

- customers in different company areas may have different preferences for the return on regulatory equity (RORE) ranges from ODIs – e.g. it may be that customers' preferences for bill levels and profiles are consistent with a narrower range.

The appendix to this letter provides additional points on our analysis for the consultation and our responses to specific consultation questions. We look forward to discussing our response with you.

Yours faithfully,

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APPENDIX - RESPONSE TO THE CONSULTATION QUESTIONS

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 welcome the principle of improving the information available to customers and CCGs, to enable them to engage effectively with water companies in setting outcome and performance commitment levels. While this is the case, there is a careful balance to be struck between providing customers with proportionate and targeted information in order to inform their engagement, but avoiding overloading them with too much information.

Furthermore, we welcome Ofwat's commitment to provide information on several price review assumptions in advance of the business plan submission. We understand that this would cover the following assumptions:

- the cost of capital;
- ranges for ODI rewards and penalties; and
- wholesale cost assessment approach.

As these are important drivers in relation to the price review outcome, we consider that providing this information should facilitate better engagement on bill levels and profiles ahead of the business plan submission. One observation is that we would like to understand what is meant by the cost assessment approach and what information would be provided – is this the cost assessment models, or the results of the cost assessment models? If the latter, there may need to be further consultation on how this information is presented (e.g. to ensure that it is presented in a way that all customers can understand).

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

We are concerned that Ofwat specifying standard outcome measures may go against the principle of customer-led plans. One of the most innovative features of PR14, was that there was a high degree of bespoke tailoring of outcomes to localised customer preferences. We note at PR14, companies had different approaches to the measurement of asset health and leakage, for example.

We believe that outcomes, performance commitments (PCs) and ODIs should be grounded in the priorities that our customers value. As these priorities will differ by company, we are concerned that the proposal to move to common outcomes will result in outcomes, PCs and ODIs that do not reflect our customer's priorities, or service improvements that our customers are not willing to pay for.

We therefore consider that it should be left up to companies (having engaged with their customers) to decide on their performance commitments and ODIs.

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

We do not support the setting of commitment levels through comparative assessments. Customers in different water company areas will have particular service priorities and their own willingness to pay for improvements. Therefore, such an approach of standardisation and comparison based target setting may lead to outcomes, performance commitments and ODIs that are not consistent with the priorities of customers in the water company area. Furthermore, such an approach may not be consistent with the principle of ensuring that companies have full ownership of their business plans (e.g. especially if the plan does not reflect the priorities of local customers).

As an alternative to this Ofwat could provide comparative information to water company CCGs. This information would enable CCGs to challenge the proposals put forward by the company in preparing the business plan, while at the same time allowing the company to develop a business plan based on the outcomes that are most important to customers in the water company area.

Such an approach would enable CCGs to decide to challenge the company to reach a national benchmark, or instead decide against such an approach in favour of challenging the company to improve performance in another service area where there is a greater willingness to pay for improvements. If the CCG opts for the latter approach of challenging the company to improve performance in another service area, we would expect Ofwat to respect the CCGs decision.

Therefore, the important distinction here is that common ODIs would not be mandated.

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

It may be possible that following customer engagement companies could develop more bespoke measures that more closely reflect the priorities of customers. As such, we consider that companies and CCGs (based on customer research) should engage and ultimately decide on the form of the leakage performance commitments in the business plan.

We also note that there are differences in how companies define and measure the level of leakage. As such, we would have some concerns if a common performance commitment was set for leakage.

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

Companies should provide clear evidence that they have followed a robust and inclusive process of customer engagement in shaping their performance commitments, as well as detail on how they reached their proposed targets.

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

We consider that the convergence and likely continued convergence of SIM scores is likely to reduce its effectiveness in the future. Therefore, we agree with the removal of the service incentive mechanism (SIM) as a measure of levels of service performance.

We note that such a new customer experience measure could include comparisons with other sectors and use of digital service enablers. We consider that care would need to be taken in comparing performance across different sectors. This is because there may be structural reasons why levels of service performance (e.g. customer satisfaction) differ across different sectors, which may mean that such comparisons are not like-for-like.

We note that Ofwat will be consulting on a preferred option in the methodology consultation and look forward to the opportunity to comment on the proposals.

More powerful outcome delivery incentives

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

We support the principle of developing more powerful ODIs for PR19. We have provided detailed comments against the 12 areas identified in the consultation.[3]

1) We consider ways in which the reputational impact of ODIs could be enhanced

[3] Ofwat (2016), 'A consultation on the outcomes framework for PR19, November, pp.29–30.

We consider that reputational incentives play an important role in the regulation of the water sector. We welcome recent initiatives that have strengthened the reputational incentives on companies, including the annual performance report.

Our experience from PR14 is that the risk-based review of company business plans (which examines the overall package of outcomes and performance commitments) and the early determinations for enhanced companies provide one of the strongest reputational incentives for companies.

2) We are discussing with the sector a licence modification to allow in period ODIs which will bring the rewards and penalties closer in time to the service performance that generated them.

As one of three companies that agreed in-period ODIs in PR14 we are broadly supportive of this approach. There is a balance between the benefit of bringing rewards and penalties closer in time to the service performance that generated them and the level of volatility in customer bills. As regards this latter point, customers may not want the water company to reduce bills in line with a penalty in one year (if the company underperforms) only to increase them to pay a reward in the next (if the company subsequently outperforms). To achieve an appropriate balance we consider that there are (at least) two possible options.

- In period ODIs with discretionary trade-offs across years. Here a company could roll-forward a reward or penalty from one year to the next – provided the company has support from its CCG. This would then provide a cumulative reward or penalty which could be distributed to customers at an appropriate point within the regulatory period. This is similar to the approach adopted in the recent determination for SWW's ODIs in 2016.[4]
- In period ODIs with a true-up midway through the regulatory period. This would be more mechanistic in nature. Here a company would roll-forward a reward or penalty to an agreed year in the period (e.g. year 3) when the cumulative reward or penalty would be distributed to customers. This would allow for rewards or penalties to be smoothed out over the regulatory period.

We would be happy to discuss these options in more detail with Ofwat.

3) We discuss the benefits of end-of-period ODIs (those reconciled at price reviews) being linked to revenue rather than adjustments to the RCV

We agree that linking end-of-period ODIs to revenue rather than adjustments to the RCV may sharpen incentives to deliver PCs to customer, e.g. by bringing rewards and penalties closer in time to the performance that generated it.

However, we consider that linking ODI rewards and penalties to adjustments to RCV may still be appropriate for some outcomes or PCs. For example, for outcomes or PCs related to asset condition, performance, reliability or resilience. In these cases, it may be appropriate to tie rewards and penalties to the RCV given that these ODIs are more likely to relate to performance over a longer timeframe (i.e. not in the individual year), and the RCV more closely reflects the asset base of the company – to which these outcomes and PCs relate to.

We think that it should be for companies to decide on the balance of ODI rewards and penalties linked to revenue versus adjustments to the RCV, in engagement with CCGs.

4) We discuss removing the aggregate cap and collar on ODIs which limit ODI rewards and penalties to two percentage points of return on regulated equity

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[4] As set out in Ofwat (2016), 'Final determination of South West Water's in-period outcome delivery incentives for 2015–16', December.

There could still be merit in retaining an aggregate cap and collar to protect customers (e.g. from excessive rewards) and investors (e.g. given that the outcome framework is still relatively new).

5) We could encourage efficient companies to hit an overall range for ODI reward and penalties that was higher than the rewards companies proposed and agreed to at PR14

We welcome that Ofwat proposes to provide guidance on the range for RORE from ODIs. Recognising that there is some element of subjectivity in setting the range, we consider that it should be for companies to decide on the actual range to adopt in the business plan, based on customer priorities as identified through customer research and engagement with the consumer challenge groups (CCGs). For example, it may be that customers preferences (e.g. for bill levels and profiles) are consistent with a narrower range for RORE from ODIs.

Furthermore, there should not be a presumption that a company with a narrower range is less efficient than other companies. Efficiency should be assessed in relation to the overall business plan and should account for several other factors (e.g. the availability of sharing mechanisms such as WaterShare).

6) We consider alternative approaches to setting ODI rewards and penalties for PR19 drawing on a wider set of information on customer preferences

We consider that it will be important to draw on as wide a set of evidence as possible to inform ODI rewards and penalties. This is something that we are considering in the context of preparing our business plan for PR19.

7) We could adopt industry-standard ODIs for the common performance commitments with powerful rewards and penalties

We consider it should be for companies and CCGs to engage on the incentive type (e.g. financial or reputational) and incentive rates. This will ensure that the ODIs reflect the relative priorities of customers in the company area.

8) We could encourage companies to increase the proportion of ODIs with financial rewards

Ofwat could encourage companies to increase the proportion of ODIs with financial rewards.

Another relevant consideration is that it need not be the case that penalties from ODIs are deducted from allowed revenues and passed through to customers in the form of lower bills. While this may be one of the ways to compensate customers for underperformance, there may alternatives. For example, in our case, another option could be to pay all penalties into WaterShare. Penalties could then be distributed to customers in several different ways in agreement with our CCG, based on customer priorities. For example, it could be used to deliver additional customer service improvements (at no cost to customers).

9) We consider the detailed design of ODIs such as the use of deadbands

We support the continued use of deadbands. We consider that these play an important role in avoiding rewards and penalties when performance is within a reasonable band of tolerance (or margin of error) in relation to the target. However, we consider that it will be important to ensure that deadbands are not set too wide so as to reduce the strength of ODIs or performance commitments.

10) We consider the implications for ODIs for an approach based on the variable cost of equity that is partly based on how stretching a company's performance commitments are

As discussed in our response to Ofwat's cost of debt consultation, we consider that a variable cost of equity is perhaps an iteration too far from one which 'rewards' good plans with specific incentives.

We would suggest that Ofwat focuses on enhancing incentives through the outcome framework and the risk based review process, rather than a variable cost of equity. To do both would risk rewarding companies twice (for preparing a good plan) to the detriment of customers, or penalising companies twice when they produce a business plan that does not pass Ofwat's tests at the risk based review.

It will be important to understand how all of the price review incentives interact with one another. To this end, we look forward to commenting on the overall package of incentives in the consultation on the methodology for PR19.

11) We consider the implication of more powerful ODIs, for example, performance commitments will need to be stretching, clearly defined and closely reflect what their customers want

We agree that ODIs and performance commitments should closely reflect what customers want and are willing to pay for.

As regards linking more revenue to ODIs, we understand that this would be achieved through rebalancing the allowed return that companies earn ex-ante through the weighted average cost of capital (WACC), versus the return that companies can earn through ODIs. In determining the appropriate balance we suggest that Ofwat has regard to the following principles:

- companies are able to finance their functions in the first place – otherwise the proposals may risk loading too much risk onto companies and ultimately customers;
- any change should not increase the level of risk facing companies and investors (e.g. the risk profile of cash flows) to the detriment of investors' confidence in the regulatory regime;
- customers may have different preferences for the return on regulatory equity (RORE) ranges from ODIs – e.g. it may be that customers' preferences for bill levels and profiles are consistent with a narrower range.

12) We discuss whether 'gated' ODIs could be used, where rewards on some ODIs are contingent on a company incurring no penalties on other ODIs

We agree with the assessment of 'gated' ODIs in the consultation document – that is, the approach may have potential drawbacks. Nevertheless, there could be a small number of circumstances where customers consider that 'gated' ODIs are appropriate. A relevant example is where customers consider that two outcomes or performance commitments (PCs) are related in some way. If the company outperforms on one outcome but underperforms on the other, customers may find it difficult to understand how a company can receive a reward on first outcome (while they see service as failing). An example could be PCs related to asset health and mains bursts, both of which customers could see as related.

We consider that it should be for companies to decide on whether it would be appropriate to include 'gated' ODIs in the business plan, based on the priorities of customers and through engagement with the CCG.

Better reflecting resilience in outcomes

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

With regard to Ofwat's proposals:

1. <u>Resilience planning principles</u>

We welcome the work Ofwat has set out within the outcomes consultation around resilience outcomes and how these may be reflected within future price determinations.

We agree that at this early stage of development that a principle based approach is appropriate as this supports development and innovation across the sector without being prescriptive around solutions or standards. This will allow each company to develop appropriate investment and operational plans to respond to the resilience challenges in the most cost effective and appropriate way. Customer engagement on Resilience is vital to ensure that these plans are aligned with customer need and that CCGs and Boards are engaged on these issues. We recognise the value of this customer engagement and are already looking at how we can deliver this within our own research programmes.

We consider that the seven principles that have been set out are appropriate and should ensure that resilience proposals that have been set out are reflective of both customer need and should be economic and efficient. In particular we consider that principles 4 and 5 are very important as they will ensure that a range of solutions are examined with both capital and operational interventions considered. These principles will also allow innovation to thrive within the regulatory regime and allow opportunities for companies to outperform and deliver greater benefit for customers and the environment.

What is unclear at this time is the policy position Defra may express around resilience within their Strategic Policy Statement due to be published shortly. We remain uncertain as to whether Defra may seek to set minimum standards for resilience across England or whether this will be left for each company to engage with their customers around the standards to be delivered. Regardless of the policy position set by Defra we consider that the principles set out would be flexible enough to support the price review process.

We agree that outcomes around resilience should be set in the longer term context and projections should be set out for a minimum of 15 years. Given the early development of resilience within the regulatory framework it will be appropriate to revisit the principles and metrics developed at each future price control period to ensure that these remain fit for purpose.

Given the early development of resilience metrics we agree with your preferred approach to develop both consistent resilience metrics for all companies to use but also allowing companies to develop additional metrics that are company specific. This will allow the industry as a whole to understand the benefits of comparators on resilience whilst also allowing companies to develop specific metrics which better reflect local circumstances this should encourage innovation and development on resilience beyond the core metrics.

We are actively engaged in the development of these comparative metrics through work with WaterUK and The Water and Wastewater Resilience Action Group (WWRAG). We look forward to the workshop in March/April where these metrics can be shared more widely across the industry.

2. <u>Customer engagement</u>

We have no further comments at this time.

3. <u>Long-term projections</u>

We have no further comments at this time.

4. <u>Common performance commitments</u>

We recognise that having a common reporting framework may help enable a greater understanding of resilience across the sector. However, as per our above concerns, basing targets on standardised approaches may not best reflect the individual preferences of customers on a company-by-company basis.

Ofwat's preferred approach seems reasonable providing that the primary focus from a business planning perspective is given to metrics developed through engagement with customers.

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

Continued from the above list:

5. <u>Asset health expectations</u>

We agree with the need to focus on asset health within the outcomes approach, maintenance investment represents a very high percentage of the overall investment within company business plans and it remains a key area of company focus and delivery.

We note that at PR14 there was a move away from a prescribed historic serviceability approach to a more company owned and derived asset health approach. Whilst this may have improved company ownership and accountability it has resulted in a level of reduced transparency, complexity and a loss of comparability as described within the consultation document.

We therefore welcome a renewed focus on asset health and the desire to rebalance these issues. For this to work appropriately we believe that Ofwat should consider whether a principle based approach to asset health is also appropriate with many of the seven principles set out for resilience being appropriate for asset health.

In particular we believe Ofwat should consider the asset health objective that is required and what asset health is it seeking to achieve. For instance, is asset health only around maintaining a stable position, would an improving position suggest that companies are investing too much or are seeking to de-risk their business at the expense of customer bills?

How would these positions change if that de-risking was leading to improved resilience of services for customers and the environment?

Both the DWI and EA seek to see improvements in compliance through maintenance investment and at times this can be seen to be in conflict with asset health measures which demonstrate a stable performance. Both regulators are seeking to see more resilient services and a de-risking through mechanisms such as drinking water safety plans and EPR application. Both are valid objectives, but what pace of delivery is appropriate and how should these factors be linked to an objective of stable asset health?

We consider that this 'objective' should be something that the CCG panel are actively engaged in within the price review process in both supporting the performance commitments put forward, the pace of improvements and change and the affordability of the subsequent investment programmes to customers. As a minimum the objective should be stable asset health, but any further improvements should be supported by the CCG along with appropriate glide paths for improvement. Where companies outperform these glide paths then there should be appropriate rewards available either in terms of ODIs on performance or where innovation has been applied which allows financial outperformance through economic or efficient targeting.

We agree with the desire to have a small number of consistency measures for asset health leaving the remainder of the basket of asset health measures to be a company (and CCG) choice. Whilst mains burst and sewer collapses are proposed for the water and sewerage networks specifically, drinking water compliance can be a surrogate for water treatment works asset health. Wastewater treatment asset health is missing from the basket of measures and as such wastewater numeric compliance should be considered. Pollution incidents cover both network and treatment work events but is dominated by network failures.

Both the network asset health measures have positive and negative issues associated with them. For instance mains bursts can be influence by both weather and leakage activities and will vary accordingly. A drive to reduce leakage will appear as a deterioration in asset health over the short term and the regulatory mechanisms should recognise this position. Sewer collapses is a relatively weak metric due to the very low number of failures that occur and can be influenced by both triviality and by proactive approaches where companies are inspecting their assets (i.e. a partial collapse will not be detected as no service failure will occur, but may be found when proactively examining the network – the time between asset failure and detection may be very long – in some cases years may occur). We consider that a better measure for sewerage networks would be sewer blockages.

We recognise the need to increase reporting requirements on asset health and to report asset health sub measures, this is a difficult balance between company governance, transparency and the workload associated with regulatory reporting. We consider that this could be considered in a risk based manner whereby under the regulatory reporting framework companies who are in a more trusted reporting position would see a reduced reporting load.

6. Reporting requirements on sub-measures

We consider that Ofwat's draft asset health performance commitments reporting requirements are reasonable.

7. Standardisation

We favour an approach where there is some scope for companies to tailor their measures to reflect findings from their customer engagement.

8. The appropriateness of rewards

As stated above, at PR14 many companies found that customers were somewhat hesitant for companies to have large rewards. However, this finding may not hold true in every case, especially where more informed customers are involved. We consider that rewards should ultimately be informed by customer engagement.

Making performance commitments more transparent

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

With regard to Ofwat's proposals:

1. Principles to make performance commitments easier to understand

We have no further comments at this time.

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

We have no further comments at this time.

3. Disseminating performance information effectively

Ofwat's proposals on disseminating performance information seem reasonable.

4. Increasing the focus of performance commitments on outcomes

We have no further comments at this time.

5. Process for developing scheme-specific performance commitment

We have no further comments at this time.