# A consultation on the outcomes framework for PR19

# Southern Water's response

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# Southern Water’s response to Ofwat’s consultation on the outcomes framework for PR19

## Overview

We very much welcome the opportunity to respond to Ofwat’s consultation on the outcomes framework for PR19. The introduction of outcomes at PR14 was highly effective in shifting companies’ focus to the delivery of their customers’ priorities. It was also widely supported by customers, who indicated high levels of acceptability of companies’ business plans at PR14. We therefore strongly welcome Ofwat’s proposals to build on this framework.

It is encouraging that the development of the outcomes framework, as with any innovation, is being seen as a learning process which will evolve over time and with experiential learning. Our response reflects on the specific proposals to address the key learning points from the PR14 process, namely, the need to ensure:

1. a consistent and fair approach across companies
2. that the outcomes framework incentivises the right behaviour
3. an appropriate focus on both current and future customers.

Our main thoughts on each of these areas are set out below, with more detail in our responses to the questions.

### 1. A consistent and fair approach across companies

Ofwat’s proposals on comparative information will stretch performance commitments and increase consistency and fairness across companies. It will be essential that the right type of information is published and that consistency is ensured. Ofwat's proposal for a core set of common measures will contribute to this goal, although a small number of the proposed measures require further consideration to ensure that they reflect customer priorities.

Ofwat’s proposal to make greater use of comparative assessment will also contribute to improving the level of consistency and fairness across companies. Customers would expect that only companies who genuinely outperform should be financially rewarded, and companies who perform below the level at which they are funded to deliver, should be financially penalised.

### 2. Incentivising the right behaviour

We welcome Ofwat's commitment to ensuring a balance of risk and reward associated with outcomes at PR19. Although guidance at PR14 aimed for a balance in risk and reward, this did not materialise in practice. For several companies, there was a clear weighting towards potential penalties over rewards. There is a risk that this could lead to a greater focus on the avoidance of underperformance rather than on outperformance.

We therefore strongly support the commitment to achieving a greater balance between risk and reward. This will encourage companies to focus on delivering better quality services for customers.

It is important that this does not result in a reduction in the allowed base cost of capital which would put at risk companies' ability to deliver services to customers and finance their functions. The allowed WACC must be based on central cases of expected performance levels.

In this context, and as discussed in our response to Ofwat’s recent consultation on the cost of debt, we are cautious of the proposal to introduce a variable cost of equity at PR19. While, in principle, we accept that this provides a mechanism which recognises differences in risks between companies' plans, we do not think it is practical to implement, nor is it necessary to drive better performance. This can be achieved through the current risk and reward framework.

In-period adjustments will also impact company behaviour by bringing incentives closer to successes and failures. These are only appropriate in certain circumstances, for example where a controllable service change has an immediate and noticeable effect on a subset of current customers. They are not appropriate where performance is inherently volatile, for example, due to weather events, as this could lead to a significant degree of bill volatility. The decision to adopt in-period ODIs is one that should be made by companies in consultation with their customers, rather than mandated.

## 3. Focusing on current and future customers

We welcome Ofwat's review of SIM. SIM has been effective in improving companies' response to failure demand, but may not best reflect customers' expectations today. We would support the introduction of a broader customer experience measure which reflects the overall service received by customers. There is merit in considering whether vulnerability can be incorporated into the customer experience measure, though we recognise that this may not be practical. We agree that vulnerability should be incorporated into the outcomes framework.

We agree that it is important to incorporate resilience into the outcomes framework, although there are challenges in determining the appropriate means of doing so. Using a single measure for resilience may be viewed as being more transparent and consistent across companies, but it would be difficult to capture all the different elements of resilience (financial, environmental, technological) within an individual measure. Multiple separate measures may be too complex and result in the same difficulties faced by the asset health regime at PR14. We would be keen to work with Ofwat and other companies to develop an appropriate approach.

In summary, we very much support the outcomes framework as a means of driving positive performance improvements across the sector since its inception at PR14. We look forward to working with Ofwat to evolve the outcomes framework and culture through PR19.

## 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 Ofwat's proposals to use improved information, including comparative information, as part of the outcomes framework, to make performance commitments more stretching.

The publication of comparative information which is easily accessible for customers and other stakeholders will increase the transparency of the sector and, therefore, enhance trust and confidence. The Discover Water performance dashboard developed through WaterUK is an example of how the sector has worked together to increase the transparency of performance data. We will use this data to inform our customer insight work for PR19.

Comparative performance information also enables customers to challenge their companies to set more stretching performance commitments, as well as to hold them to account on their commitments. We therefore fully support Ofwat's proposal to include the use of comparative information in the risk-based review.

One area that has received particular attention is the use of comparative information as part of willingness-to-pay studies. Recent studies have found comparative performance information had no impact on customers' priorities or their willingness-to-pay for services[1]. This suggests that some further consideration of how comparative information can be used in willingness-to-pay studies is necessary.

The studies carried out to date have focused on the impact of providing customers with comparative performance information. However, it is not clear that comparative performance information should, on its own, have a significant influence on customers' willingness-to-pay. Comparative performance information can be expected to affect the level at which customers want their companies to perform, but we would expect comparative price information to be more relevant for customers' willingness-to-pay.

This is a complex area and the current framework for carrying out willingness-to-pay studies does not lend itself to easily test the impact of comparative price information in this way. Nevertheless, we think that further research to determine whether comparative price information is useful for customers to express their willingness-to-pay would be beneficial for the industry.

As a first step, providing customers with comparative performance information within willingness-to-pay studies appears to be appropriate. Evidence suggests that it is received positively by customers, and will therefore contribute to increasing trust and confidence in the sector.

[1] http://www.frontier-economics.com/publications/keeping-up-with-the-joneses/. The research did, however, find that customers were more satisfied and found the surveys easier to complete when comparative information was provided, particularly when this was in the form of graphs.

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

We generally support Ofwat's proposals for a core set of common performance measures alongside companies' own bespoke measures. This will provide greater consistency and fairness across companies. It will also contribute towards more stretching performance by enabling customers to better understand their companies' relative performance levels and hold them to account.

To be effective these core measures should reflect the priorities of customers across all companies. As recognised by Ofwat in its consultation, a number of the proposed ten measures were adopted as ODIs by most companies at PR14, suggesting that, on a national basis, customers share a common interest in a number of core areas. Broad customer support for common performance measures will strengthen the case for their inclusion at PR19.

A key challenge that has arisen from the PR14 process is the consistency of definition, and therefore direct comparability of performance metrics across companies. The development of the Discover Water dashboard, and the associated ODI reporting consistency work, has highlighted some of the challenges in collecting and reporting performance data in a way that is meaningful to customers. Therefore, we support Ofwat's proposal to develop common definitions for the final set of common measures and propose that it builds on the experience gained through the development of the Discover Water dashboard.

Our position on each of the ten proposed common performance measures is set out below:

**Table 1: Common performance commitments**

| Proposed performance measure | Evidence of customer support | Appropriate for common performance commitment? |
|---|---|---|
| New customer experience measure | Will replace SIM; specific focus on customer. | Yes |
| Water quality compliance | Strong focus on this measure at PR14 for most companies; a statutory requirement. | Yes |
| Customer water supply interruptions | Strong focus on this measure at PR14 for most companies. | Yes |
| Water distribution input (or leakage and per capita consumption) | Distribution input will only be a priority in some areas (e.g. water stressed areas). Leakage is a priority in most areas. Per capita consumption may be a better measure in terms of transparency and customer engagement. | Yes; per capita consumption is our preferred measure |
| Abstraction incentive mechanism | This is likely to be a customer priority in some areas (e.g. water stressed areas), but not all. | No; not a priority in all areas |
| Customer property sewer flooding (internal) | Strong support for this measure at PR14 for most companies. | Yes |
| Wastewater pollution incidents | Strong support for this measure at PR14 for most companies. | Yes |

| Proposed performance measure | Evidence of customer support | Appropriate for common performance commitment? |
|---|---|---|
| | | |
| Asset health water – pipe bursts | This measure may not be directly relevant to customers. | Yes, but further company-specific measures also required |
| Asset health wastewater – sewer collapses | This measure may not be directly relevant to customers. | Yes, but further company-specific measures also required |
| Possible new measure or measures of resilience | New area of focus for PR19 within outcomes framework; likely to have customer support. | Uncertain; further consultation required (see response to Q8) |

Ofwat are also consulting on whether the mechanisms for applying rewards and penalties, for example in-period or end-of-period adjustments, are made common across all companies for these measures. We agree that in-period adjustments bring incentives closer to actual company successes or failures during the reporting period, but think that these should only be applied where such behaviour has an immediate and noticeable effect on customers. In addition, the decision as to whether to not to apply incentives via company revenues or the RCV requires an understanding of the type of investment required to address any performance issues. In both cases we believe that these are decisions that should be taken by companies, in consultation with their customers, rather than being mandated as a blanket approach across the sector.

Regarding Ofwat's proposals on common incentive rates, we would support an approach based on willingness-to-pay (which will include the provision of comparative information). Further details on our position on these issues can be found in our response to Q3 and Q7.

We support Ofwat’s proposal for a bespoke ODI for vulnerability to be adopted by all companies. This will ensure that vulnerability forms a key part of all companies' business plans. Vulnerability is a key issue for the industry, and without a requirement for an ODI, it is possible that customers as a whole will not recognise it as a priority. This may be the case despite it having a significant impact on only a subset of customers.

Ofwat examine the issue as to whether or not there should be ODIs applied to each of the separate sub caps. We are broadly supportive of this approach, provided there is no link between how performance in a service area in one price control affects performance in another.

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

We welcome Ofwat's proposal to carry out the comparative assessment earlier in the PR19 process at the risk-based review. This will give companies an opportunity to review any adjustments to their business plans with their customers to ensure they are supported before the publication of draft and final determinations.

Early evidence on a number of performance measures suggests that the comparative assessment carried out at PR14 was an effective tool in incentivising companies to improve their performance. Performance across companies has improved for a number of the measures, and companies that are on track to earn rewards for 2015-16 performance are performing at the upper quartile levels set at PR14.

Rewarding continuous performance improvement should be a key objective for the comparative assessment. For this to be credible, companies should only be able to earn rewards for genuinely industry-leading performance levels. This will be a minimum expectation for customers and will increase their trust and confidence in the outcomes framework.

A second key objective for the comparative assessment is to ensure that companies face financial penalties for performance that is below the level at which they are funded to deliver. We think some further refinements to the PR14 approach are necessary to achieve this at PR19. The current approach has resulted in companies facing potential financial penalties for performance that is below upper quartile. However, the cost assessment models do not allow funding for upper quartile performance levels. Companies are, therefore, at risk of financial penalties for performance which is above the level for which they are funded.

This point is addressed in the Economic Insight's paper 'Outcomes framework at PR19' for Thames Water[2]. They propose two possible options to address this issue; either adjustments to performance commitments to the level at which an upper quartile cost company is expected to deliver, or adjustments to the cost allowance to reflect the costs associated with delivering upper quartile performance levels.

We propose an alternative approach to the comparative assessment to address this issue. Adjustments to performance commitments could be made to the upper-quartile level. Below this level no company should earn financial rewards. A penalty deadband would be set at the industry-average performance level - this would approximate the performance levels implied by the cost assessment models. It would ensure that companies only earn rewards for industry-leading performance, but do not suffer penalties for performance at a level above which they are funded.

Ofwat are also seeking views on a number of specific proposals relating to the design of the comparative assessment. These are: which data to use; what performance level to adjust PCs to; the use of glidepaths; how many years of data to use; individual vs. baskets of measures; common reward and penalty rates; special factors; which measures to include. We respond to each of these below:

- We support the use of historic data for the comparative assessment, as this would give companies the most certainty to carry out their investment planning. To increase the strength of incentives Ofwat may wish to consider dynamic deadband adjustments.

[2] http://www.economic-insight.com/wp-content/uploads/2016/11/Outcomes-Framework-for-PR19-Final-Report.pdf

However, these should be applied to reward deadbands only (to ensure companies earn rewards only for genuine outperformance) and not penalty deadbands, for which companies are funded on a historic basis.

- As reported in Economic Insight and Thames Water's report on the outcomes framework, adjustments to PCs beyond the upper quintile level are likely to weaken incentives, as the distance between the upper quartile and levels beyond this would require substantial improvements to performance. Therefore, we support an approach which involves making adjustments to either upper quartile or upper quintile level.
- We support the use of glidepaths for new measures (measures which were not subject to comparative assessment at PR14) to give companies the opportunity to improve historic performance before they face penalties. We suggest glidepaths are applied to deadbands and not PCs, and that they are applied only to penalty deadbands and not reward deadbands. This will ensure companies do not earn rewards until they are at the industry-leading level from the start of the period.
- We support adjustments to PCs based on three-year average performance data to ensure outlier data points do not skew the deadbands.
- We support adjustments to individual measures rather than baskets of measures to support greater transparency and simplicity.
- We do not support common reward and penalty rates. This would undermine customers' preferences as expressed through willingness-to-pay studies – the provision of comparative information should also reduce the element of variation in willingness-to-pay estimates that is not due to genuine differences in preferences. This should make any remaining variation more acceptable.
- We think it is important that there is a process for special factor adjustments to the comparative analysis. Ofwat's three-step process applied at PR14 was appropriate to determine whether special factors exist, but the process was extremely stringent – it is unlikely that none of the representations put forward were legitimate.
- We support the six measures proposed by Ofwat for the comparative assessment (water quality compliance, interruptions to supply, internal sewer flooding, pollution incidents, mains bursts, and sewer collapses).

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

We support the proposal for a consistent basis for leakage measurement at PR19, although we note that this will require some companies to reassess their historic leakage targets, which may impact companies' Water Resource Management Plans. This impact will need to be understood. To allow the new leakage calculation to be built into companies' WRMPs, there will need to be a period of time when both metrics are reported before switching to the new measure.

We agree that the sustainable economic level of leakage should be reported and its relationship to leakage performance commitments should be explained. However, the SELL, in its current form, can favour worse-performing companies in some circumstances. This is because more efficient leakage repair costs will drive a lower SELL. This should be taken into account when comparisons are made between the SELL and performance commitments.

Ofwat also propose that the long-term value of water needs to be taken into account in setting leakage PCs. We see merit in a further piece of work to examine which elements should be captured in the calculation of the long-term value of water. In particular, we need to consider whether natural capital should be included as part of this valuation. If it is included, this would increase the value of water, and result in a lower optimal leakage level. We would welcome the opportunities to work with others in the sector on this issue.

There may also be a case to set leakage targets at a Water Resource Zone level. This would align leakage PCs with companies' WRMPs.

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

Companies should aim to set their bespoke performance commitments at the economically efficient level – where the marginal cost of production is equal to the marginal benefit. PCs set at this level are appropriate as they would maximise the societal welfare associated with water services.

We have learned from previous price reviews that, due to significant uncertainty around both the benefits and the costs associated with incremental changes in service levels, deriving accurate estimates of economically efficient service levels is very challenging. We therefore welcome additional guidance is this area.

We are highly supportive of Ofwat's approach to benefits valuation at PR19. In particular, we support Ofwat's position on encouraging companies to test alternative methods to stated preferences approaches and that these should be used to support and cross-check (and potentially triangulate) the findings of stated preference willingness-to-pay studies.

The ability for companies to use alternative methods to obtain or supplement willingness-to-pay valuations is a further development for PR19 and carries a degree of uncertainty. We think that to maximise the benefits of trialling various approaches, Ofwat's risk-based review should focus more on whether and how different approaches are incorporated into companies' plans, rather than whether the "right" numbers are obtained.

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

Ofwat are seeking early views on eight areas on the development of a new customer experience measure. These are (1) the ultimate outcome, (2) wholesale to retail, (3) beyond water, (4) beyond contacts and complaints, (5) a multi-channel approach (6) the role of complaints (7) incorporate vulnerability, and (8) beyond end-users. We respond to each of these below.

Currently the ultimate outcome (1) being measured is customer satisfaction. We agree that this is an important element of customer service; arguably the most important element. However, we think there are additional dimensions of the customer experience that are not captured by customer satisfaction alone. We think that these should be reflected in the future measure.

Furthermore, since the SIM is focused solely on customer satisfaction, there will likely be diminishing returns to continuing to focus solely on this area, as significant improvements have already been made across the sector. Higher returns in the form of better customer service may be available by extending the focus to dimensions which have not yet been incentivised as strongly.

We would, therefore, support the inclusion of additional measures alongside customer satisfaction in order to get a better overall picture of customers' experiences, and to exploit potential higher returns available in the form of improvements to customer service.

In particular, we would support the inclusion of measures of value-for-money, trust and confidence, and fairness. We do not think a measure of customer loyalty should be included, as household customers in the water industry do not have the option to switch their service provider.

There are a number of ways that these elements of customer service could be measured. CCWater currently publish performance on these as part of their annual Water Matters report. We would also suggest that Ofwat considers the Trust Matrix, Net Easy, and Net Promoter.

We would also suggest that Ofwat considers the structure of the survey questions, as some customers struggle with the current format. One approach would be to use a ten-point survey to measure customer perceptions.

We think the current split between the wholesale and retail elements of the measure (2) is appropriate. We agree with Ofwat's view that the current approach acknowledges the importance of good customer service across both parts of the business and accounts for the potential severity of contacts related to operations.

Comparisons beyond water (3) may be appropriate to drive performance forward in the sector. We support an approach that measures the relative performance of water companies compared with other utilities, but not beyond the utilities sector. This is for two reasons; (i) it is difficult to know how comparable water companies are with companies outside the utilities sector, and (ii) this would be a significantly more stretching target than is currently the case. Consideration also needs to be given to appropriate adjustments for regional differences where these are evident across sectors, which recent work has shown to be significant[3].

[3] https://corporate.thameswater.co.uk/about-us/our-strategies-and-plans/-/media/06167023ce854d3a96709a68c073e3f0.ashx?bc=white&db=web&la=en&thn=1&ts=57fd5df7-c11d-40c8-956c-e1cae657abd7.pdf

We set out our preferred approach to comparative assessment in Q3. We would support a similar approach for the new customer service measure, in that companies should only be rewarded for (utility) sector-leading performance, and only be penalised where their performance falls below (utility) sector-average performance.

Our preferred approach is for the new measure to be designed to include all customers (4), and not just those that have contacted companies with a query or complaint. We think the best approach to do this would be to include all bill-payers as the population from which to take the survey sample. This is because, as Ofwat state in their consultation, all bill-payers receive some level of customer service, simply by receiving a bill. Companies should be incentivised to deliver good service for all of these customers, not just to those that have made contact.

We support a multi-channel approach (5) to the new measure. The proportion of customers who are communicating with water companies through alternative channels indicates that this would better capture the level of customer service provided by companies.

One channel that would be important to consider in a multi-channel approach is social media. It is possible to measure the general sentiment of customers towards their companies based on their social media comments. We support exploring further whether this can be incorporated into the new measure. It will be important to ensure that the methodology for measuring customer sentiment results in companies picking up the right information to enable proper comparisons.

We think there is weaker justification for the inclusion of the number of complaints as the quantitative element (6) of the measure. There is a strong argument that its inclusion could create perverse incentives for companies – by discouraging them from providing multiple channels through which customers can communicate (and make complaints). This may be addressed by including the number of contacts resolved first time, rather than the number of complaints, as the measure for the quantitative element.

We support the inclusion of vulnerability (7) within the new measure. Vulnerability is a key part of the regulatory framework and it is important that the experiences of vulnerable customers are taken into account. One approach would be to explicitly include a sample of vulnerable customers within the survey to ensure their experiences are properly reflected within the overall customer service scores.

We think that the measure should account for the service provided beyond end-users (8), but this should be separate to the retail-based element of the measure. In developing its approach Ofwat should build on the work that is being carried out by WaterUK to measure customer service to developers.

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

The shift to the outcomes approach at PR14 has provided a framework which encourages companies to focus on delivering their customers' key priorities. This has resulted in a substantial behavioural shift within the water industry. Ofwat are now seeking to strengthen the incentives associated with the outcomes framework in order to encourage companies to seek further performance improvements to the benefit of customers.

For several companies the PR14 approach resulted in a balance of risk and reward which is significantly weighted towards penalties. This risks encouraging companies to focus on the avoidance of underperformance over driving outperformance. The appropriate application of stretching but attainable reward incentives is important if companies are to be incentivised to drive performance levels forward. We therefore support Ofwat's aim to strengthen incentives and achieve a greater balance of risk and reward at PR19.

It is important to recognise, however, that strengthening incentives in this way could increase the risk faced by companies. If the allowed cost of capital is made dependent on achieving upper quartile performance this would put at risk companies' abilities to deliver services to customers and finance their functions. The allowed WACC must be based on central cases of expected performance levels.

Ofwat have considered a number of options to increase the power of incentives. These are: strengthening reputational incentives; variable cost of equity; in-period ODIs; revenue vs. RCV adjustments; removal of reward caps and penalty collars; increasing the risk and reward range; encouraging reward ODIs; industry standard ODIs with strong financial incentives; deadband options; 'gated' ODIs. We respond to each of these below.

We support Ofwat's proposals to strengthen the reputational incentives associated with ODIs through the publication of more information on companies' performance, for example, through the Discover Water dashboard. This will encourage companies to achieve and outperform their performance commitments.

As set out in our response to Ofwat's recent consultation on the cost of debt, we do not support the introduction of a menu-based approach to the cost of equity. While, in principle, we accept that this would provide a mechanism which recognises differences in risks between companies' plans, we do not think it is practical to implement, nor is it necessary to drive better performance. The level of return can be linked to the delivery of customer outcomes through the current risk and reward framework.

We are supportive of strengthening incentives through the use of in-period ODIs in certain circumstances. We support their use in cases where a controllable service change has an immediate and noticeable effect on a subset of current customers. We do not think they are appropriate where performance is inherently volatile, for example, due to weather events, as this could lead to a significant degree of bill volatility. In such cases, performance needs to be considered over a number of years. We believe that decisions on which PCs should be linked to in-period ODIs should be for companies should make in consultation with their customers.

We are also supportive of retaining the option to make adjustments via revenues or the RCV depending on the type of measure. For example, where the impact of a service improvement or failure is immediate, revenue adjustments may be preferable; where there is a long-term effect which impacts customers now and in the future, RCV adjustments may be preferable.

We do not support the removal of caps and collars without adequately addressing the current balance of risk and reward. Without addressing the risk and reward balance, this would substantially increase the net penalty risk associated with ODIs.

Similarly, we do not support increasing the range of rewards and penalties without adequately addressing the balance of risk and reward. Southern Water’s aggregate penalty collar cuts off the maximum penalty well before the expected maximum (at P90); our maximum reward (at P10) is significantly short of the current aggregate reward cap. If the ranges are increased without addressing the risk and reward balance the maximum potential penalty will simply increase and there will be no change to the maximum potential reward.

Encouraging ODIs with the potential for rewards as well as penalties would help to address the current imbalance and will strengthen the incentives to outperform. It will be useful to understand from Ofwat the type of evidence that will be acceptable to obtain increased outperformance incentives at PR19. That is, whether willingness-to-pay evidence will be required or if a broader range of evidence will be acceptable.

We do not recognise a strong case for industry standard incentive rates. As set out in Q1 to Q3, this would risk undermining customers’ priorities and willingness-to-pay, which should be made more robust by the provision of appropriate comparative information.

We support some form of adjustments to deadband mechanisms to strengthen incentives. For example, adjusting deadbands so that rewards and penalties are applicable to the target once the deadbands are breached would strengthen incentives.

We support the option to use ‘gated’ ODIs and proposed these at PR14. We think that this mechanism can provide a safety net for customers by ensuring that rewards for outperformance do not come at the expense of other services. One possible approach would be to require reward incentives to be gated based on the maintenance of asset health measures (see response to Q9).

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

We acknowledge that this is a new area which involves making decisions under significant uncertainty, and will involve a degree of experiential learning during PR19.

We do think that, due to the multi-faceted nature of resilience, covering all of its aspects within a single measure could prove to be a significant challenge. It may be preferable to have separate resilience metrics (in addition to customer-focused and asset health measures) associated with the relevant performance measures.

On the other hand, this may lead to difficulties in ensuring consistency and transparency in approaches across companies. It is important to take the lessons from the asset health framework at PR14 into account, where the degree of heterogeneity in approaches across companies has made it difficult to make meaningful comparisons between companies.

On balance, we support an approach which involves separate resilience metrics for relevant measures. This would include, for example, a measure which is focused on reducing flooding risk in exceptional weather events. The measures could then be combined to form a basket of measures, or presented alongside their associated customer-facing ODI measures.

The impact of infrequent events is difficult to measure and quantify. This makes arriving at robust targets challenging. We would recommend an approach which focuses on risk (likelihood and expected impact) of events rather than the events themselves. The effect of reducing risk in this way would translate indirectly to improvements to separate customer-focused and asset health measures.

We support Ofwat's resilience planning principles and agree that there should be a focus on trying to understand customers' preferences with respect to resilience. Certain features of resilience planning, such as its long-term focus and concern for low probability but high impact events, makes this a challenging area for customers to think about. This will need to be acknowledged within the risk-based review.

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

There are some useful lessons to be learned from the asset health approach that was introduced as part of the outcomes framework at PR14. An asset health regime is important to provide current and future customers with additional confidence that companies are properly maintaining their assets.

We would support an approach that makes this the main objective of the asset health regime. Companies' primary focus should be to deliver their customers' key priorities. This should not come at the expense of asset health, which would be measured on a secondary basis. One option would be to set asset health performance commitments at a maintenance level of performance, and then 'gate' reward incentives associated with other ODIs on the achievement of the asset health targets. Companies would then face strong incentives to maintain their assets.

To ensure consistency and fairness across companies, particularly if asset health measures are used to gate ODIs in this way, we would propose a move towards standardisation. The result of the asset health regime that was introduced at PR14 has made it quite difficult to meaningfully compare performance across companies. This is largely due to differences in the way asset health ODIs are designed and applied across companies. We suggest a simplification to the measurement of some key asset health measures that are relevant across all companies, with greater consistency in their design and application.

We think it is also important to note that there are interactions between asset health measures in particular, and that this can lead to unintended consequences. For example, there are trade-offs between reducing leakage and the number of mains bursts. In average weather years this is not an issue, but in dry years this can cause issues. These trade-offs will need to be acknowledged and reflected in companies' targets.

We also support Ofwat's proposed asset health reporting requirements.

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

We support Ofwat's efforts to introduce guidance to make performance commitments more transparent for customers. We agree with Ofwat's proposed principles for ODI definitions and the inclusion in the risk-based review of how information is disseminated to stakeholders; we think these will both contribute to the legitimacy of the outcomes framework.

We also support Ofwat's proposals to increase the clarity of asset health sub-measures. As referred to in our response to Q9, a key learning point from PR14 was the difficulty in understanding asset health performance across companies due to the differences in design and definitions of measures. Greater clarity around definitions will contribute towards addressing these issues.

There is a risk that the size of the overall outcomes framework which, at PR19, will include asset health measures, resilience measures, a new customer experience measure, common performance measures, and bespoke performance measures, may impact transparency and clarity for customers. It may also dilute the strength of incentives for companies. In attempting to cover all aspects of service delivery within the outcomes framework, there is a risk of the overall effectiveness of the framework being reduced, both for customers and companies.

There is also a risk that increasing the complexity of mechanisms within the framework can also reduce transparency for customers and the overall effectiveness of the framework. 'Gated' ODIs, baskets of measures, separate resilience metrics, the new customer experience measure, and a variable cost of equity, will all need to be considered taking this risk into account.

Ofwat have also made some specific proposals on scheme-specific ODIs. Our view is that ODIs should be as customer-focused as possible. This means that the costs and benefits of specific schemes should be built into the incentives associated with customer-facing measures wherever this is possible. We support the use of scheme-specific ODIs where this is not possible.

Should you have any queries or regarding our response, or would like to discuss any aspect of it with us, please contact our Head of Economic Regulation, Nikki Deeley, on 01903 272336 or by email nikki.deeley@southernwater.co.uk