Customer Challenge Group (CCG) chairs meeting

Jon Ashley, Chair

12 October 2016

Agenda

Time	Agenda item	Presenter
10.30	**Welcome and introductions**	**Jon Ashley**
10.35	**Housekeeping** Comments on the note of the last meeting Action log	**Jon Ashley**
10.45	**November consultation on outcomes** - More stretching performance commitments - More powerful outcomes delivery incentives - Incorporating resilience into outcomes - Greater transparency and outcomes focus	**Jon Ashley**
11.55	**Break**	
12.05	**DWI proposals for engagement with CCGs going forward**	**Milo Purcell and Caroline Knight (DWI)**
12.25	**Water 2020 update and forward timetable** Cost of debt consultation Water 2020 timetable	**David Black**
12.50	**Close** Future meeting dates and forward agenda	**Jon Ashley**

Outcomes Consultation

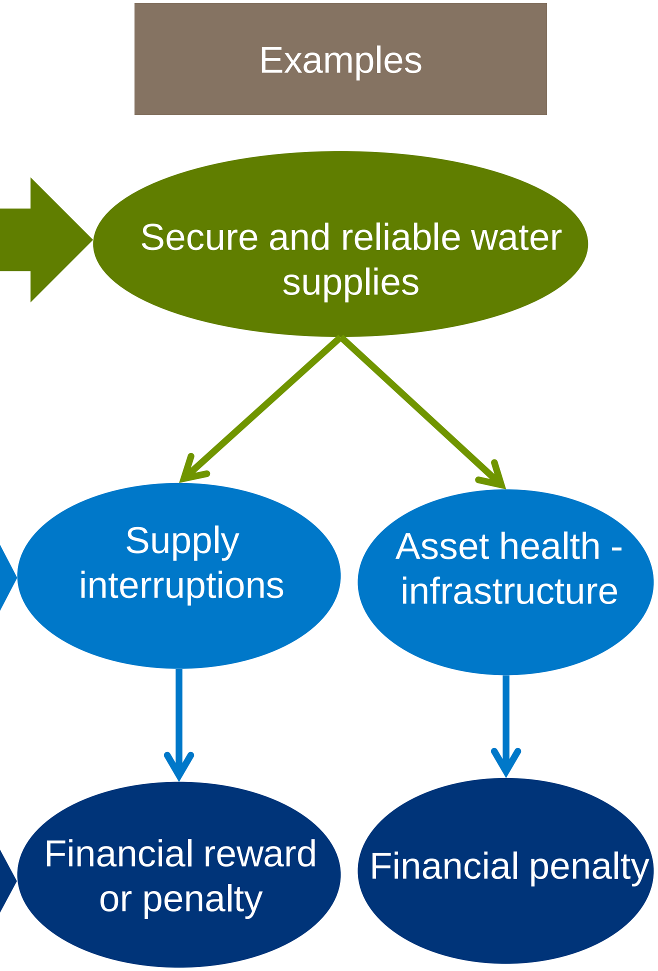
Jon Ashley

A reminder - What are outcomes?

Outcomes are the high level objectives valued by customers and society.

Performance commitments (PCs) are the pledges companies make about service levels in order to make progress towards their outcomes.

Outcome delivery incentives (ODIs) are the rewards and penalties that encourage companies to deliver their PCs. ODIs can be reputational or financial.



Outcomes were one of the biggest innovations of PR14, and have helped re-focus companies on delivering for customers. For PR19 we have gone back to first principles to consider the outcomes framework, reflected on the lessons learned from PR14 and engaged with our stakeholders on how the outcomes framework can be improved.

In the November consultation we are consulting on four areas where the outcomes framework can be improved:

1. Making performance commitments (PCs) more stretching
2. Increasing the power of Outcome Delivery Incentives (ODIs)
3. Improving how resilience is captured through outcomes
4. Making PCs more transparent and outcomes related

Separately we are consulting on a licence modification for in-period outcome delivery incentives for all companies.

We plan to consult on a number of ways of making performance commitments more stretching:

Making comparative information more easily available to customers and CCGs so that they are empowered to challenge companies' proposed performance commitments.

Revisiting the PR14 guidance to companies on setting bespoke performance commitments.

Consulting on a set of common PCs which all companies must have and whether these should have standard definitions.

Considering more stretching targets for common PCs: using the frontier company; using a dynamic approach etc.

Discussing options for a new common performance commitment on customer satisfaction which will stretch companies to improve customer satisfaction.

We will revisit the issue of stretching performance commitments in the July 2017 methodology consultation when we will consider all the price review targets in the round. We want to co-ordinate this work with cost assessment so that more stretching PCs do not just result in higher cost submissions.

Future Customer Performance Commitment ('Future of SIM')

- SIM has made a very significant and positive impact on the customer service provided by companies, and has effected real culture change at the companies across all levels. However, a number of developments and challenges suggest that it is time to review SIM

- We want to retain a customer experience measure, and have an open mind as to what this could look like. There is a range of options for us to consider. We want our measure to be ambitious and forward-looking**.**

Retain	Reform	Replace
Retain in current format with minimal changes	Reform with significant changes in methodology. For example: • maintain qualitative element only • cover more contact channels • increase sample sizes • introduce customer segmentation	Replace entirely with different mechanism(s). For example: • external measure, e.g., ICS, PWC measure of trust, TransportFocus customer emotional tracking 'in the moment', etc. • new/innovative technique for measuring satisfaction, trust, other. • bespoke solution but targeting different outcome(s)

Some fundamental questions:

- Which outcome should we measure against (e.g. satisfaction, trust, confidence, …other)?
- Should water companies be compared against: other water companies; other utilities; or all markets/industries?
- Should we try to measure the customer experience with both the network and retail elements of the operations? What does the potential arrival of domestic retail competition mean in this context?

Area 2 – Increasing the power of ODIs

Outcome delivery incentives (ODIs) are a crucial part of the PR14 incentive package as they link companies' revenue to the services that matter to customers and the environment.

We plan to cover four areas in the November consultation:
Discussing the benefits of in-period ODIs and how they might be applied at PR19. We are consulting separately on in-period ODIs through the consultation on licence modifications.

Discussing approaches to attaching more money to ODIs.

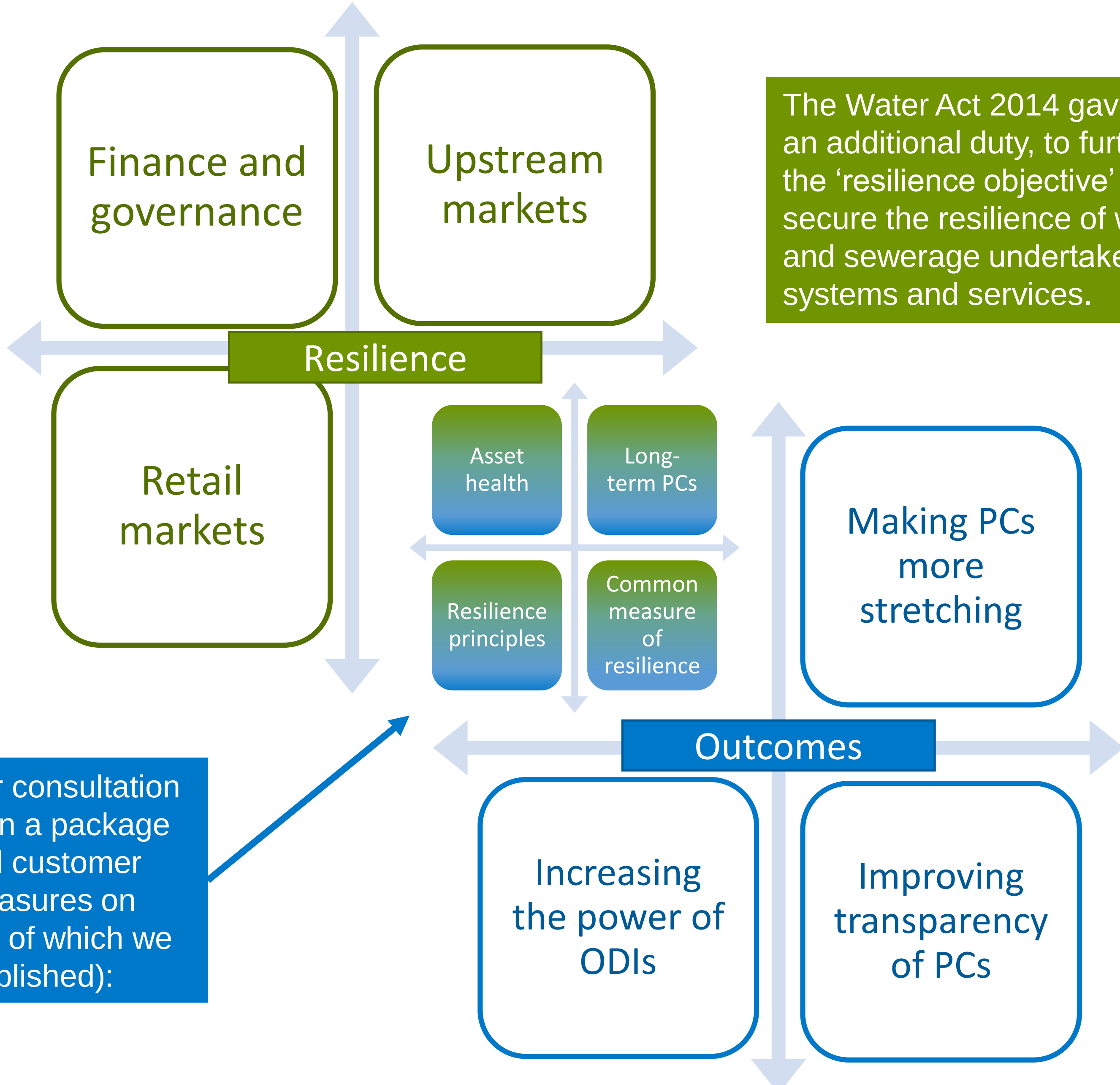
Discussing a new approach by an Australian regulator which links service performance to the cost of equity and how this could supplement ODIs.

Considering some of the issues raised by more powerful ODIs such as the need for clear definitions.

We will revisit the issue of increasing the power of ODIs, in more detail, in the July 2017 methodology consultation when we will consider all the price review incentives in the round and responses to the November 2016 consultation.

Area 3 - Incorporating resilience into outcomes

The Water Act 2014 gave us an additional duty, to further the ‘resilience objective’ to secure the resilience of water and sewerage undertakers’ systems and services.



In the November consultation we will consult on a package of outcomes and customer engagement measures on resilience (some of which we have already published):

Area 4 – Improving the transparency of PCs and their outcomes focus

There are a group of other issues we plan to include in the November consultation on outcomes which relate to improving the transparency of PCs and their focus on outcomes.

Consulting on whether performance commitments should be made more transparent and easier to understand for customers.	Discussing how performance commitments can be made more "outcomes"-focussed, particularly scheme-specific performance commitments.
Asking whether there are areas we have not discussed in the consultation which stakeholders think should be covered by performance commitments.	Confirming our policy that we expect companies to submit the definitions of all their PCs – but not the targets or any associated incentives - ahead of business plans.

Timeline for the work on outcomes

The November consultation on outcomes is a major step in the development of outcomes policy for PR19. It builds on the previous Water 2020 consultations (see below left) and will feed into the PR19 methodology consultation in July 2017.

Past

Future

July 2015
December 2015
May 2016

Sept 2016

October 2016

November 2016

July 2017

In consultations up to now we have:

- confirmed that we will retain outcomes for PR19
- consulted on in-period ODIs
- consulted on long-term commitments
- emphasised the importance of comparative information in customer engagement

Consultation on licence modifications

The licence modification consultation includes a proposal for all companies to have in-period outcome delivery incentives (ODIs).

PR19 Methodology consultation

We will consult on the method for setting PCs and ODIs and the method for setting common targets for common PCs.

Ofwat

DWI proposals for engagement with CCGs going forward

Milo Purcell and Caroline Knight (DWI)

CCG Chairs meeting: PR19 and DWI

- DWI's role and objectives for PR19
- Likely DWQ issues at PR19
- Engagement with CCGs

DWI's role and objectives for PR19

- We will provide detailed guidance on strategic objectives and statutory obligations
- We will seek the necessary investment to deliver wholesome drinking water
- We will challenge water company plans for short-term work to confirm their justification of need, and check that the solutions are appropriate, sustainable and provide a resilient water supply.
- We will work with other stakeholders to achieve these objectives

DWQ issues at PR19

- New obligations
  - Radioactivity – limited impact due to waiver process
  - Annex ii sampling programme changes – limited impact
- Catchment management
- Strategic and operational risk management
- Asset maintenance

Methods of engagement

Generic issues

- CCG Chair sessions
- Teleconferences with CCG Chair groups with similar issues

Individual Company issues

- One-one basis by email
- Teleconferences
- Meetings on request, if DWQ issues are significant.

Contact details

Contacts for all PR19 and AMP6 issues:

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W2020 update and forward timetable

David Black

Water 2020 update

W2020 - workstream developments since our last meeting

2016				
May	Jun	Jul	Aug	Sep

Cost of Debt consultation

Work towards the **Outcomes consultation – Nov 2016**

Workshops – new markets

We are currently holding workshops to deal with the more technical issues around introducing the new market for Water Resource and Bioresources which we announced in our May 2016 document. This is supporting the design of the price control which we will have further details on in the Methodology Consultation – July 2017

Information about these workshops is available on our website here: http://www.ofwat.gov.uk/regulated-companies/improving-regulation/future-price-setting-for-2020/

Licence implementation

We are making amendments to companies' licences to take account of the early policy decisions we made in our May 2016 document on:

- Moving away from RPI to CPI or CPIH
- Introducing markets for water resources and bioresources
- Introducing information remedies to support the new markets
- Allowing in-period adjustments to revenue for ODIs where companies engagement with its customers supports this approach.

The Section 13 consultation will be in October or November 2016

We are currently consulting on the approach to setting the cost of debt as part of the Water 2020 programme.

Cost of capital

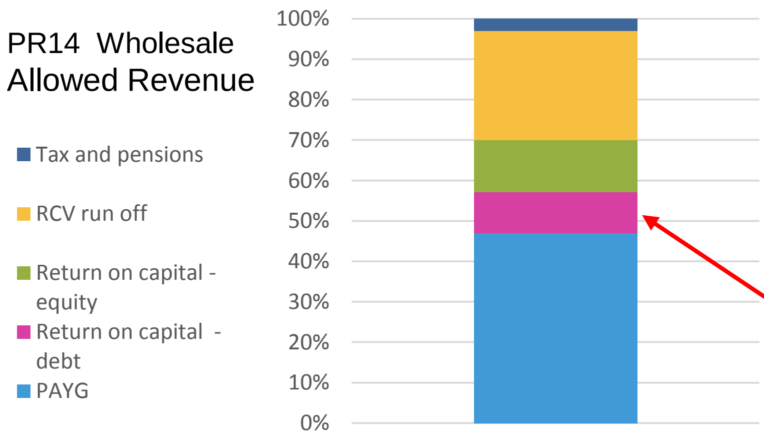
The cost of capital refers to the allowed return to companies on the regulatory capital value (RCV). It is calculated on the basis of the:

- cost of debt
- cost of equity

The weighting between debt and equity is determined by the gearing level. We set the cost of capital based on a notional financing structure of an efficient company, which was set at 62.5% in PR14. This means that company's actual gearing may be different to the notional gearing but, in line with our policy decisions, financing structures are a matter for companies and their investors (and customers do not bear that risk).

Cost of debt

The cost of debt is the efficient cost that a company will incur to service its borrowings. It is the expected return that providers of debt finance require, taking into account the risks involved.



The cost of debt is a significant component of customer bills

The cost of debt comprises around 10% of the bill

Review of how we determine the cost of debt allowance (1)

Our current approach

Historically, we set a cost of debt in the final determination, **which is then fixed for the regulatory period** and without any true up at the end of the period. This means:

- companies face a risk of under/outperformance and bear the costs/retain benefits from any difference between the allowed and actual cost of debt
- customers do not bear these risks (which they are not best placed to manage or bear); and
- companies have an incentive to outperform our cost of debt assumptions.

In 2010-15 and in some previous periods, many companies outperformed against our cost of debt allowance and that outperformance comprised a significant proportion of their returns, as noted by the National Audit Office (NAO) and Public Accounts Committee (PAC).

Objectives for our review

Our key objectives for setting the cost of debt allowance are:

- **an efficient allocation of risk** – in particular to allocate risk to companies (and their investors) where they are best able to manage and control it
- **cost reflectivity** – how well does the allowance reflect the costs faced by an efficient company? This helps to secure the long-term legitimacy of the price controls and the financeability of a company.

Review of how we determine the cost of debt allowance (2)

We are consulting on three options for PR19

Option 1: continue with the current **fixed allowance approach** – this sets the cost of debt at the start of the price control for the full control period. This approach provides strong incentives for companies to manage financing costs, but means that customers do not share in benefits or bear costs from market changes in the cost of new debt during the period.

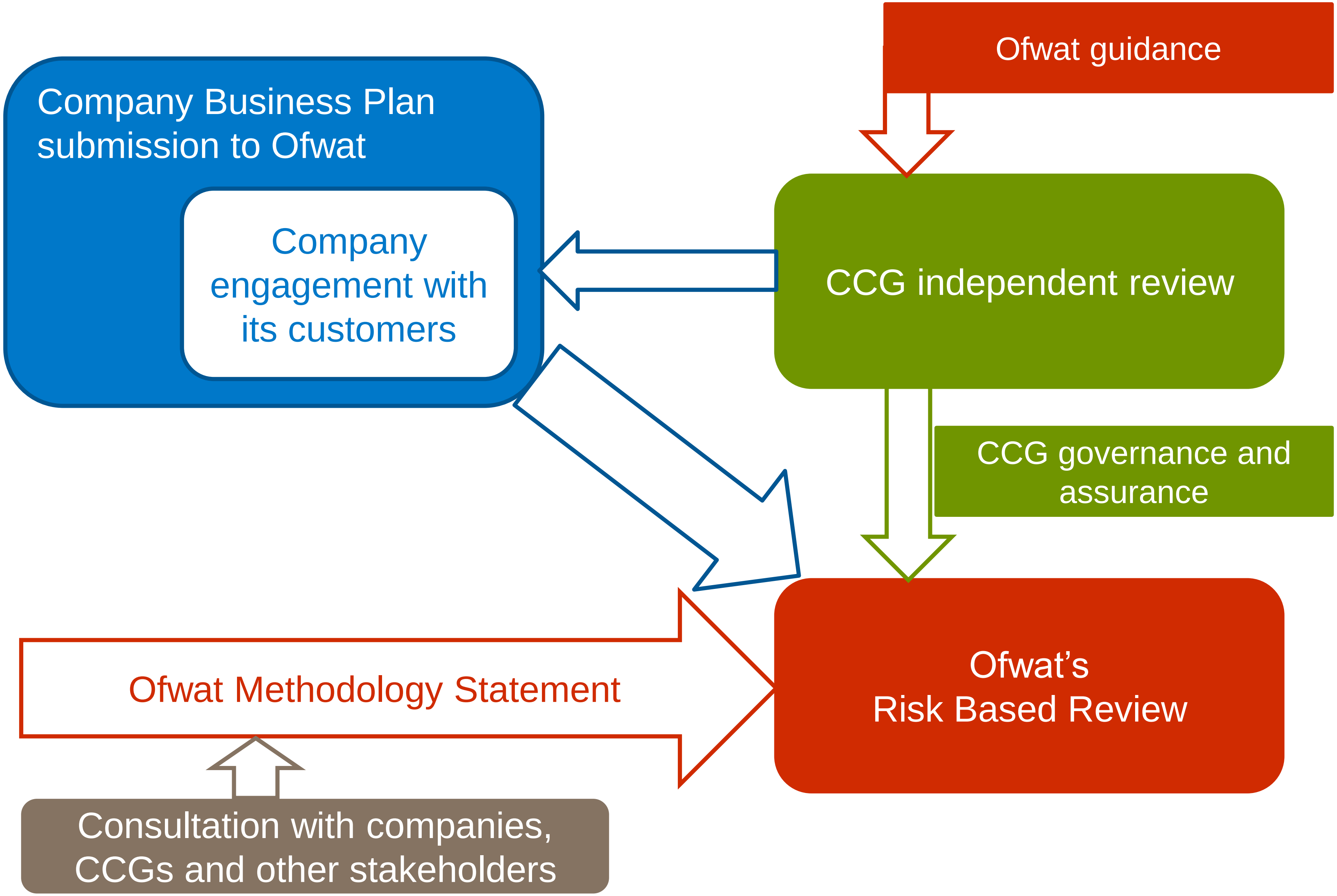
Option 2: full indexation of the cost of debt – under this approach our assessment of what it would cost an efficient company to finance its business is linked to and based on a trailing average of the cost of debt over a 10 to 20 year period and as a result, the cost of debt allowance would move annually in line with market conditions. This means that customers would benefit from any reductions in the market cost of debt during the period, but are also exposed to the risk of increases in the cost of debt during the period.

Option 3: indexation of the cost of new debt only – this approach means that the forecast errors from estimating the cost of debt for the forthcoming review period are corrected and that customers bear risk around changes in the market rates over the period. Existing debt continues to be set on the same basis as option 1.

Our preferred option is **Option 3**. Our consultation closes on 17th October after which we will consider respondents' representations.

W2020 forward timetable

Reminder: how customers' views feed into the risk based review



W2020 forward timeline

Implement licence modifications, if agreed

Implementation of business retail market

2016				2017											
Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec

Outcomes consultation

Our November consultation will cover:

- Making performance commitments (PCs) more stretching
- Increasing the power of Outcome Delivery Incentives (ODIs)
- Improving how resilience is captured through outcomes
- Making PCs more transparent and outcomes related

Responses to the consultation will feed into the methodology consultation

Methodology consultation

Our methodology consultation will set out our proposals on how we will determine how companies' allowed revenues are set in practice. Within this document, we will set out how we propose to use customer engagement in the risk based review.

To note: the methodology consultation will cover all aspects of the Water 2020 programme

PR19 Methodology

Taking account of representation from our consultation, we will set out our final approach to setting price controls. This will include:

our expectations for the information each water company should include in its business plan, setting out its proposals for the control period and

how we will review and challenge those plans

Close

Jon Ashley