



# **Delivering Water 2020: Consulting on Ofwat's methodology for the 2019 Price Review**

## Introduction

The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and sewerage customers in England and Wales. CCWater has four regional committees in England and a committee for Wales. We welcome the opportunity to respond to Ofwat's consultation on its proposed approach to assessing water company business plans and setting price controls, performance targets and incentives for 2020-25 in the 2019 price review (PR19).

## Executive Summary

The draft price review methodology builds on a range of earlier consultations and workshops Ofwat has held through its Water 2020 programme. We welcome the stakeholder engagement Ofwat has carried out during its development.

We believe that the methodology should be a set of mechanisms and processes that achieves the following outcomes for customers:

- Prices and changes to bills that are acceptable to customers.
- Companies investing in the future and becoming more efficient and innovative.
- Affordable bills for customers.
- Delivery of customer priorities for water and wastewater services.
- A step change in the resilience of services now and in the future.
- Effective support for the vulnerable.
- Clarity for customers on what they will receive in return for their money.
- Companies only receive incentive rewards for exceptional performance that benefits customers

In summary, CCWater broadly welcomes the following proposals:

- The framework for setting price controls, outcomes and Performance Commitments in both a short-term and a long-term context, which focuses on delivering resilient services now and in the future.
- Ofwat's intention to 'test' how well companies propose to address customer affordability and vulnerability in their business plans. We provide suggestions in our response on how the use of commonly applied and bespoke Performance Commitments can help ensure that companies are challenged to increase and improve the assistance received by customers who need it.
- The new measures for incentivising improvements in customer contact handling and wider customer satisfaction under the 'Customer Experience' (C-MeX)

measure. However, we would like to see two separate C-MeX measures and incentives for:

- Customer contacts and complaint handling' ('C-MeX contacts'); and
- Customer satisfaction with value for money and Net Promoter Score ('C-MeX satisfaction').

Two separate Outcome Delivery Incentives (ODIs), with two sets of measures and Performance Commitments, each incentivised strongly and separately, would increase their impact to drive improvements in customer service and communication.

Strongly incentivising companies to continually improve customer satisfaction and customer service performance (rather than ODIs for other service improvements that may be viewed negatively by many customers) would have the effect of focussing companies on their customers and lead to greater segmentation. This would mimic, to some extent, what would happen in a competitive market.

- Increased comparability with several commonly applied Performance Commitments and measures.
- The signal that the Weighted Average Cost of Capital (WACC) will be lower at PR19. The WACC assumption should not lead to the scale of outperformance seen since PR09 (and indeed since privatisation), as companies have consistently raised finance at a lower cost than Ofwat assumed. This has been at the expense of customers.
- The challenge for companies to use a wide range of evidence to establish customers' priorities and 'willingness to pay'. This should give them greater detail on the expectations of different customer groups to incorporate into their business planning.
- More dynamic approaches to setting efficient totex for wholesale price controls, and a move towards 'frontier' efficiency in the setting of retail controls.

However, we have concerns with the following elements of the draft methodology:

- The opportunity for companies to incur greater financial rewards and penalties from ODIs. While we understand Ofwat's regulatory rationale for using ODIs to drive the delivery of better outcomes by companies, many customers did not support this incentive model at PR14. There is a risk of a negative customer reaction, particularly if ODI rewards drive bill increases and inflation also rises. Ofwat needs to be sure that its proposed ODIs regime would produce results that are acceptable to customers.
- Removal of the +/- 2% cap on the Return on Regulated Equity (RoRE) for ODI rewards, which opens the door for significant bill increases. Ofwat will need to show that rewards relate to tangible service improvements that customers accept and are happy to pay higher bills for rewards achieved under this regime. The collection of rewards should also be spread over time to avoid bill spikes for customers.

- Index linking the cost of new debt financing at a time when interest rates are historically low and are more likely to increase than decrease.

We would like to see the following changes or additions to the methodology to strengthen the delivery of good outcomes for customers:

- Most or all of the value of the full package of financial ODIs applied to the C-MeX measures and incentives we suggest. This will drive companies to increase customer service and value for money, thus increasing customers' trust and confidence in the sector (a key Ofwat objective). This would also encourage:
  - A focus on customers similar to how companies may act in a competitive market; and
  - An additional incentive for companies to collect any rewards over time.
- While the commonly applied Performance Commitments proposed by Ofwat broadly reflect areas of service customers value (based on evidence of customers' views in the past), there is an opportunity before the final methodology is finalised to gather evidence to confirm that these measures reflect customers' priorities.
- Common Performance Commitments on customer affordability and vulnerability using qualitative measures of:
  - Customers' view of the affordability of their bills;
  - Customer awareness of vulnerability assistance that is available; and
  - Customer satisfaction with the quality of the assistance they receive.

Companies should set additional bespoke vulnerability and affordability based Performance Commitments to reflect the profile of affordability and vulnerability in their areas of supply, to complement these common measures.

- Companies required to triangulate varied sources of evidence of customers' views and preferences to strengthen their business plan proposals. We wish to see triangulation applied in a way that avoids 'confirmation bias' (i.e. companies triangulating evidence to confirm an assumption about customers' views).
- A requirement that companies use evidence of customers' views to set the pace of delivery of service improvements and investments (the trade off between the short term and long term) when assessing their proposed ratio between recovering totex in the short term and long term (the 'Pay as you go' - PAYG - ratio).
- Confirmation that Ofwat will, as part of its assessment, look at companies' research to test the customer acceptability of the business plan 'package' of outcomes, Performance Commitments, potential ODI impacts and prices. Customer acceptability is a crucial success measure of each company's business plan and of the price review as a whole.

With specific reference to how the methodology should apply to regulated companies in Wales:

- We think a form of C-MeX should be developed for non-household customers in Wales to help monitor and incentivise improvements in non-household customer satisfaction and customer service.
- Ofwat should continue to regulate non-household retail prices and service in England to help protect customers while the new retail market is in its infancy. We think that Ofwat should also continue to regulate non-household retail and services in Wales to help ensure non-household customers in Wales receive efficient prices and service performance that is at least equivalent to the better performing retailers in England.

## Guide to our response

Our response to the consultation is split into the various chapters in the draft methodology. At the top of each section we present our key points for easy reference, with further points and additional comments in our responses to each of the questions Ofwat raises.

## Engaging customers (Chapter 2)

### Key points

We support:

- Ofwat's challenge to companies to build on the improvements to customer engagement at the 2014 price review by using different methods of research to establish customers' 'Willingness to Pay' and the use of a wider range of sources of customer evidence to justify business plan proposals.
- Improvements in customer segmentation with companies challenged to understand and address the varied preferences and expectations of different customer groups.

We would like to see in the final methodology:

- A customer acceptability test of each company's business plan 'package' of outcomes, Performance Commitments, potential ODI impacts and price. The results should be part of the risk-based review. Companies should understand the reasons for any customers' rejecting the plan, and consider actions to mitigate these customers' concerns. Customer acceptability is a crucial success measure of each company's business plan and of the price review as a whole.
- A demonstration of how companies have triangulated different sources of customer evidence in a way that avoids 'confirmation bias'. This should deliver a greater understanding of the needs and expectations of different customer groups.
- Customer Challenge Groups (CCGs) provided with guidance on how to show they have challenged companies to develop 'customer-centric' business plans.

While Ofwat does not ask any specific questions in this section of the draft methodology, we would like to raise the following points.

### A step change in 'Willingness to Pay' (WTP) research

We are supportive of Ofwat's challenge to companies for an 'evolution' in WTP research and overall customer engagement at PR19. This would ensure that short-term and long-term outcomes, Performance Commitments, and incentives reflect customers' views and expectations. Companies should also conduct research to test that the overall business plan package is acceptable to customers.

We would like to see improvements in WTP research, with companies using stated preference and revealed preference techniques where available, as recommended in the analysis carried out by ICF Consulting Services<sup>1</sup>.

If WTP research is to be used to calibrate ODI rewards and penalties, then customers should be made aware that the results will be used for this purpose.

### **Customer segmentation**

We welcome the proposal for Ofwat to consider how companies have gained a better understanding of different customers' views. We would like companies to provide evidence that investments reflect the needs and preferences of different customer groups and ask that Ofwat includes this in its customer engagement assessment in the final methodology.

### **Applying triangulation**

Similarly, we wish to see clear evidence that companies have triangulated different sources of evidence of customers' experiences, expectations and preferences. Effective triangulation can provide insight into the views and expectations of different customer groups, or reveal customer behaviour or preferences that might otherwise not be discovered. ICF's report<sup>2</sup> suggests a high level framework for effective triangulation.

However, companies should demonstrate that their approach to triangulation avoids the risk of 'confirmation bias', where companies may triangulate results to confirm or uphold an existing assumption about customers' views.

The companies should explain their rationale for the customer engagement they have used (and how this evidence has been interpreted) both in their business plans and in their customer engagement meetings with Ofwat in early 2018.

### **Customer acceptability of business plans**

Given the importance of customers finding business plans acceptable, Ofwat should confirm in its final methodology that companies must test the acceptability of their business plan package with customers. This testing should cover outcomes, Performance Commitments, associated potential ODI impacts, and price.

The profile of bills presented to customers in this research should also incorporate inflation forecasts, to ensure the bill impacts shown to customers are as accurate to real life bills as possible.

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<sup>1</sup> 'Improving Willingness to Pay in the water sector' - ICF Consulting Services, July 2017  
<https://www.ccwater.org.uk/wp-content/uploads/2017/07/Improving-willingness-to-pay-research-in-the-water-sector.pdf>

<sup>2</sup> 'Defining and Applying Triangulation' - ICF Consulting Services, July 2017  
<https://www.ccwater.org.uk/wp-content/uploads/2017/07/Defining-and-applying-triangulation-in-the-water-sector.pdf>

Companies should demonstrate that they understand the demographic and affordability profile of customers who do not find the plan acceptable, the reason(s) for their view, and propose actions to address these customers' concerns.

### Using CCG reports

We support Ofwat's proposed use of CCG reports in assessing companies' customer engagement and how this evidence has been interpreted and used to build business plans.

We would like Ofwat to make clear in its final methodology how it will judge the level of rigor in the CCGs' challenges to companies' business plan proposals and the evidence that underpins them. It could do this by, for example, requiring a log of significant challenges made to companies' thinking or plans.

We would like Ofwat to confirm to CCGs what information and support it will provide to help CCGs achieve this.



## Assessing vulnerability and affordability (Chapter 3)

We recognise the progress made over the past few years by Ofwat, Defra, Welsh Government, companies and others on this important topic. We have been pressing for affordability and vulnerability issues to have greater prominence within Price Reviews.

### Key points

We support:

- Ofwat's intention to apply tests to measure how well companies are proposing to address customer affordability and vulnerability in their business plans.

We would like to see in the final methodology:

- More ambition on tackling affordability and vulnerability issues, including a common Performance Commitment (PC) for each. We believe that the inclusion of common PCs is essential to raise awareness and incentivise action. Two additional PCs would logically fit alongside the existing proposals outlined in Chapter 4 and would ensure that key consumer priority issues and concerns are covered.

On affordability:

- A wider definition of affordability measures to include debt alleviation schemes and the use of charitable trusts as well as take up of social tariffs and WaterSure.
- More focus on how companies should identify and address the needs of customers with affordability issues who do pay regularly but struggle to do so.
- Companies encouraged to make a greater contribution towards supporting customers struggling with affordability issues. Reporting on social tariff funding contributions from companies as well as from customers would help reveal how the cost burden is shared.
- A common PC based on customers' views on the affordability of their water bill. We believe customers themselves are the best source of robust information on affordability and this PC captures the overall outcome that we would like to achieve. We already track this figure.

On wider vulnerability:

- The introduction of both common and bespoke PCs to incentivise action and track how customer vulnerability is being addressed.

- PCs for vulnerability that are driven by customers. These could cover customer awareness of available assistance and customer satisfaction with the help they receive. We think that a qualitative measure of consumers who agree the services offered by their company meets their need would make a good common Performance Commitment.

*Q1. Do you agree with our proposal to use the five principles of customer engagement; customer support; effectiveness; efficiency and accessibility, to assess how a company is addressing affordability in its business plan?*

We agree that the issues identified need to be taken into account in assessing companies' plans to address customer affordability. We suggest that a further consideration to be added to these is the extent to which companies are contributing to the funding of affordability assistance.

We are particularly keen that companies engage with future generations and take their needs into consideration so that services and charges are balanced fairly across the generations. Delivering fair and affordable charges should be a long-term commitment by companies.

We welcome the additional visibility and prominence that Ofwat has given to affordability and vulnerability in the draft methodology. However, we also think there needs to be a big increase in the level of ambition. The current limitations on funding for social tariff schemes (which rely heavily on customers agreeing to fund such schemes through bills) present a major challenge in terms of achieving further significant growth in the reach and effectiveness of financial assistance schemes.

Our research indicates that around 3 million households in England and Wales do not consider their water charges to be affordable. Ofwat has previously reported that a similar number are spending more than 5% of their income after housing costs on water and sewerage services.

The social tariff schemes currently in place have the potential to give some support to around 410,000 households based on what customers are willing to contribute through bills. A further 140,000 are receiving help through the WaterSure scheme. That suggests that the current arrangements may leave the problem unsolved for around 4/5ths of the 3 million households who consider that their bills are not affordable to them.

Companies should do more to share the cost burden with customers, allowing more to benefit from support. We also know from our research that customers are more willing to contribute through bills where they can see that the company is also playing their part.

This issue is likely to be brought into sharp focus by the introduction of data sharing powers which form part of the Digital Economy Act which received Royal Assent in April. The powers are likely to provide potential for more rapid increases in the take-up of schemes, including the possibility of automatically applying discounts in some cases.

The benefits of these new powers are likely to be significantly constrained unless steps are taken to overcome the funding limitations described here. We are keen to work with Government and the industry to identify a way forward on this issue.

**Q2. Do you agree with our proposal to use information and measures on affordability, including possible common measures, to assess how a company performs against the five principles in its business plan?**

The proposed approach could be improved in the following ways:

- The scope of what will be considered as an affordability measure is not currently clear. We believe it is important to recognise the support provided through measures such as debt alleviation schemes and charitable trusts as well as social tariffs and WaterSure. There is, however, also a need to recognise the differences in the type of help provided by such schemes and the impact these have i.e. on-going help with future bills or a single intervention to help with existing arrears.
- A decrease in revenue outstanding is cited as an example of a method of measuring the effectiveness of interventions. However, this does not capture a significant number of customers struggling with affordability issues. We know from our research<sup>3</sup> that many financially vulnerable customers continue to pay their water bill beyond the point which is affordable to them by making sacrifices on other essentials such as food and heating. We feel that the development of schemes that target people struggling to pay is an area ripe for innovation.

Our recent work in this area has supported industry efforts to identify and engage effectively with such customers. This has led to the number of households supported by social tariffs almost doubling during the last year.

It is therefore important that measures of effectiveness are not confined to debt related criteria but also reflect the benefit provided to those suffering in silence and just about managing to pay their water bill. We feel consumers are best placed to tell us if they consider their water bills to be affordable.

We currently undertake annual research to track customer views on the affordability of water bills. We believe this could be used as a common PC which would reflect impact across the range of customers served. This could be a stand-alone common PC or be part of a combined PC on affordability.

- Quantitative measures of financial support (both the average bill reduction provided and the number of households helped) will need to take account of the extent of the customer funding contribution and what companies are contributing through benefit sharing. Clearly it is easier for a company which has been given a customer mandate for a large contribution through bills to deliver an assistance scheme which supports a high number of households and delivers a high average level of bill reduction. That is not the case for companies whose customers have agreed to little or no funding through bills.

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<sup>3</sup> 'Living with Water Poverty 2014 <https://www.ccwater.org.uk/wp-content/uploads/2014/09/Living-with-water-poverty-in-2014-Report-of-research-findings.pdf>

- We believe a measure of company funding contribution, such as the ratio of assistance provided to the costs passed on to customers, would be a useful common measure. This would help incentivise companies to share the burden of costs with customers and in doing so expand the scope of the support which can be provided.

***Q3: Do you agree with our proposed option for requiring companies to propose bespoke Performance Commitments for addressing vulnerability in their business plan?***

We see a role for bespoke PCs on vulnerability but they should be complemented by a common PC.

We believe that the industry should work collaboratively both within the water sector and more widely with others not only to offer consumers a core level of consistent help but also continuously review and improve the tailored support that they make available to consumers.

Bespoke PCs are useful in encouraging innovation and responding to the needs of consumers. We have also seen the benefits of collaborative working with the sector and beyond to address vulnerability issues. We have seen good examples of collaboration in the water sector to find joint solutions in other areas, such as catchment management and flooding. We feel that the approach of having bespoke PCs for partnership working on vulnerability is one which would benefit consumers.

We believe that **all** companies should have in their business plan a common PC to incentivise companies to provide a service that is inclusive and accessible to all their customers. These PCs should be reputational only so that companies do not profit financially through assisting those customers who are in vulnerable circumstances or who have affordability issues.

We consider that consumers themselves are best placed to comment on whether they find the service offered by the company meets their needs. We propose a common PC based on the percentage of consumers who agree the services offered by a company meets their need.

This would be an effective initial PC as it would track whether consumers believe that companies are designing and implementing inclusive services. We are considering tracking this in our annual Water Matters research. We believe that this question should be asked of all customers, as vulnerability can be transient as well as permanent. We would be keen to work with Ofwat to establish how this could be developed into a robust common PC.

***Q4: Do you agree with our proposed option for using common measures in our assessment of companies' approaches to addressing vulnerability in their business plans?***

A suite of common measures would be useful to compare performance in addressing vulnerability. In addition to these measures we would like to see inclusion of both

common and bespoke PCs to encourage companies to strive to deliver better assistance for their customers (as set out in our answer to question 3).

We do have some concerns regarding the proposed common measures in the draft methodology:

- Regarding *‘reporting on the proportion of eligible customers receiving support through vulnerability assistance options’*:

In order to establish eligibility, companies would need to be told by the consumer, their representative or via ‘explicit consent’ data share from other organisations. It is therefore most probable that companies will experience difficulties in establishing eligibility and it will be difficult to gain evidence that the information given on eligibility is robust.

- Regarding *‘number of customers contacted by the company about eligibility for vulnerability assistance options’*:

If companies send out a priority services leaflet with the annual bill then all customers will be contacted about eligibility but it does not measure if they have read and understood the information. Support should be carefully targeted and this proposal as it stands could drive the opposite behaviour.

We consider qualitative measures would be more effective. In order to capture customer views on whether they find company services accessible and whether they are aware of additional help available, we propose that the following common measures would be more effective:

- The percentage of consumers aware of the additional help available. This would track how successful companies’ have been in engaging effectively with consumers. Rather than measure a company on whether it has informed a consumer, it is more beneficial to measure the effectiveness of that information by measuring awareness e.g. was the message received and understood by the consumer. We already track this in our annual Water Matters research.
- The percentage of consumers satisfied that their company’s services are easy to access. This would cover all consumers and track whether they believe that companies are designing and implementing inclusive services. We are also considering tracking this in our annual Water Matters research.
- We are also tracking on an annual basis the number of consumers per 10,000 connections receiving non-financial vulnerability assistance (priority services). Whilst it is useful to compare take up in areas, it is also difficult to say for certain why some companies have lower take up than average. However, the distribution of needs is likely to be more evenly spread geographically than for affordability. As such we have adopted a frontier approach to this metric to drive improvements. We plan to continue to track and analyse for robustness.

We are keen to work with Ofwat to understand in more detail how these measures can be used in the assessment of companies' business plan proposals and subsequently to track progress on how vulnerability is being addressed.

## Delivering outcomes for customers (Chapter 4)

### Key points

#### We support:

- The principles for setting common Performance Commitments (PCs) and the benefits from greater comparability and more stretching performance targets this should deliver.
- Companies required to set bespoke PCs to complement the common PCs, to reflect evidence of local customers' expectations, risks to service delivery and the environment or other issues.
- The 'D-MeX' PC and ODI to encourage improvements in the way companies serve and respond to the needs of developers.

#### We have concerns about:

- The greater range of financial rewards and penalties from ODIs. While we understand the regulatory rationale for ODIs as a way of driving better outcomes, evidence from the 2014 price review shows that many customers do not accept the concept of paying rewards in return for what they see as companies' 'day job'. This carries a risk of a negative customer reaction, particularly if ODI rewards drive future bills and customers cannot see any benefits in return. This could damage customers' trust and confidence in the sector. We offer suggestions to mitigate this risk below.

#### We would like to see in the final methodology:

- Evidence to confirm the common PCs Ofwat propose do reflect areas of service that customers view as priorities. Ofwat will need to show that any financial rewards achieved for meeting or exceeding PCs relate to tangible service improvements that customers accept and are happy to pay higher bills for.
- We would like to see the common measures of customer affordability and vulnerability suggested in our response to Chapter 3 included in the list of common PCs.
- Separate 'C-MeX' PCs and incentives for:
  - Customer satisfaction with customer contact handling alongside complaint handling performance ('C-MeX contacts'); and
  - Customer satisfaction with value for money, alongside Net Promoter Score ('C-MeX satisfaction'). Customers' opinions of the value for

money of services they receive can act as a more rounded measure of customers' views, as shown by our research<sup>4</sup>.

- Most or all of the value of financial ODIs applied to the C-MeX measures and incentives we propose, to drive companies to increase customer service and value for money, thus increasing customers' trust and confidence in the sector (a key Ofwat objective). This would encourage:
  - A focus on customers and customer segmentation similar to how companies may act in a competitive market; and
  - An additional incentive for companies to collect any rewards over time in a way that does not damage customer perception.
- Within the 'C-MeX contacts' ODI, the measure of complaints should have a financial penalty to help prevent a deterioration in complaint handling performance.
- Resilience based PCs with measures that reflect both actual service failures and current and future risks.
- Given customer concerns with financial incentives, Ofwat should reconsider its approach to setting incentive targets. If it were to proceed with service related incentives, it should as a minimum pursue a more dynamic approach to setting PC targets at 'upper quartile' and 'frontier' levels, with targets adjusted over time. This would:
  - Help ensure performance targets are genuinely stretching;
  - Ensure rewards are only achieved for significant service improvements;
  - Disincentivise companies from being average or 'static', thus driving continual improvement; and
  - Mitigate the risk of easy to achieve targets and a possible negative reaction by customers to ODI driven bill increases.
- The continued use of caps and collars as a form of protection against unlimited rewards or penalties.
- The C-MeX measure applied to non-household customer satisfaction in Wales.

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<sup>4</sup> Value For Money - A Report on the Drivers of Satisfaction in the Water and Sewerage Industry (Creative Research, 2013. <https://www.ccwater.org.uk/research/value-for-money-a-report-on-drivers-of-satisfaction-in-the-water-and-sewerage-industry-2/>)



## ***Q1 Do you agree with our proposals for common and bespoke Performance Commitments?***

We agree with:

- The eight principles for setting common PCs set out in the methodology.
- The proposed 14 common PCs as they reflect sufficient breadth across customer experience and service levels.
- The inclusion of resilience and asset health measures within the common 14 PCs, as this introduces the consideration of ‘risk’ as well as serviceability.

The proposed common PCs also leave sufficient flexibility for companies to develop bespoke PCs to reflect local customer priorities.

The 14 common PCs cover areas which have historically been of concern to customers. However, there is an opportunity ahead of the final methodology for Ofwat to gather evidence to confirm that the proposed measures and the ambition for improvement:

- Are supported by customers; and
- Accurately reflect customers’ priorities going forward, and that the scale of required improvement and its consequential costs (including the potential financial rewards) are supported by customers.

We welcome the work undertaken to agree consistent definitions for measuring performance. This will make comparative assessments less complex and more accessible for stakeholders, customers and customer representatives. If the measures are to form the basis of a comparative ‘league table’ they must be meaningful and non-technical for customers.

### **Customer vulnerability and affordability**

As shown in our response to Chapter 3 (affordability and vulnerability), a combination of common and bespoke PCs should be used to track and compare how companies are addressing customer vulnerability and affordability issues.

Common PCs should be based on customers’ view of the affordability of their water bill, and measuring customer awareness of, and satisfaction with, the vulnerability assistance that is available. These should be supplemented with bespoke PCs as the local situation of each company needs to be considered. Companies must be required to include bespoke PCs to reflect the local profile of affordability and vulnerability in their areas.

These PCs should be reputational only so that companies do not profit financially through assisting those customers who are in vulnerable circumstances or who have affordability issues.

## Defining Performance Commitments

Common PCs with consistent definitions allow for comparison and will assist CCGs during the development of individual companies' plans during the rest of the PR19 process.

It is vital that both common and bespoke PCs are transparent and we agree with Ofwat's principles for PC definitions (clear, unambiguous, complete and concise).

Companies will need to clearly demonstrate that their proposed bespoke PCs reflect the priorities of, and are supported by, their customers. We welcome Ofwat's call for a step change in customer engagement at PR19 to provide evidence of acceptability for companies' proposed PCs.

We welcome the removal of the Abstraction Incentive Mechanism (AIM) from the list of proposed common PCs, as this is more suited to bespoke PCs linked to individual company areas.

## Common resilience PCs

The introduction of two new resilience measures to reflect the Cabinet Office's four aspects of resilience misses the original intent of the Cabinet Office's work.

Their 2011 document '*Keeping the Country Running*'<sup>5</sup> states that, "*the contribution made by each of these four components needs to be considered*". Crucially, it doesn't say that all four components need to be implemented, only considered, with the best mix of interventions chosen to reflect the risks faced.

Having common PCs that reflect the four components implies that all four should be done. This could result in misplaced resilience investments where companies believe that it is somehow compulsory to have all four resilience components delivered.

We think it is sensible to include leading as well as lagging indicators of resilience that will include risk of failure as well as actual system failures.

It is important that companies are not rewarded for just providing the level of service that customers have already paid for. Customers must not be exposed to the risk of paying twice for improved service.

## Asset Health PCs

We understand the reasoning behind the proposal to have four common PCs for asset health, supplemented by bespoke PCs. While these are not measuring a specific outcome for customers and the environment, we agree that it is legitimate to include some 'output' measures that act as leading indicators for outcomes that customers care about, such as interruptions or sewer flooding.

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<sup>5</sup> 'Keeping the Country Running: Natural Hazards and Infrastructure' (Cabinet Office, 2011)  
<https://www.gov.uk/government/publications/keeping-the-country-running-natural-hazards-and-infrastructure>

We think that a better explanation of asset health measures is needed to ensure customers can make that link between the measure and the outcome that ultimately affects them.

There is a risk that emphasis on the four common asset health PCs could give an imprecise view of the overall health of a company's assets and this may lead to a false sense of security over the longer term. Therefore, we welcome the expectations set out in the draft methodology, for companies and CCGs, when considering and agreeing bespoke PCs.

We support the proposal to not allow aggregation of asset health measures. It is important that customers and stakeholders have a clear picture of the health of all assets and that companies are not incentivised to offset poor performance in one area with good performance in another.

For similar reasons we also consider that PCs and associated ODIs should stand alone and not be dependent on achieving any gating performance measure.

### **Leakage PC**

We support Ofwat's proposals to set challenging performance levels for leakage. Historically leakage has been a common concern for customers and, if and when water becomes scarcer in the future, this concern will increase. We would want to see, however, clear evidence that customers support the proposed targets given the relative costs and benefits of leakage reduction.

### ***Q2 Do you agree with our proposals on setting Performance Commitment levels?***

Companies' PC levels must be appropriately stretching. Our research (and that of several companies) at PR14 revealed that many customers do not support the concept of paying financial rewards for service delivery they consider to be the 'day job'. Therefore, if rewards for service outperformance are to be justified, they must be acceptable to customers if Ofwat is to pursue its proposed ODI regime.

As a minimum, rewards should only be given for exceptional performance in areas of service which customers' value or view as a priority.

Stretching PC targets should also challenge companies to improve service performance and resilience, for current and future customers, and for the environment. They should also help improve efficiency in service provision when linked to cost assessment tests.

We agree that companies should be able to take account of their particular circumstances, including any customer engagement, when setting PC targets, while providing CCGs, customers and other stakeholders with the tools to challenge the degree of stretch in the proposed PCs. Companies should validate their PC levels through a number of approaches and provide evidence that they have done so.

We welcome Ofwat's intention to scrutinise companies' forecasts of initial service levels for 2019-20 following the experience of PR14. This will help ensure targets for 2020-25 are genuinely stretching for companies.

We support Ofwat's expectation that companies should propose performance levels to achieve at least the upper quartile forecast in 2024-25 for common PCs covering;

- Water quality compliance;
- Water supply interruptions;
- Internal sewer flooding; and
- Pollution incidents.

It is unclear how the 'frontier' and 'upper quartile' thresholds will be set for the new measures that are only just being introduced, and we would welcome clarity from Ofwat on this.

We recognise that gauging exceptional performance for bespoke PCs will be harder, without the benefit of the comparators available for the common PCs, but companies will need to justify the level of performance when setting their bespoke PCs.

### Setting dynamic PC targets

PCs should be set to encourage continuing improvement, particularly if Ofwat proposes that companies benefit financially, despite customers' concerns. Ofwat would need to consider the use of dynamic targets that can vary through the price control period as a way of driving continuous improvement.

Dynamic targets can be fine tuned and linked more directly to actual levels of performance that companies report, making them more relevant and consistently stretching. This would mean that the 'frontier' and 'upper quartile' thresholds would gradually increase over time, pressing companies to continually improve in order to achieve a reward. Companies that remain static or average compared to others would then risk incurring a penalty. Dynamic target setting would be more akin to how a competitive market would see companies striving to improve performance.

Ofwat will need to be clear on when PC targets may be reviewed (for example, after two years, when there may be sufficient performance data available to enable this).

Under Ofwat's proposed regime, the majority of PCs would be subject to in-period financial ODIs. This would mean that it would be more appropriate to use annual data to measure success. This will ensure that, in time, rewards and penalties reflect more closely the performance which generated them.

Multi-year averaging should be used where there is good reason to do so due to external factors, such as weather, which may cause an unreasonable risk of volatility.

### ***Q3. Do you agree with our proposals for strengthening Outcome Delivery Incentives?***

Our research and research by some of the companies at PR14 shows customers have reservations about ODIs and may react negatively if ODI rewards are seen to increase bills in return for service improvements which customers view as the company's 'day job'. The risk of such a reaction increases if customers' bills are also affected by higher inflation.

If the revised ODI model Ofwat proposes is to deliver improvements customers would be willing to pay for (with the risk of a negative customer reaction mitigated), we think the framework for ODIs would need to be:

- Understandable and acceptable to customers, with rewards achieved only for substantially improved performance reflecting shifting frontier or upper quartile targets. This should take into account the companies' starting point and, therefore, the 'stretch' in performance they have made to reach upper quartile or frontier level.
- Set on the basis of the size of the reward correlated to the level of performance the company has reached. Similarly, if a company is already at the frontier (or upper quartile level) then they should only be rewarded for shifting that forward. If a company is not upper quartile, then the incentive should be there for them to improve.
- Strong enough to ensure company Boards and shareholders focus on improving performance for customers to achieve returns. This is why we propose applying all or most of the available value of the total ODI package to the two separate C-MeX ODIs we suggest below. This should encourage frontier shifting performance and promote innovation.

It is appropriate that an average company with average performance would expect to incur penalties rather than rewards on its ODI package. Companies will be incentivised to manage this risk by ensuring they deliver for customers, and this may help allay customers' concerns.

Our suggestion of a more dynamic approach to setting PC targets (and therefore the thresholds for financial rewards and penalties) would help ensure that rewards are only attained for genuinely stretching improvements.

We would also like to see companies engage with customers to ensure that the service improvement(s) they are receiving justifies the reward the company will apply to its revenue allowance.

We have a concern that companies may be biased towards PCs that carry a financial ODI and welcome Ofwat's proposal to strengthen the profile of reputational ODIs as this will help offset that risk. The greater use of consistent and comparable measures, notably in the proposed common PCs, will make performance more transparent to customers and media and so enhance the impact of reputational ODIs.

The majority of financial ODIs should be linked to revenue so rewards and penalties are closer to the performance which generates them than those linked to RCVs. This means that the burden on future customers of paying for the benefits enjoyed by today's customers is lower.

Ofwat's proposal that financial ODIs should be the default makes sense in this respect, but for some measures - particularly those relating to long-term PCs - the link to RCV may be justified.

While the use of in-period ODIs will avoid step changes in bill levels at future price reviews, they will potentially create bill uncertainty and volatility year to year.

Customers will also no longer know at the end of the Price Review what will happen to their bills over the next five years because of in-period ODIs. There is a danger that customers could be misled about future prices if ODI in period adjustments lead to significant bill increases.

It is important that any bill impacts for ODI rewards are acceptable to customers, and companies would need to explain to customers what they are receiving in return for the increase and that they are not simply being rewarded for doing the 'day job'.

Companies would also need to be challenged to spread or pace the collection of any rewards to help reduce the potential bill impact, especially if higher inflation on wholesale charges also drives annual bill increases. Our suggested 'C-MeX satisfaction' ODI may help encourage companies to do this as bill increases could have a negative reaction on customer satisfaction.

### ODI financial parameters

We have concerns about Ofwat's proposal to increase the strength of financial ODIs by removing the aggregate cap and collar and to provide an indicative range of  $\pm 1$  to  $\pm 3\%$  of RoRE.

This has the potential to create unexpectedly large bill increases, which could increase the risk of companies being biased towards delivery of those PCs attracting the greatest financial rewards.

Therefore, we consider the continuing use of caps and collars is appropriate and necessary to give customers protection against potentially unlimited rewards.

Furthermore, applying greater value of the ODI 'package' to the two C-MeX ODIs we suggest below would encourage companies to spread the collection for any rewards achieved, and ensure that rewards are only applied if there are tangible improvements in customer service and customers' 'view of the value for money of the services they receive.

The level of reward/penalty for ODIs must also be acceptable to customers. Companies must provide evidence of customer acceptability of paying a reward in return for a service improvement. We would like to see evidence that customers are satisfied with a tangible service improvement before a reward is added to allowed revenue.

Because customers are likely to have differing views on the value they place on PCs, the level of ODI reward/penalty should not be common but is best set individually by each company based on its engagement with its own customers and CCG.

Ofwat is proposing to encourage frontier shifting performance in the common PCs by introducing a scheme of enhanced reward/penalty for exceptional performance. To be effective we consider that the measure of exceptional performance must:

- Be at a level which is higher than the current performance level of the best performing company, and represent a stretching target for that company;
- Increase over time through the use of adjustable dynamic targets, if industry-wide performance improves and justifies a shift in the ‘frontier’ threshold; and
- Companies will need to provide evidence that an area of service is a priority for customers and that customers will accept the service improvement and subsequent reward.

Poor performing companies should be encouraged to improve above the enhanced penalty threshold. Setting the penalty threshold at the average performance level at the start of the price control period will incentivise all below average companies to improve. These companies should be expected to have an action plan to improve.

We agree with Ofwat that ‘trigger’ ODIs should be avoided. These will offer only a set target for service delivery and will not encourage continuing improvement above that level, which the ODI framework is overall looking to achieve.

#### ***Q4. Do you agree with our proposed Customer Measure of Experience (C-MeX)?***

We broadly support Ofwat’s proposal for a new measure to replace the Service Incentive Mechanism (SIM) with C-MeX. While the SIM has helped drive the right company behaviour and, in turn, reduce complaints and improve customer satisfaction from their contact with companies, C-MeX is an opportunity to resolve many of the concerns we have raised in the past about SIM<sup>6</sup>.

However, we think C-MeX could be improved further with a few significant changes:

- Two separate C-MeX ODIs to measure and incentivise:
  - Customer satisfaction with the value for money of the services customers receive, measured by surveys (‘C-MeX satisfaction’). This should carry a financial incentive, with a measure for Net Promoter Score alongside this as an additional reputational incentive.
  - Customer satisfaction with their contact with companies, along with a measure of the number of escalated complaints (‘C-MeX contacts’). This should be a financial incentive applied to the survey used to measure customer satisfaction with contacts, with a penalty applied to complaint handling to help prevent deterioration in companies’ performance.
- Applying all or most of the value of the full ODI financial reward/penalty range to the two C-MeX ODIs. This would lead to a greater focus on serving customers and increasing customers’ view of value for money in a way that would mimic how a competitive market operates. This could also help drive customers’ trust and

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<sup>6</sup> See CCWater’s response to Ofwat’s Water 2020 consultation on the proposed outcomes framework (January 2017) <https://www.ccwater.org.uk/wp-content/uploads/2013/12/CCWater-response-to-Ofwats-consultation-on-the-outcomes-framework-for-PR19.pdf>

confidence in the sector, and mitigate the risk of a potentially negative customer reaction if ODIs applied to other measures are seen to drive future bill increases.

We explore in more detail how our suggested C-MeX ODIs can work in the sections below.

### The case for two separate C-MeX ODIs

We believe the two separate ODIs will better incentivise companies, with contacts/complaints and wider customer satisfaction measured and incentivised separately for the following reasons:

- Appropriately strong financial rewards and penalties applied to each of the two C-MeX ODIs we propose will drive customer service improvements and customer satisfaction. While customers may have concerns about the application of ODI rewards for doing the 'day job', companies would be incentivised via the C-MeX satisfaction ODI to spread the collection of any rewards as sudden bill spikes could harm their performance against this measure.
- Despite the penalties of the existing SIM, some companies continue to lag behind the rest of the industry with their customer service, through poor survey scores and complaint numbers. In our 2016 complaints report, three companies reported significant increases in the number of written complaints, one of which (Dŵr Cymru) reported twice the number of the previous year. A strengthening of the incentive, through the introduction of the C-MeX contacts ODI, would help to address this.
- A customer perception survey and contact experience survey are different. Companies may focus on one of the measures and be satisfied with an average score rather than strive for excellence in both.

### How financial ODIs should apply to 'C-MeX contacts' and 'C-MeX satisfaction'

We propose that:

- The 'C-MeX satisfaction' ODI has financial rewards and penalties for the broader customer satisfaction survey, with Net Promoter (NPS) applied as an additional reputational incentive.
- The 'C-MeX contacts' ODI has financial rewards and penalties applied for performance against a high target for surveyed customer satisfaction with their contact with companies, alongside a (smaller) financial penalty based incentive for complaint handling.

We would like to see stronger financial incentives applied to C-MeX than Ofwat currently propose because the potential effect on retail costs (+/-12%) appears to be comparable to the incentive parameters for the current SIM and may not drive the step change in improvement C-MeX should aim to achieve.

While we raise concerns about the potential bill impact implied by the increase in the ODI financial threshold to an indicative +/- 3% of RoRE, the ODI package could deliver



better outcomes for customers (and much greater customer focus) if a larger percentage of the available incentives were applied to the two C-MeX ODIs we suggest.

These could act as self regulating incentives in that, while companies would be incentivised to deliver a range of improvements, they will also be incentivised to spread the bill impact and ensure rewards are acceptable to customers, due to the risk of a negative impact on customer satisfaction if they fail to do so.

We support the rewards and penalties being applied annually in the pricing period which removes the previous SIM gap years.

### **Why a penalty should be applied for poor complaint handling performance**

There should be no compromise on customer service and any argument that companies were improving based on customer satisfaction survey and NPS scores would have little credibility if complaints increased.

SIM has encouraged companies to work hard to avoid complaints and to resolve those received effectively first time. We do not want to see this incentive lost in any new measure, which is why we propose that a financial penalty should remain linked to complaint performance.

A penalty could apply if companies' performance falls under a defined threshold for dealing with complaints at Stage 2 or above (essentially covering all escalated complaints). This is because any new measure must continue to penalise companies financially that fail to resolve complaints effectively and encourage the avoidance of complaint escalation and the need for our investigations.

We note that Ofwat would prefer the measure of complaints to be a reputational incentive, because it considers that otherwise, concerns over consistency and companies' reluctance to communicate with customers would remain. We believe this issue can be addressed through the careful consideration and development of customer contact definitions (which we explore further below).

The reputational impact of poor complaint handling performance can complement the incentive to improve that a financial penalty would provide. Our annual complaints report generates significant interest from customers, the media and the industry and companies are aware of the reputational impact that poor performance can bring.

### **The use of Net Promoter Scores**

As shown above, we would prefer to see the inclusion of a Net Promoter Score (NPS) in our proposed 'C-MeX satisfaction' ODI as a measure to show how customers' views of water and wastewater services and price compare with other sectors.

NPS is a strong comparative tool that is easy to understand. If there is consistency in how it is measured, it will allow the water industry can benchmark itself against leading industries in customers' eyes.

Many companies have adopted NPS as a measure they use themselves, though we have observed significant differences in the NPS generated for the same company when it is measured through different survey tools with different sampling methodologies.

We would therefore encourage a nationally consistent approach to measuring the NPS in the C-MeX satisfaction ODI, conducted by the same method and administered by the same supplier. We agree with Ofwat's view that companies providing the information would risk inconsistency.

We believe NPS should be collected but used only as a reputational incentive, to complement the survey-based measures in 'C-MeX satisfaction'.

## Use of customer satisfaction surveys

### *C-MeX satisfaction*

We support the telephone survey (using available landline or mobile numbers) of customers who have not contacted their company to measure customers' views of their satisfaction with the value for money of the services they receive. We believe this is a strong measure because customers' opinion of the value for money of services they receive can act as a more rounded measure of customers' views, as shown by our research<sup>7</sup>.

This will encourage innovation and better customer communication from companies, and it should close the gap resulting from the existing SIM's focus on contacts only. Including all customers should also help improve the water industry's current standing in the Institute of Customer Service's UK Customer Satisfaction Index.

It also has the potential (due to the associated financial incentive applied to it) to drive companies to ensure that customers are not only finding the bill they pay acceptable, but recognise the value of the services they receive in return.

### *C-MeX contacts*

We agree the customer contact survey should continue and customer satisfaction should include both the handling of the contact and the resolution. However, to be fully inclusive, the survey should continue to be a telephone survey (both landline and mobile) rather than moving online or becoming a text-based survey.

Although more and more customers are using online services and text messaging, the survey should, for now, maintain a telephone approach or it would exclude customers who are not online or contactable by email. These are typically an older demographic and by being 'offline' they have a greater reliance on good telephone service as there is no scope to sense check information via the internet. While an online survey could reduce costs, this does not compensate for the exclusion of households where a valid email address is not available.

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<sup>7</sup> Value For Money - A Report on the Drivers of Satisfaction in the Water and Sewerage Industry (Creative Research, 2013. <https://www.ccwater.org.uk/research/value-for-money-a-report-on-drivers-of-satisfaction-in-the-water-and-sewerage-industry-2/>)

The survey sample should also be all contacts rather than resolved only as this is about the process, not just final resolution. Ofwat rightly points out the difficulties and potential inconsistencies when companies only provided resolved contact data. Customer views on resolution are often different to those of the companies.

The majority of contacts are usually enquiries resolved at point of contact, which means they are relatively straightforward contacts. It is important to include contacts which are more complex and take longer to resolve.

We would like to see the surveys conducted monthly as this would:

- Provide a bigger sample and fill a possible shortfall in customer satisfaction with resolution;
- Pick up any short-term customer service issues, as on some occasions a problem can come and go between SIM surveys; and
- As the current survey asks customers if their contact was a complaint, this will provide useful information to both support the complaint numbers provided by companies for the C-MeX complaints measure and encourage companies further to minimise complaints as these contacts bring lower levels of satisfaction.

We welcome the opportunity to work further with Ofwat on developing complaint definitions without disincentivising ‘good’ company contacts.

### Defining complaints in the ‘C-MeX contacts’ ODI

We welcome Ofwat’s proposal to work with companies and ourselves to develop complaint definitions, including complaints made through wider contact methods such as social media and webchat.

We have already begun discussions with the industry and Ofwat on including social media and webchat for our annual complaints report. It is important to have a joined-up approach with Ofwat and the industry on presenting this information consistently in our reporting and in the C-MeX measure.

For complaints data to accurately reflect company performance there is a requirement for a clear definition of what constitutes a complaint through all channels of communication. It is important that there are no contact or complaint types excluded. Data must give an accurate and true reflection of the industry performance.

Including telephone complaints rather than the current unwanted contacts measure will also be clearer for customers and may allow comparisons with some other sectors. Ensuring that the definition is clear should also help avoid inconsistent reporting.

With the various communication channels now available for customers, we consider the Ofwat proposal to ask companies to provide only a minimum of four is disappointing and not an ambitious target. Companies should be expected to offer customers all methods, including by visit, telephone, text, social media, post, email, and webform; and to be able to collect data on each method.

## Non-household customers in Wales

We think a form of C-MeX should be developed for non-household customers in Wales to help monitor non-household customer satisfaction. As competition is not extended to companies operating mainly or wholly in Wales, it is important to have a mechanism through which issues of concern to non-household customers can be monitored and companies challenged.

This could be a similar design model as the household C-MeX, though comparisons would be limited to companies in Wales only. We would be happy to discuss with Ofwat in more detail the elements of what such a measure should be. Our quarterly reports monitoring contact from non-household customers in Wales could be used as one of the sources of data to contribute to the measure. Our non-household customer satisfaction survey could also be considered to form part of such a measure, as previous surveys may provide a baseline for comparison.

### *Q5. Do you agree with our Developer Services Measure of Experience (D-MeX)?*

Yes, because the D-MeX measure targets an area of business that has historically been a cause of concern in terms of service delivery and satisfaction. D-MeX can act as a standalone measure, separate to the two C-MeX ODIs we propose in this response.

We agree with Ofwat's proposals to introduce a separate measure for developers through a customer survey. Only around 1% of complaints CCWater receives against companies each year are about developer service issues. This level of contact would get lost if it was included within the C-MeX measure or be disproportionate if it had an increased weighting.

## Securing long-term resilience (Chapter 5)

### Key points

We support:

- Ofwat's proposed principles for securing long-term resilience through the assessment of company business plans and supporting evidence. This should lead to the best value short-term and long-term solutions to address current and future risks.

We would like to see in the final methodology:

- The principle of using customer engagement in assessing companies' resilience proposals should include a requirement for companies to identify:
  - customers' expectations in the short term and long term; and
  - the potentially varied expectations and needs of different customer groups, especially vulnerable customers.
- Resilience presented in terms that are accessible for customers by focussing on what it means for them; this should lead to better customer engagement on this important topic.
- The tests for resilience proposals to include how clearly both current and future risks are understood and articulated. This will help prevent resources for resilience building from being misallocated between the present and the future.

### *Q1: Do you agree with our resilience planning principles?*

Yes. We agree that:

- The approach to resilience should broadly consider financial, corporate and operational resilience in the round. We note that this broad definition is difficult for customers to relate to intuitively. Research has shown that customers naturally think of resilience in terms of the ability to respond to, and recover from, shocks. We think that the current use of broad resilience terminology could detract from having high quality engagement with customers on the elements of resilience that directly affect them.
- The long-term resilience of the services customers receive should be a core principle in Ofwat's assessment of company proposals. Companies need to identify their customers' service expectations, in the context of short-term and long-term risks, so they can identify the right pace of delivery of service improvements at a cost customers will accept. We think that couching resilience in terms of service levels, rather than referring to the large number of threats and hazards that could have an impact on resilience, is the most effective way to engage with customers on this important topic.

We have the following suggestions to reinforce the specific principles:

- Principle 3 (customer engagement) should refer to engaging with customers on their expected levels of service in *the short term and long term*. We also think this principle would be improved by recognising the potentially varied expectations of different customer groups, especially vulnerable customers, which improved customer engagement may reveal.
- Principle 4 (broad consideration of intervention options) should refer to companies engaging with their stakeholders (including us and CCGs) on the options to manage resilience and how they plan to build resilience with third parties.

**Q2. Do you agree with our approach to assessing resilience in the initial assessment of business plans?**

Yes. We support the consideration of the best value solutions for customers in the short term and long term as a primary objective in the approach to this assessment.

While we agree that '*companies should consider whether and how resilience risks could be better managed across company boundaries at a regional/national level*', analysis of the costs and benefits of such proposals and how they will be taken forward are crucial.

In previous responses to Water 2020 consultations we have supported water companies working together to make best possible use of available and proposed new resources. We will expect to see companies undertaking meaningful engagement with their customers and stakeholders on their proposed strategy.

We would also like to see a requirement for companies to set out both their current and future level of risk in a clear and customer focussed manner. Sharing their understanding of the risks to delivering reliable water and sewerage services provides the context for engaging with customers on resilience. It also acts to help prevent companies from misallocating resources for resilience building between the present and the future.

## Wholesale controls (Chaper 6)

### Key points

#### We support:

- The proposed design of the wholesale price controls for network plus, and bio resources.

#### We would like to see in the final methodology:

- Greater clarity in general on the water resource price control. We are concerned that the complexity of the proposals could lead to inertia that prevents necessary investment to balance supply and demand.
- Further justification on the timing of the in-period adjustments in the water resource price control to address our concerns that it may dissuade companies from investing in new resources.

*Q1. Do you agree with our proposals for the form of control for network plus water and network plus wastewater as set out in the ‘wholesale controls’ chapter and Appendix 7, ‘Wholesale revenue incentives’?*

Yes. The design of the water and wastewater network plus controls is broadly similar to the five-year wholesale revenue controls set at PR14.

We welcome the commitment to deliver more transparency and efficiency in relation to the cost of developer services, within the scope of the network plus controls.

We also support the continuation of the Wholesale Revenue Forecast Incentive Mechanism for all wholesale controls, as a means of encouraging companies to more accurately forecast wholesale revenue.

### Thames Tideway Tunnel (TTT)

We support the proposed wholesale control for the TTT as a continuation of the arrangement from PR14, when Thames Water’s associated costs were subject to a specific control.

Clearly the bulk of the cost relates to the TTT’s costs (which are billed to Thames’ wastewater customers). We would like to see the combined costs of this project continuing to be transparent to all Thames’ wastewater customers.

*Q2. Do you agree with our proposals for water resources as set out in the ‘wholesale controls’ chapter and Appendix 5, ‘Water resources control’?*

The water resources revenue control (with its associated water trading incentives introduced at PR14) is very complex. There is a risk that this could lead to inertia by companies in addressing supply-demand balance issues and delivering the best value solutions for customers and the environment.

For example, we note that the water resources yield for each company will act as the capacity measure underpinning the revenue control, with an in-period adjustment made if a company enters a water trading agreement with another party, or a market entry elsewhere changes the water resource yield.

While this mechanism ensures customers are not paying a water resource wholesale charge that is disproportionate to the cost of supply, the timing of the in-period adjustment may dissuade companies from investing in new resources to benefit customers and the wider environment.

Ofwat notes that water trading is currently not at its 'optimum' level and wish to see more consideration of this by companies. However, water trading incentives should not disincentivise companies from making essential investment in water resources where this is the best value option for customers and the environment.

Ofwat requires companies with significant investment in new water resources after 2020 to propose risk-sharing arrangements to share market-wide utilisation risk with their customers. However, it is unclear what proportion of that risk will be carried (and paid for) by water customers in these circumstances and we would like to see further clarity on this.

***Q3. Do you agree with our proposals for access pricing for English water companies set out in the 'wholesale controls' chapter and Appendix 5, 'Water resources control'?***

We note that English water companies will need to submit proposed access prices for each water resource zone at PR19 based on average cost-based charges for network access and an equalisation payment to reflect the incumbent company's incremental water resource costs.

However, it is not clear how these access prices will be assessed by Ofwat. Access prices should protect customers from significant bill changes due to deaveraging, whilst fostering the market Ofwat would like to implement. We would welcome more clarity from Ofwat in the final methodology to show how it will ensure access prices will achieve this.

***Q4. Do you agree with the proposal for company bid assessment frameworks set out in Appendix 9, 'Company bid assessment frameworks: the principles'?***

We support the bid assessment framework for third parties that are interested in the market. This will create more clarity and confidence. We question why information about the water resource bid assessment is not included in the information requirements for water resources (there is a requirement for information on bids for bio-resources, but not for water).

We support the use of market information requirements to be collected and published by companies to provide transparency for potential new entrants.

***Q5. Do you agree with our proposals for the form of control for bio resources as set out in the 'wholesale control' chapter and Appendix 6, 'bio resources control'?***



We broadly agree with the proposed design of the bio resources revenue control, and agree with the proposals to enable greater collaboration between incumbent companies and other stakeholders who may enter this new market, as this may lead to greater efficiencies that customers will benefit from.

## Direct procurement (DPC) (Chapter 7)

### Key points

#### We support:

- The principle of companies procuring appointed providers to deliver larger schemes, where this is proven to be a more cost-effective option than delivering these schemes 'in house'.

#### We would like to see in the final methodology:

- A strengthening of the safeguards to ensure that customers are protected, and will not have to financially 'bail out' any appointed provider that fails to deliver the scheme to the required standard or 'goes bust'. Incumbent companies should be responsible for the providers' customer service performance and any complaints it generates.
- A raising of the £100 million whole life cost threshold for projects. The current threshold could potentially lead to a large number of projects falling under DPC. As this is untested in the water sector (with the exception of the Thames Tideway) we believe this may present an unacceptable level of risk to customers.

*Q1. Do you agree with our draft guidance that appointees should focus on projects likely to deliver the greatest customer value for DPC at PR19? (We ask that appointees provide a list and description of which projects, based on our guidance, they consider would be in scope at PR19.)*

We support the principle of companies considering a DPC model on suitable projects where the competitive nature of the tender process is likely to deliver cost savings for customers and avoids passing risks to customers of financing or service failures.

However, the £100 million threshold for DPC may cover many schemes and introducing DPC for a large number of projects could present an unacceptable level of risk to customers. We would advocate a much higher threshold being used initially.

In addition, the benefits delivered to customers from this approach are not clear at this point. Using a higher threshold would allow evidence to be gathered in 2020-25 from a limited amount of projects which would help inform a decision on whether the approach should apply to more projects in the future.

We understand that an incumbent company will have to run the direct procurement exercise and will be excluded from bidding themselves. However, if it is more cost effective for the scheme to be delivered 'in house', then consideration of this option should be included in the process.

Our underlying concern is that this approach could lead to a lot of additional effort for companies with very little reward for customers. This additional effort could detract from companies focussing on more material consumer issues.

**Q2. What are your views on the type of tender model (i.e. an early or late tender model) appointees should use? Do you have any views on whether or not we need to specify a tender model companies should use?**

We do not believe that it is necessary for Ofwat to specify a particular tender model as it is likely that different projects will lend themselves to using different models. Specifying a particular model (such as the early tender) might also prevent companies from utilising the DPC model for projects that require delivery early in the Asset Management Plan (AMP) period.

Companies will need to demonstrate that the chosen tender model is the most efficient model available. We expect Ofwat to robustly challenge the company to show that its decision making process has delivered the best outcome for its customers.

**Q3. What are your views on the overall commercial and regulatory model, including our draft procurement and contract principles set out in appendix 10, 'Direct procurement for customers'?**

We welcome Ofwat's acknowledgement that it needs to play a role to protect customers from the costs of a failed tender process or inefficient allocation of risk. The Step-in clause that Ofwat mentions should be expanded upon to cover issues that may emerge during construction or operation of the asset.

Safeguards should also be built into any contract to prevent customers from being asked to bail out any failed project or to suffer any degradation of service. Effectively, the regulated incumbent company should carry the risk, not customers.

The incumbent company should also be responsible for the appointee's compliance with relevant standards, customer service performance, communication and any complaints that are raised by customers.

The incumbent company should also be responsible for the appointee's compliance with relevant standards, customer service performance, communication and any complaints that are raised by customers.

## Retail controls (Chapter 8)

### Key points

#### We support:

- The continued use of a weighted average revenue control for household and non-household retail, using a more dynamic method to move the cost assumptions within these retail controls to frontier efficiency.
- The proposed review of retail price controls in period, as this may reveal actual performance and cost efficiencies that can 're-set' the 2020-25 retail controls to further benefit customers.

#### We would like to see in the final methodology:

- Ofwat continuing to regulate non-household retail prices and service in Wales, using cost efficient benchmarks based on costs in the non-household retail market in England to help ensure customers in Wales receive services and prices that are at least equivalent to the better performing retailers in England.

*Q1. Do you agree with using a weighted average revenue control, where appropriate taking account of different costs by customer type for the residential retail price controls for English and Welsh water companies?*

We welcome the proposal to continue to use a weighted average revenue control where the data shows that there are different costs for the five different customer types identified in the consultation document.

*Q2. Do you agree with using an average revenue control for business retail price controls for Welsh companies not subject to competition?*

*Q3. Do you support price controls for water service customers of Welsh companies using more than 50 megalitres a year?*

To answer both questions, we think Ofwat should continue to regulate non-household retail prices and service in Wales, regardless of customers' level of consumption. We support the use of cost efficiency benchmarks, from the non-household retail market in England, as the basis for this. It is important that price controls are set in a way that prevents significant bill impacts for non-household customers.

Non-household customers in Wales should also get service performance which is at least comparable to the better (retail and wholesale) performers in England. Non-household customers in Wales (ineligible to switch supplier) may also have different priorities or expectations than those in England.

Water companies need to continue to engage with non-household customers in Wales to ensure their issues are not neglected. We expect companies to research non-household customers' views on services and charges to identify any billing related issues that they face.

***Q4. Do you support price controls for business retail activities for English water companies that have not exited the business retail market?***

Yes, it is important to ensure that customers of the non-exited companies are afforded the same backstop protections as those included within the Retail Exit Code.

***Q5. Do you support a three-year price control for residential retail activities and business retail activities?***

Yes, we consider that it is appropriate for Ofwat to revisit the price control after three years in order to consider the evidence available from the non-household retail market. Customers should benefit from new information as soon as is practical.

## Securing cost efficiency (Chapter 9)

### Key points

#### We support:

- Ofwat's proposed approach to totex cost assessments and benchmarking to identify and apply further efficiencies to benefit customers. Companies should be no longer allowed a glide path to required levels of cost efficiency, particularly as inefficient companies will have had the 2015-20 period to catch up.
- The use of historical and forecast cost benchmarking to set more challenging efficiency baselines.
- The new simplified totex efficiency benefit sharing mechanism.

#### We have concerns with:

- The potential customer bill impacts of cost allowances given for National Environment Programme schemes that may not be fully identified and costed at Final Determinations. We would not like to see customers pay an excessive cost for a scheme that may be smaller than envisaged at the time costs are set.

#### We would like to see in the final methodology:

- Ofwat only allowing special cost factor adjustments for well evidenced, exceptional and unavoidable costs.

### *Q1. Do you agree with our overall approach to cost assessment?*

Yes. We agree with the move to the totex approach to wholesale costs introduced at PR14, coupled with the additional information on costs companies can provide under the various wholesale controls. This should enable a step change in cost efficiency that will deliver greater value for money for customers.

In response to earlier Water 2020 consultations, we suggested a combination of historical and forecast cost benchmarking to set more challenging frontier efficiency baselines, so we welcome Ofwat's development of this approach in the draft methodology.

We note that Ofwat will also look at using relevant benchmarks from other comparable sectors in this process, and that the approach will be different for assessing enhancement totex (as less data is available for less 'routine' expenditure), but note that the dual historical / forecast approach will still apply.

At PR14, much of the consideration of business plans in CCGs during the later stages of the process was dominated by debates about modelling of efficient costs, with

companies developing their own models which were different to Ofwat's<sup>8</sup>. It may be beneficial for Ofwat to publish its totex models at PR19 help avoid this situation occurring again.

We also support the proposed efficiency tests that will apply to business plans, and the disincentive for companies to submit poorly evidenced special cost factor claims, especially as cost proposals can be adjusted downwards if evidence supports this. The disincentive for poor 'special cost factor' claims should help CCGs and Ofwat avoid having to challenge such cases.

***Q2. Do you agree with our proposed cost sharing incentive?***

Yes. We welcome the simplification of the cost sharing incentive. The proposed approach is more flexible and should encourage companies to propose greater cost efficiencies that will help deliver greater value for money for customers.

We support the principle of allowing companies a greater share of outperformance for achieving more ambitious cost efficiencies, as customers should benefit from the lower cost to deliver services that this implies. The asymmetric approach (in that companies carry a greater share of the penalty for underperforming) is a stronger disincentive to poor performance.

***Q3. Do you agree with our proposals to funding unconfirmed environmental requirements? Which of the two options do you consider is more appropriate and why?***

We note that some parts of the National Environment Programme (NEP) relating to Water Framework Directive (WFD) requirements may not be confirmed until December 2021. Ideally we would prefer companies not to have a cost allowance for this, if there is justification to either postpone the schemes or receive a cost adjustment at the 2024 Price Review.

However, these elements of the NEP may be significant for some companies. In this case, we think it is a sensible proposal to allow an efficient cost allowance based on a forecast, and then these assumed costs are either added to or reduced depending on the size of the programme when the actual cost is known. We would not like to see customers pay an excessive cost for a scheme that may be smaller than envisaged at the time costs are set.

***Q4. Do you agree with our approach to cost adjustment and our proposed approach to make the process more symmetric?***

We welcome this approach, which is consistent with the Competition and Markets Authority's (CMA's) suggestion in 2015 following the review of Bristol Water's appeal of its PR14 final determination. This means that Ofwat can adjust proposed expenditure downwards or upwards if benchmarking or other evidence shows there is justification for

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<sup>8</sup> The Competition and Markets Authority (CMA) also used a different model to Ofwat in its review of Bristol Water's appeal against its PR14 Final Determination.

this. Ofwat should only allow upward adjustments for well evidenced, exceptional and unavoidable costs

***Q5. Do you agree with our proposed approach for assessing retail (residential and business) costs at PR19?***

We said, in responses to the PR14 draft methodology, that there should be a gradual move toward setting retail price controls on ‘most efficient cost to serve’ in the future. We are therefore supportive of Ofwat’s aim of setting efficient baselines using econometric baselines.

Ofwat should only allow adjustments for well-evidenced, exceptional and unavoidable costs. Companies should not be allowed a glide path - particularly as inefficient companies will have had the five-year AMP6 period to catch up.

***Q6. Do you agree with our preferred approach not to index the retail controls for a measure of general inflation and if appropriate, deal with input price pressure as part of our totex allowance?***

We agree as we have not seen evidence that retail input costs are affected by inflation to the degree that wholesale costs are.

***Q7. Do you agree with our proposal for the transition programme?***

Yes, as the focus on outcomes introduced at PR14 should encourage longer term planning. If it is demonstrably more efficient and there are benefits for customers for companies to bring forward post 2025 investment into 2020-25, then this should be allowed.



## Aligning risk and return (Chapter 10)

### Key points

We support:

- Ofwat's signal that companies will be set a lower assumed cost of capital, given companies' outperformance of earlier cost of capital assumptions at customers' expense.
- The application of CPIH as an inflation index on wholesale charges and 50% of Regulated Capital Values (RCVs) from 2020.

We would like to see in the final methodology:

- A deferment of the proposed index link for the cost of new debt. We have concerns that there is likely to be a potential customer bill impact from the index linking of new debt financing at a time when the cost of borrowing (currently at a very low level) may only increase in the short to medium term.

*Q1. Do you agree with our proposed approach to setting the cost of equity, based on the best estimate of expected returns in the 2020-25 period?*

We broadly agree with Ofwat's approach to setting the cost of equity within the WACC for 2020-25, and welcome the indication that there will be a lower cost of capital assumption at PR19 when the methodology is finalised in December 2017.

It is important that the WACC enables companies to finance their functions and offers investors a reasonable return, but avoids the level of outperformance seen at earlier price controls. This saw customers pay more than they should have<sup>9</sup>, and has a negative effect on customers' trust and confidence in the sector and how it's regulated.

The CAPM methodology for setting the WACC is familiar and well established to the sector and its investors and should provide a degree of stability. We would like Ofwat to consider the level of risk incorporated into the equity betas as our analysis of earlier price reviews shows that, for a largely monopoly sector, the level of risk was over estimated at earlier reviews. This risk should be lower at PR19 given that the indexation of the cost of new debt passes an element of risk onto customers.

With the availability of other incentives for companies such as ODIs and the totex efficiency sharing mechanism, it is important that, to achieve returns, companies should be looking to improve service performance, increase customer satisfaction, and become more totex efficient, as well as be efficiently financed.

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<sup>9</sup> As highlighted in the 2015 reports on the economic regulation of the water sector by the Public Accounts Committee (January 2016) and the National Audit Office (October 2015). Analysis of the share performance of the listed water companies since privatisation in 1989 shows that returns to shareholders have broadly been higher than the market average (measured by the FTSE Share Index).

We support the continuing use of a notional financial structure rather than a company specific one, to avoid customers paying a WACC based on a comparatively inefficient company structure, or for previous errors by company Boards or management.

Customers should not be expected to 'bail out' a highly geared company if a company's decision to be structured in this way proves to be unsustainable. We expect Ofwat to address this risk by forcing such companies to refinance to protect customers, if it is shown that a company's preferred structure carries an unsustainable risk.

***Q2. Do you agree with our approach to index linking the cost of new debt?***

We have concerns about this mechanism being introduced at a point when interest rates are at a historic low.

Index linking the cost of new debt will remove some risk for companies and this should be reflected in a lower overall cost of capital. However, this involves estimating just how much this risk is worth. History has shown that estimating the cost of capital is difficult and to date Ofwat's track record in setting this value has consistently favoured companies, as shown by evidence of the gains from lower than assumed financing costs since PR09.

With an index linked cost of new debt, increases in the cost of debt within the period would ultimately be borne by consumers. With interest rates currently very low, and an expectation that they will increase, this is a real risk for consumers. Coupled with higher inflation applied to wholesale charges, could be a 'double whammy' for customers.

***Q3. Do you agree with our proposal to index price controls to CPIH?***

Yes. We note that the Office of National Statistics has recommended a move away from RPI for UK regulators. We consider the 50-50 application of CPIH to the company Regulatory Capital Values (RCVs) to be a pragmatic approach for 2020-25, as companies will still have a significant level of RPI linked embedded debt during this period.

***Q4. Do you agree with our proposal for setting tax allowances for PR19 including a proposed true up mechanism?***

We agree with the principle of an adjustment, but note that it will work two ways. Customers may benefit if a company has lower tax commitments than forecast, but may pay more if a company's tax liabilities increase.

This mechanism should incentivise companies to handle their tax affairs efficiently. We note that Ofwat will calculate tax allowances on the basis of a company's actual gearing. This will ensure that customers, rather than investors, benefit from a higher tax shield from interest payments. This means if a company wanted to increase gearing, customers will receive the tax benefits. We welcome this initiative.

## Financeability (Chapter 11)

### Key points

We would like to see in the final methodology:

- Evidence of customers' short-term and long-term acceptability used as a factor in assessing the balance of short-term and long-term cost recovery when setting 'Pay As You Go' (PAYG) ratios. Companies should not have a ratio that increases short term revenue to 'compensate' for a lower WACC.
- Customers should not be disadvantaged under the PAYG model, so Ofwat should 'true up' the ratios set at PR14 if evidence shows that companies used the ratios for their financial benefit to the detriment of customers.
- Small company premiums are allowed only where there is evidence of a financing constraint, and that the value of what the small company will deliver for customers at least equals the value of the premium.

### *Q1. Do you agree with our overall approach to assessing financeability?*

We broadly agree with Ofwat's preferred approach but have some concerns about how it will be applied.

The principle of applying tests to ensure companies can finance their commitments to customers in the short term and long term is one we support. We consider that companies' evidence of customers' short-term and long-term acceptability should be a strong factor in the analysis Ofwat will undertake in assessing financeability in line with this principle.

The PAYG ratio is the lever for establishing short-term and long-term totex recovery (from revenues and RCV run off). We support the principle of the PAYG ratio but would not like to see it being used as a lever to compensate for a lower WACC.

The PAYG ratio should reflect the balance of opex/capex (i.e. how the business is operating) and should be influenced by customers' view of the trade off between the long/short term pace of delivering improvements and associated spreading of costs/bill impact. Therefore we support Ofwat in placing customer evidence as a central part of the 'test' for assessing a company's PAYG ratio proposal.

Ofwat should also ensure that the PAYG ratios set at PR14 achieved the right balance of short/long term cost recovery. If evidence shows that customers may have been paying too much in the short term since PR14, customers should receive an adjustment to compensate for this at PR19.

We note that Ofwat proposes to use the same assessment for Small Company Premium WACC as used at PR14. Small company premiums should only apply where:

- A company has clear evidence of a financing constraint to justify an additional small premium; and

- Where the value of what customers will receive from the delivery of an efficient plan outweighs the additional premium on the WACC.

***Q2. Do you agree the calculation of the metrics at set out in section 11.5 of the 'Aligning Risk and Return: Financeability' chapter that we are proposing to use in our assessment?***

Yes, because the metrics Ofwat sets out are consistent with the common approaches used in financial markets.

## Accounting for past delivery (Chapter 12)

### Key points

In the final methodology, we would like to see:

- The customer contact survey element of C-MeX used as a proxy for SIM in 2019-20, as SIM 'scores' will not be available for this year at the risk based review of business plans.
- Companies required to produce a transparent, accessible version of their plans, so customers can see what companies will deliver.

*Q1 Do you agree with our proposed approach for dealing with PR14 reconciliations and SIM? If not, please explain your alternative approach and why this would be in customers' interests.*

We believe that the contact survey element proposed for C-MeX should be used as a proxy for SIM in 2019-20, before the C-MeX measures are introduced fully from 2020. It is important that companies that have reputational incentives based on SIM maintain their focus on these areas. Abandoning the incentive for the final year of PR14 would not send the right message about the continuing importance of focussing on complaints performance and customer satisfaction.

We welcome the continuation of the flexibility that allows companies to apply revenue adjustments either in the first year or spread over a number of years. Customers should be engaged in this decision as part of the business planning process and we would expect companies to make clear the impact that different options will have on bills.

*Q2. Do you agree with our proposed approach for reflecting how well the company is delivering for customers over the 2015-20 period in the initial assessment of business plans? If not, please explain your alternative approach and why this would be in customers' interests.*

Yes, as we argued at PR14 that that an assessment should be made that reflects how effectively the company has delivered its previous commitments, and importantly, that it has communicated its performance to its customers.

The company's 2015-20 performance is also an indication of how achievable its plans for PR19 are likely to be. We would expect Ofwat to give greater scrutiny to a company's plans where its past performance indicates that its plans are likely to be unrealistic or unachievable.

We suggest that a far more substantial initial assessment is applied for companies that were awarded 'enhanced' status of their plan at PR14 but have not subsequently delivered their commitments, especially as customers would have paid a reward for the company achieving this status.

## Securing confidence and assurance (Chapter 13)

### Key point:

- Business plans should form part of an on going customer engagement programme and we would like to see companies set out how they intend them to be used in this context.

*Q1. Are the business plan and data requirements clear and sufficiently specified?*

*Q1a. Are there any areas we need to look at again?*

*Q1b. Is there any data missing, or included but not required?*

*Q2. Do you agree that our approach to assessing assurance can provide us and stakeholders with confidence in the companies' business plans?*

In answer to all four questions, we welcome the requirement for companies to include a clear narrative in their business plans that signposts readers to specific information. It is important that companies' plans are clear and accessible, especially for customers since it is their bills and services that will be affected.

Companies should see their business plans as part of their on-going customer engagement process, and in this context, we would like to see Ofwat encouraging companies to publish plain English version of their plans for customers and stakeholders to easily access. We would like to see companies find accessible and engaging ways to communicate their business plans with their customers, and would welcome companies explaining in their plans (and engaging with their CCGs) on how they intend to do this.

While we can see advantages from Ofwat requiring early information on companies' cost adjustment claims, we would like Ofwat to take steps to ensure that business plans do not become fragmented due to this phasing of data submissions. It is essential that the whole plan is tested with customers, as opposed to a series of smaller parts, to ensure that it meets their overall costs and service expectations.

## The initial assessment of business plans (Chapter 14)

### Key points:

#### We support:

- The nine key tests and business plan categories Ofwat propose.
- The consideration of companies' past performance as part of the evidence used in the nine tests.

#### We would like to see in the final methodology:

- Confirmation that customer evidence will be taken in account in all of the key tests, not just the ones that more directly relate to customer engagement.
- Ofwat acknowledge that companies' research to test the customer acceptability of the plan is taken into account in these tests, particularly how companies should have identified and addressed the concerns of customers who find the plan unacceptable. We believe customer acceptability is a key success measure of the price review and therefore this should be reflected in the tests for each company's plan.
- A test of business plan characteristics that is in line with our proposed improvements to customer engagement, PC setting, incentives and costs set out in this response.

### *Q1. Do you agree with our proposed approach to the initial assessment of business plans?*

We think the one-shot process proposed for the initial assessment is a positive step as it encourages companies to take greater ownership and responsibility for their plans. We agree that the starting point of the assessment is that all plans are subject to 'significant scrutiny' until evidence emerges through the assessment that justifies a different approach.

### *Q1a: In terms of the nine test areas?*

Although customers are clearly part of the first three test areas, we would like to see Ofwat ensuring that the views of customers are taken into account in all the test areas. The approach could be as straightforward as seeking evidence of how the interests of consumers are being considered within each test area.

Ofwat should also take account of companies' past performance, as well as their business plan proposals (and supporting evidence) as part of the tests.

Additionally, as companies should test their business plan package of price, outcomes, Performance Commitments and incentives for customer acceptability, Ofwat should also use this evidence when testing plans. The acceptability testing may be relevant to many of the nine tests because companies should identify and address the reasons given by

customers who find the plan unacceptable. These reasons may relate to some of the issues covered in the nine tests.

Earlier in this this response, we have made proposals for how Ofwat should improve the tests applied to assessing company business plans:

- Engaging customers. Our comments in Chapter 2 explore how customer engagement on short-term and long-term issues (and how different engagement techniques should be used and triangulated) can help achieve a greater level of customer influence in the outcomes companies propose to deliver.
- Affordability and vulnerability. Our comments in Chapter 3 propose a blend of bespoke and commonly applied Performance Commitments (PCs), using more qualitative measures, which can help ensure companies deliver more ambitious actions to address these issues.
- Delivering outcomes. Our comments on Chapter 4 show how a more dynamic approach to setting PC targets, coupled with customer engagement, can help ensure proposed PCs and the resulting ODI rewards and penalties are acceptable and have customer 'buy in'.
- Securing long term resilience. It is important that customer views on short-term and long-term trade offs is taken into account in this assessment, and that it should cover current and long-term risks to services.
- Targeted controls, markets and innovation. We think this test should reinforce the need for companies to demonstrate that the investment(s), or other actions proposed to deliver required outcomes offers value for money for customers
- Securing cost efficiency. We agree that companies' costs should be measured against an efficient benchmark, taking into account historical and forecast costs.
- Aligning risk and return. Companies should ensure that customers are not carrying unjustified risk, and that the PAYG ratio is applied in a way that establishes a balance of cost recovery that is fair and acceptable to current and future customers.
- Accounting for past delivery. We support an assessment of past performance as part of the assessment of the plan. Companies should have delivered their 2015-20 commitments efficiently if they are to be awarded one of the higher business plan categories.
- Securing confidence and assurance We support an assessment of whether companies have identified all risks and proposed solutions or mitigations to address them, and that plans have 'sign off' by company Boards.

***Q1b: In terms of the business plan characteristics we want to see? (high quality, ambition and innovation)***



We agree with the three characteristics, but these should reflect the focus on achieving value for customers which we explore in our proposals for the final methodology elsewhere in this response:

- **High quality.** We stress that customer engagement evidence should be of high quality and show that company PCs, incentives and price are grounded in credible evidence of what customers' expect and find acceptable.
- **Ambition.** Companies should propose stretching PCs that push them to strive for optimum performance and efficiency. Our suggestions raised in Chapter 4 (Outcomes) on dynamic target setting, and common and bespoke PCs (including C-MeX) will help achieve this.
- **Innovation.** In order to achieve high quality and ambitious plans, companies are encouraged to develop innovative approaches to delivering required outcomes that are more sustainable and/or cost effective. We believe that strengthening the incentives for companies to increase customer satisfaction (see Chapter 4 on our recommendations for the C-MeX contacts and satisfaction ODIs) would encourage companies to be more innovative in their customer engagement and communication.

We would also welcome Ofwat looking at these characteristics in the round, as ultimately the business plan as a whole should achieve the outcomes for customers we set out in the bullet points on the first page of this response's Executive Summary.

***Q1c: In terms of the business plan categories we propose to assign companies to? (significant scrutiny, slow track, fast track, exceptional)***

Ofwat should be under no obligation to use all their categories in practice. If, for example, no companies meet the criteria for 'exceptional', then no companies should be allocated this status.

***Q1d: In terms of the financial, procedural and reputational incentives we propose to put in place?***

We do not want to see companies being rewarded "up front" financially on the promise of future delivery as this is not in the best interests of consumers. We have observed during this AMP that companies with PR14 "enhanced status" have struggled to deliver on their promises in some areas. These companies may receive a bonus based on promises they may not fulfil.

If up-front financial incentives are included in the package for the exceptional companies we would like to see a claw back mechanism in places to refund customers. One mechanism could be to build this into strong ODI penalties for underperformance.

***Q2. Do you agree with our proposed approach to assessing a company's ability to deliver results for customers and the environment from innovation?***

We welcome the inclusion of innovation as a key characteristic within business plans. This is a good method of incentivising innovative approaches because it doesn't dictate in advance how much investment should be made on innovation or what constitutes good

innovation. This gives companies freedom to set out what innovation means in their circumstances for their customers.

## Enquiries

Any enquiries about this consultation response should be addressed to:

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