

Response to Ofwat consultation Methodology for the 2019 Price Review

1.0 Summary

- 1.1 We are pleased to respond to the PR19 draft methodology consultation. Over the last twenty years there has been significant progress in enhancing the water environment and Ofwat's contribution has been critical. We believe this price review methodology will provide another important step towards ensuring high quality, sustainable and resilient water and wastewater services, a healthy water environment and communities better protected from flooding.
- 1.2 We support the proposals to strengthen the outcomes approach and the introduction of a new resilience framework. We agree with the expectation that companies need to innovate and plan for the long-term. These proposals closely align with our own ambitions for the water industry and should help companies ensure excellent environmental performance; help protect and enhance the wider environment; and further improve their resilience to drought and flooding.
- 1.3 We agree with plans to introduce separate price controls for water resources and bioresources and greater integration across water resources and wastewater.
- 1.4 As the environmental regulator for the water industry in England our role is to advise government, water companies and Ofwat on the likely environmental opportunities and risks associated with the price review. We set out a summary of our consultation response below followed by more detailed answers to 21 of the 68 questions posed in the consultation.
- 1.5 The main points of our response are:
- Company performance commitments should take account of local environmental and flood risk pressures and opportunities, customer priorities and the regulatory expectations and best practice set out in the Water Industry Strategic Environmental Requirements (WISER) strategic steer.
 - We expect to see an allowance in price limits for all 'green' and 'amber' measures in the Water Industry National Environment Programme (WINEP3).

- Upper quartile performance should be seen as the industry benchmark and we would expect leading companies to be striving for frontier performance and beyond.
- Requiring companies to adopt resilience principles and resilience performance commitments shows the outcomes approach is evolving in the right direction and will give all parties confidence that companies are planning for the long-term.
- Moving away from a sustainable economic level of leakage (SELL) is a positive step. Leakage performance commitments should be stretching and we expect those companies facing the greatest challenges (high levels of leakage in water stressed areas) to be doing the most.
- We expect to see common performance commitments for pollution incidents mirror the metrics used in the Environmental Performance Assessment (EPA).
- We would like to see natural asset and natural capital type metrics included as part of the asset health long list.
- Sewer blockages are the main cause of sewer flooding and pollution incidents and should be added to the list of common performance commitments.
- We support higher rewards for very high levels of performance but we do not want to see companies compromise their regulatory obligations as a result.
- We would like to see Ofwat promoting the transition programme as a mechanism for investing in early delivery environmental measures.
- Past performance and evidence relating to prosecution rates, non-compliance and incident self-reporting should be taken into account in the initial assessment of business plans.
- High quality plans should include evidence that companies have worked closely with partners and stakeholders to identify, agree and design joint solutions on flooding and catchment management.

1.6 In answering the consultation questions we have limited our comments to specific issues that we feel are relevant to our role in protecting people, communities and the environment.

2.0 **Delivering outcomes for customers**

Q1. Do you agree with our proposals for common and bespoke performance commitments?

2.1 Yes, we strongly agree with the proposals. They encourage the right balance of common and bespoke performance commitments. While it is important to be able to compare company performance across the industry different pressures mean that company business plans will need to reflect local priorities and customer preference. The examples of bespoke environmental commitments set out in chapter 2 are a good starting point for this. We strongly agree that performance commitments should be supported by long-term performance projections.

Q1a. Do you agree with the common Performance Commitments (1 - 14)?

- 2.2 We agree with some of the proposals but not all. Overall, we support using common performance commitments with standard definitions as the basis for ensuring that companies have sufficiently stretching targets. It is right that the list of common performance commitments covers the services that are most important to customers and the company activities that have the biggest effect on the environment. The inclusion of resilience performance commitments shows the outcomes approach is evolving in the right direction. The focus on flooding and drought appropriately captures the need for companies to consider the resilience of their assets to the increasing occurrence of extreme weather. These metrics will help give all parties confidence that companies are planning for the long term. We will continue to support Ofwat and the water industry develop these resilience metrics.
- 2.3 For the wastewater flooding risk metric, we believe option 1b is more advanced than 1a, and will better quantify risk in a consistent way. We support the proposal that where there is no data (no model), and the risk grade of the catchment is between 2 to 5, the pipes in that catchment should be assumed to surcharge. This will incentivise the wider application of sewer models and support long-term wastewater planning activities. We support option 2 and believe it has the potential to positively reward those companies that take action to understand the performance of their sewerage networks and the interaction of combined sewer overflows with environmental and social benefits. Option 3 also offers a metric that we think should be investigated and developed further.
- 2.4 We are pleased to see pollution incidents as a common performance commitment. These can have significant effects on customer's current and their future use and enjoyment of the water environment. Our preference is for this common performance commitment to mirror the pollution incidents metrics in the EPA. This would mean a commitment based on serious pollution incidents (category 1 and 2), or a total pollution incidents commitment covering category 1, 2 and 3 incidents. A category 3 incident is where pollutants enter the water course but have limited effect. Category 3 incidents are a useful indicator of potential operational problems but are not of greatest concern to ourselves, businesses and customers. Setting a common performance commitment based on category 1 and 2 serious pollution incidents would help reinforce the WISER expectation that serious pollution incidents should be trending to towards zero.
- 2.5 We support having a separate package of common performance commitments for asset health, but would like to see sewer blockages added to the list. Sewer blockages are the main cause of sewer flooding and pollution incidents and we know that what is flushed down the drain has a huge impact on blockages. A common performance commitment in this area would better incentivise companies to make household and business customers' part of the solution. Companies should be assessing the health of their current assets using metrics that record performance of the infrastructure throughout the lifetime of the structure(s) rather than catastrophic failure such as sewer

collapse.

- 2.6 We would like permit compliance to be a common performance commitment using the EPA definition. This will enable bench marking between companies and drive greater compliance with legal obligations. We do not think that asset health measure 4: pollution incidents caused by non-infrastructure (above ground) assets should be based on the number of category 4 pollution incidents. Category 4 incidents are no-impact events and we do not collect or validate this data, or use it to report performance.

Q1b. Do you agree with our approach to asset health outcomes?

- 2.7 We agree with some of the proposals for asset health outcomes but not all. Partially standardising the approach to asset health seems sensible and we strongly support the removal of aggregated sub-measures. Introducing a long list of bespoke measures is a positive step but the list is very focussed on existing built assets. We would like to see some examples of natural asset and natural capital type metrics included in the asset health long list.
- 2.8 Customers and Customer Challenge Groups (CCGs) will require support to help them challenge companies on their asset health proposals. This is a complicated area and while preventing the aggregation of measures will reduce complexity and increase transparency we would like to see Ofwat develop proposals for helping customers to better understand this area of performance.
- 2.9 Although sewer blockages is on the long list of asset health measures our preference is for it to replace sewer collapses as a common performance commitment. Blockages have previously replaced collapses as a serviceability measure. We believe there is little incentive for companies to choose sewer blockages as an additional measure as it is more challenging to meet than sewer collapse. We disagree with including category 4 pollution incidents on the long list of asset health measures for the reasons set out in 2.6.
- 2.10 Asset health performance commitments should drive innovation and stretching performance and we would expect to see upper quartile performance as a starting point.
- 2.11 There is some inconsistency in the definition of category 1 and 2 pollution incidents in appendix 3. It is listed as a 'wastewater metric' but the definition refers to pollution from 'all asset types'. We believe this should be sewerage only (in line with the EPA).
- 2.12 The bespoke performance commitment 'percentage of total population equivalent served by sewage treatment works in breach of Water Resources Act (WRA) or Urban Wastewater Treatment Directive (UWWTD) consent look-up table' should be revised. This is a subset of overall numeric compliance. We suggest a commitment based on the percentage of population equivalent served by sewage treatment works with numeric limits which were non-compliant with sanitary look-up table limits or nutrient limits, UWWTD look-up table limits or nutrient limits. We undertake numeric compliance assessments

on a calendar year basis and population equivalent figures are submitted annually by the companies to Ofwat. The WISER expectations in this area are not limited to biochemical oxygen demand and / or phosphorus so we expect to see 100% compliance with all look up table permits.

Q1c. Do you agree with our approach to bespoke PCs including areas that bespoke PCs should cover?

- 2.13 We strongly agree with the approach. Bespoke performance commitments are an opportunity to focus on local service pressures and priorities. For the environment and flood risk this could mean going beyond statutory obligations, adopting new approaches or trialling innovative techniques with customers and partners. Companies should use bespoke commitments as a way of improving their operations and the culture of the organisation. For example, working across company boundaries on issues such as security of supply, collaborating with other risk management authorities on flooding improvements and applying sustainable catchment approaches.
- 2.14 The examples of bespoke environmental commitments set out in chapter 2 are a good starting point. When developing bespoke commitments companies should take account of local environmental pressures, customer priorities and the regulatory expectations set out in WISER.
- 2.15 We continue to support the use of the Abstraction Incentive Mechanism (AIM) to improve the resilience of water supply and ensure that it is provided in a more sustainable way. AIM should be used to enable companies to deliver solutions quicker, or achieve outcomes that go beyond current regulatory requirements.

Q2. Do you agree with our proposals on setting performance commitment levels?

- 2.16 Yes, we agree with the proposals. Companies should be setting stretching performance commitments to meet the needs of the environment and customers. Engaging customers and stakeholders must be the first step in determining appropriate performance levels. We accept that setting the initial service levels can be difficult, however, we do not believe that companies should receive rewards for deteriorating performance, especially when these relate to pollution incidents, non-compliance or customer priorities such as sewer flooding. CCG scrutiny and the proposed approaches to assessing performance levels in Table 4.4 will help but other mechanisms should be put in place to ensure that initial service levels are accurate and do not lead to perverse rewards.
- 2.17 We strongly agree with companies setting long-term performance commitment projections using best available evidence, for example drainage strategies. These should align with other strategic planning requirements such as water resource management plans, river basin management plans and WISER.

- 2.18 Upper quartile performance should be seen as the industry benchmark and we would expect leading companies to be striving for frontier performance and beyond. Creating a more ambitious culture is essential if the industry is to innovate in a way that helps it meet the challenges ahead. This is an opportunity for the water industry to turn the good practice from PR14 into common practice for PR19.

Q2c. Do you agree with our proposals to setting leakage performance commitment levels?

- 2.19 Yes, we strongly agree with the proposals. We see these proposals as a great improvement. They align with the WISER expectation that water companies will set challenging targets for leakage based on customers' views and the potential for innovation. Moving away from SELL is a positive step and we expect those companies with the greatest challenges (high levels of leakage in water stressed areas) to be doing the most. Ofwat should consider using the companies' current resource position and existing levels of leakage to determine appropriate performance levels. We expect the downward trend in leakage to be reflected in companies' long-term commitment projections. We welcome the requirement to use the new reporting method and definition for the Final Determination, recognising that it may take some companies' time to implement.

Q3. Do you agree with our proposals for strengthening outcome delivery incentives?

- 2.20 Yes, we agree with the proposals. We support the use of outcome delivery incentive (ODIs) rewards where companies are looking to go beyond their statutory duties or are delivering quicker or achieving additional outcomes beyond those intended. We do not support the use of ODIs to reward companies for complying with their existing statutory requirements.
- 2.21 Reputational ODIs can be an effective way of encouraging innovation and new approaches, for example catchment based solutions or source control options. Open reporting of performance is extremely important and we support the use of comparative tables for reputational ODIs where appropriate.
- 2.22 Financial ODIs should be transparent, proportionate and effective. We support using in-period ODIs, applying end-of-period ODIs to revenue rather than the Regulatory Capital Value (RCV) and discouraging the use of deadbands. We agree with the use of higher rewards for very high levels of performance but we do not want to see companies compromise their regulatory obligations as a result. Where high level performance commitments are made business plans should contain supplementary information on how companies intend to achieve them.

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

- 2.23 Yes, we agree with the proposals and support option 1. Focussing on the overall customer experience as well as customer service will provide an

insight into customers' wider view of company performance, including the environment and resilience. We accept the purpose of C-MeX is to incentivise excellence for the whole customer journey but we hope the measure can also be used to consider areas such as reputation, legacy and customer engagement.

3.0 **Securing long-term resilience**

Q1. Do you agree with our resilience planning principles?

- 3.1 Yes, we strongly agree with the principles. The principles touch on all the key aspects of resilience and should rightly form part of the initial assessment of business plans. They could be further improved by asking companies to make it clear how their understanding of risk has informed their final options, thereby drawing out the "golden thread" that links assessment to options to investment.
- 3.2 Principle 3 should reflect the need to engage with stakeholders and partners as well as customers. Customers' focus will principally be on resilience to events that directly impact them. They will not necessarily be concerned to the same degree over resilience to environmental impacts and this should be taken into account when considering the outcome of customer engagement on decision making and weighting.
- 3.3 The figure 5.1 and the supporting commentary focusses on resilient services, underpinned by resilient organisations. Would like to see the resilience of catchments and the rewards of enhancing our natural capital featuring more prominently. Long-term planning and climate change adaptation are implicit elements in how companies address the resilience agenda.

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

- 3.4 Yes, we strongly agree with the approach. Building long-term resilience requires collaboration and co-operation and companies can show leadership by clearly setting out the issues and sharing their understanding of risk and forward programmes of work. Water companies have choices in how they address resilience challenges, including working with and through third parties. For example, a company could make a critical network asset more resilient to coastal flooding by either; building a bund to protect the asset, investing in a third parties flood defence or re-locating the asset. These choices and their cost and benefits will need to be clearly presented to CCGs, so customers are assured that most cost effective options have been considered.

4.0 **Targeted controls, markets and innovation**

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?

4.1 Yes, we agree with the guidance. It is right that companies, as procurer of the service, continue to be responsible for ensuring compliance with requirements and standards enforced by the regulators. We expect water company Boards to provide assurance that a competitively appointed provider will deliver the expected outcomes on its behalf.

5.0 **Securing cost efficiency**

Do you agree with our overall approach to cost assessment?

5.1 We do not fully agree with the approach to assessing abstraction charges. Compensation payments are no longer relevant to water companies so subsistence charges alone should be used to assess the materiality of abstraction charges and determine the best approach going forward. We agree that there should be an efficient allowance for abstraction charges but do not have a view on whether charges should be included in benchmarking models or not.

5.2 It should be clear when requesting abstraction charges evidence from companies whether this relates to existing licence stock, projected licence stock the current Environment Agency charge regime.

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?

5.3 Water companies have an obligation to complete Water Framework Directive measures that are deemed technically feasible, cost effective and affordable. The WINEP will identify which of these measures water companies must include in business plans. To help companies plan for measures where there is a time difference between business plan final determination (2019) and ministerial signoff of the cycle 3 river basin management plans (2021) we have added a traffic light system to reflect the different levels of uncertainty associated with the development of measures, economic appraisal and ministerial decisions.

5.4 The table below summarises the criteria used in the WINEP managing uncertainty traffic light coding.

| Traffic light | Certainty | Justification | | |
|---------------|-----------|--|--|--|
| | | Evidence that water company action is needed | Evidence that measures are cost beneficial | Ministerial agreement on affordability |
| Green | High | ✓ | ✓ | ✓ |
| Amber | Medium | ✓ | ✓ | ✗ |
| Red | Low | ✓ | ✗ | ✗ |
| Purple | Minimal | ✗ | ✗ | ✗ |

5.5 We expect to see an allowance in price limits for the measures in WINEP3 associated with high (green) and medium (amber) certainty. Information on red measures is provided to companies to inform business plans rather than be associated with specific cost allowances. We expect companies to make

cost estimates for red measures during planning as these may change to amber or green as planning progresses.

- 5.6 Overall, the PR19 environmental measures are more certain than PR14 since economic analysis is complete, there is an established list of specific measures and a technically achievable limit for phosphorus has been agreed. Measures should be complete 3 years after the plans are published and we will be looking for any measures signed-off by ministers in 2021 to be completed during AMP7.
- 5.7 Setting a cost allowance based on the full scale of the high (green) and medium (amber) certainty programme will ensure water companies are able to fulfil their obligation to protect and enhance the water environment. We agree that customers should be protected and would therefore support linking efficient funding to a clear and transparent adjustment mechanism; one that both penalises companies for non-delivery and also rewards them for going further and faster in the delivery of their obligations where there is customer support.

Q7 Do you agree with our proposals for the transition programme?

- 5.8 Yes, we agree with the proposals. Transition programmes can help companies to plan and deliver programmes of work that do not necessarily align with the 5 year AMP period. WINEP3 will be released to water companies in March 2018 and where there is a relatively high degree of certainty around measures (green and amber) we think companies should be able to start designing and implementing solutions before the start of AMP7. We would like to see the methodology specifically promote the transition programme as a mechanism for helping companies meet early delivery environmental requirements within the AMP period, for example, bathing and shellfish waters measures and investigations that will inform PR24.

6.0 Accounting for past delivery

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.

- 6.1 Yes we agree with the approach. Past performance provides a good indication of how well companies understand their business and assets and how realistic their plans are looking forwards.
- 6.2 Company performance goes beyond the commitment made in business plans. How effectively companies respond to and recover from incidents is a strong guide of performance. Evidence such as prosecution rates, non-compliance and incident self-reporting should also be taken into account in the initial assessment of business plans. Any past performance assessment should factor in "how" as well as "what" commitments were achieved. Evidence that poor practice was employed in order to achieve commitments should be

factored into the assessment of past performance.

- 6.3 Some environmental performance commitments relating to rivers improved currently only have a target set for the end of the period i.e. 2019-20. Where this is the case it would be helpful for companies to provide evidence of progress to date i.e. to 2017-2018.

7.0 Securing confidence and assurance

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

- 7.1 Yes, we agree with the approach. Boards should be satisfied that the company will meet its statutory obligations. We welcome the proposals to publish the whole of companies' business plans, including data table commentaries and supplementary information on outcomes, performance commitments and investment decisions.
- 7.2 As referenced in section 13.7.2 and in line with the government's strategic policy statement we have written to all water companies outlining the obligations and expectations for the water industry during the price review period 2020-2025. Water companies should set out in their business plans and commentaries how they plan to deliver against these WISER expectations. We will also be looking for formal assurance from company Boards that they are planning and investing appropriately to enable them to meet these obligations.

8.0 The initial assessment of business plans: securing high quality, ambition and innovation

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

- 8.1 Yes, we agree with the proposal to base the initial assessment of business plans on the quality and level of ambition and innovation. The business plan tests relating to outcomes and securing resilience should look specifically at whether companies have taken account of the expectations in WISER. This should be in addition to the tests relating to Board assurance. High quality and fast-track business plans should include robust evidence that companies have engaged customers and partners on non-statutory environment expectations. High quality plans should also include evidence that companies have worked closely with partners and stakeholders to design and agree joint solutions that deliver wider benefits for customers and the environment, for example catchment approaches and integrated drainage solutions. We expect business plans that do not demonstrate that companies will meet their statutory and statutory plus expectations to be categorised as slow-track.

Q1a. In terms of the nine test areas?

- 8.2 We agree with some of the proposals but not all. We believe the second test area should be retitled 'delivering outcomes for customers and the

environment'. This will highlight the role that companies play in protecting and improving the environment and maximising the benefits that customers receive from a healthy water environment.

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

- 8.3 Yes, we agree with the guidance. The use of a four tier scoring mechanism and removing an obvious middle ground should encourage companies to aim for the top 2 rather than the bottom 2 categories.

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

- 8.4 Yes, we agree with the proposals.

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

- 8.5 Yes, we strongly agree with the approach. Companies should be looking to innovate and develop new ways to improve services and tackle environmental issues. A number of companies pioneered new technologies and techniques at PR14 and we would expect these to be adopted more widely.

Further information

Further information to this response can be obtained from Pete Fox, Director Land, Water and Biodiversity, by post at Environment Agency, Richard Fairclough House, Knutsford Road, Latchford, Warrington, Cheshire, WA4 1HT or by telephone on +442030250929 or by e-mail at pete.fox@environment-agency.gov.uk

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