July 2023

Consultation on the measures of experience performance commitments at PR24

Ofwat

About this document

This document sets out our proposals for the high-level design of the **measures of experience at the 2024 price review (PR24)**. This includes the following mechanisms, which we introduced at PR19:

- the **customer measure of experience (C-MeX)**;
- the **developer services measure of experience (D-MeX)**; and
- the **business customer experience in Wales performance commitment**.

While not in scope of this consultation, we also provide an update on the **business and retailer customer measure of experience (BR-MeX)**, which is new for PR24.

We invite responses to this consultation by **26 September 2023**. We will review responses and set out our draft decisions in our PR24 draft determinations in June 2024.

Responding to this consultation

We welcome comments on this consultation. We have summarised our consultation questions in Annex A3 of this document. Please email your response to PR24@ofwat.gov.uk by 26 September 2023. If you wish to discuss any aspect of this consultation, please email PR24@ofwat.gov.uk.

We intend to publish responses to this consultation on our website at www.ofwat.gov.uk. Subject to the following, by providing a response to this consultation you are deemed to consent to its publication. If you think that information in your response should not be disclosed, please identify that information and explain why it should not be disclosed. We will consider this when deciding what information to publish. You have the right to object to our publication of the personal information that you disclose to us in submitting your response. If you do not want us to publish specific personal information that would enable you to be identified, our privacy policy explains the basis on which you can object to its processing and says more on how we process personal data. Information provided in response to this consultation, including personal data, may be published or disclosed in accordance with legislation on access to information – primarily the Freedom of Information Act 2000 (FoIA), the Environmental Information Regulations 2004 (EIR) and applicable data protection laws. Under the FoIA and the EIR, there are statutory Codes of Practice which deal with obligations of confidence. If we receive a request for disclosure of information which you have asked us not to disclose, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances.

Summary

Water companies in England and Wales need to improve the customer service they provide to residential customers, developers and businesses.

Through our 2024 price review (PR24), we **drive improved outcomes by linking the returns of investors to the services they provide to customers using the outcomes framework**. Companies that perform relatively well can recover greater revenue from their customers, while companies that fall short are required to return funding to customers through lower bills.

Reviewing our approach

In our final methodology for PR24, we committed to **reviewing our key mechanisms for incentivising excellent customer service in the water sector** – the customer measure of experience (C-MeX), the developer services measure of experience (D-MeX), and the two business customer experience measures (the business customer and retailer measure of experience (BR-MeX) in England and the business customer experience performance commitment in Wales).

These incentive mechanisms encourage improved customer service, **alongside our wider tools** – including performance commitments, with financial incentives linked to operational and environmental performance, as well as our monitoring and enforcement approaches.

We have **engaged with stakeholders over the course of 2023 through a range of workshops and meetings**, including water companies, customer groups and representatives of property developers and competitors in the new connections market.

Informed by this engagement and further analysis, we have produced this policy consultation to set out our emerging thinking and to gather views from stakeholders.

Our proposed changes for PR24

C-MeX

- **Rebalancing the focus of the measure towards customers that have contacted their company or experienced operational incidents**, to ensure companies put greater focus on those customers most likely to experience the worst service.
- **Making a greater use of cross-sector benchmarks to put even stronger incentives on companies to improve**, with water companies only able to earn outperformance payments if they perform better than the average of service providers in the wider economy – and even higher payments available to them if they perform as well as the best service provider in the wider economy. Water companies will still

compete with each other, but we propose a greater focus on cross-sector comparisons in order to meet the expectations of customers.
- **Streamlining our approach to C-MeX by making greater use of our wider regulatory tools**, for example by removing payment gateways where they are better dealt with elsewhere, such as through the new customer-focused licence condition, as well as our monitoring and enforcement powers.
- **Calculating incentive payments based on a proportion of regulatory equity**, which should maintain investor focus on improving customer service.

D-MeX

- **Increasing the weight of competitors (self-lay providers and new appointees) and large customers within the survey**, to better reflect market shares and to increase company focus on promoting choice for developers, which should support housebuilding in England and Wales.
- **Maintaining protections for the very smallest customers**, which are least able to participate in the market.
- **Reducing the weight of the quantitative component**, reflecting the progress that has been made in driving up standards, and to ensure that high-volume transactions are still reflected, while putting a greater emphasis on customer satisfaction.
- **Maintaining a relative approach to allocating incentive payments**, with water companies incentivised to compete with each other.
- **Calculating incentive payments based on a proportion of regulatory equity**, which should maintain investor focus on improving customer service and reflect changes to how the developer services market is regulated.

Business customer experience in Wales

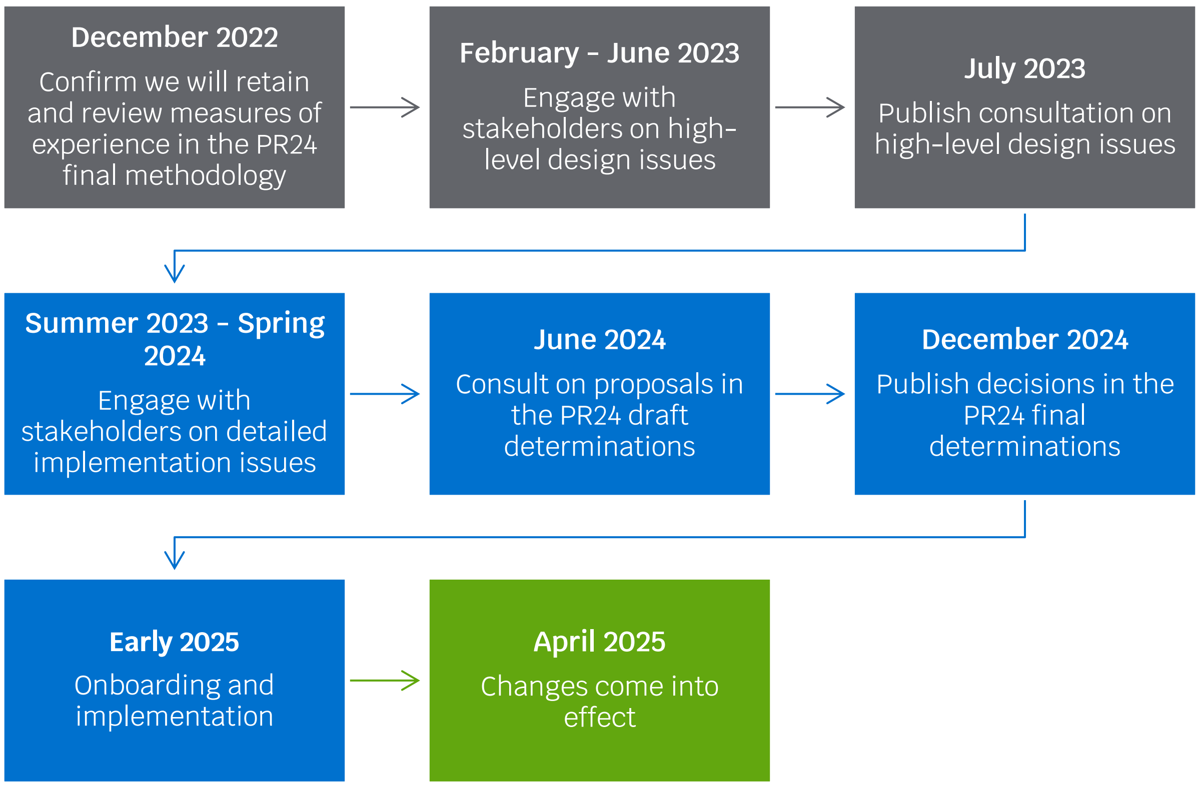
- **Introducing new elements for customers that have contacted their company or experienced operational incidents**, to increase the focus of Welsh water companies on improving their direct customer service and how they handle operational incidents.
- **Treating customers equally regardless of their size**, reflecting that the very smallest customers are likely to need the most protection and what is practical for water companies in Wales.
- **Maintaining the use of absolute targets** – set at stretching but achievable levels, reflecting that there are only two water companies in Wales, with limited comparators.
- **Calculating incentive payments based on a top-down approach and a proportion of regulatory equity**, like we do for other performance commitments.

We are continuing to engage with stakeholders on the design of BR-MeX in England.

Next steps

Informed by the responses we receive to this policy consultation, and further analysis of annual performance data for 2022-23 and 2023-24, **we will set out our draft decisions for consultation as part of our draft determinations in June 2024**, before confirming our decision in our final determinations in December 2024.

We are **engaging separately with stakeholders on more detailed survey and sampling issues** ahead of implementing the mechanisms in April 2025. We will continue to explore the feasibility of our proposed approaches, informed by further research and analysis.



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1. Introduction

1.1 Background

We published our final methodology for the 2024 price review (PR24) in December 2022, which set out our expectations of water companies and our approach to drive them to deliver more for customers and the environment. It reflected our four key ambitions for PR24:

- delivering greater environmental and social value;
- reflecting a clearer understanding of customers and communities;
- driving improvements through efficiency and innovation; and
- increasing focus on the long term.

To meet these ambitions, we will use a wide range of regulatory tools, of which the price review is one. Our outcomes framework is central to the price review, holding companies to account for the outcomes that customers pay for and incentivising them to go further where it will create value.

As part of our outcomes framework, at the 2019 price review (PR19) we introduced two new performance commitments, with associated financial and reputational incentives, to encourage companies to improve the services they provide to residential and developer services customers – C-MeX and D-MeX. At PR19, we also had identical bespoke performance commitments for Dŵr Cymru and Hafren Dyfrdwy, focused on the experience of business customers in Wales, the vast majority of which cannot choose their retail services provider.

High-level policy issues

In our PR24 final methodology, we said we will **retain C-MeX, D-MeX and the business customer experience in Wales performance commitment**. We said that we would continue to review their design and effectiveness alongside our wider policy work and market developments, prior to the publication of our draft determinations.

We also said we expected to see a **step change in residential customer service**. We consider that customer service in the water sector needs to improve and we want to see companies deliver a step change in customer service – for all customers, and especially those that are worst served. To drive this change, we said we would increase the financial incentives associated with C-MeX, subject to further review, in addition to reviewing its design.[1]

For PR24, we will also introduce a **new measure of experience focused on the experience of business customers and retailers in England (BR-MeX)** as a common

[1] Ofwat, 'Our final methodology for PR24 – Appendix 8: Outcome delivery incentives', December 2022.

performance commitment for all companies in England.[2] We expect it will incentivise incumbent water companies (wholesalers) to take a more customer-orientated approach to resolving frictions in the business retail market and improve their performance. We are working closely with the market operator (MOSL) and other market participants to design BR-MeX prior to our draft determinations.

Detailed implementation issues

We are separately considering more detailed implementation issues, such as sampling and survey approaches for each incentive mechanism, by working with stakeholders as part of our determinations. We started by holding a workshop with the outcomes working group on potential sampling and survey approaches for C-MeX on 27 June 2023.[3]

1.2 Approach to policy development

After publishing our final methodology for PR24, we started reviewing C-MeX, D-MeX and the business customer experience in Wales performance commitment in early 2023.[4]

We have actively engaged with a range of external stakeholders, including water companies, CCW, consumer organisations and representatives from developer services customers (see Annex A2). Overall, we have had 16 separate engagement meetings and workshops, in which we have gathered views on how the measures of experience are currently operating and how they could be improved.[5]

Strategic priorities of the UK and Welsh governments

In developing our policy approach, we have acted in accordance with the strategic policy statements of the UK and Welsh governments.[6]

This includes taking account of the **UK government's strategic priorities** to serve and protect customers, including through challenging companies to provide excellent customer service. We have also considered the role of competition and markets, where this provides benefits to customers and supports the UK government's wider priorities, for example in relation to housebuilding.

This also includes taking account of the **Welsh Government's strategic objectives** for us to focus on outcomes, with the delivery of core services being a key part of improving the future wellbeing of the people of Wales, and supporting the foundational economy through

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[2] Ofwat, 'Our final methodology for PR24 – Appendix 7: Performance commitments', December 2022.
[3] Ofwat, 'Reviewing C-MeX for the 2024 price review (PR24): detailed implementation issues', June 2023.
[4] Ofwat, 'PR24: Developing C-MeX and D-MeX', 2023.
[5] See meeting slides and summaries from outcomes working group sessions on our website.
[6] Defra, 'The government's strategic priorities for Ofwat', March 2022; and Welsh Government, 'Strategic priorities and objectives statement to Ofwat issues under section 2B of the Water Industry Act 1991', December 2022.

performance commitments that protect developers and businesses of all sizes. As the Welsh Government notes, competition and markets can raise standards and we have carefully considered the best way to facilitate this in line with the existing developer services market.

Using our full regulatory toolkit

As we have conducted our review, we have considered our wider regulatory toolkit and when other tools might be more effective than the price review. We acknowledge the benefits and limitations of each of our tools and aim to take a holistic regulatory approach when considering how best to drive improvements in service and performance.

While PR24 is one of our primary tools to regulate and incentivise companies to provide excellent customer service, we also use our wider toolkit outside of PR24, where appropriate – including our new customer-focused licence condition, charging rules, monitoring and reporting frameworks and enforcement powers.

Assessing the impacts of our proposals

We set out summary tables of the expected impacts of our policy proposals for each of C-MeX, D-MeX and the business customer experience in Wales performance commitment in Annex A1 of this document. They are based on broad packages of options which we have assessed in detail throughout the main document.

2. C-MeX

This section summarises how C-MeX currently works, before setting out our proposals for:

- the balance of customer groups within C-MeX;
- allocating incentive payments; and
- calculating incentive payments.

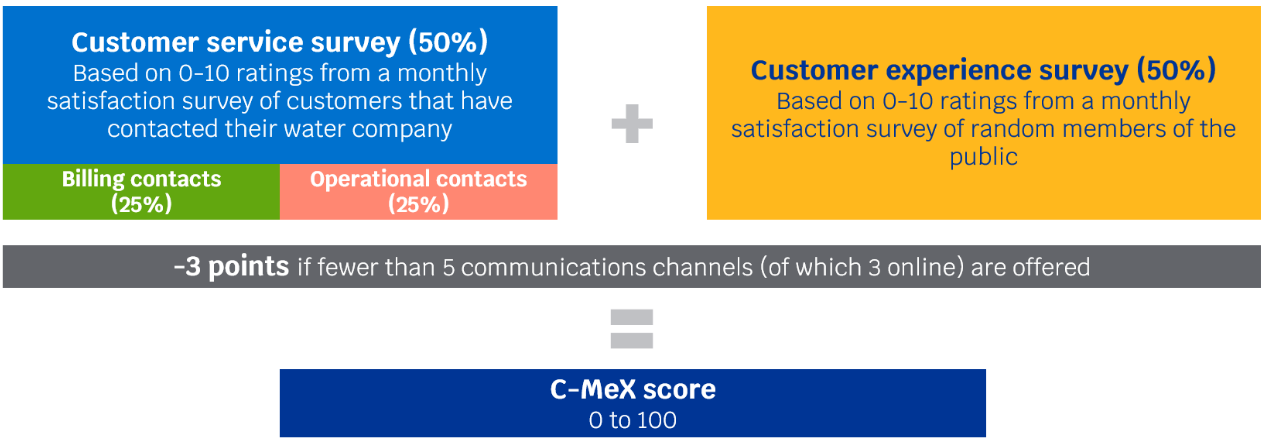
We will separately consider more detailed implementation issues, working with stakeholders, as part of our determinations.

2.1 How C-MeX currently works

We introduced C-MeX at PR19 to replace the service incentive mechanism (SIM) as our primary tool to improve service for residential customers. It came into effect in April 2020.

As set out in Figure 2.1, each company's C-MeX score is calculated based on two customer satisfaction surveys and an adjustment if companies offer insufficient contact channels for their customers.

Figure 2.1 – How we currently calculate C-MeX scores for PR19



Standard performance payments under C-MeX depend on a company's performance relative to those of other companies, with companies above the median score receiving outperformance payments and companies below the median score incurring underperformance payments.

Companies can earn higher outperformance payments of up to +12% of their residential retail revenue if the company:

- is one of the top three performers by C-MeX score;

- is above a cross-sector threshold based on the all-sector upper quartile of the UK Customer Satisfaction Index (UKCSI); and
- has lower than the industry average number of household complaints (per 10,000 connections).

We apply C-MeX payments every year through adjustments to the company's allowed revenues, which limit how much companies can charge their customers.

2.2 Balance of customer groups

2.2.1 Current approach

We use quotas (or targets) for different customer groups or service areas to ensure that we interview a sufficient and representative number of customers about their experience. We also use weightings if we did not manage to achieve our quotas and to increase the focus of companies on key service areas, such as operational incidents.

Currently, each company's C-MeX score has two components, each weighted 50%:

- a **customer service (or contact-based) survey** – a customer satisfaction survey of a sample of residential customers that have contacted their company; and
- a **customer experience (or non-contact) survey** – a customer satisfaction survey of a randomly selected sample of a company's overall residential customers.

Within the customer service survey, we use quotas and weightings so that half of interviews are from customers that contacted their company about operational issues and half about billing issues or general enquiries. For companies that provide water and wastewater services, we also equally split water and wastewater operational contacts. This is so billing contacts do not dominate operational contacts, and for dual service companies, water contacts do not dominate wastewater contacts.

We have considered **alternative options** for the balance and representation of some customer groups within C-MeX, including:

- **increasing quotas and weightings** for some survey components; and
- **adding new components** for some customer groups.

We have also considered the role of our wider regulatory tools.

2.2.2 Stakeholders' views

Most stakeholders supported **changing the weights of the survey components** in C-MeX:

- Stakeholders **broadly supported reducing the weight of the customer experience survey**, with some concerns that the non-contact survey is encouraging companies to focus on marketing and communications to improve awareness, or that external factors and wider issues such as the level of charges may be driving satisfaction levels.
- While a few suggested removing it, **most stakeholders supported maintaining the customer experience survey** to drive companies to consider the satisfaction of their wider customer base.
- Two companies (Portsmouth Water and South East Water) suggested either reducing the weight of operational incidents or removing the wastewater component entirely, to reduce perceived disadvantages or unfair comparisons for water-only companies.

There were **mixed views on adding a new component focused on the satisfaction of vulnerable customers**:

- Some stakeholders suggested a new component for customers in vulnerable circumstances, potentially based on the priority services register (PSR), with one arguing these customers' experiences may vary significantly from the broader customer base.
- But some disagreed, arguing C-MeX already incentivises better service for vulnerable customers and other regulatory tools are likely to be more effective.
- Other stakeholders suggested sampling more vulnerable customers within the existing surveys instead, although others argued they may already be overrepresented in the customer service survey, assuming they are more likely to contact their company.

Some stakeholders **suggested adding or expanding components**:

- **total complaints received**, with higher negative scores for escalated complaints – CCW argued it is a good indicator of customer service and would change company behaviour, while other stakeholders said it overlaps with the contact-based component and that the complaints definition may be insufficiently robust;
- **metrics relating to worst-served customers**, such as call waiting times and the number of repeat customer contacts relating to operational incidents (suggested by CCW and Sustainability First); and
- **broadening the operational component** to include customers that have not contacted their company, with Scope, the disability equality charity, suggesting this may increase the representation of vulnerable customers, especially disabled customers, if they are less likely to contact their company during operational incidents.

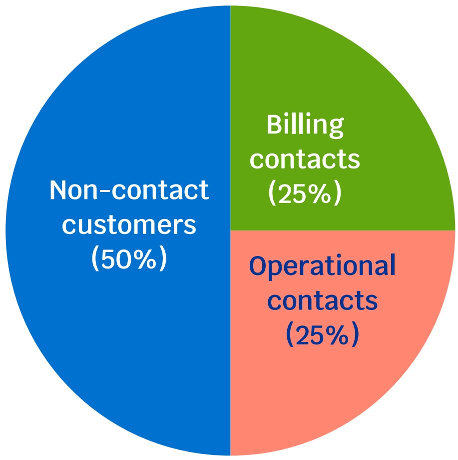
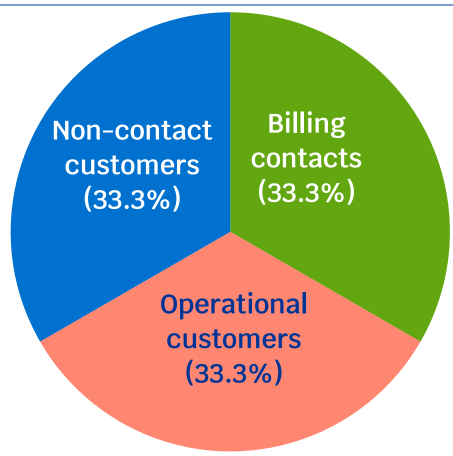
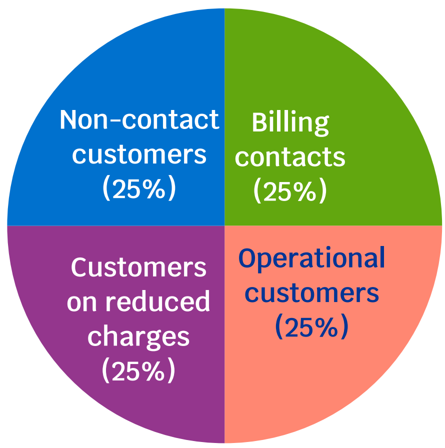
Some stakeholders suggested that other regulatory tools (such as the customer-focused licence condition and complaints action plans by CCW) meant limited changes to C-MeX are required.

2.2.3 Our assessment and proposals

We have reflected on the feedback provided by stakeholders and analysis of years 1, 2 and 3 performance data to create the proposals for consultation below.

Selecting options for assessment

We have considered the following four key options:

Options	Detail
Option 1 – Keep our current approach, with the customer experience survey and customer service survey components equally weighted at 50%.	
Option 2 – Reduce the weight of the customer experience survey and broaden the operational element to also include customers that have experienced operational incidents but did not contact their company. The customer experience survey would be weighted at 33.3%, with the billing contacts survey weighted at 33.3% and customers experiencing operational incidents weighted at 33.3%.	
Option 3 – Add a new component for customers on reduced charges, such as those on social tariffs and WaterSure schemes, as a proxy for customers likely to be facing affordability challenges or in vulnerable circumstances. For simplicity, each component would be equally weighted at 25%.	

Options	Detail
Option 4 – Add a new component for customers that have had escalated complaints, where their issues were not resolved first time by their water company. For simplicity, each component would be equally weighted at 25%.	

In selecting this shortlist, we have **considered and discounted a wider range of options**:

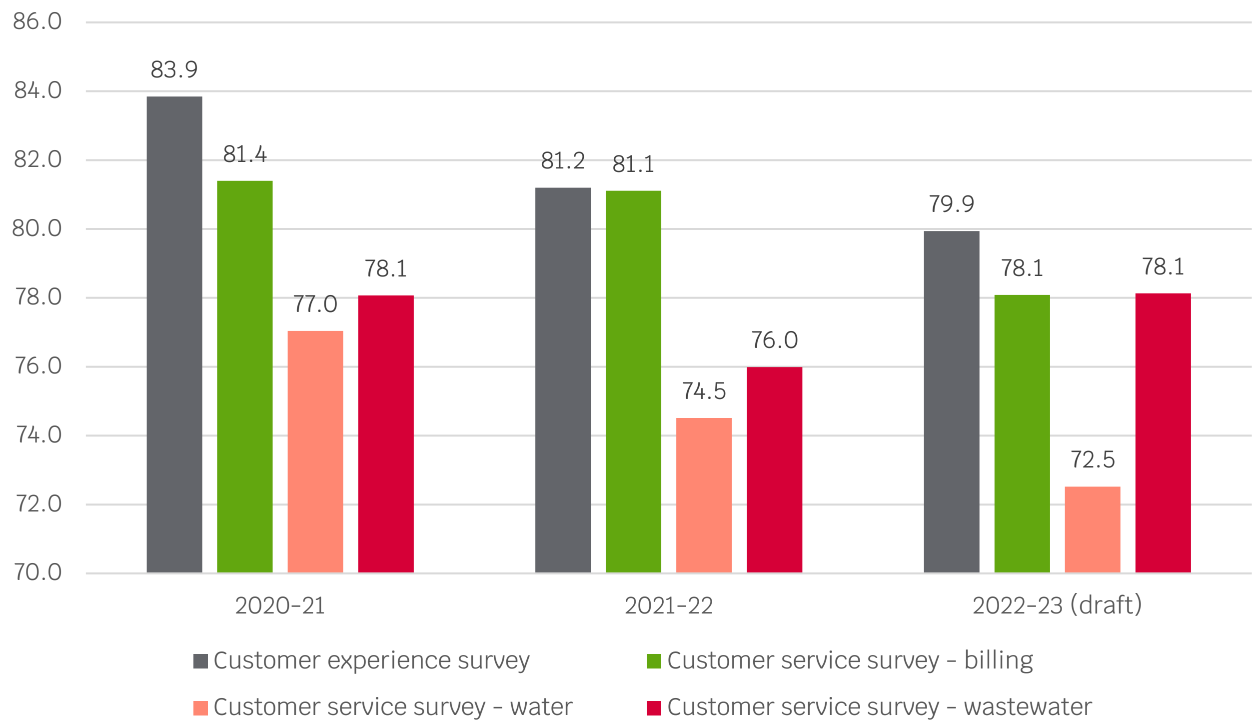
- for **customers in vulnerable circumstances**, we selected reduced charges (option 3) as a potential proxy for customers that are vulnerable, because it is an objective measure and should generally be more well-defined. Alternative definitions, such as the priority services register, are more likely to be subjective and inconsistently applied based on our assessment of companies' research into vulnerable customers in 2022, which showed that companies have different approaches to identifying vulnerable customers.
- for **customers that have made a complaint**, we considered the most viable option to be a component focused on the experiences of escalated complainants (option 4). This is because it is more likely to reflect the experience of customers, which is the outcome we are aiming to incentivise, rather than total complaints received, which are outputs. Total complaints may also have the unintended consequence of discouraging companies from proactively communicating with their customers and making themselves accessible.

Our assessment

Our preferred option is **option 2, to reduce the weight of the customer experience survey within C-MeX and to broaden the operational component so that there is a greater weight put on customers that have experienced operational incidents**. We consider this option provides stronger incentives on companies to focus on customers that are most likely to experience the worst service, while maintaining balanced protections for all customers. We consider this is necessary because customers that have contacted their company are generally less satisfied on average than those that have not, as shown by Figure 2.2. Our joint research with CCW also shows that the experience of customers affected by sewage in homes needs to improve, and increasing the focus of companies on customer that have experienced operational incidents should help to achieve this. [7]

[7] Ofwat and CCW, 'Customer experiences of sewage flooding', May 2022.

Figure 2.2 – C-MeX industry yearly average scores per component



While some stakeholders suggested removing the customer experience survey entirely, we consider that reducing its weight is more appropriate because it ensures that companies are incentivised to improve the experience of all of their customers – which can and should include the perception of water companies as a whole. We consider reducing its weight helps to manage the concerns that these factors may reduce the focus of companies on providing direct service to their customers.

We consider **expanding the operational component to include all customers that have experienced operational incidents** should further focus companies on improving the service to their worst-served customers. This aligns with customer preferences – based on research, customers prioritise reducing operational issues, such as sewage in homes, over more general customer service.[8] Moreover, our research on customers' experiences of sewage in homes found that sewer flooding has a significant negative impact on customers, and that for some customers it was difficult to contact their water company.[9] By broadening the operational element, we are aiming to better reflect the experiences of all customers that experience operational incidents, and not just those that were able to contact their company.

Finally, this option is proportionate given it is based on existing measures from PR19. Broadening the operational element may add to regulatory burdens, but companies should already know which properties were affected as part of preparing their annual performance reports. And, in any case, we consider this is necessary to encourage service improvements for a key group. Based on our analysis, we consider there should be a sufficient sample due to

[8] Yonder, 'Preferences research – Full Yonder report', 11 April 2022.
[9] Ofwat and CCW, 'Customer experiences of sewage flooding', May 2022.

the number of affected properties reported for existing performance commitments, such as water supply interruptions and sewer flooding, but welcome views from stakeholders on the feasibility of our proposal. As now, we would expect to evenly weight water and wastewater operational incidents for water and wastewater companies to avoid water-related incidents overwhelming wastewater-related incidents and distorting company focus.

Reflecting recent engagement with stakeholders about which types of billing and enquiries contacts should be included in C-MeX,[10] as well as new research with CCW into the experience of customers affected by operational incidents, we will take account of both projects when determining the feasibility and practicality of our preferred approach.

We have **considered and reject adding new components for customers on reduced charges (option 3) or customers with escalated complaints (option 4)** for the following reasons.

Customers on reduced charges, such as social tariffs and WaterSure (option 3), may reflect customers that are financially vulnerable, and companies should be able to provide contact details for these customers. However, we consider they are inconsistently applied across companies so may not be targeted at the customers most in need. For example, some customers on social tariffs may be over the state pension age but not be financially vulnerable, while more vulnerable customers may not be on reduced charges due to low awareness or other barriers that prevent those customers from accessing them.

While there is limited evidence that customers in vulnerable circumstances are less satisfied than customers in general, we consider companies should ensure that customers in vulnerable circumstances receive excellent service. This will partly be achieved through C-MeX, as vulnerable customers will be sampled in the customer service and customer experience surveys. But to achieve this overall aim, we aim to use a holistic approach based on a range of regulatory tools beyond C-MeX, such as:

- developing a customer-focused licence condition, which includes a draft provision for "the full diversity of customers' needs" to be "identified, understood and met by companies in the services and extra help they provide" – with the ability to take enforcement action when companies fall short;[11] the licence condition is supported by guidance, and we are currently engaging with stakeholders on updating our guidance on customers in vulnerable circumstances;
- exploring charging innovation to support the affordability of water bills;[12]
- challenging companies to improve the reach and accuracy of their priority services registers, including through data sharing with the energy industry and others;
- continuing to work with CCW as it delivers a new 'one stop shop' approach to alternative dispute resolution in the water sector; and

[10] Ofwat, 'Reviewing C-MeX for the 2024 price review (PR24): detailed implementation issues', June 2023.
[11] Ofwat, 'Customer-focused licence condition', 2023.
[12] Ofwat, 'Conclusions on charging innovation to support affordability', March 2023.

- increasing monitoring work and enforcement capacity.[13]

In terms of a **new component for escalated complaints (option 4)**, it is likely to be effective at targeting improvements in customer service for customers whose issues have not been resolved first time by their water company.

But we consider the existing data on escalated written complaints is insufficiently robust to include within C-MeX as its own component – for example, there were fewer than 9,500 escalated written complaints in 2021-22, with as few as 16 reported by Portsmouth Water.[14] Such low numbers may be challenging to sample effectively, and could lead to such customers being substantially overweighted compared to other customer groups, leading to unfair outcomes and excessive focus by companies. Companies may also be more able to manipulate samples, for example by discouraging escalations from customers with very negative experiences.

While we could include escalated telephone complaints as well as escalated written complaints, this is currently not publicly available and lacks sufficient robustness and consistency. Until very recently, CCW has stated that the data quality around telephone complaints has been of such poor quality that it has not published company-specific volumes following a definition change in 2019-20.[15] In its latest report, CCW reported that based on an independent audit, companies complied with its new telephone complaints definition only 84% of the time.[16]

If there are material issues relating to how companies are handling complaints, we consider our wider regulatory tools – such as the new customer-focused license condition, monitoring, enforcement and partnership working with stakeholders such as CCW – are more effective and flexible than C-MeX in resolving them.

Q2.1: Do you agree with our proposal to reduce the weight of the customer experience survey to 33.3%?

Q2.2: Do you agree with our proposal to broaden the operational incidents component to include all customers affected by operational incidents and not just those that contacted their company?

[13] Ofwat, 'Enforcement capacity bolstered with £11m funding increase', 16 May 2023.
[14] CCW, 'Household customer written complaint handling by water companies in England and Wales', 22 September 2022, pp. 37-39.
[15] CCW, 'Household customer complaints to water companies in England and Wales 2019-20', September 2020.
[16] CCW, 'Household customer complaints report – 2022', September 2022.

2.3 Allocating incentive payments

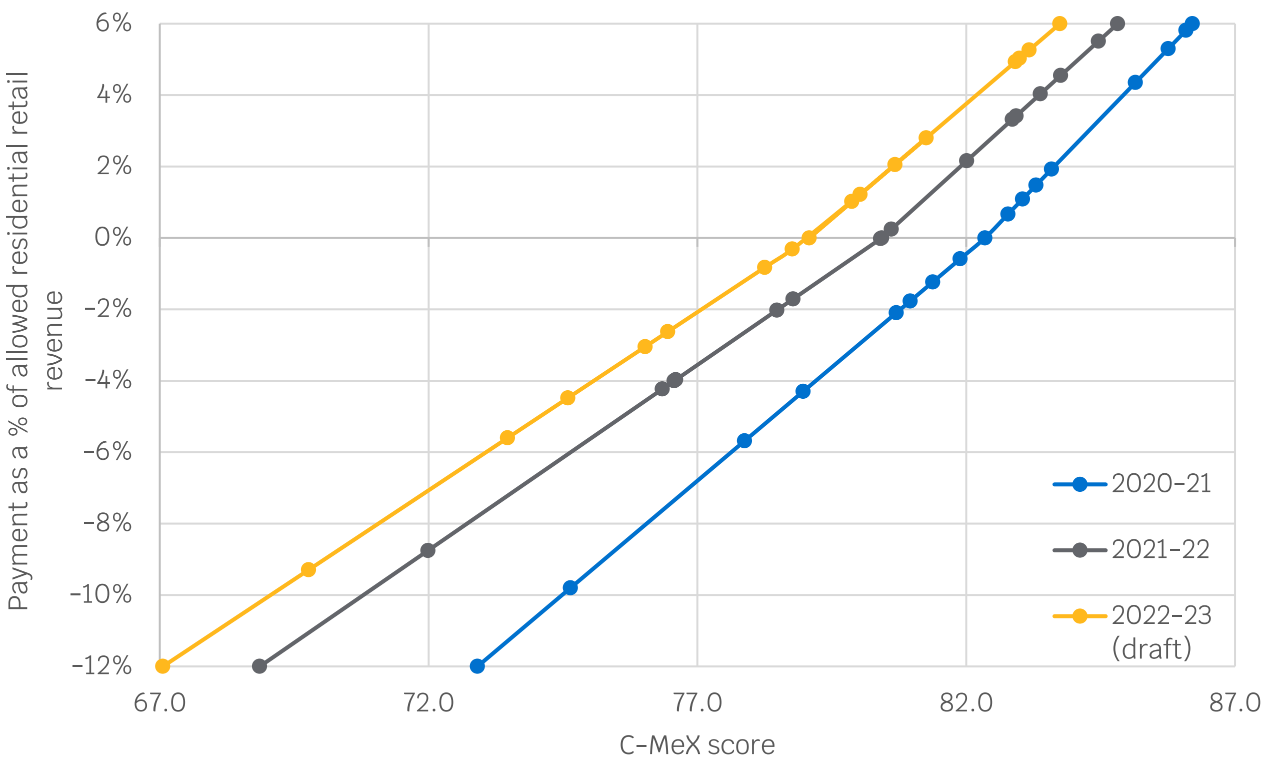
2.3.1 Current approach

C-MeX is currently a **relative incentive**. This means that companies receive outperformance payments or incur underperformance payments based on how their annual score compares to other companies. For PR19, payments depend on where a company scores relative to both the scores of the median company and either the highest or lowest performing company.

As shown in Figure 2.3, companies that score above the median company receive standard outperformance payments of up to +6% of that year's allowed residential retail revenue, while those that score below incur underperformance payments of up to -12%. The median company does not receive any payments.

We apply C-MeX payments every year through adjustments to the company's allowed revenues, which limit how much companies can charge their customers.

Figure 2.3 – Performance and payments for C-MeX since 2020



Companies can earn higher outperformance payments of up to +12% of their residential retail revenue if the company:

- is one of the top three performers by C-MeX score;

- is above a cross-sector threshold based on the all-sector upper quartile of the UK Customer Satisfaction Index (UKCSI); and
- has lower than the industry average number of household complaints (per 10,000 connections).

However, no company has achieved higher performance payments in 2020-21 and 2021-22. This is because no water company has been above the cross-sector threshold based on the upper quartile of the UKCSI.

During our engagement, we have considered **alternative options** to allocating incentive payments for C-MeX, such as:

- **using absolute targets** – this would make a company's payments depend on where a company scores relative to a certain score, like most other performance commitments; or
- **making greater use of cross-sector benchmarks** – so payments are more closely linked to how satisfaction with a water company compares to firms in the wider economy. This could include streamlining the gateways to higher performance payments.

2.3.2 Stakeholders' views

Some stakeholders **supported keeping C-MeX as a relative incentive**:

- Some companies suggested there is insufficient evidence to change from the current approach, noting that C-MeX has only operated since 2020.
- Some stakeholders said relative incentives provide stronger incentives on companies, simulating a competitive market where a company's revenue is at risk if it provides relatively poor levels of service compared to other providers.
- CCW said it disagreed with setting company-specific absolute targets to avoid the worst-performing companies receiving outperformance payments for the same level of service as better-performing companies.

However, some stakeholders **supported changing to absolute targets**, with arguments including:

- they encourage greater collaboration between companies, unlike relative incentives;
- they provide more certainty for companies about their incentive payments, which could lead to stronger incentives;
- they avoid penalising companies that improve their absolute performance, if they still score below other companies (Independent Challenge Group for Affinity Water); and
- they are more likely to ensure that poor-performing companies do not receive outperformance payments despite comparing favourably to other water companies (Scope, the disability equality charity).

Some stakeholders suggested **alternative approaches** to allocating payments:

- SES Water proposed using a symmetrical zone around the median score with no outperformance nor underperformance payments (a 'deadband'), which it suggested would reduce clustered scores around the median since different scores may not necessarily indicate significantly different customer experience between companies;
- Thames Water suggested an additional mechanism to reward companies that improve their absolute scores even if their relative ranking does not change, which it says is a particular issue for the last-placed company; and
- CCW suggested adding new gateways for standard payments, for companies to be below average on total complaints and to show no significant decline in complaints handling.

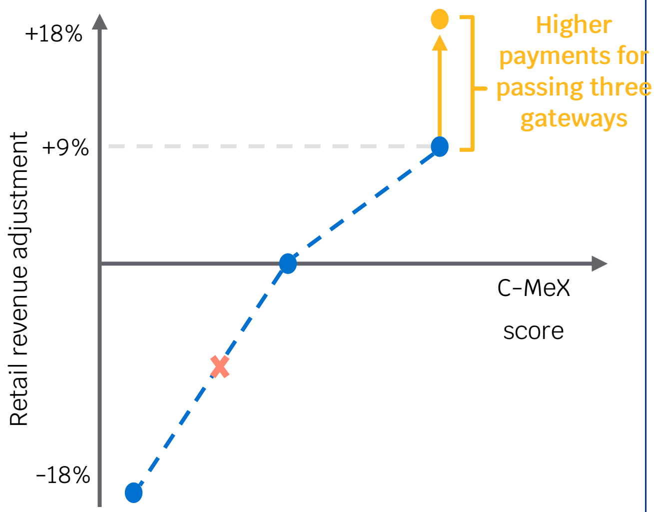
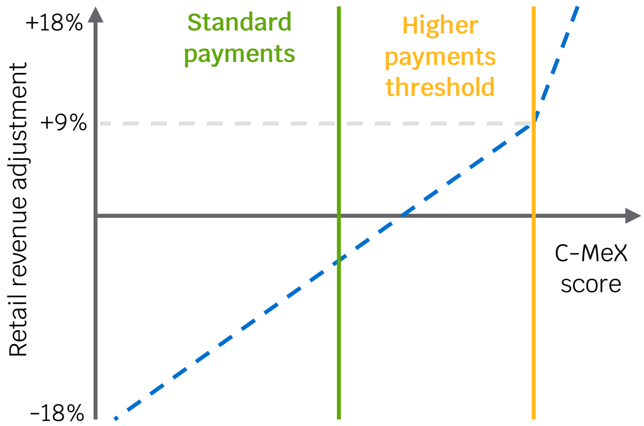
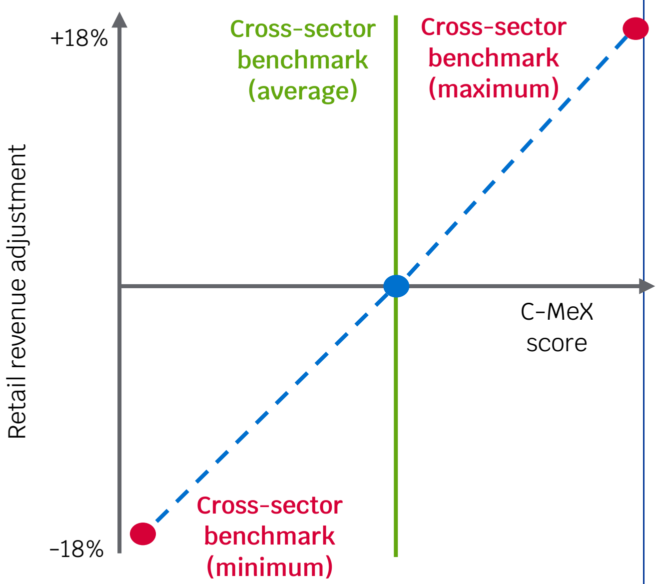
We received **mixed views on the use of cross-sector benchmarks**:

- Some stakeholders, including CCW, supported making greater use of cross-sector benchmarks in C-MeX, to provide stronger incentives on water companies and to drive customer service to be as good as customer service in other sectors.
- But some water companies said a cross-sector benchmark based on the UKCSI is unachievable, or insufficiently robust, with concerns including the relatively low sample sizes underpinning the scores of individual water companies in the UKCSI, and whether water companies can be compared with other sectors. Sustainability First also said there is a lack of transparency associated with the UKCSI due to the cost of accessing data.
- Some companies proposed using alternative measures within the water sector instead of a cross-sector benchmark to stretch water companies or achieve higher incentive payments, such as measures based on vulnerable customers, the priority services register or complaints.

2.3.3 Our assessment and proposals

We have reflected on the feedback provided by stakeholders and analysis of years 1, 2 and 3 performance data to create the proposals for consultation below.

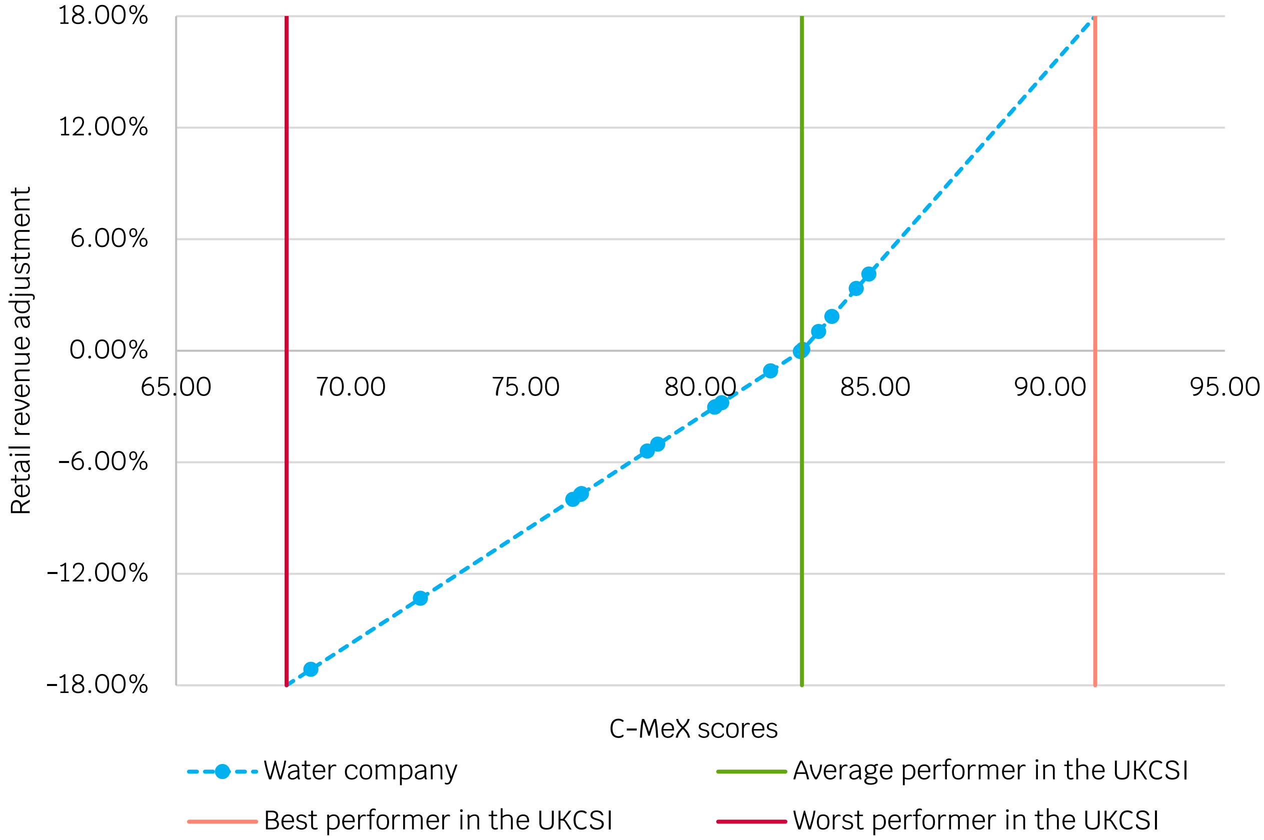
We have considered the following three options for **allocating incentive payments** (for the purposes of this section, we assume maximum incentive payments are up to ±18% of residential retail revenue, in line with our PR24 final methodology):

Options	Detail
Option 1 – Keep our current approach (a relative incentive between water companies). A company's standard incentive payments would depend on its C-MeX score relative to those of other companies. Companies would be able to access higher performance payments if they pass the three existing gateways.	
Option 2 – Change to absolute targets. A company's standard incentive payments would depend on where a company scores relative to an absolute performance target. Companies above their targets receive outperformance payments, and companies below them incur underperformance payments. Companies can access higher outperformance payments if they pass a higher gateway, most likely based on previous performance.	
Option 3 – Make greater use of cross-sector benchmarks (a relative incentive based on how water companies compare to the wider economy). A company's incentive payments would depend on how its customer satisfaction compares to service providers in the wider economy. Companies would earn outperformance payments if they perform above a threshold based on a cross-sector average, with maximum outperformance payments for performing as well as the best service provider in the wider economy and maximum underperformance payments for performing at the level of the worst service provider. Under this option, we would remove gateways for higher performance payments.	

Our preferred option is **option 3, to make greater use of cross-sector benchmarks in C-MeX**. This maintains competition between water companies, with even stronger incentives to improve their performance. Like in competitive markets, a company's revenue is at risk if it provides relatively poor levels of service compared to other providers. And by making greater use of cross-sector benchmarks, companies should face even stronger incentives to improve their customer satisfaction relative to other firms in the wider economy, helping to promote a step change in customer service.

Reflecting the views of some customers and stakeholders, water companies will only be able to earn outperformance payments if they compare favourably to firms in the wider economy. As well as providing stronger incentives on water companies to improve, we consider this puts an appropriative level of risk on them. As Figure 2.4 shows, our analysis of performance in 2022 showed that 6 out of 17 water companies were above or close to the cross-sector average.[17] While none are currently above the cross-sector upper quartile, we consider there is scope for them to achieve material returns if they substantially improve their customer service. And in principle, if all companies substantially improve their current performance compared to firms in the wider economy, they could all earn outperformance payments.

Figure 2.4 – C-MeX scores in 2021-22 under our preferred option



We also consider our proposed approach helps to address the concerns raised by some stakeholders about our current approach that companies at the very top or bottom of C-MeX

[17] Wessex Water (84.8), Northumbrian Water (84.5), Portsmouth Water (83.8), South Staffs Water (83.4), Dŵr Cymru (82.93) and Bristol Water (82.86) compared to an adjusted cross-sector average of 82.9 out of 100.

face limited incentives to improve their performance. By basing maximum outperformance and underperformance payments on the highest and lowest preforming service providers in the wider economy, water companies should face continuous marginal incentives to improve – unless they are the best or worst in the wider economy, which we consider to be unlikely. If a water company is the worst performing service provider in the wider economy, we would expect to consider using our wider tools, including engagement and enforcement.

We acknowledge there are potential drawbacks with our proposed approach. While it builds on our existing relative approach, it is new and would require further implementation. It would also heavily rely on external cross-sector benchmarks, which would need to be sufficiently robust and practical to use. Some stakeholders have raised concerns with the robustness and transparency of the UKCSI, which we currently use in C-MeX. We are considering these concerns and investigating how our use of the UKCSI in C-MeX could be improved or replaced for PR24.

As part of adopting option 3, we **propose to streamline the higher performance payments gateways** by removing them. Instead, companies would be able to earn the maximum payments for C-MeX based on their relative performance compared to the best performing service provider in the wider economy, as above. Given the current distribution of water companies compared to the UKCSI, we consider this provides sufficient incentive on companies without the additional complexity of gateways. We also consider the existing gateways, such as being one of the top-three performers in C-MeX or below average of total complaints, are duplicative or better dealt with outside of C-MeX using other tools.

We have considered and reject absolute targets (option 2). As well as providing weaker incentives than options 1 and 3, we are concerned that absolute targets are challenging to set and may be more susceptible to external factors that could lead to all water companies receiving outperformance payments that are unearned (for example due to an economy-wide increase in corporate trust) or vice versa in terms of underperformance.

We also disagree that a relative incentive hinders collaboration or provides insufficient certainty, as suggested by some stakeholders. Companies can share best practice and currently we provide companies with their draft scores compared to other water companies' scores every quarter, minimising uncertainty risk. On top of this, other price review mechanisms, such as the innovation fund, can support collaboration, where appropriate. We also consider that by using external benchmarks, our proposed approach further removes any perceived barriers to collaboration, as a water company's score will not affect another water company's payments, unless it is the best or worst performer in the wider economy.

We do not agree with SES Water's proposal to apply a deadband around the median score. We are not convinced that it would reduce clustering, as companies would be financially indifferent within the deadband, and we consider there are benefits to providing a continuous incentive on companies to improve their performance. With broadly symmetrical incentives, we would expect payments associated with companies' scores to broadly balance over the five-year period, unlike a deadband which may increase the negative financial risk.

Q2.3: Do you agree with our proposal to make greater use of cross-sector benchmarks when allocating incentive payments for C-MeX?

2.4 Calculating incentive payments

2.4.1 Current approach

Currently we base a company's incentive payments on a proportion of its annual allowed residential retail revenue. This is intended to ensure that the incentives for each company are broadly proportionate to the company's size.

In our PR24 final methodology, we said maximum incentive payments would be at least ±18% of a company's annual allowed residential retail revenue. Separate to this consultation, we will finalise the incentive size of C-MeX in our draft and final determinations, based on the latest evidence.

2.4.2 Stakeholders' views

Affinity Water said companies with smaller regulatory capital values (RCVs) than other companies have a greater exposure to C-MeX. It suggested setting incentive sizes based on potential return on regulatory equity (RoRE) impacts rather than a proportion of revenue.

2.4.3 Our assessment and proposals

We have considered the following options:

- **Option 1 – Proportion of residential retail revenue (our current approach)**. Maximum outperformance and underperformance payments would be based on a percentage of a company's annual allowed residential retail revenue.
- **Option 2 – Proportion of return on regulatory equity**. Maximum outperformance and underperformance payments would be based on a percentage of a company's regulatory equity at an appointee level.

Our preferred option is **option 2, to base maximum incentive payments on a proportion of regulatory equity**.

Our current approach is intended to ensure that the incentives for each company are broadly proportionate to the company's size. But as we set out in Appendix 8 of our PR24 final methodology, regulatory equity varies widely between companies. We estimated that maximum payments for C-MeX at PR19 were as low as ±0.25% RoRE for Dŵr Cymru and as high as ±1.07% RoRE for Hafren Dyfrdwy.[18] This could mean that for some companies, the relative importance of C-MeX is lower from the perspective of investors, which will generally focus on those performance commitments with the highest financial risk and return.

In addition, as RCVs grow over time, which are the basis of regulatory equity, C-MeX could continue to shrink as a share of a company's risk and return package, potentially reducing company and investors focus further. However, we could manage this risk by increasing the size of C-MeX periodically at each price review.

While this is a change in approach, we consider the relative complexity is broadly the same as our current approach based on allowed revenue, since regulatory equity is already in the annual performance reports.

Q2.4: Do you agree with our proposed approach to calculating incentive payments for C-MeX, where maximum payments are based on a proportion of each company's return on regulatory equity?

[18] Ofwat, 'PR24 final methodology: Appendix 8 – Outcome delivery incentives', December 2022, p. 49.

3. D-MeX

This section summarises how D-MeX currently works, before setting out our proposals for:

- the balance of developer services customer groups;
- the quantitative metrics within D-MeX.
- allocating incentive payments; and
- calculating incentive payments.

We will separately consider more detailed survey issues, working with stakeholders, as part of our determinations.

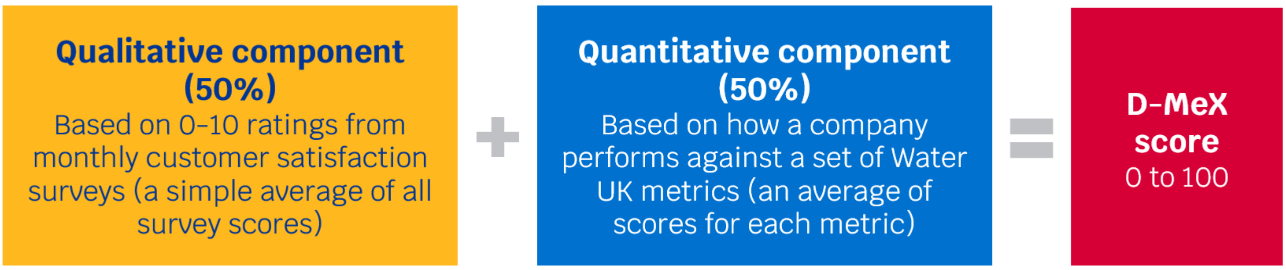
3.1 How D-MeX currently works

We introduced D-MeX at PR19 due to concerns that developers were receiving poor service from some water companies. D-MeX is designed to incentivise water companies to provide an excellent customer experience to developer services customers, including small and large property developers, self-lay providers, and those water companies with new appointments (NAVs, which we refer to as 'new appointees'). D-MeX came into effect in April 2020.

A company's overall D-MeX score is calculated from two components that contribute equally:

- a **qualitative component**, based on the ratings provided by developer services customers who transacted with the company throughout the reporting year to a customer satisfaction survey; and
- a **quantitative component**, based on the company's performance against a set of selected Water UK Developer Services performance metrics throughout the reporting year.[19]

Figure 3.1 – How we currently calculate D-MeX scores for PR19



Performance payments under D-MeX depend on a company's performance relative to those of other water companies, with companies above the median score receiving outperformance payments and companies below the median score incurring underperformance payments.

[19] Ofwat, 'Reviewing D-MeX for PR24', February 2022, slide 11.

We apply D-MeX payments every year through adjustments to the company's allowed revenues, calculated as a proportion of annual developer services revenue. This limits how much companies can charge their customers overall.

3.2 Balance of developer groups

3.2.1 Current approach

Currently, customers are **weighted equally** in the qualitative component of D-MeX, with no weighting for certain customer groups, such as self-lay providers, new appointees and larger developers. This results in some customers that have many transactions with water companies each year only accounting for a small percentage of surveys. We currently partly address this by reducing the 'exclusions period' for developer services customers that transact with more than one water company, which increases the chance that they are surveyed each month.[20]

During our engagement, we have considered **alternative options** for the balance of developer services customer groups within the survey component of D-MeX, such as increasing the weight of some groups – namely self-lay providers, new appointees and larger customers, or weighting by the volume of transactions that they have with water companies.

We note that the balance of representation within D-MeX is also affected by the quantitative metrics (see section 3.3). Because the quantitative component uses all data submitted rather than a sample, and includes specific metrics for different types of customers, it generally boosts the representation of multi-transaction customer groups within D-MeX.

3.2.2 Stakeholders' views

Stakeholders broadly agreed that **self-lay providers and new appointees are currently underrepresented in D-MeX**, especially in the survey.[21] Some companies and other stakeholders also said that **large developer customers are also underrepresented**, arguing that their voice is drowned out by smaller developers. Some companies and other stakeholders suggested weighting survey responses by the number of activities completed to reflect the number of interactions by each customer.

[20] In our current guidance for the 2020-25 period, we say that developer services customers will not be re-interviewed about the same company until six months after the previous interview. However, where a developer services customer transacts with multiple companies, they will not be interviewed about a different company until two months have passed.
[21] Notes from Outcomes Working Group, 7 March 2023.

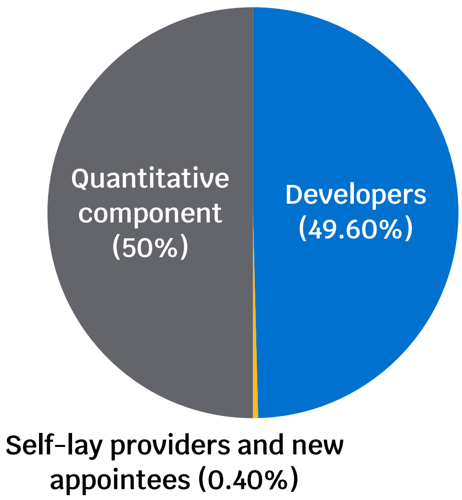
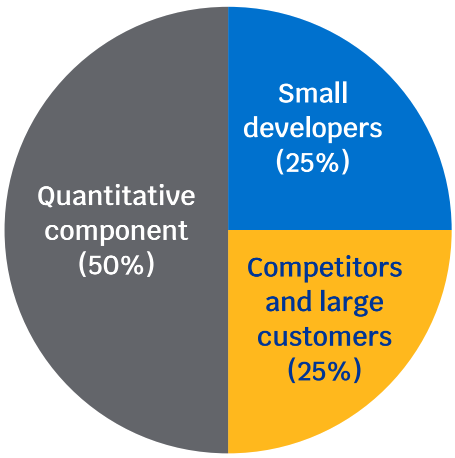
Water companies had mixed views about whether D-MeX should be used to encourage growth in the developer services market, with some suggesting that other tools may be more appropriate than increasing the weight of services provided to competitors within D-MeX.

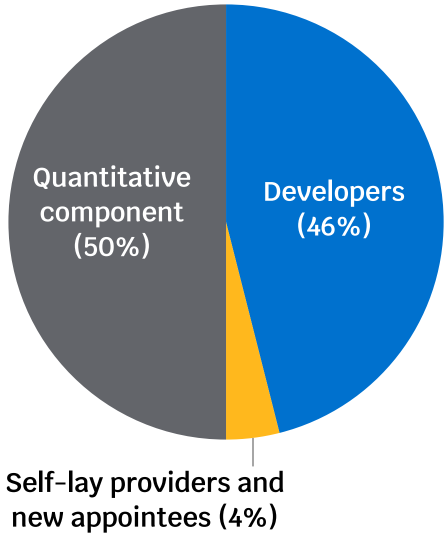
3.2.3 Our assessment and proposals

We have reflected on the feedback provided by stakeholders and analysis of years 1, 2 and 3 performance data to create the proposals for consultation below.

Selecting options for assessment

We have considered three broad options for balancing different customer groups in the qualitative component of D-MeX:

Options	Detail
Option 1 – Equally weight customers (current approach). No higher weightings for self-lay providers, new appointees and larger developers.	
Option 2 – Increase the weight of competitors and large developers. Ensure self-lay providers, new appointees and larger developers are guaranteed to be surveyed. For example, make them half of the qualitative component or more frequently survey those that deal with water companies. We could identify larger developers by asking them how many sites they generally work on in the survey, for example.	

Options	Detail
Option 3 – Weight by volumes. Weight customers by their volumes of transactions with water companies, so it should broadly represent the market share of different customer groups.	

For the purposes of this section, we assume the qualitative component, which is based on customer satisfaction surveys, is unchanged from 50% of D-MeX (but see section 3.3).

Our assessment

Our preferred option is **option 2, to increase the weight of competitors and larger developers**. For example, we could ensure self-lay providers, new appointees and larger developers account for 50% of surveys, with smaller developers accounting for the other 50%. While this increases the chance that competitors and larger customers are surveyed by reducing the relative number of interviews with small customers, we consider this maintains protections for small customers because there is still a reasonable chance they will be surveyed with acceptable statistical accuracy.

We consider our preferred option addresses current evidence, which suggests that competitors are underrepresented. Over the last two years, we estimate that self-lay providers and new appointees have respectively accounted for only 0.8% and 0.03% of completed interviews, below their market share of around 8% of transactions in the quantitative component. While this is partly counterbalanced by a higher number of self-lay provider and new appointee metrics in the quantitative component, which means that they currently make up around 25% in D-MeX overall, competitors still appear to be underrepresented despite relying on upstream services provided by incumbents to them.[22]

Our preferred option should incentivise incumbent water companies to put greater focus on providing upstream services to alternative providers, such as self-lay providers and new appointees, which should promote further competition in the downstream market. While this may over-incentivise the delivery of services to competitors in some areas (for example, only

[22] This is based on self-lay provider and new appointee metrics making up 14 out of the 29 (48%) quantitative metrics and the quantitative component being 50% of overall D-MeX. Combined with 1% completed interviews for these customer groups in the other 50% of D-MeX, this equates to 25% (≈ (48% x 50%) + (1% x 50%)).

5% of new properties were connected by self-lay providers or new appointees in South West Water's region in 2021-22), this may reflect long-term growth in market shares – and in fact across England and Wales, 60% of new properties were connected by self-lay providers and new appointees in 2021-22.[23]

We have also analysed survey data for the first three years of D-MeX, which indicates that larger developer customers appear to be currently underrepresented in the survey, with one-off connections accounting for around 80% of completed interviews. Customers that make more than 10 repeat contacts a year appear to only account for around 1% of completed interviews.[24] This suggests that larger customers are likely to be underrepresented in the qualitative component compared to their likely number of interactions with incumbents.

Increasing the voice of larger customers helps to address concerns raised by stakeholders that these customers are currently underrepresented in D-MeX. We also consider our proposal supports the UK and Welsh governments' strategic objectives and ambitions around housebuilding, by removing potential barriers for large developers when connecting new homes to water and wastewater networks.[25] While larger customers may need less protection than smaller customers because they are more able to participate in the market, there are some non-contestable services where they are reliant on incumbent companies. We consider the current approach (option 1) may lead to companies focusing less on the service they provide to competitors and larger developers and therefore may face relatively weak incentives to support the market compared to our preferred option.

Option 3 would better represent the market share of different customer groups compared to option 1, increasing the chance that larger customers and competitors are surveyed and scaling as the market share of competitors grows. There would also be less of a risk of crowding out small customers compared to option 2. But it may not promote the market as strongly as option 2, since option 2 deliberately over weights competitors compared to their current market share, whereas under option 3 customers are weighted equal to their market share each year. We also consider option 3 would add undue complexity compared to our preferred option because the volume of transactions will change each year.

Q3.1: Do you agree with our proposal to have half the qualitative component for small developers and the other half for self-lay providers, new appointees and larger developers?

Q3.2: Should we include self-lay providers, new appointees and larger developers in the same group, as we propose?

[23] Ofwat, 'PR24 final methodology: Appendix 3 – Developer Services', December 2022, p. 27.
[24] Note that this may be due to customers that are successfully surveyed being excluded from being surveyed for six months to avoid over-surveying, in line with our 2020-25 guidance for D-MeX. But this is shortened to two months for customers that interact with multiple companies.
[25] Welsh Government, 'Programme for government: update', December 2021.

Q3.3: How should we identify larger developers in the qualitative survey?

3.3 Quantitative metrics

3.3.1 Current approach

The quantitative component uses a set of Water UK service metrics and makes up 50% of a company's overall D-MeX score, with the qualitative component making up the other 50%.

To calculate a company's overall score for the quantitative component, we take a **simple average of the scores for each metric**. The score for each metric is the percentage of transactions that have been completed by the water company within the target time period. For example, if a target is 28 days and the water company completes a transaction within that 28-day period, it has complied with that transaction. The score for each metric is its percentage compliance, which is calculated as the number of compliant transactions divided by the total number of transactions received.

From our analysis and engagement with stakeholders, we have identified and considered **ways we can address potential issues with the quantitative component**, such as reducing the weight of the quantitative component within D-MeX or reviewing the underlying service level targets. We want to ensure that any changes made are proportionate and focus companies on the service they provide to their customers.

3.3.2 Stakeholders' views

The **majority of stakeholders supported retaining the quantitative metrics within D-MeX**, arguing that they had improved performance and delivered benefits for customers. But **some stakeholders suggested removing or reducing the weight of the quantitative component**, to manage potential limitations with the component and to increase the overall stretch of D-MeX.

Some representatives of self-lay providers proposed replacing the metrics with fixed penalties for companies that do not meet each target, similar to the guaranteed service standards framework in energy.[26]

Some stakeholders **supported making the metrics more stretching**, with CCW and representatives of self-lay providers and new appointees suggesting more stretching target dates than current times for specific metrics, to meet customer expectations. Independent

[26] See, for example, Ofgem, 'New standards for network connection services', October 2010.

Water Networks and the Independent Networks Association, which represents new appointees, suggested the targets on the metrics should be set based on upper quartile actual industry performance in the current 2020-25 period.

But some stakeholders **did not support making the metrics more stretching**, arguing that any changes should only be made if there are clear benefits from making the change. One self-lay provider said that while quicker is good, companies meeting their targets and delivering on their promises to customers is more important. Water companies argued that high scores do not necessarily mean the metrics are easy to achieve, and that because some of them rely on statutory requirements which companies are funded to deliver, increasing their stretch may lead to higher charges for customers.

On the **scope and definition of the metrics**, some stakeholders suggested:

- leaving them unchanged – arguing that D-MeX has only been in operation for two years, the metrics are reasonably comprehensive, are already stretching or that more stretching targets could squeeze out competitors if set above current service levels in the market;
- reducing the number of metrics – to increase the focus on those metrics that are more stretching or of a priority to customers;
- adding new metrics to the quantitative component;
- reweighting the metrics – so that there are higher weightings for high-volume activities or those of relative importance to customers; and
- reviewing the detailed definitions of specific metrics.

Other proposals from stakeholders included:

- changing how the metrics are calculated, from the current approach where there is a binary pass or fail measure, to further incentivise improvements once a target date has been missed; and
- working with water companies to ensure they are not interpreting the metrics differently due to ambiguity in the definitions and reporting inconsistently.

3.3.3 Our assessment and proposals

Retaining the quantitative component

Because it has an important part to play, we **propose to retain the quantitative component as part of D-MeX**. We consider it incentivises companies to provide a minimum level of service to their customers in a reasonable time period, and there is evidence that performance has improved since it has been included in D-MeX.

Removing the quantitative components risks the unintended consequence that service levels fall backwards. The quantitative component also ensures better representation of customers that engage in a large number of transactions such as self-lay providers, new appointees and large developers because the quantitative component is based on the volume of transactions, rather than samples, and includes specific metrics for those customers.

As such, we **propose to maintain our broad approach to the quantitative component in D-MeX – with potential adaptations discussed below**. We have considered changing the approach as suggested by some self-lay providers, but consider that introducing fixed penalties for companies that do not meet individual targets would not be a proportionate change to make at this stage of the price review. It is also difficult to set a penalty at the appropriate level to drive the right incentives for companies and the administration of such a scheme would add regulatory burdens with unclear benefits.

Where necessary, we have other tools in our toolkit to address concerns that companies are not providing minimum standards, including the Code for Adoption Agreements and our enforcement powers.[27]

Adapting the quantitative component at PR24

High average scores on the quantitative component indicate that companies are focusing more on the service that they are providing to developer services customers, which is positive and indicates that the introduction of the metrics has been successful at improving performance since they were introduced. It also suggests that there may be scope to make the quantitative metrics more stretching for PR24 to improve performance further.

We have considered four options for the quantitative component at PR24:

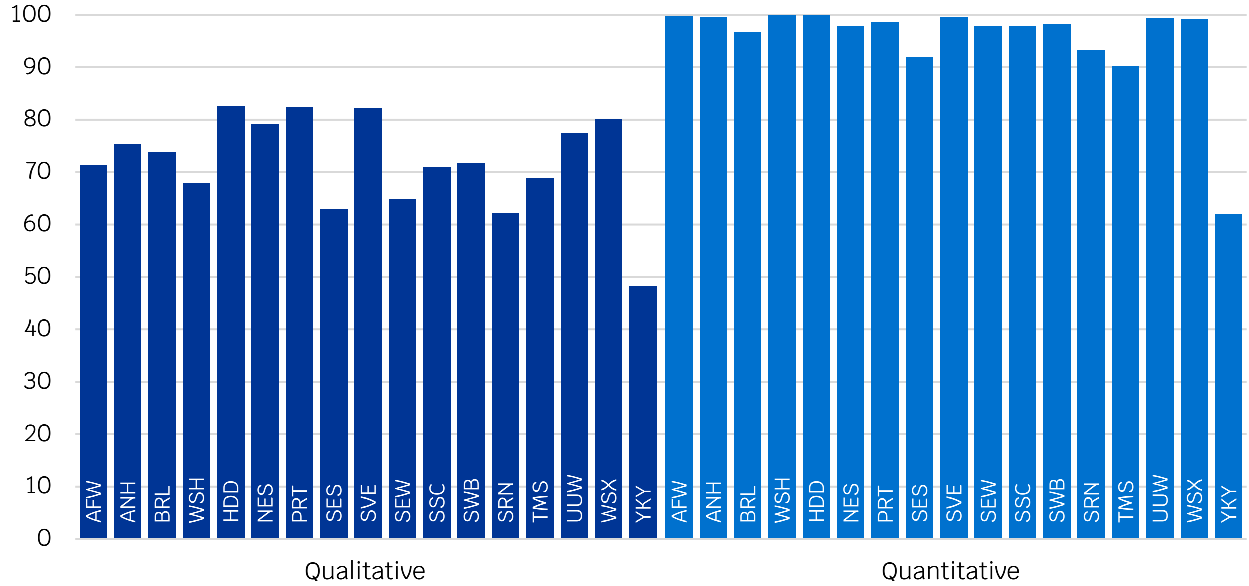
- **Option 1 – Maintain the current approach**. Maintain 50% weights for each of the qualitative and quantitative components and maintain the underlying calculation approach with no change to the underlying service targets.
- **Option 2 – Reduce the weight of the quantitative component**. For example to 33.3%, with a 66.6% weight for the qualitative component. Maintain the underlying calculation approach with no change to the underlying service targets.
- **Option 3 – Reweight or reduce the number of metrics**. Increase the weight of metrics by their relative importance to customers or by volumes of activities completed, or remove those that are least stretching or least important to customers. This would be informed by stakeholder feedback and data analysis.
- **Option 4 – Review the underlying metric definitions and service level agreement targets**. This would be based on further stakeholder feedback and data analysis.

We do not consider it is appropriate to maintain the current approach (option 1) as it does not address concerns raised by stakeholders about the overall stretch of D-MeX. As shown in Figure 3.2, the quantitative component scores are higher on average than the qualitative

[27] The Code for Adoption Agreements sets out the minimum levels of service English water companies must provide to developer services customers and what happens if they fail to deliver the minimum levels of service.

component scores with less company variation. Average scores for the qualitative component in 2021-22 were 71.9 compared to 95.4 on the quantitative component.

Figure 3.2 – Performance on the qualitative and quantitative components in 2021-22



Early indications from year 3 quantitative data suggest that quantitative component scores remain high – with a mean score of 98.12% (with Yorkshire Water staying as the lowest scorer but increasing to 92.89%) on the Water UK dashboard for the first three quarters of 2022-23. High average scores with little company variation suggests that the quantitative component is currently not materially differentiating between water companies, with their overall D-MeX scores largely being determined by their relative performance on the qualitative component.

Our preferred option is **option 2, to reduce the weight of the quantitative component to 33.3%**. This is a simple change to implement which should increase the overall stretch within D-MeX by increasing the focus of companies on the satisfaction surveys, which should strengthen incentives on companies to provide levels of service targeted at what individual customers expect. We consider this is a proportionate change to make at this stage, given D-MeX has only been in full operation for two years, and we have received reasonable support for this proposal. There is a risk that because the quantitative component currently boosts the representation of self-lay providers and new appointees in D-MeX, reducing its weight could reduce their representation. To help manage this risk, we are increasing the weight of self-lay providers and new appointees in the qualitative element (see section 3.2).

We do not consider there is sufficient evidence to adopt options 3 or 4 at this stage. We have limited evidence of clear gaps within the quantitative component of D-MeX, based on existing stakeholder feedback. And where they may exist, we consider a more representative qualitative component will help to ensure that companies take account of them, as they will be key drivers of customers' feedback and ratings. Both options are likely be disproportionate while also adding significant regulatory uncertainty, with unclear benefits to customers from a detailed review alongside substantial changes already taking place in the developer services market.

Option 3 could also have perverse incentives if we were to unintentionally reduce or remove metrics that are important for customers. This option would also add undue complexity and could make it harder for stakeholders to understand D-MeX than it currently is.

For these reasons, we intend to **maintain the existing calculation approach (a simple average of scores for each metric)**. As well as providing regulatory consistency, and being proportionate, this approach implicitly increases the impact of metrics with relatively low volumes. This ensures that some low-impact but high-volume metrics do not dominate D-MeX, and helps to ensure an adequate representation of different customer types, such as self-lay providers and new appointees, despite their relatively low volumes of work.

Some stakeholders raised **concerns about the consistency of reporting on the quantitative metrics**. We agree that data quality and assurance is key to ensure robust comparisons between companies. We expect companies to report actual performance against the metrics in their annual performance reports. We expect companies to provide commentary to outline their assurance process and the findings. In line with our policy for other performance commitments, we note that it is each company's responsibility to report accurate and complete information and it must have adequate processes in place to do this. We are able to take enforcement action to address breaches of legal obligations that we are responsible for enforcing, where appropriate.

Q3.4: Do you agree with retaining the quantitative component in D-MeX?

Q3.5: Do you agree with reducing the weight of the quantitative component in D-MeX to 33.3% while increasing the weight of the qualitative component to 66.6%?

3.4 Allocating incentive payments

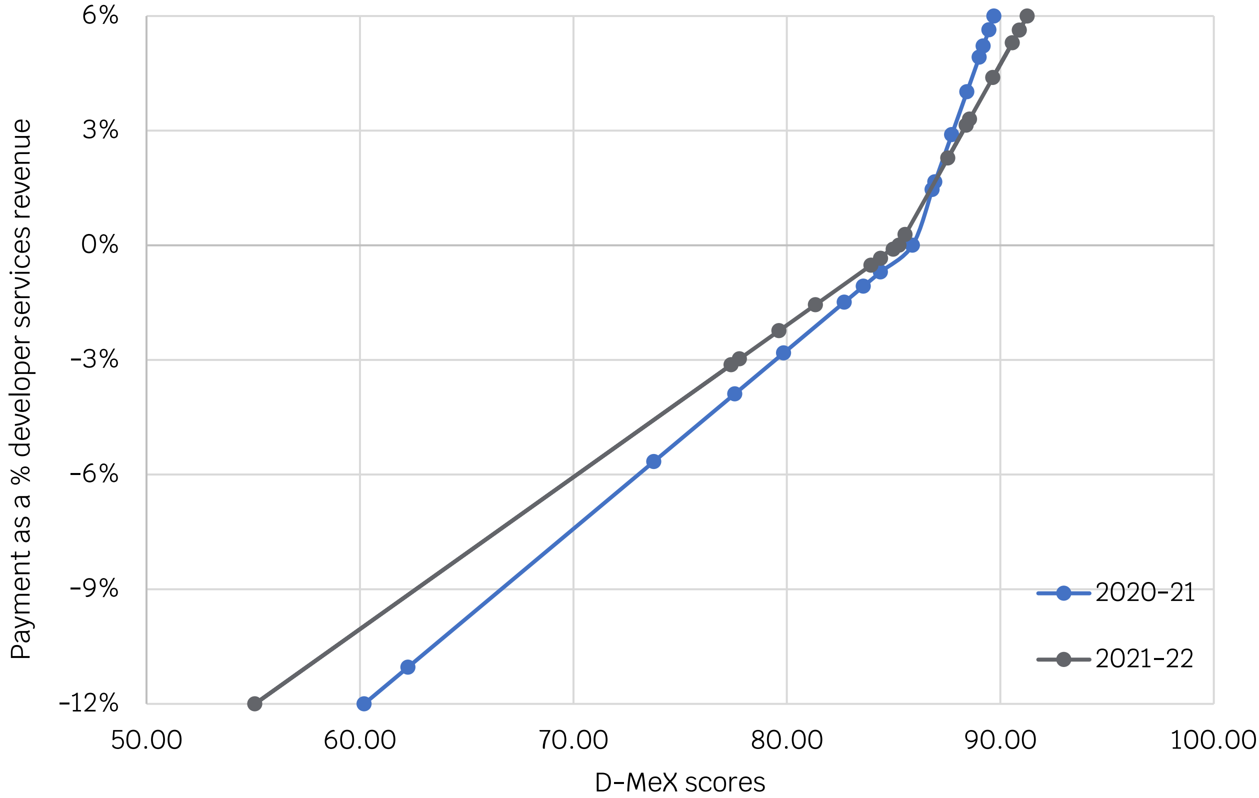
3.4.1 Current approach

D-MeX is currently a **relative incentive**. This means that the size of a company's incentive payments depends on its D-MeX score relative to those of other companies. A company's payments depend on where a company scores relative to both the median company and either the highest or lowest performing company scores.

As shown in Figure 3.3, companies that score above the median company receive standard outperformance payments of up to 6% of that year's actual developer services revenue, while those that score below incur underperformance payments of up to 12%. The median company does not receive any payments.

We currently apply D-MeX payments every year through adjustments to each company's allowed revenues, which limit how much companies can charge their customers.

Figure 3.3 – Performance and payments for D-MeX since 2020



During our engagement, we have considered **alternative options** to allocating incentive payments for D-MeX, such as using **absolute targets** - this would make a company's payment depend on where a company scores relative to an absolute performance target, like most other performance commitments.

We have also considered using **separate calculations for English and Welsh companies**, and for **water and wastewater services** when allocating incentive payments.

3.4.2 Stakeholders' views

Some companies and other stakeholders **supported a relative approach**, with arguments including that it is relatively simple, promotes competition and it would be challenging to set robust absolute targets given that D-MeX has only been in operation since 2020.

However, some companies and other stakeholders **supported changing to absolute targets**, with arguments including:

- they encourage greater collaboration between companies, unlike relative incentives;

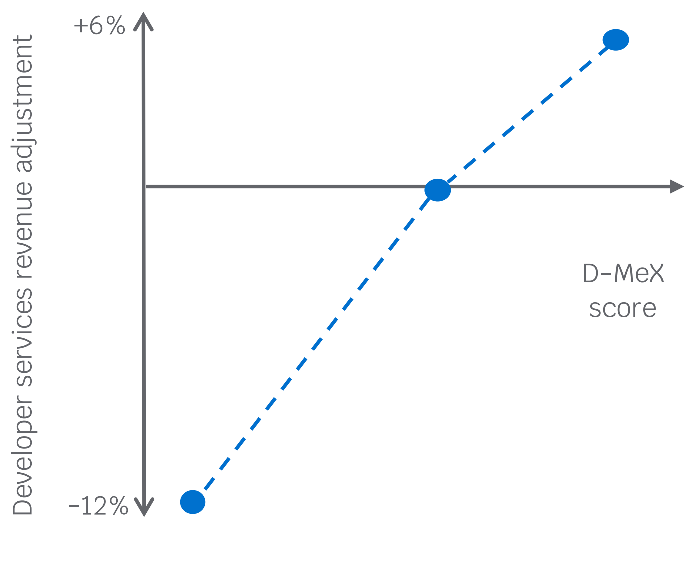
- they provide more certainty for companies about their incentive payments, which could lead to stronger incentives;
- they avoid penalising companies that improve their absolute performance, if they still score below other companies;
- they are more likely to ensure that poor-performing companies do not receive outperformance payments despite comparing favourably to other water companies; and
- they enable us to take account of the different legislative and regulatory frameworks in England and Wales when setting those targets (Dŵr Cymru).

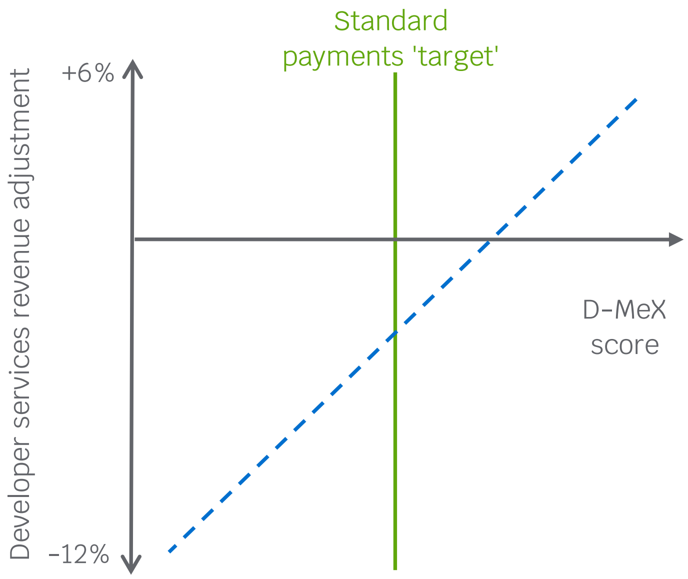
South East Water and Portsmouth Water **suggested we do not include water and wastewater services** together in a single league table.

3.4.3 Our assessment and proposals

We have reflected on the feedback provided by stakeholders and analysis of years 1 and 2 performance data to create the proposals for consultation below.

We have considered two options for how we allocate payments for D-MeX:

Options	Detail
Option 1 – Keep our current approach (a relative incentive between water companies). A company's incentive payments would depend on its D-MeX score relative to those of other companies.	

Options	Detail
Option 2 – Change to absolute targets. A company's incentive payment would depend on where a company scores relative to an absolute performance target. If it performs above the target, it would receive outperformance payments, and if it performs below the target, it would receive underperformance payments.	

At this stage, we have been unable to find a viable cross-sector benchmark for D-MeX, unlike for C-MeX.

Overall approach

Our preferred option is **option 1, to keep D-MeX as a relative incentive**. We consider this provides strong incentives for companies to keep improving their performance, as it maintains competition between water companies and therefore should incentivise continued improvement and lead to better service for developers.

While absolute targets would give us the flexibility to have different targets by company, we only have two years of D-MeX performance data, so there may be practical challenges in setting absolute targets at a stretching but achievable level. Unlike relative incentives, with absolute targets there is a no guarantee that a certain proportion of companies get either outperformance or underperformance payments. It has the risk that all or most companies could outperform or underperform if targets are not set at the correct level. Absolute targets are also more susceptible to sector-wide external factors, such as a change to legislation for housebuilders that leads to increased satisfaction so that all companies receive outperformance payments for factors substantially outside of their control which may not reflect improved performance (and vice versa if it leads to reduced satisfaction).

Some companies have argued that there may be increased uncertainty for companies with relative incentives since they do not know the performance of other companies. However, companies currently receive quarterly survey results and some information on performance on the quantitative element of D-MeX is available before annual adjustments are made, which we consider mitigates any uncertainty risk. We also disagree that relative incentives necessarily hinder collaboration between water companies – they can share best practice, where that is appropriate.

We recognise the risk that there may be comparatively weaker incentives on bottom performers to improve their performance if they are far behind other companies as the cost of improvement may outweigh the benefits. To address this concern, we can make use of wider tools such as enforcement and engagement to target repeated poor performers.

Separate calculations for English and Welsh companies

At this stage, we are **not minded to have separate league tables for English and Welsh companies**. While English and Welsh companies operate in different legislative and regulatory environments, we consider core customer service is sufficiently comparable and, through effective communication, companies can explain any differences to their customers as part of providing their service.

We have also found no evidence from our analysis of survey data to suggest that legislative differences between Wales and England put either Welsh or English companies at a disadvantage within D-MeX. Comparing the metrics associated with potential legislative differences, as set out by Dŵr Cymru, we do not find a material difference between average customer satisfaction on these metrics between English and Welsh companies. We estimate there is a less than 3% difference between companies operating in both nations (with an average satisfaction rating of 7.17 for English companies, weighted by the number of transactions for each company, compared to 6.97 for Welsh companies, also weighted by the number of transactions for each company). We also find no material differences in average satisfaction for metrics without legislative differences.

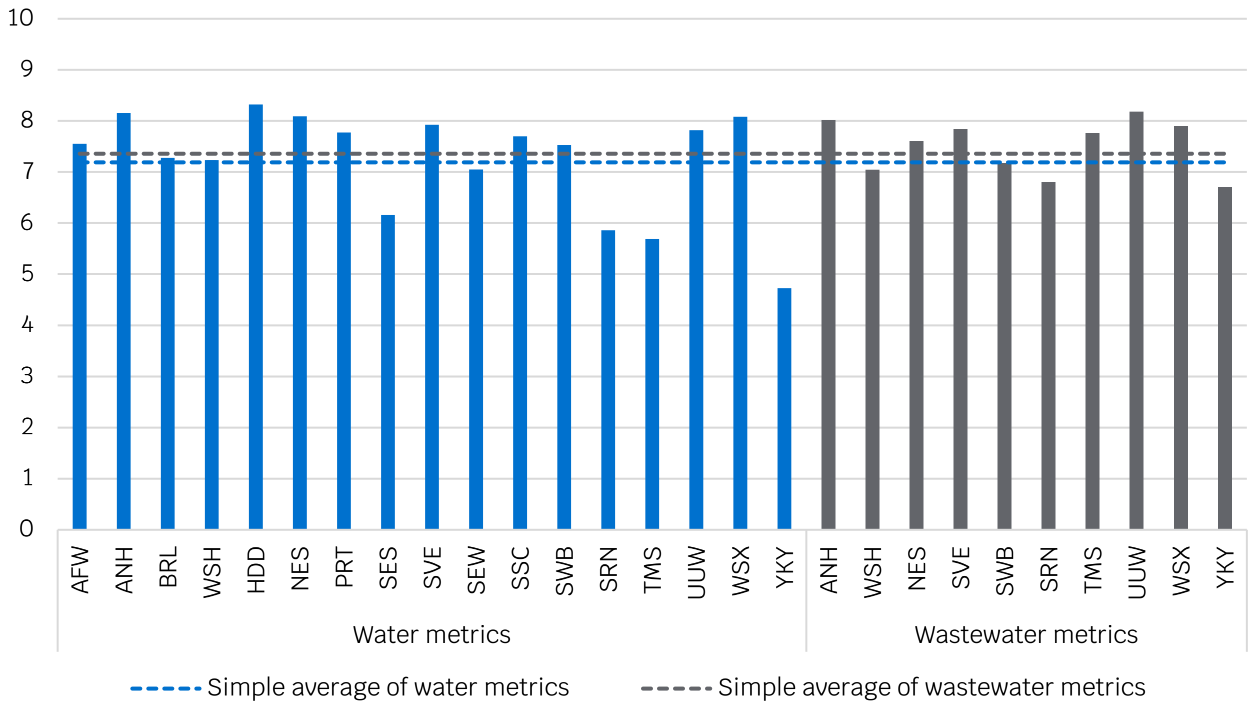
In any case, we are concerned that excluding Welsh companies from the league table and changing to absolute targets for only these companies would weaken incentives on all companies by removing relative benchmarks, as well as the risk that targets for the Welsh companies could be set at an incorrect level due to limited data. As set out above, we consider we can achieve better outcomes with a relative approach, so we are minded to reject setting absolute targets for Welsh companies only.

Separate calculations for water and wastewater services

We have considered whether we should have separate league tables for water and wastewater services. We could calculate payments separately for water and wastewater activities and add them together at the end. This may reduce the risk that water-only companies are 'unfairly' compared to water and wastewater companies.

But we have found limited evidence of material differences between water and wastewater services from analysis of 2020-21 and 2021-22 performance to justify introducing additional complexity. As Figure 3.4 shows, there is around a 2% difference between average customer satisfaction scores for all companies on the qualitative component for contacts associated with water metrics (7.19) and wastewater metrics (7.36). We also find around a 4% difference on the quantitative component between water metrics (94.52%) and wastewater metrics (98.75%) in the same year. It may also be challenging to survey and allocate responses from customers that receive water and wastewater developer services from the same incumbent company. As such, **we do not propose separate calculations for water and wastewater services at this stage**.

Figure 3.4 – Average scores for the qualitative component split by water and wastewater metrics in 2021-22[28]



Q3.6: Do you agree with our proposal to keep D-MeX as a relative incentive?

Q3.7: Do you agree with our proposal to not have separate calculations for English and Welsh companies?

Q3.8: Do you agree with our proposal to not have separate calculations for water and wastewater services?

[28] All successful interviews for Hafren Dyfrdwy in 2021-22 only related to water metrics.

3.5 Calculating incentive payments

3.5.1 Current approach

Currently we calculate the maximum incentive payments for D-MeX based on a proportion of a company's annual developer services revenue within the price control.

In Appendix 3 of our PR24 final methodology, we said that we would change how we regulate developer services at PR24 to take some activities outside of the price control. We summarise these changes in Box 3.1. Because of this, we may need to change how we calculate incentive payments for D-MeX at PR24.

Box 3.1: Summary of changes to developer services regulation at PR24

- We will **remove wastewater site-specific developer services** from the wastewater network plus price control at PR24 **(for all companies)**.
- We will **remove water site-specific developer services** from the water network plus price control at PR24, but they will still be subject to our charging rules **(for English companies only)**.
- We will **retain water site-specific developer services** in the water network plus price control due to competition being less widespread, and we lack powers to establish charging rules to protect developer services customers **(for Welsh companies only)**.

These changes will result in the regulated revenue that companies receive from developer services falling.

In our PR24 final methodology, we said maximum incentive payments would remain at +6% to -12% of a company's annual developer services revenue. Separate to this consultation, we will finalise the incentive size of D-MeX in our draft and final determinations, based on the latest evidence.

3.5.2 Stakeholders' views

Affinity Water said companies with smaller regulatory capital values (RCVs) than other companies have a greater RoRE exposure. The company **suggested setting incentive payments based on potential RoRE impacts** rather than a proportion of revenue.

Fair Water Connections (FWC) said that rewarding companies by a multiple of their developer services revenue deters competitive provision because the more revenue a company loses (through work done by competitors) the lower a company's potential reward is. The stakeholder **suggested basing incentive payments on total activity volumes** rather than the proportion of work that companies retain.

3.5.3 Our assessment and proposals

Given changes to developer services activities within the price control (see Box 3.1 above) we have considered if we should change how we calculate incentive payments for D-MeX, which is currently based on a proportion of a company's actual developer services revenue.

We have considered four options for calculating maximum incentive payments:

- **Option 1 – Proportion of actual developer services revenue (current approach)**. We would base incentive payments on a percentage (currently +6% to -12%) of the actual developer services revenue collected by companies within the price control.
- **Option 2 – Proportion of actual developer services revenue both within and outside of the price control**. Same as option 1, but we would require water companies to report the revenue that they recover outside of the price control for developer services activities for the purpose of calculating incentive payments.
- **Option 3 – Based on a maximum RoRE**. Companies could earn payments based on a maximum RoRE (for example -0.2% to +0.1% RoRE), so the potential payments in RoRE terms for being the top or bottom performer would be the same for all water companies.
- **Option 4 – Proportion of the total number of new connections in a company's area**. We would specify a £ value per new connection based on the relationship between the number of new connections (provided by either the incumbent company or a competitor) and current developer services revenue. We would then multiply this value by the number of connections made each year by either the incumbent or a competitor and a percentage (for example -12% to +6%) to calculate the maximum incentive payments for each company.[29]

Our preferred option is **option 3, to base maximum incentive payments on each company's RoRE**. We consider this provides the strongest incentives on companies to improve their performance, as it should mean that all companies face the same incentive from the perspective of their investors, which will generally focus on those performance commitments with the highest returns. In addition, as RCVs grow over time, which are the basis of regulatory equity, this approach avoids D-MeX shrinking as a share of a company's risk and return package, potentially reducing company and investor focus further.

There is a risk with this approach that not taking account of the level of developer services activity in a company's area could under-incentivise companies in high-growth areas and

[29] Under this option, we would expect to set a common rate per property for all companies for simplicity. For example, based on 2021-22 annual performance reports where developer services revenue (water) was £260m and the number of new water connections connected by incumbents and competitors was 268,000, this would equate to a rate of £970 per property (= £260m / 268,000). During the period, we would multiply this value by each company's relative position and the number of connections it made that year.

over-incentivise them in low-growth areas. But because all companies have to provide non-contestable services, and we observe some correlation between a company's number of new connections and its RCV, we consider this is not a substantial risk. It is also practical to apply because companies already include RCVs in their annual performance reports.

We reject option 1 because it would provide comparatively weak incentives on companies, reflecting less money at stake due to some activities being taken out of the price control. It also risks creating arbitrarily different incentives for English and Welsh companies, since water site-specific services are remaining in the price control for Welsh companies at PR24. While option 2 addresses this by including revenue from non-price control activities, it may be less practical and add undue complexity. Options 1 and 2 have further drawbacks, because they only reflect the revenue from activities carried out by incumbent companies. This means that maximum incentive payments will be less for companies with high levels of self-lay provision in their areas. Some stakeholders have suggested this could create perverse incentives on companies to deter competitive provision and may unfairly disadvantage companies with high self-lay penetration. While this may not have a material effect on company decisions in practice, there is a greater potential risk than at previous price reviews because we expect non-incumbent provision to continue to grow.

While option 4 potentially addresses this issue by scaling by the number of new connections made by each incumbent company, helping to ensure that maximum incentive payments reflect the level of developer services activity in that company's area, we consider this adds excessive complexity for only a limited increase in accuracy. Option 3 is also consistent with our proposed approach to C-MeX (see section 2.4).

Q3.9: Do you agree with our proposed approach to calculating incentive payments for D-MeX, where the maximum incentive payments are based on a proportion of each company's return on regulatory equity?

4. Business customer experience in Wales

This section summarises how the business customer experience in Wales performance commitment currently works, before setting out our proposals for:

- adding new elements;
- accounting for large customers;
- allocating incentive payments; and
- calculating incentive rates.

This section only applies to companies operating wholly or mainly in Wales.

4.1 Current approach

At PR19, both Dŵr Cymru and Hafren Dyfrdwy had identical bespoke performance commitments to incentivise good customer experience for their business customers. This is important as customers of premises which use systems located wholly or mainly in Wales are mostly not eligible to choose their water retailer (only those that consume more than 50 megalitres of water a year are eligible to choose their retailer), unlike for business customers of water companies in England.

In our final methodology for PR24, we said that we would retain the business customer experience measure for the two Welsh companies.

This performance commitment currently measures the average score from 1 to 5 from quarterly business customer satisfaction surveys. Both companies currently have absolute targets of 4.5 out of 5. Companies undertake a survey of 250 business customers from their customer base per quarter (1,000 in total per year).

4.2 Adding new elements

4.2.1 Current approach

Currently, business customer satisfaction surveys are taken from the generality of business customers (whether or not a customer has contacted their company).

We have considered **adding new elements for customers that have contacted their company or experienced operational incidents**, to increase the focus of companies on improving their core retail services, providing services to those customers most affected by the performance of their water company.

4.2.2 Stakeholder views

We have engaged with stakeholders in Wales over the last few months, primarily through meetings with the two water companies and CCW.

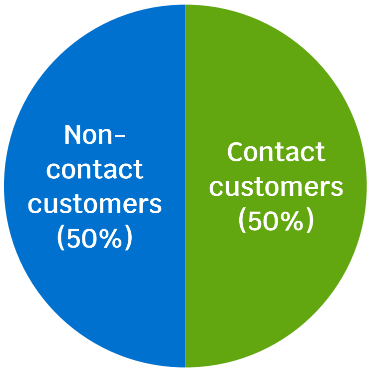
Both water companies and CCW **supported adding a contact element** to this performance commitment, saying that the survey would more closely align with company performance.

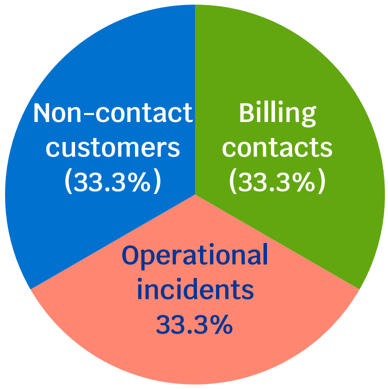
While Hafren Dyfrdwy was supportive, it noted there may be **practical challenges with adding a contact element** given it receives very few monthly contacts. The company said it was unsure whether it has enough contacts for a separate operational contacts element.

Dŵr Cymru said that splitting billing and operational contacts would add **additional complexity** to the mechanism.

4.2.3 Our assessment and proposals

We have considered the following options for what customer groups to include in this performance commitment:

Options	Detail
Option 1 – the generality of business customers (our current approach), which will include a proportion of those that have and have not contacted their company.	
Option 2 – introduce a new contact-based element to take a proportion of the sample from customers that have contacted their company (for example, 50%).	

Option 3 – introduce new elements for customers that have contacted their company or experienced operational incidents (for example, 33.3% non-contact customers, 33.3% billing-related contacts and 33.3% customers that have experienced operational incidents).	

Our preferred option is **option 3, to introduce new elements for customers that have contacted their company or experienced operational incidents**. We consider this would increase the focus of companies on their core retail services, as well as providing services to those customers affected by operational incidents. In contrast, option 1 would provide too low a chance that customers that have contacted their company or experienced issues are reflected in the survey, particularly for Dŵr Cymru's relatively large business customer base.

We consider that the additional complexity of splitting by billing and operational incidents contacts, and including customers that have experienced an operational incident but not necessarily contacted their water company, is justified to increase company focus on all aspects of customer service. This helps to address concerns by CCW that companies may not be adequately incentivised to provide good customer service for these customer types. If we opted for option 2, there would be a risk that billing-related contacts would dominate the contact element, leading to a lower focus from companies on the experience of customers affected by operational incidents. This approach is also more consistent with our approach to both C-MeX and D-MeX, where we survey customers that have had interactions with their water company, and particularly for C-MeX where we currently split by operational and billing contacts and we similarly intend to broaden the operational element (see section 2.2).

Hafren Dyfrdwy raised concerns with the practicality of this approach, given its small number of contacts. We have assessed how many contacts companies currently receive each month, with Hafren Dyfrdwy receiving around 6,500 contacts each year, of which 1,100 were related to operational issues. On this basis, we consider there are sufficient contacts to achieve a robust sample for the smallest company. We will work with both companies and other relevant stakeholders to establish an effective sample size for this mechanism. From our discussions with both companies, given their systems are already set up to manage incoming contacts for C-MeX and D-MeX, we expect this approach to be practical to implement.

Q4.1: Do you agree with our proposal to add a contact element to the business customer experience in Wales performance commitment?

Q4.2: Do you agree with our proposed weightings of 33.3% for non-contact customers, 33.3% for billing-related contacts and 33.3% for customers that have experienced an operational incident?

4.3 Accounting for large customers

4.3.1 Current approach

Business customers in Wales are highly heterogenous. The vast majority are small and medium-sized enterprises, but some very large customers use high volumes of water and wastewater services.

Smaller customers may need more protection, because they are less able to engage with their water company when things go wrong, although almost all small and large customers cannot change their provider. Larger customers are likely to have a greater impact on the economy and society, and there is a risk that they may not get sampled at all.

Under the current approach, all customers are treated the same regardless of their size or characteristics.

4.3.2 Stakeholders' views

Both companies and CCW **did not support adding a large customer element**. They said that there is not currently an issue of representation, and this would add undue complexity. They also said it is important that smaller customers, which may need the most protection, are given a sufficient voice in the survey.

4.3.3 Our assessment and proposals

We consider two options for how we approach large customers in the survey:

- **Option 1 – Weight customers equally in the survey** regardless of their size or other characteristics (our current approach); or
- **Option 2 – Give a higher weight to large customers**, for example based on the volume of water consumed or whether they self-identify as a large customer based on their employee numbers or another variable.

Our preferred option is **option 1, to maintain the current approach of equally weighting customers in the survey**. We consider this is most protective of smaller customers, which may need the most protection compared to larger customers due to less capability to interact with companies when things go wrong. We consider this also recognises that larger customers are likely to be implicitly upweighted through adding a contact element (see previous section 4.2), as they are more likely to contact their company.[30]

This approach is also proportionate and simple to administer, particularly for Hafren Dyfrdwy which has very few large business customers.

Q4.3: Do you agree with our proposal to equally weight customers in the survey?

4.4 Allocating incentive payments

4.4.1 Current approach

The current performance commitment is an absolute measure, with targets of 4.5 out of 5 for both companies. A company receives outperformance payments if it performs above this target and underperformance payments if it performs below this target.

We could instead adopt a relative approach, for example using customer satisfaction with business retailers in the English business retail market as a benchmark.

4.4.2 Stakeholders' views

The two Welsh companies and CCW **supported absolute targets**, saying that Welsh companies are not comparable to business retailers in the English business retail market.

4.4.3 Our assessment and proposals

We have considered the following options for allocating payments:

- **Option 1 – Absolute targets (current approach)** for both companies, with targets primarily based on historical performance and business plan proposals. This is similar to how we set incentives for other performance commitments, such as sewer flooding.

[30] Europe Economics, 'The introduction of B-MeX into the Business Retail Market', March 2021, section 4.4.2.

- **Option 2 – Relative benchmark approach**, which could for example be based on how Welsh companies compare to customer satisfaction with business retailers in the English business retail market.

Our preferred option is **option 1, to set absolute targets for both companies**. We consider this option is likely to be more stretching than option 2 based on data which shows that business customers in England are less satisfied than in Wales after the opening of the business retail market, with both companies above the English company average in 2017-18 for the PR14 business retail service incentive mechanism (SIM).[31] We also consider it is more practical to implement as there may not be available and consistent data on English retailers to compare against during the 2025-30 period.

But we are proposing to move the customer satisfaction scoring from 0-10 instead of 1-5, the current approach. This increases the granularity and comparability with C-MeX and D-MeX.

We are aware of the potential risks associated with absolute targets in terms of ensuring targets are set at a stretching but achievable level, as noted elsewhere in this document. We will set targets using historical and forecast data, informed by company business plan proposals, and use benchmarks where possible for robustness checks during the determinations process. To protect customers and companies, we expect to set caps and collars on this performance commitment.

Q4.4: Do you agree with our proposal to set absolute targets for both Welsh companies?

Q4.5: Do you agree with our proposal to move from a 1-5 rating to 0-10 in the satisfaction survey?

4.5 Calculating incentive rates

4.5.1 Current approach

Given our proposal to use absolute targets for this performance commitment at PR24, unlike C-MeX and D-MeX (see section 4.4), we need to establish how we will set incentive rates.

At PR19, we set the incentive rate for this performance commitment using customer valuations. For Dŵr Cymru, we based it on the company's equivalent performance

[31] Ofwat, 'Reconciling the business retail service incentive mechanism consultation', August 2019, p. 10.

commitment at PR14, and for Hafren Dyfrdwy we used Dŵr Cymru's incentive rate, adjusted for Hafren Dyfrdwy's smaller size.[32]

4.5.2 Stakeholders' views

We are using this consultation to seek views from stakeholders.

4.5.3 Our assessment and proposals

We have considered the following options for calculating incentive rates for this performance commitment:

- **Option 1 – Require companies to carry out customer research on marginal improvements**. This is the approach we used at PR19.
- **Option 2 – Set maximum payments based on a proportion of a company's allowed business retail revenue**. This is similar to our approach for C-MeX and D-MeX at PR19.
- **Option 3 – Use a top-down approach, where we put a maximum return on regulatory equity (RoRE) at risk**, informed by historical performance. This is our approach to most other performance commitments that have absolute targets at PR24.[33]

Our preferred option is **option 3, to calculate payments using a top-down approach based on a proportion of RoRE**. This should provide strong and meaningful incentives on companies to focus on providing excellent customer service to their business customers. It is also consistent with our approach to setting indicative incentive rates for most other performance commitments that have absolute targets at PR24.

We consider option 3 is also more practical and proportionate than the alternatives. Given business plans are due in October 2023, companies will not have time to carry out customer valuations research. Option 2 may risk substantially different RoRE impact between the two companies, particularly since Hafren Dyfrdwy is a relatively small company. It is also unclear whether the incentives would be strong and meaningful if the maximum payments based on a proportion of revenue (for example, ±18% as in C-MeX) were set at 0 and 10, given current performance is close to 8 or 9 out of 10.

If we were to adopt option 3, we expect we would use ±0.5% appointee RoRE, which is consistent with our current approach to indicative rates at PR24. Because we may have limited performance data in company business plans, we would most likely divide the 0.5% RoRE by a performance range equivalent to the difference between the historical median

[32] Ofwat, 'PR19 draft determinations: Dŵr Cymru – Delivering outcomes for customers actions and interventions', July 2019, p. 36; and 'PR19 draft determinations: Hafren Dyfrdwy – Delivering outcomes for customers actions and interventions', July 2019, p. 30.
[33] Ofwat, 'Outcomes Working Group slides – PC mapping/ODI rates', 29 June 2023, slide 3.

performance for both companies and the maximum possible score (10) to achieve an incentive rate per unit of performance. Consistent with our PR24 final methodology for other performance commitments, we intend to set symmetrical outperformance and underperformance rates for this performance commitment.

Because its survey methodology is likely to be new, we would expect to set caps and collars on this performance commitment and welcome views from stakeholders.

Q4.6: Do you agree with our preferred option for calculating incentive rates for this performance commitment based on a maximum return on regulatory equity?

Q4.7: Do you agree with our suggested approach to set caps and collars on this performance commitment?

5. BR-MeX

As we set out in our final methodology, we will introduce the business customer and retailer measure of experience (BR-MeX) as a common performance commitment for companies in England at PR24.

We have commissioned a customer research agency to work jointly with us and the market operator (MOSL) to develop and pilot business customer and retailer surveys to ensure they are robust for implementation from April 2025.

To further support the development of BR-MeX, we are also engaging with trading parties and CCW through industry workshops and a BR-MeX working group (see details on our website).

As set out below, we will set out our proposed incentive design in the draft determinations, before finalising our decisions in the final determinations.

Date	Deliverable
Summer 2023	Pilot period to test and develop the B-MeX and R-MeX surveys with Ofwat's appointed research agency, following a competitive tender process.
Early 2024	Publication of the pilot report and recommendations on the business customer and retailer survey designs. We may also consult on them.
June 2024	Proposed BR-MeX specification set out in the PR24 draft determinations.
Summer 2024	Shadow period and trialling to further test the B-MeX and R-MeX surveys and incentives.
December 2024	Final specification of the BR-MeX incentive in the PR24 final determinations.

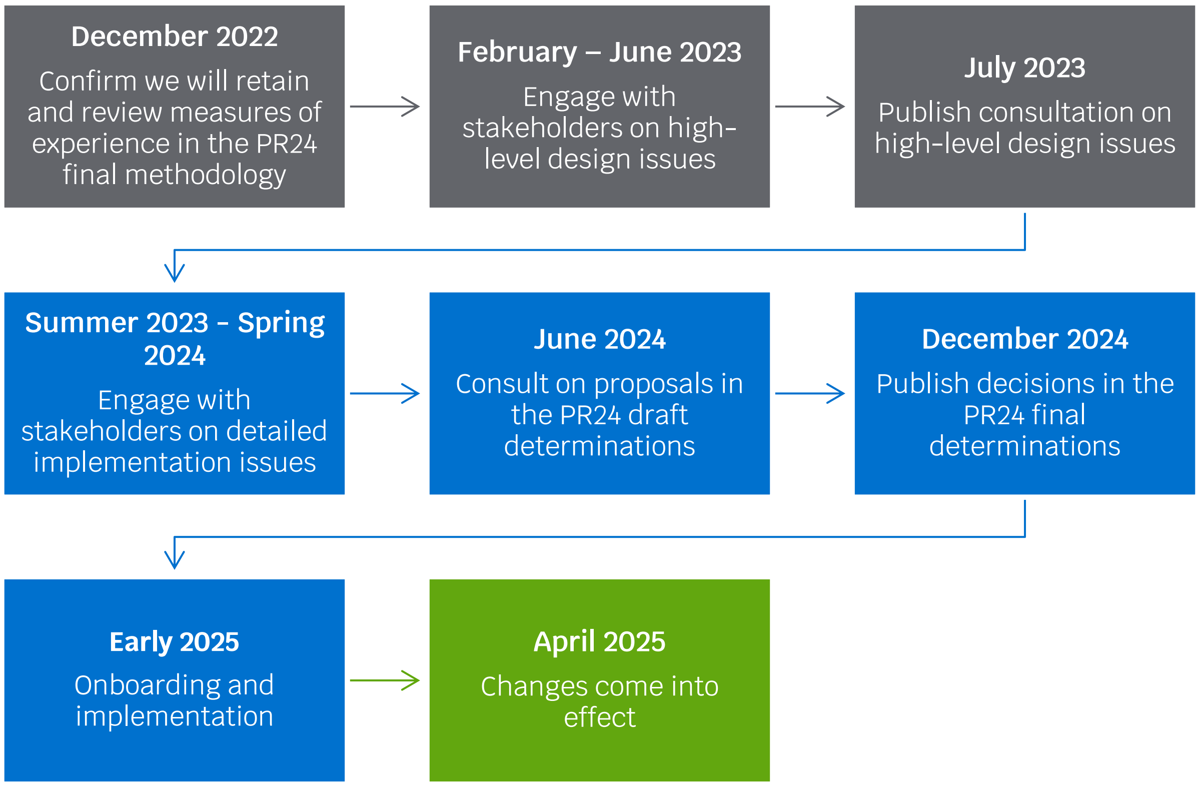
6. Next steps

We invite responses to this consultation by 26 September 2023.

In parallel to our review of the high-level design of the measures of experience and their incentives at PR24, we have started reviewing detailed implementation issues, following the timeline set out in Figure 6.1. We will continue to consider these survey and sampling issues, working with water companies and other stakeholders, during the determinations phase of PR24.

Considering the responses we receive, as well as any future stakeholder engagement, we will set out our policy proposals in the PR24 draft determinations, due to be published in May 2024 for consultation, ahead of our PR24 final determinations in December 2024. Our final policy decisions will take effect from April 2025.

Figure 6.1 – High-level timeline for our review



A1 Impact assessment summary tables

In this section, we set out a summary of the expected impacts of our policy proposals for C-MeX, D-MeX and business customer experience in Wales. These are based on three broad packages of options which we have assessed in detail in the main document.

Our assessment criteria align with our impact assessment tables for the PR24 final methodology (see Appendix 14), where we consider each package's contribution to our ambitions for PR24:

- increasing focus on the long term;
- delivering greater environmental and social value;
- reflecting a clearer understanding of customers and communities; and
- driving improvements through efficiency and innovation.

In addition, we consider the potential impact on customer bills, the potential impact on companies, including returns and the potential regulatory burden, the potential impact on other stakeholders and the practicality of implementation.

Each option is scored with a number of ticks (✓) from 1-3, with 1 reflecting a low impact and 3 representing a large positive impact. Where there is expected to be a negligible impact, a dash is used, and n/a is used where the criteria is not applicable.

A1.1 C-MeX

This impact assessment summary table considers three packages for the high-level design of C-MeX at PR24. We have broadly considered these packages below, with detailed assessment of the options we have considered in section 2 of the main document.

The three packages we assess are:

1. **Current approach – retaining our PR19 approach**. Under this package, the customer experience survey and customer service survey components are equally weighted at 50%. Payments are allocated using a relative incentive approach with gateways for higher performance payments (performing above a threshold based on a cross-sector benchmark, below average on total complaints and in the top three of C-MeX scores). Payments are calculated based on a proportion of allowed annual residential retail revenue.
2. **Preferred approach – making greater use of cross-sector benchmarks and reducing the weight of non-contact customers**. Under this package, the weight of the customer experience survey is reduced and the operational component is broadened. A company's payments would depend on how its customer satisfaction compares to that of other service providers in the wider economy, with the higher payments gateways removed. Payments would be calculated based on a proportion of maximum return on regulated equity.
3. **Alternative approach – change to absolute targets and add a new component for customers on reduced charges**. Under this package, we would introduce new components focused on the satisfaction of customers on reduced charges. Payments would depend on where a company scores relative to an absolute performance target, with a higher threshold for higher performance payments. Payments would be calculated based on a proportion of maximum return on regulated equity.

	1. Current approach	2. Preferred approach	3. Alternative approach
Increasing focus on the long term	Calculating payments based on residential retail revenue may unintentionally reduce the size of maximum incentive payments between price reviews from the perspective of investors, due to RCVs growing over time. This could weaken incentives to invest in improving customer service over the long term. ✓	Calculating payments based on a maximum return on regulated equity helps to future proof the incentive and provide companies and their investors with the confidence to invest in improving customer service over the long term. ✓✓✓	Calculating payments based on a maximum return on regulated equity helps to future proof the incentive and provide companies and their investors with the confidence to invest in improving customer service over the long term. ✓✓✓
Delivering greater environmental and social value	n/a	n/a	n/a
Reflecting a clearer understanding of customers and communities	Companies may insufficiently focus on customers that have contacted them or experienced operational incidents. Strong incentives for companies to improve their performance by competing with each other, but this may be relatively weak for the bottom performers.	Companies likely to increase their focus on customers that have experienced operational incidents, aligning with customer preferences. Linking payments to how water companies compare to service providers in the wider economy, they are likely to focus more on providing customers with what they want.	A new component based on the satisfaction of customers on reduced charges may encourage companies to focus more on understanding their experiences. High risk that all companies receive outperformance payments due to external factors, which are unlikely to match customer

	Half of companies are guaranteed to receive outperformance payments, which may not align with customer expectations around minimum levels of service. ✓✓	Only allowing outperformance payments for being better than a cross-sector average is also likely to reflect customer expectations. ✓✓✓	expectations. But if absolute targets are set perfectly, guarantees that companies only receive outperformance payments for meeting the minimum expectations of customers. ✓✓
Driving improvements through efficiency and innovation	Incentivises companies to improve their performance through a framework that should encourage them to pursue efficiencies and innovation to perform better than other water companies. The cross-sector threshold for higher payments may further incentivise water companies to seek potential innovations from the wider economy. Incentives are likely to be weaker for bottom performers, particularly if they are less efficient than other water companies. ✓✓	Stronger incentives for water companies to improve their performance compared to the best service providers in the wider economy, helped by removing the higher payments gateways. ✓✓✓	Comparatively weak incentives on companies to improve due to lack of dynamic competition, but greater certainty on future payments due to absolute targets may encourage companies to be more open about exploring cost efficiencies. ✓✓
Impact on customer bills	Customers can face higher bills and pay up to +9% of residential retail revenue each year if their company outperforms, and up to +18% if they experience customer service that compares favourably with firms in the wider economy. Customers can receive lower bills if their company underperforms, equivalent to up to -18% of residential retail revenue each year. ✓✓	Customers can face higher bills of up to +18% of residential retail revenue each year and lower bills of up to -18% based on how their company compares to firms in the wider economy. If companies do not improve their current performance, customers would receive lower bills on average. We estimate that the current range would be -17% to +4% compared to ±18% (or -18% to +9% if no company passes the higher performance gateways) for package 1. ✓✓✓	With absolute targets, there is a risk that the customers of all companies face higher bills due to external factors (and vice versa for underperformance). ✓
Impact on companies	Companies' returns reflect their performance compared to other water companies, with a reasonable balance of risk and return. Minimal implementation issues for companies. ✓✓✓	Companies' returns reflect their performance compared to other firms in the economy, which could lead to some water companies more likely to receive underperformance payments than outperformance payments, if they do not improve their customer service. Minor implementation issues for companies due to new components. ✓✓	Companies' returns reflect their performance against absolute targets, which could lead to higher returns if the targets are not sufficiently stretching. Minor implementation issues for companies due to new components. ✓✓✓

Impact on other stakeholders	n/a	n/a	n/a
Practicality of implementation	Easy to implement as no change to current mechanism. ✓✓✓	Highly reliant on external benchmarks. Changes to the operational component could add minor regulatory burdens. ✓✓	It should be relatively straightforward for companies to provide contact details of customers on reduced charges. However, due to poor data quality and inconsistent applications between companies, a component for these customers may not be targeted or effective. ✓

A1.2 D-MeX

This impact assessment summary table considers three packages for the high-level design of D-MeX at PR24. We have broadly considered these packages below, with detailed assessment in section 3 of the main document.

The three packages we assess are:

1. **Current approach – retaining our PR19 approach**. Under this package, the qualitative component and quantitative component would contribute equally to the overall D-MeX score. We would have no weights for different customer groups in the qualitative component. Payments would be allocated using a relative approach and calculated based on a proportion of developer services revenue.
2. **Preferred approach – increasing the weight of the qualitative component and increasing focus on competitors and larger customers**. Under this package, the weight of the qualitative component would increase to 66.6% and the quantitative component would be reduced to 33.3%. We would increase the weight of self-lay providers, new appointees and larger customers in the qualitative component. Payments would be allocated using a relative approach and calculated based on a maximum return on regulated equity.
3. **Alternative approach – maintaining the weights of the qualitative component (with volume-based weights for different customer groups) and conducting a detailed review of the quantitative component**. Under this package, the qualitative component and the quantitative component would contribute equally to the overall D-MeX score. We would increase the weight of different customer groups based on the volume of transactions with each company. We would conduct a detailed review of the underlying

service metrics in the quantitative component to increase their scope and stretch. Payments would be allocated using absolute targets and calculated based on the number of new connections in a company's area.

	1. Current approach	2. Preferred approach	3. Alternative approach
Increasing focus on the long term	Calculating payments based on developer services revenue may unintentionally reduce the size of maximum incentive payments between price reviews from the perspective of investors, due to RCVs growing over time. This could weaken incentives to invest in improving customer service. ✓	Calculating payments based on a maximum return on regulated equity helps to future proof the incentive and provide companies and their investors with the confidence to invest in improving customer service. ✓✓✓	Calculating payments based on the number of new connections may unintentionally reduce incentive payments between price reviews from the perspective of investors, as with package 1, which could weaken incentives to invest. ✓
Delivering greater environmental and social value	Insufficient representation of competitors and larger customers may not promote the developer services market and housebuilding as effectively as alternative packages. ✓✓	Promoting the developer services market helps to contribute to the UK and Welsh governments' objectives on housebuilding. ✓✓✓	Promoting the developer services market helps to contribute to the UK and Welsh governments' objectives on housebuilding. ✓✓✓
Reflecting a clearer understanding of customers and communities	Measures the satisfaction of developer services customers and incentivises companies to improve services provided to them, but does not address concerns that competitors and larger customers are underrepresented and that D-MeX is sufficiently stretching. Incentivises companies to improve their performance by competing with each other, but this may be relatively weak for the bottom performers. Half of companies are guaranteed to receive outperformance payments, which may not align with customer expectations around minimum levels of service. ✓✓	A higher weight for the qualitative component should materially increase the focus of water companies on the satisfaction of their developer services customers. Helps to address customer concerns about the underrepresentation of competitors and larger customers and the overall stretch of D-MeX. Incentivises companies to improve their performance by competing with each other, but this may be relatively weak for the bottom performers. Half of companies are guaranteed to receive outperformance payments, which may not align with customer expectations around minimum levels of service. ✓✓✓	Helps to address customer concerns about the underrepresentation of competitors and larger customers and the overall stretch of D-MeX. High risk that all companies receive outperformance payments due to external factors, which are unlikely to match customer expectations. But if absolute targets are set perfectly, guarantees that companies only receive outperformance payments for meeting the minimum expectations of customers. ✓✓
Driving improvements	Low representation of self-lay providers and new appointees in D-MeX may insufficiently support	Should drive further improvements through efficiency as increasing the representation of	Should drive improvements through efficiency as increasing the representation of competitors

through efficiency and innovation	the market, reducing competitive pressure on costs and service. Leaving the quantitative component unchanged, with concerns about the stretch of the targets, may not incentivise efficiency and innovation to improve performance. Incentivises companies to improve their performance through a framework that encourages them to pursue efficiencies and innovation to perform better than other water companies. Incentives are likely to be weaker for bottom performers, particularly if they are less efficient than other water companies. ✓✓	competitors should promote the market, driving down costs and increasing service. Leaving the quantitative component unchanged may not improve performance as much as package 3, but this is mitigated by increasing the weight of the qualitative component instead. Incentivises companies to improve their performance through a framework that encourages them to pursue efficiencies and innovation to perform better than other water companies. Incentives are likely to be weaker for bottom performers, particularly if they are less efficient than other water companies. ✓✓✓	should promote the market, driving down costs and increasing service. More stretching targets on the quantitative metrics could encourage companies to increase their efficiency and pursue innovation. Comparatively weak incentives on companies to improve due to lack of dynamic competition, but greater certainty on future payments due to absolute targets may encourage companies to be more open about exploring cost efficiencies. ✓✓✓
Impact on customer bills	Customers can face higher bills and pay up to +6% of developer services revenue each year if their company outperforms. Customers can receive lower bills if their company underperforms, equivalent to up to -12% of developer services revenue each year. ✓✓✓	Customers can face higher bills and pay up to +6% of developer services revenue each year if their company outperforms. Customers can receive lower bills if their company underperforms, equivalent to up to -12% of developer services revenue each year. ✓✓✓	With absolute targets, there is a risk that the customers of all companies face higher bills due to external factors (and vice versa for underperformance). ✓
Impact on companies	Since developer services revenue within the price control will reduce, outperformance and underperformance payments to companies will fall (assuming no change to the maximum incentive size). ✓	Companies' returns reflect their performance compared to other water companies, with a reasonable balance of risk and return. Minor implementation issues for companies due to changes to the qualitative component. ✓✓	Companies' returns reflect their performance against absolute targets, which could lead to higher returns if the targets are not sufficiently stretching. Significant implementation issues for companies due to changes to the qualitative component and the review and changes to the quantitative component. ✓
Impact on other stakeholders	Self-lay providers, new appointees and larger customers would continue to be underrepresented in D-MeX. ✓	Self-lay providers, new appointees and larger customers should receive higher quality services from incumbent water companies due to being more represented in the qualitative component of D-MeX.	Self-lay providers, new appointees and larger customers should be more represented in the qualitative component of D-MeX, although not as much as in package 2.

		✓✓✓	Unclear impact on market competitors, depending on the outcome of the review into the quantitative metrics. ✓✓
Practicality of implementation	Easy to implement as no change to current mechanism. ✓✓✓	Changes to the qualitative component could add minor regulatory burdens. ✓✓	Substantially more complicated to implement as would require a detailed review of target dates in the quantitative component. Connections-based approach to calculating incentives payments would add complexity. ✓

A1.3 Business customer experience in Wales

This impact assessment considers three packages for the high-level design of the business customers in Wales experience performance commitment at PR24. We have broadly considered these packages below, with detailed assessment in section 4 of the main document.

The three packages are:

1. **Current approach – retaining our PR19 approach**. Under this package, customer satisfaction surveys would only be from the generality of customers, with all customers treated equally with no weights. Payments would be allocated using absolute targets. We would require companies to carry out customer research on marginal improvements to calculate incentive rates.
2. **Preferred approach – introducing new elements for customers that have contacted their company or experienced operational incidents (no weights for customers), allocating payments based on absolute targets and using a top-down approach for incentive rates**. Under this package, customer satisfaction surveys would be made up 33.3% from customers that contacted their company about billing-related issues, 33.3% from customers that experienced operational incidents (including contacts) and 33.3% from the generality of customers. Payments would be allocated using absolute targets and calculated using a top-down approach and a proportion of regulatory equity.
3. **Alternative approach – introducing new elements for customers that have contacted their company or experienced operational incidents (with higher weights for larger customers), allocating payments using a relative approach and using a top-down approach for incentive rates**. Under this package, we would take the same approach as package 2 but upweight larger

customers in the surveys. Payments would be allocated using a relative approach, informed by the satisfaction of customers with English business retailers. We would calculate incentive rates using a top-down approach and a proportion of regulatory equity.

	1. Current approach	2. Preferred approach	3. Alternative approach
Increasing focus on the long term	n/a	n/a	n/a
Delivering greater environmental and social value	n/a	n/a	n/a
Reflecting a clearer understanding of customers and communities	Customers that contacted their company or experienced operational incidents highly unlikely to be surveyed. Risk that both companies receive outperformance payments due to external factors, which are unlikely to match customer expectations. But if absolute targets are set perfectly, guarantees that companies only receive outperformance payments for meeting the minimum expectations of customers. ✓	Focuses companies on improving services to the customers most affected by the performance of their water company. Splitting by billing and operational contacts encourages companies to focus on all aspects of customer service. Risk that both companies receive outperformance payments due to external factors, which are unlikely to match customer expectations. But if absolute targets are set perfectly, guarantees that companies only receive outperformance payments for meeting the minimum expectations of customers. ✓✓✓	Focuses companies on improving services to the customers most affected by the performance of their water company. Splitting by billing and operational contacts encourages companies to focus on all aspects of customer service. Focuses companies on improving services to large customers, which are likely to have a larger contribution to the economy. But may reduce the focus on the very smallest customers, who may need the most protection. ✓✓
Driving improvements through efficiency and innovation	Greater certainty on future payments due to absolute targets may encourage companies to be more open about exploring cost efficiencies. ✓✓✓	Greater certainty on future payments due to absolute targets may encourage companies to be more open about exploring cost efficiencies. ✓✓✓	Dynamic competition can drive performance improvements, but likely to provide comparatively weak incentives to improve due to Welsh companies comparing favourably to their English counterparts. ✓✓
Impact on customer bills	Customer bills can rise if their company outperforms or fall if their company underperforms. Depends on where we set their targets and how companies respond. ✓✓	Customer bills can rise if their company outperforms or fall if their company underperforms. Depends on where we set their targets and how companies respond. ✓✓	Customer bills more likely to rise because Welsh companies compare favourably to their English counterparts. ✓

Impact on companies	No implementation requirements to implement a contact-based element, but challenges in carrying out customer research at this stage of the price review for unclear benefits. Companies' returns reflect their performance against absolute targets, which could lead to higher returns if the targets are not sufficiently stretching. ✓✓	Additional complexity of adding a contact-based component, but companies already have similar systems in place for C-MeX and D-MeX. Companies' returns reflect their performance against absolute targets, which could lead to higher returns if the targets are not sufficiently stretching. ✓✓	Additional complexity of adding a contact-based component, but companies already have similar systems in place for C-MeX and D-MeX. Companies' returns likely to increase because Welsh companies compare favourably to their English counterparts. ✓
Impact on other stakeholders	n/a	n/a	n/a
Practicality of implementation	Easy to implement as no change to current mechanism, but new customer research may be challenging to deliver at this stage of the price review for unclear benefits. ✓✓✓	Relatively straightforward to implement based on stakeholder feedback, but potential challenges with sampling customers that have experienced operational incidents, particularly for Hafren Dyfrdwy due to its size. Top-down approaches to setting incentive rates is much simpler than customer research. ✓✓	Challenges with identifying and sampling larger customers as there are small sample sizes. More complicated to implement. Significant challenges with identifying and implementing a relative benchmark that is stretching and deliverable. Top-down approaches to setting incentive rates is much simpler than customer research and is consistent with our approach to other performance commitments with absolute targets. ✓

A2 Stakeholder engagement

The following table includes a list of stakeholders we engaged with as part of our review.

Stakeholder groups	Stakeholders
Water companies	• Affinity Water • Anglian Water • Bristol Water and South West Water • Dŵr Cymru • Hafren Dyfrdwy • Northumbrian Water • Portsmouth Water • SES Water • Severn Trent Water • South East Water • South Staffs Water • Southern Water • Thames Water • United Utilities • Wessex Water • Yorkshire Water
Customer organisations	• Consumer Council for Water (CCW) • Scope • Sustainability First
Developer organisations	• Home Builders Federation
Self-lay providers (SLPs) organisations	• Representative from BJ Utilities • Representative from Fair Water Connections • Representative from Infrastructure Gateway Ltd • Representative from Tri Connex
New appointees (NAVs) organisations	• Independent Water Networks • Representative from ESP Water • Representative from the Independent Networks Association
Others	• Institute of Customer Service • Water UK New Connections Committee

A3 Consultation questions

C-MeX

Q2.1: Do you agree with our proposal to reduce the weight of the customer experience survey to 33.3%?

Q2.2: Do you agree with our proposal to broaden the operational incidents component to include all customers affected by operational incidents and not just those that contacted their company?

Q2.3: Do you agree with our proposal to make greater use of cross-sector benchmarks when allocating incentive payments for C-MeX?

Q2.4: Do you agree with our proposed approach to calculating incentive payments for C-MeX, where maximum payments are based on a proportion of each company's return on regulatory equity?

D-MeX

Q3.1: Do you agree with our proposal to have half the qualitative component for small developers and the other half for self-lay providers, new appointees and larger developers?

Q3.2: Should we include self-lay providers, new appointees and larger developers in the same group, as we propose?

Q3.3: How should we identify larger developers in the qualitative survey?

Q3.4: Do you agree with retaining the quantitative component in D-MeX?

Q3.5: Do you agree with reducing the weight of the quantitative component in D-MeX to 33.3% while increasing the weight of the qualitative component to 66.6%?

Q3.6: Do you agree with our proposal to keep D-MeX as a relative incentive?

Q3.7: Do you agree with our proposal to not have separate calculations for English and Welsh companies?

Q3.8: Do you agree with our proposal to not have separate calculations for water and wastewater services?

Q3.9: Do you agree with our proposed approach to calculating incentive payments for D-MeX, where the maximum incentive payments are based on a proportion of each company's return on regulatory equity?

Business customer experience in Wales

Q4.1: Do you agree with our proposal to add a contact element to the business customer experience in Wales performance commitment?

Q4.2: Do you agree with our proposed weightings of 33.3% for non-contact customers, 33.3% for billing-related contacts and 33.3% for customers that have experienced an operational incident?

Q4.3: Do you agree with our proposal to equally weight customers in the survey?

Q4.4: Do you agree with our proposal to set absolute targets for both Welsh companies?

Q4.5: Do you agree with our proposal to move from a 1-5 rating to 0-10 in the satisfaction survey?

Q4.6: Do you agree with our preferred option for calculating incentive rates for this performance commitment based on a maximum return on regulatory equity?

Q4.7: Do you agree with our suggested approach to set caps and collars on this performance commitment?

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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