



# **A consultation on the outcomes framework for PR19**

**An Ofwat consultation paper**

## 1.0 Introduction

1. The Consumer Council for Water is the statutory consumer organisation representing water and sewerage consumers in England and Wales. The Consumer Council for Water has four regional committees in England and a committee for Wales. We welcome the opportunity to respond to Ofwat's consultation on the outcomes framework for PR19.

## 2.0 Executive Summary

- 2.1 It is vitally important that the new framework and regulatory model for outcomes, performance and financial incentives is both legitimate to customers and stretches companies to improve those measures that matter to customers. Many of the customers we engage with on these issues continue to harbour reservations about the outcome incentive approach and do not want companies to be incentivised, at customers' expense, for doing 'the day job'.
- 2.2 We understand the regulatory argument that giving companies that improve performance the incentive and capacity to increase revenues can be seen as replicating a competitive market. However, in this monopoly industry, where the burden of paying financial rewards for better performance falls on customers with no choice, the incentive regime needs to be viewed as acceptable by them. The choice of metrics and the value associated with them need to be designed to lead to continually stretching performance in the areas of service that customers value, and to deliver an increase in levels of customer satisfaction that compares well with other sectors that customers experience.
- 2.3 We welcome the opportunity of responding to Ofwat's consultation and respond to the 10 consultation questions in section 3 below. We believe that Ofwat's aims for the revised outcomes framework could be realised through an incentive regime that is based on three key building blocks;

### 2.3.1 Continuing use of the Service Incentive Mechanism (SIM)

- SIM has been successful in driving improvements in the quality of how companies handle customer contacts. Complaints have fallen and companies are dealing with those made more effectively.
- SIM needs to develop to reflect all the channels of communication customers use to contact their companies and some modifications to methodology and samples.
- This should motivate companies to continually improve how they address customer contacts. It would require a sufficiently strong financial penalty/reward to successfully motivate companies to improve, with a method of measuring performance that is consistent and allows for statistically meaningful comparison between companies.

We look forward to working with Ofwat in any future consultation on the development of the SIM methodology.

### 2.3.2 A new Customer Experience Measure

- We support the development of a new Customer Experience Measure (CEM) separate from SIM. The CEM should gauge overall customer satisfaction with a company's services, and ideally be comparable with other sectors to motivate the water industry to drive its customer focus towards the best of relevant comparator industries. Net

Promoter Score (NPS) is one way of doing this, being readily available from other sectors and, we understand, appropriate for use in the monopoly water sector.

- It should be based on a survey of all customers, not just those who have contacted the company.
- The level of reward/penalty must be sufficiently large to incentivise overall company behaviour and should be at least comparable to SIM. The scale of this element should be large enough to cause a step change in customer focus and segmentation that might be expected from a highly competitive market.
- We have considered carefully whether an adequate performance against this measure should be a prerequisite for a company to access other rewards. On balance, we have concluded that the measure should stand alone and not act as a gating measure for wider ODIs to avoid the introduction of uncertainty in company planning and investor confidence.

### 2.3.3 Stretching PCs and ODIs reflecting customers' priorities

- There should be a core set of common PCs reflecting universal customer priorities complemented by a small number of bespoke PCs based on additional priorities identified through individual companies' engagement with customers. If the common PCs are incentivised, they should stretch companies towards industry leading performance, perhaps through rewarding top quartile performers. Ofwat needs to consider that customers show scepticism towards companies being paid to 'do the day job' and oppose financial incentives for delivering a regulatory requirement.
- Outcomes should be based on common definitions and measures to enhance comparability and the effectiveness of reputational incentives.
- Greater use of in-period ODIs will more closely link outcomes to rewards, but any mechanism should minimise the bill volatility that consumers do not welcome. A system using rolling averages of performance over a number of years may help spread the potential bill impact of rewards. Also, a strongly incentivised customer satisfaction measure (as described in 2.4.2 above) may help encourage companies to take steps to avoid customer bill instability.
- We believe that there should be a programme of research, led by Ofwat and supported by CCWater, to:
  - engage customers in the choice of areas for common PCs; and
  - gauge customers' views on, for instance, whether upper quartile performance should be the threshold for access to rewards for these measures.

- 2.4 In terms of the overall scale of these three incentives, their combined impact must be strong enough relative to the rewards available to companies from efficiency savings and financial engineering to ensure company Boards and shareholders focus attention on how the company performs for customers.

### 3. Response to Consultation Questions

#### 3.1 Making performance commitments more stretching

##### Q1: What is your view on the use of improved information, including comparative performance information, to make performance commitments more stretching?

In addition to our comments above, which we believe would stretch companies appropriately, we agree that better comparative information, well presented and that is easily accessible, will enable CCWater, CCGs and other stakeholders to challenge companies more effectively. This is important both in terms of their progress in delivery of existing PCs, but in the development of business plans for PR19 and in making associated outcome targets stretching.

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

- We agree that the 10 proposed common PCs cover areas of service delivery and customer experience that reflect the highest priorities which customers have historically identified.
- A set of common PCs, with consistent definitions to make them comparable should reflect outcomes which are important to customers across the sector, while still allowing scope for companies to adopt individual ‘bespoke’ PCs to cover local priorities where there is strong customer demand for these.
- We agree that it is not appropriate to define a common PC in regard to services to customers in vulnerable circumstances. These are better covered by bespoke commitments which reflect the local circumstances.
- Too many common PCs (with consistent methods of measurement applied) could be seen as a return to the more prescriptive method of regulation that applied when companies reported under the Overall Performance Assessment. This risks stifling the development of more innovative approaches by companies, which should be encouraged. In this context, there needs to be a balance achieved between;
  - Realising the benefits of comparing performance in allowing transparency and challenge in areas of service that are important to customers; and
  - Incentivising companies to be innovative in service delivery and in planning for long term service improvements.
- There is an opportunity in 2017-18 to confirm that customer priorities for 2020-25 align with the ten common PCs proposed through national engagement and consultation, before the PR19 methodology is finalised in December 2017.

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

- The most appropriate method, or methods, of determining rewards/penalties will depend on the PC being considered and the way success is measured.
- Having common PCs with consistent definitions will make comparative assessments less complex and more accessible for stakeholders and customers. Some outcome measures will need to be normalised to account for different company operating environments to allow for realistic comparison of performance.
- Overall the method used must incentivise improvement and not demotivate poorer performers.

- The new Framework should, as far as possible, seek to mimic a competitive market place. We agree that making outcome targets dynamic, so that upper quartile performance levels can vary over time is one way to achieve this.
- We do not consider that a basket approach to determining overall performance is appropriate due to the drawbacks highlighted by Ofwat in the consultation document, but particularly due to its complexity and lack of transparency for customers.
- Using historic performance and rolling averages will help mitigate the effect of one-off incidents or, for example, weather-related performance.
- We agree that glidepaths should be unnecessary for established commitment measures.

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

- We agree that leakage is consistently identified as a key priority by customers. It is important that any measure of performance is understandable and accessible to customers. A consistent methodology for measuring and reporting leakage is required to allow comparability.
- Reporting leakage as per property/day is the most appropriate measure because:
  - It is easily understood by customers.
  - It captures the total leakage on a company's system.
  - It can incentivise companies to address customer-side leakage.
- We do not support the use of Distribution Input as a measure of leakage performance as it is too easily affected by changing weather patterns. In hot periods, more water is put into distribution to meet demand and leakage falls in percentage terms. The reverse is true in wet periods.
- We agree that leakage is a complex area and outcome targets must take account of individual companies' operating situations. Nevertheless, leakage targets must be robust and stretching to avoid the 'easy' outperformance by some companies during this price control period.

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

- We support the use of a limited number of bespoke PCs to complement the proposed common PCs, but suggest that they:
  - must reflect specific priorities of individual companies' customers and stakeholders, established through robust engagement. These would allow companies to be innovative in developing services and in adapting to local circumstances.
  - can be made more stretching by referencing outcomes to comparative performance of industry leaders or GAP analysis against customer expectations identified through the customer engagement process.
  - can be used to form a package, or building blocks, to achieve an ultimate outcome through discrete stages. Associated rewards can be made dependent on the achievement of each stage of a project and on its completion.
- We agree with Ofwat's reasoning for not proposing a common PC to cover customers in vulnerable circumstances which is better suited to a bespoke PC. Companies' engagement with customers should lead to an understanding of the level of vulnerability in their customer base and a profile of the customers who require support. Companies should be required to develop or extend initiatives (such as social tariffs) to address these customers' needs and set appropriate bespoke PCs and ODIs.

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

- We support the development of a new Customer Experience Measure for PR19. This should be in addition to, and separate from, SIM.
- A commonly applied PC (with sufficiently strong ODI rewards and penalties applied) based on customer satisfaction or Net Promoter Score should drive companies to improve across a wide range of areas of service, including how they communicate with customers.
- The measure for this outcome must involve research with a representative sample reflective of the whole of the company's customer base. It should not be limited to customers who have contacted the company, but should aim to gauge levels of satisfaction of all customers. This will distinguish the measure from SIM.
- The reward/penalty associated with the new measure must be sufficiently strong to successfully motivate companies to improve, with a method of measuring performance that is consistent and comparable across the industry. The incentive should be at least as strong as SIM to drive the desired outcome.
- The CEM should be based on a quantitative survey of a representative sample of customers.
- The measure should be comparable with customer service measures in other sectors. This would allow customers the opportunity to compare performance between companies in the water sector and businesses more widely and is more likely to drive the water industry to improve against other leading industries. Net Promoter Score is therefore worth exploring, being readily available from other sectors and, we understand, appropriate for use in the monopoly water sector.
- Any new measure should stand alone and not act as a gating mechanism for delivery of wider outcomes. This would avoid uncertainty about returns that could negatively affect investor confidence and management planning for the long-term.
- If strong enough this outcome incentive could also lead companies to self regulate in terms of their business plans and in managing the bill impact of their wider ODI rewards. A company may be incentivised to smooth its bill profile or face a negative reaction in its customer satisfaction measure and be penalised accordingly.

**3.2 More powerful outcome delivery incentives**

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

- We support Ofwat's intention that the revised Framework for ODIs should be strong enough to ensure company Boards and shareholders become more focused on delivering improved performance for customers in order to achieve returns.
- We welcome Ofwat's intention to become tighter on limiting the opportunity for outperformance on totex, cost efficiency and the cost of capital financing to redirect the focus of company management.
- We believe a new Customer Experience Measure will assist in driving the change in behaviour the revised Framework is aiming to achieve.
- The levels of reward/penalty should be capped, so while strong enough to motivate companies, there is a limit to the penalty and reward that may be applied. This would place a limit on bill volatility and allow for the use of an affordability cap on bill rises.
- There should not be symmetry between reward and penalty levels for specific operational ODIs where the consequence of failure in meeting a PC is greater for customers than that of success. Past research has shown that customers accept the use

of penalties more than rewards. Customers are unhappy to pay rewards for improvements which they consider companies should be making in any case.

- There is greater benefit to customers of financial ODIs linked to revenue as they offer the opportunity of reward/penalty closer to the performance which generates them, than those linked to the RCV.
- We support the continuing use of deadbands which offer protection to customers and companies against factors which are outside their control - e.g. weather conditions - and there will be ODIs for which their continuing use is appropriate.
- We do not support the use of 'gated' ODIs as these can act as disincentives for wider performance if the required gated measure is not being achieved.

### **3.3 Better reflecting resilience in outcomes**

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

- We agree that it is important that resilience and resilience planning are reflected in the Framework, and that this is transparent to customers. Resilience forms part of the delivery of a number of the common PCs proposed - e.g. sewer flooding, leakage and supply interruptions.
- Companies should, therefore, be encouraged to have commitments relating to resilience and service reliability that forms part of a long term strategic target.
- We agree that strategies must be based on long term risk assessment. This must look not only at how assets have performed in the past but also forecast performance taking into account future risks - both environmental and situational (eg house building) - and evidence of customers' expectations. This will require companies to work with other agencies as necessary. Companies should be encouraged to explore alternative mitigating measures as part of risk assessments.
- While PCs relating to long term resilience outcomes could have long term targets (with periodic 'milestone' targets included), a periodic review of these commitments should be undertaken to address the risk of long term plans becoming outdated and companies being tied into strategies which cannot adapt to changing situations.
- Financial ODIs applied to resilience PCs must be set to encourage long term investment but milestone rewards can be applied within single price review periods to encourage companies to plan to deliver outcomes smoothly.
- We support Ofwat's option of a combination of company self-determined resilience PCs complementing a number of common resilience measures.

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

- We consider that customers are less likely to accept rewards relating to asset health commitments, which they will see as a fundamental requirement of service delivery. Asset health is implicit in several of the common PCs Ofwat has proposed (leakage, supply interruptions, sewer flooding for example) and, therefore, can be covered more widely in bespoke PCs if required.
- We agree that partial standardisation will allow for greater innovation and fits better with Ofwat's aim of a less restrictive outcomes framework for PR19.

### 3.4 Making performance commitments more transparent

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

- PCs and associated ODIs should be transparent to customers as this provides customers with information about how well their company is delivering services, in the context of how well the company compares with others.
- We would encourage comparison with performance in other industries, eg through the use of Net Promoter Scores, where appropriate.
- More transparent PCs will strengthen reputational ODIs by making it easier for customers and stakeholders to hold companies to account.
- Companies must ensure their PCs are communicated effectively and presented in a way that is clear, unambiguous, complete and concise to gain support of customers and stakeholders.

## Enquiries

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