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31 January 2017

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[BY EMAIL ONLY]

Dear Jon

The outcomes framework for PR19

We consider the outcomes framework to be an important building block of the PR19 price control framework and therefore welcome the opportunity to provide input into its design. The increased focus on achieving the outcomes our customers' value was one of the most positive changes at the last price control review and we therefore support the intent of your consultation – to build on and improve the framework and the way it is administered.

We have previously made the point that to enhance the PR14 process requires striking a better balance between a proper fulfilment of the regulator's duties and the scope for innovation and diversity driven by the priorities of the particular customers we serve. This is drawn into sharp focus when considering the outcomes framework, and in particular where to apply consistency and where to allow companies to reflect their stakeholders' priorities. We are of the view that this balance can be better achieved by making some small changes to the proposals put forward in the consultation. We describe these changes in response to the questions raised.

The consultation rightly focuses on the outcomes framework, but we have now reached a point in the process where the key building blocks of the price control framework can no longer be looked at in isolation. We remain concerned that there are interactions, particularly with the cost assessment framework, that are not addressed in this consultation and feel that there is merit in the industry debating these interactions before the PR19 methodology document is published.

From a process perspective we welcome the acknowledgement that there are areas that can be improved on following PR14. We are pleased to see you reiterate your commitment to publish key information prior to the submission of business plans. The PR19 methodology consultation that will be published in July is therefore key. A fully understood intended framework will be critical to enabling companies to run an efficient business plan development process that meets all stakeholders' requirements. Given the wide ranging nature of the options presented in the consultation it would be helpful to understand now if there are areas which are unlikely to be resolved for the July consultation and where additional input from the industry could help narrow the focus.

Responses to the questions in the consultation are included in Annex 1. If you would like to follow up on any of the points we raise please get in touch with Joanna Campbell (JoannaC@waterplc.com, 01737 785 692).

Yours sincerely

John Chadwick
Finance and Regulation Director

Annex 1

SESW responses to specific questions posed

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

Use of comparative information from across the industry was not at the centre of our engagement process at PR14. This was principally due to the limited data available following the reduced focus placed by Ofwat on reporting and monitoring of performance metrics.

We welcome the renewed emphasis on this area and agree that comparable information will help customers give informed opinions about what level of service they want to see from their own water company. We already strive to provide our customers and other stakeholders with the most reliable comparative information that is available.

We agree that this should be one of the areas covered in Customer Challenge Groups' (CCGs) reports, which will be submitted alongside company business plans. We continually share our own performance with our own Customer Scrutiny Panel and we have discussed the Discover Water metrics with the members of our Panel, who all felt it was a positive step forward.

During the course of the Water 2020 programme there have been a number of references to areas that will be included in the risk-based review. The PR19 methodology document should make it clear how the risk-based review tests will be applied. This clarity would help us design a plan that best meets our customers', stakeholders' and your requirements.

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

In principle, we support the targeted introduction of common performance commitments. This is on the basis that the framework recognises that:

- areas targeted must reflect what our customers and other stakeholders consider to be of most importance and that views on relative importance will genuinely vary across the country; and
- companies are currently in different positions – both in actual performance and in the way they measure it – and Ofwat must take a joined-up approach to ensure that the strive for consistency does not inadvertently damage trust in the sector by suggesting that performance has in the past been overstated.

The topics covered by the proposed common performance commitments – which you state reflect engagement in the last planning cycle – are very likely to remain the areas of importance to customers. What has not been tested is whether the proposed metrics truly reflect what customers care most about. The consultation acknowledges that these concerns have been raised by some stakeholders but does not attempt to identify a solution. The consultation emphasises that companies are free to develop additional bespoke commitments. However, in our drive to keep the framework transparent and understandable for customers and stakeholders we do not wish to end up with a large number of performance commitments, and in particular, multiple commitments covering the same areas of performance. For example, customers may place more importance on the frequency of supply interruptions rather than their duration. We currently have 21 performance commitments and our Customer Scrutiny Panel has already expressed reservations about increasing the number of performance commitments.

Our proposed solution is to allow companies the flexibility to adopt alternative performance commitments, covering the same important areas, where they can demonstrate that they more closely reflect customers' preferences than Ofwat's chosen common performance commitment.

We have the following points on the choice of common performance commitments:

- Mean zonal compliance is a well-established, consistently measured and reported figure and therefore has some of the qualities you would want in a common performance commitment. We understand that the Drinking Water Inspectorate is looking at alternative approaches to reporting of water quality and this needs to be taken into account when setting a commitment until 2025.
- We agree that using distribution input, or water abstracted, could incentivise both demand management and leakage control through one commitment. However, the level of company control in managing these two elements of water efficiency varies and therefore we think they are best incentivised separately.
- Leakage remains of key interest to our customers and is therefore an appropriate metric for a common performance commitment.
- Customer demand is impacted by a number of factors that are outside of companies control and vary by region. These factors include the weather and affluence in the area. We therefore think it is not a good candidate for a common performance commitment and instead companies should be able to develop bespoke commitments around demand management if this is a priority in their area. If per capita consumption (PCC) is to be used as a common performance commitment then Ofwat will need to provide companies with a definition to follow that explains what level of consistency is expected in the assumptions required for the calculation (for example on occupancy rates). Current measures of PCC only capture household demand which could mean that companies reduce their focus on business customer demand management which would not be a desirable outcome.
- The abstraction incentive mechanism is not a suitable candidate for a common performance commitment because the ability for companies to apply it varies considerably.

We are also concerned that common commitments could create a situation in which Ofwat requires a level of performance on individual measures that contradict what our customers have said they value and wish us to deliver. The consultation fails to adequately recognise that these unintended consequences exist and reflect this in the proposed approach. We address this point further in response to question 3.

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

Setting industry targets for common commitments raises four principal issues.

1. It risks undermining the customer research process by setting targets which will not necessarily align with our customers' priorities – meaning the targets require us to invest more or less than we would have done otherwise. We, like many other companies, are already working with customers and other stakeholders to identify priorities so there is already a risk that this issue will materialise as we will not have a final PR19 methodology decision until December.
2. On many measures of performance there has been a lack of consistent definitions meaning comparisons based on historical data will capture these differences in measurement rather than truly reflect different levels of performance. This opens the window for companies to argue for special adjustments which undermines the whole point of common commitment levels. The recent work to improve consistency is welcomed and we fully support moving to consistency in key metrics. However, we remain concerned that limitations in the data available could result in inappropriate targets or the need for significant company level adjustments.
3. It is unclear how Ofwat intends to reflect any common targets in the comparative cost assessment process which leaves significant risk that companies are set targets that they are not given the time and adequate funding to deliver.
4. If each target is set in isolation the process risks creating a basket of measures that requires significant funding to deliver rather than allowing companies to target the areas that matter most to their customers and stakeholders.

Taking these issues into consideration we have assessed whether any of the proposed common commitments would be suitable for comparative assessment. We believe that currently only water quality measures would be suitable for comparative assessment and the use of common targets. This is because there is consistency in the way this is measured and it is a statutory standard set by the Drinking Water Inspectorate. But, note that the Drinking Water Inspectorate is considering alternative measures for water quality. A new customer experience measure would also be suitable on the basis that there is continued consistency in measurement between companies that is present in the Service Incentive Mechanism.

For other measures, the risk-based review and CCG review process provides adequate incentive for companies to make sure that their targets are sufficiently stretching in the context of their current performance levels and customers' priorities.

One area where we think additional commonality is required is the incentive rates used to calculate rewards and penalties. Creating greater consistency in this area would help assure customers that companies will not be over-compensated for delivering the improvements they commit to make. The PR14 process for setting incentive rates was unnecessarily complex and we support Ofwat's conclusion that it can be simplified.

Designing an appropriate methodology for setting incentive rates requires a decision on the approach to risk and reward and the approach to comparative cost assessment. These areas cannot continue to be looked at in isolation.

For example, the incentive rate for a reward could be set to recover the efficient cost of delivering the incremental improvement plus a rate of return. Equally, for a penalty the rate could be set based on the avoided costs plus a rate of return. This approach has a number of benefits but its application is dependent on other aspects of the price control framework.

- It does not require any valuation of customers' willingness-to-pay (WTP) which was contentious at PR14 and added an unnecessary layer of complication. The consultation notes that the PR14 approach required companies to provide "precise estimates" of WTP. But, as evidenced at PR14, a range of estimates could be provided for what, on paper, looked to be a similar performance improvement. Ofwat has stopped short of requiring companies to apply the same methodology to WTP research and therefore one would expect there to be a range of estimates again. Taking WTP out of the incentive rate calculation does not negate its importance as part of the package of customer and stakeholder research. Valuations would still be used as part of the exercise of identifying the priorities and deciding which performance commitments should be financially incentivised.
- Funding the efficient cost of delivery through the incentive rate is predicated on the cost assessment process resulting in allowances that are set on the basis of maintaining current performance levels. There are still a number of uncertainties in how cost assessment will be applied and how it will interact with other elements of the price control framework. For example, the current approach to totex baseline assessment does not take into account the current differences in companies' service levels.
- Application of a rate of return is dependent on Ofwat's position on the balance of risk and return in the base allowance versus the incentive regime. Moving the balance in favour of greater risk in the incentive regime may be looked on unfavourably by those stakeholders who do not support the use of financial rewards linked to performance.

The approach Ofwat will require us to take in setting incentive rates needs to be settled in the July methodology statement and be accompanied by clarification on the position on the related aspects of the price control framework noted above. Without this clarification there is a real risk that companies press ahead with customer WTP work that ultimately does not fit with the regulatory approach and as an industry we will have wasted customers' money and time.

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

Leakage is not measured consistently across companies. Recent work led by Water UK has shown that there will be a cost to requiring a consistent approach and it will create, in some cases, large swings in individual companies' reported performance and an overall increase in reported leakage. We fully support the recent work to improve consistency in the way key performance metrics are measured, but the impact of these changes needs to be recognised and addressed.

We agree that leakage should not be subject to a common commitment level – for the reasons stated in the consultation and because of the current limitations in the consistency of approaches to measurement adopted by companies. We therefore think that the focus of regulatory scrutiny should be on the year-on-year reduction a company targets and ensuring the target is well-justified. Moving to increased consistency and managing the reputational and financial implications could then be addressed through the PR19 process and the following five-year period.

We think that for all performance commitments there is a degree of performance that is driven by uncontrollable events, in particular the weather. The way to address this for leakage and other performance commitments is to apply a multi-year average approach or to have deadbands set to allow performance to fluctuate around a target before any penalty or reward is incurred. It would be reasonable to take either approach in the outcomes framework rather than both.

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

Ofwat must decide whether it wants companies to engage their customers and set innovative performance commitments or whether it wants to oversee a more consistent approach. The presentation of options in the consultation leaves us concerned that Ofwat does not know which way it wants to go.

In our view the development of bespoke performance commitments should be left as a choice for companies, based on discussion with customers and other stakeholders, and the areas to be covered or metrics to be applied should not be mandated by Ofwat. We would therefore argue that the guidance should be limited to the data requirements needed to justify the targets incentive rates chosen.

We believe that this approach worked well for our customers at PR14. For example, recognising that per capita consumption (PCC) in our supply area is higher than average we introduced a performance commitment in this area. The approach we took provides an incentive to reduce

PCC while recognising that influencing factors, such as the weather, are beyond the company's control.

If Ofwat decide that more consistency is warranted then we would argue that detailed guidance is needed. Companies do not want to be in the position of being negatively assessed at the risk-based review because the guidance issued was ambiguous.

We ask that the July methodology publication provides clarity on which approach Ofwat intends to follow so we can get on with the process of developing a business plan that meets our customers', stakeholders' and regulator's requirements.

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

The Service Incentive Mechanism (SIM) has worked well for customers and has helped drive improvements in service levels across the industry. We agree that PR19 provides a good opportunity to review the mechanism and consider how the current approach can be improved while not losing site of the aim to incentivise companies to deliver a better service to customers. A new approach must also ensure that there is continued consistency across companies.

We welcome the early engagement on this topic while all options are still on the table and hope that there is further opportunity for the industry to work together on the detailed design of a new mechanism. This is the one area in the consultation where it may be more sensible to devote additional time to deciding what, as an industry, we want to achieve with this mechanism and take it forward separately from the PR19 methodology development. It is also an area that requires an impact assessment as some of the options discussed: for example including the views of customers using different channels, could create additional cost and we need to test whether these costs will drive additional benefits.

We make some initial comments on the questions raised below.

- We agree that the focus should remain on satisfaction for the reasons outlined in the consultation. We consider that the focus should continue to be on customers that have come into contact with the company rather than the entire population served.
- The incentive should continue to apply to wholesale and household retail services and allow for results to be considered separately for the two business units to aid any future separation of services. The qualitative element of the SIM achieves this separation but the current quantitative element does not.
- We are in favour of removing the quantitative element from a new customer experience measure and think this can be done with no detriment to the overall incentive. Companies could still apply incentives to complaints and/or unwanted calls through their choice of performance commitments if this is proven to be a customer priority that is not covered elsewhere in the incentive framework.

- The financial incentive should be focused on a simple calculation of customer satisfaction. The same survey could be used to explore views in more depth but this should not form part of a financial incentive.
- Changing the measure from one of comparative assessment to one that looks beyond the sector is a reasonable evolution. We would support using reasonable evidence from other sectors to set a target in advance, but further debate is required on what sectors and evidence would be suitable for use. If using information from other sectors the comparability of different survey approaches needs to be considered. For example, a survey from another sector may be based on a total population but the SIM replacement may remain focused on the views of customers that have contacted their water company. This would limit the ability to make a fair comparison as there is evidence of a self-selection bias present in surveys that only target a section of the population. This bias is not an issue if the survey remains comparative across the sector as all companies' results are subject to the same bias. We welcome Ofwat's statement that "Companies will need to focus, and invest, to improve their performance in relation to many other industries". This needs to feed into the discussions taking place on retail cost assessment.
- In principle it is a good idea to seek satisfaction ratings from customers that contact us via channels other than over the phone. The practical application of this may however be a challenge and the options need to be considered and assessed. The Market Place for Ideas paper from Affinity Water and Frontier Economics shows that the percentage of customers using newer channels to communicate with water companies is low. Our own customer survey suggests that the vast majority of our customers prefer to use the phone as their main method of contact. Based on the potential for low volumes of additional views Ofwat needs to consider whether such a change would drive benefits that would outweigh the additional costs.
- If a suitable self-selection approach can be found then it would be interesting to separate the views of customers in vulnerable situations. We do not think it would be appropriate to apply a separate financial incentive because the sample size is likely to be too small to create statistically valid results.
- Providing an excellent service to developers and retailers is as important as providing this to customers. However, their needs are different and therefore we do not think that they should be included in the customer experience measure that replaces the SIM. Existing measures are in place to drive excellent service to these customers and companies have the option of designing additional bespoke incentives for PR19.

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

There is a strong reputational incentive to set stretching performance commitments and to meet the targets we developed with our customers. The incentive exists through the business planning process via the CCG review process and the risk-based review assessment, and through the regular communications and annual reporting that we provide to customers and other stakeholders. This has been recently enhanced with the increased focus on comparing across the industry, including through the Discover Water website. These existing tools work well and any additional measures to increase the strength of reputational incentives risks further complicating the regulatory framework.

The consultation states that “ODIs are relatively less powerful than the financing and cost incentives” and implies that this means there is “relatively weak financial incentives to deliver improvements to service”. We consider the reputational incentive to deliver performance commitments is strong. We remain unconvinced that putting greater weight on the magnitude of financial incentives will drive better outcomes for customers and could create increased variability and less predictability in charges.

Our response to question 3 contains feedback relevant to some of the specific proposals listed in the consultation. In addition:

- rather than removing the use of aggregate cap and collar it should be an area where companies have the freedom to choose the approach they take in their business plan; and
- guidance on an overall range should incorporate all aspects of out-/under-performance in the price control framework and not simply be focused on the range for ODIs.

These suggested variations from the proposals in the consultation would leave the onus on us to develop a business plan that balances risk and reward in a way that allows us to meet the needs of all stakeholders including customers and investors.

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

The principles proposed are sensible and it is reasonable to expect companies to justify resilience driven investment using these principles. Through the cost assessment working group there has been some discussion of a common requirement for cost-benefit analysis (CBA) which could equally be applied as a means of evidencing the needs case and cost efficiency of resilience schemes. There has not been a conclusion on whether guidance from Ofwat for CBAs will be prescriptive or principles based. We would urge Ofwat to select an approach by the July PR19 methodology document and stick to it.

There are some key themes to resilience – adapting to the impacts of climate change, meeting the demands of a growing population and mitigating the impact of economic changes – but what individual companies need to do to continue to deliver a resilient system will almost certainly vary. Our preference is therefore that alongside the planning principles companies are allowed to develop individual approaches to resilience that link back either to the proposed set of common performance commitments or develop bespoke commitments to allow for levels of resilience to be monitored. Ultimately not delivering a resilient system will show through as poor performance on the commitments set.

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

We agree that asset health is not an outcome and focusing financial and reputational incentives on delivering outcomes should ultimately ensure that asset health is appropriately managed. The current proposals acknowledge that outcome delivery and asset health are different but then appears to focus on incentivising asset health as if it was an outcome.

On the basis that the cost of managing the health of our assets is provided through base revenue allowances we see no benefit to having an additional financial incentive linked to asset health metrics. Focus should therefore be on developing metrics that we can report against to give customers, regulators and other stakeholders the visibility they need to have confidence that we are managing our assets appropriately.

To achieve visibility we think Ofwat must introduce a more standardised approach to reporting requirements. This would ensure transparency on asset health while leaving the outcomes framework – and most importantly the flexibility for companies to adopt outcomes that reflect customer priorities – unaffected.

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

We agree with the principles around transparency and dissemination of information about actual performance. We expect this to be an area that CCGs will focus on.

We agree that scheme specific performance commitments should be limited. Our preference would be to recognise that major schemes impact on outcomes. Therefore delivering those schemes is incentivised though an outcome, and related performance commitment, rather than directly via a penalty targeted at delivery of a scheme. In principle we support submission of special cost factor claims and our associated approach to protecting customers outside of the business plan submission process. It could provide a suitable mechanism for dialogue on such areas of investment outside of the business plan review process. We would welcome discussion on the proposed timetable and the process in more detail to understand what would be required from us and how Ofwat see this process working alongside the business plan review process.