
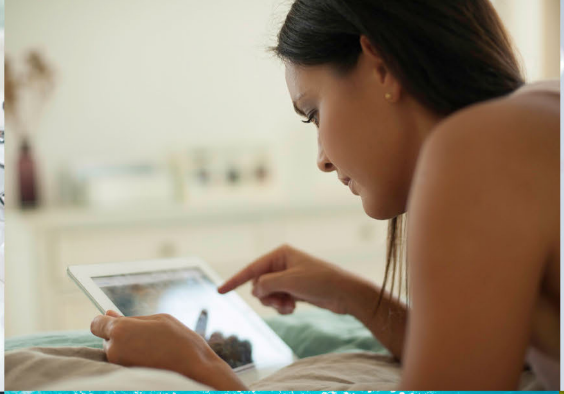







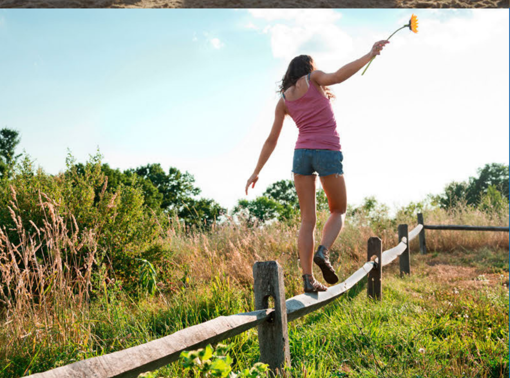

NWG living water

# OUTCOMES FRAMEWORK FOR PR19

Our consultation response




# A CONSULTATION ON THE OUTCOMES FRAMEWORK FOR PR19
# NORTHUMBRIAN WATER GROUP'S RESPONSE

## Overview of our response

### Introduction

Our company vision is to be the national leader in the provision of sustainable water and wastewater services. Central to this is our commitment to delivering unrivalled customer service. We therefore very much welcome the opportunity to contribute to the debate on outcomes and incentives through this consultation.

We agree that it is important to build on the innovative approach to outcomes that was introduced at the 2014 price review (PR14). This led to a step change within industry, by incentivising a focus on delivering what matters to customers, future customers and the environment. As such there is a real opportunity at the 2019 price review (PR19) to enhance incentive-based regulation in the sector.

We have used a balanced scorecard to measure performance within our own company for some time, alongside the setting of leading performance targets. This approach has driven significant service improvements for both our customers and the environment. We therefore welcome a similar approach being embedded in the regulatory framework.

We have considered and responded to the ten consultation questions in detail over the following pages. This response reflects the views of our Board. The key points of our response are set out below.

### Making performance commitments more stretching

We strongly support the use of comparative information to drive improvements in performance. In most markets this is how customers exercise choice, by comparing the performance of products and services. This information must be transparent and consistent, supported by clear definitions and rigorous independent audit. We view this as essential to maintaining trust and confidence and achieving a level playing field for all companies. Such information will then provide customers with the evidence they need to challenge companies. We have made significant efforts in this regard, for example, by publishing comparative information on our own 'Discover Water' web pages.

We support the proposal that a set of core measures of success should be applied to all companies, and that outcome delivery incentives (ODIs) should be attached to common measures of success. These ODIs should be meaningful and transparent to customers. Similarly we can see benefits from introducing common commitment levels for a core set of performance commitments. In our response we suggest a pragmatic solution as to how these commitment levels might be applied, which is for them to apply to individual measures with rewards based on achieving upper quartile performance.

Companies should also be free to engage on bespoke measures that have strong customer support. We would also expect companies to engage with customers more broadly on subjects such as trust, transparency and loyalty.

We welcome the opportunity to use a wider and richer evidence base when setting performance levels for bespoke performance commitments, so that they can more fully reflect customer priorities.

Leakage is an important area for customers and we are already working to increase the consistency and transparency of leakage reporting. We believe that leakage commitments should reflect the economics of leakage and be derived as part of a company's overall plan, not based solely on comparative data.

We welcome the proposals for a new customer experience measure. We see many benefits from this being co-created with customers and other stakeholders. There are also opportunities to include a wider range of evidence sources, including information gathered from contact through social media and outbound contacts.

We would also support the introduction of a new qualitative customer experience measure for developer services.

**More powerful outcome delivery incentives**

We believe that ambitious companies should be able to earn higher returns for delivering higher performance. We are therefore supportive of the proposals to introduce more powerful incentives for leading companies.

In designing incentives, it is important to avoid any scenario where, for example, a poorly performing company earns a reward merely for improving its own performance from a poor starting position. Such scenarios could damage customer confidence in the regulatory framework. Performance should be measured relative to frontier performance rather than the historic performance of the company.

We believe that rewards or penalties should be made in-period so that they more closely reflect the timing of company performance. It is also important that the scale of rewards and penalties is such that they constitute a worthwhile prize, and thereby promote strong incentives.

When it comes to setting common ODI rates we would support allowing companies to take a top-down approach. This could include letting companies choose a target return on regulatory equity (RoRE) range within an envelope and using the findings from their customer engagement to determine the balance of rewards and penalties on bespoke incentives.

We support the suggestion that ranges for the RoRE should be symmetric between reward and penalties. This could be achieved by setting the cost of equity at an industry average level but giving companies an opportunity to earn varying returns on equity based on the level of performance delivered. We also agree that there would be merit in removing the aggregate RoRE cap and collar and giving companies greater scope to choose the appropriate balance of risk and return. This could be an area where a company declares its risk appetite for outcome delivery.

We believe that Ofwat's variable cost of equity proposal could be modified to become a company outcome incentive choice at the time when the company submits its business plan. This initial choice could be indicative, with a final choice made as part of the final determination. This approach would give those companies that are confident about outperforming an opportunity to choose increased incentives and higher returns for delivering that outperformance.

**Better reflecting resilience in outcomes**

We see resilient services as a cross-cutting issue, and one that is fundamental to our business. It is our intention that resilience will underpin our own business planning at PR19. We are therefore fully supportive of the drive to better reflect resilience in the outcomes framework, as set out in the consultation document.

In terms of the more detailed proposals, we agree with the proposed resilience planning principles, particularly those that encourage companies to consider a broad range of intervention options (including response and recovery).

We consider that bespoke resilience measures are more appropriate than common measures, in part because companies face different challenges in their areas. There is also a risk with common measures that the measures end up dictating the method, not the outcome.

In our view there is scope for companies to meet their resilience obligations through the assurance framework. The assurance assessments that Ofwat applies could include consideration of the extent to which companies have identified and mitigated risks to service.

**Making performance commitments more transparent**

We agree with proposals to make performance commitments more transparent by making sure that common definitions are sufficiently detailed. We would also support a programme of independent horizontal audits to provide assurance on consistency and engender trust and confidence.

We think there should be a strong link between performance commitments and outcomes that have been shaped by comprehensive and open customer engagement.

## Making performance commitments more stretching

**Q1: What is your view on the use of improved information, including comparative performance information, at PR19 to make performance commitments more stretching?**

We strongly support the use of comparative information to drive improvements in performance. Indeed, we already scrutinise benchmarking data when setting our own performance targets. Our performance against these targets, and our relative performance compared to the rest of the industry, is also scrutinised by our Customer Challenge Group (CCG). This approach has driven significant service improvements for both our customers and the environment.

We agree that giving more information to customers provides the evidence they need to challenge their companies. In this regard we have engaged extensively with Water UK on the development of the Discover Water dashboard. We have also started to share more detailed information on our own comparative performance by placing Discover Water specific 'landing pages' on our website. These have been well received by both Water UK and Ofwat as a way of providing even greater transparency to customers.

For comparative assessments to be credible, they must be based on information that is genuinely capable of comparison. To be certain that this is the case, each measure must be clearly defined and these definitions must then be applied in a robust way. These processes should be underpinned by a programme of proportionate but rigorous and independent ex-post horizontal audits where checks for consistency are made. We view this as essential to maintaining trust and confidence.

We have played a key role in work to date to establish robust and consistent definitions for metrics such as leakage, interruptions and sewer flooding. We are on the steering group for the UKWIR project on the consistency of performance measures, for example. We would welcome an approach that builds further on this work.

We strongly support the use of comparative information when engaging with customers. We agree that such comparative information needs to be framed appropriately if it is to result in meaningful engagement. Again, we welcome the opportunity to work with our CCG on this.

We are supportive of incentivising the use of better information in business planning.

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

We are very supportive of a limited set of core measures of success that apply to all companies, whilst still leaving scope for companies to innovate.

As we noted in our response to Q1, it is imperative that all companies measure their performance against these common measures of success in a consistent way.

We are broadly supportive of the common measures of success that are proposed in section 2.5, subject to the following specific comments.

- We consider that sewage treatment works discharge compliance is a significant omission. The quality of continuous discharges has the potential to have a significant long-term impact on the quality of rivers and bathing waters. All companies already report performance against this measure under the Environment Agency's current monitoring regime.
- We agree with the observation that the Abstraction Incentive Mechanism may not meet the 'applicable to all companies' test for a common performance commitment.
- While we are very supportive of resilience being reflected in the outcomes framework, it is important when selecting specific measures to make sure they drive the right behaviour and do not undermine outcomes-based thinking. We consider this further in our answer to Q8 and Q9.

We are supportive of the approach whereby ODIs are attached to common measures of success. We think that incentive rates should be set in a consistent way across the industry and should not be based on local results of willingness to pay (WTP) surveys. While these surveys can be helpful to determine relative customer priorities, the results are not sufficiently consistent or accurate to be used for calculating incentive rates. We consider this further in our response to Q7.

We agree that ODIs should be specific to price controls, on the basis that it should be possible to attach all ODIs to an individual price control on a 'primary driver' basis. The need for ODIs to be price control specific, however, should not detract from the requirement to make outcomes and performance commitments meaningful and transparent to customers.

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

We welcome the introduction of common commitment levels for a core set of performance commitments. At PR14 the introduction of ODIs and performance commitments that were set by companies in consultation with their own customers was a substantial and positive innovation. It has, however, resulted in some companies earning rewards for a level of comparative performance that would see a different company incur a penalty. This is difficult to explain to customers and does not seem fair, nor does it appear to drive incentives for frontier companies. For selected performance commitments, setting common commitment levels has the potential to resolve this issue.

We are broadly supportive of the measures proposed for comparative assessments.

In our view, comparative assessments work best in relation to performance commitments that relate to mandatory standards, where robust common definitions already exist. It would be beneficial for sewage treatment works compliance to be included alongside drinking water quality.

We support the inclusion of bursts and collapses in the list of common performance commitments as measures of asset health. We do not agree that they are comparative service measures.

We support setting common commitment levels for individual measures, based on achieving at least upper quartile performance. Rewarding the performance of leading companies is important as it sets the benchmark and provides incentives for all companies to catch up. This also reflects competitive markets where leading companies earn higher returns until competitors are able to match their performance.

Further sense checks should be applied. In each case it should be established that the proposed level of performance is likely to be acceptable to customers. In addition there will be cases where the industry is already performing at, or close to, zero failures or 100% compliance on a given measure. In such cases there is a risk that making further improvements (or indeed maintaining the current high level but with a greater degree of certainty) can require significant investment with no meaningful change in outcome from a customer's perspective.

While we strongly support a comparative approach, there is obviously the potential that performance commitments that are set comparatively across the industry might conflict with the results of local engagement with customers.

A simple solution would be to consult customers on the acceptability of the proposed framework for those core measures that are subject to common commitment levels. In other words, to seek customers' views about setting performance commitments on a comparative basis using upper quartile assessments. This would enable a more genuine and meaningful conversation with customers than if companies consulted in detail on targets for these measures, the results of which could be overridden by independent horizontal assessments.

Companies should also be free to engage on bespoke measures that have strong customer support. We would also expect companies to engage with customers more broadly on subjects such as trust, transparency and loyalty.

Consideration would need to be given on whether customer consultation on the proposed framework for common commitment levels should be carried out locally or on a national basis.

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

We strongly support proposals to increase the consistency and transparency of leakage reporting. This is critically important to maintaining trust and confidence in the water industry.

We believe that leakage commitments should be derived as part of a company's overall plan and should not be set in a simplistic way based on comparative data (although comparative data provides helpful context and should be referred to in justifying commitments).

We agree that targets should be expressed in megalitres although we would support these targets being set on the basis of a three-year rolling average, which we discuss further below.

We believe that robust calculation of the sustainable economic level of leakage (SELL) is key to setting appropriate targets. We would support incentives for companies to drive the SELL down over time. There is a balance to be struck, however, between maintaining customer trust, and incurring unnecessary expenditure that has an upwards impact on bills. We do not support forcing companies to operate below the SELL.

**The commitment levels that companies report for common performance commitment should be measured on a consistent basis in total megalitres and based on financial years.**

Leakage estimation is complex and is dependent on a wide range of input data and calculations. Simplification in order to derive a single number for use as the performance commitment presents a risk and it may instead be more appropriate to set a range.

We strongly support efforts to improve the consistency and transparency of leakage reporting. This is a key element of the comparative approach.

However, there seems to be no obvious and fair comparative measure of leakage performance. Approximate comparisons can be made using the measure of litres per property per day, but this approach is not appropriate for assessing leakage targets, as it fails to take account of many critical factors. These include:

- The company's resource position.
- The cost of water.
- The condition of the infrastructure.
- Operating conditions such as water pressure levels and soil types.

It is our view that a performance commitment on leakage should be considered within the context of an individual company's overall water resource plan or business plan. While a total megalitres measure is appropriate for comparing an individual company's compliance with its future plans, it has limitations if used out of context for making comparisons across companies.

In light of these considerations it is our view that while there should be consistency in the definition and measurement of leakage, target setting should be done at a company-by-company level. Comparative data should be used to provide context but should not be used to derive targets in a mechanistic way. Companies should be required to explain why their approach to leakage is customer focused and efficient, especially when compared with the efficiency of approaches adopted by other companies.

In terms of a consumption indicator, we consider that using a combination of leakage levels and per capita consumption (pcc) is better than relying on distribution input alone. Together they provide contextual information for company plans and illustrate the extent of water efficiency and network maintenance that is being undertaken. The distribution input measure is also sensitive to fluctuations in the demand from non-households. We would advocate the development of a consistent methodology for measuring pcc.

We agree that targets should ultimately be expressed in total megalitres. Although there are arguments for measuring leakage over a different period to the regulatory year (say a summer-to-summer cycle, which would avoid year end coinciding with winter peaks) this would complicate regulatory reporting. We would however support the assessment of leakage over a three-year rolling period. This would offer better opportunities for managing leakage effectively and efficiently as it would allow the effects of factors outside of management control to be considered within a wider timeframe. Managing down any spikes that occur in leakage in a report year over a longer timeframe, for example.

**Improve the consistency of data underlying leakage.**

We recognise that leakage is an area of significant interest for our customers and are taking part in ongoing work to establish a better definition of leakage as part of the industry working group.

We strongly support the case for improving the consistency of leakage estimation across companies. In this regard we are playing a leading role in the Water UK project that is seeking to drive greater consistency.

Assessing the overall level of leakage requires a wide range of data inputs as well as an understanding of where in the network the leakage is taking place. A key part of the assessment is the use of appropriate, robust and consistently derived figures for the water balance. This would include the pcc figure, particularly if the measure is being used as part of an industry-wide comparison.

**Companies to report the sustainable economic level of leakage and its range in their business plans.**

We support the proposal that companies should report their SELL in business plans, along with the key underlying assumptions.

**Companies should take into account their long-term expectations of the future value of water, the scope for water trading and the resilience of their supplies when considering their leakage commitment levels.**

We agree that the future value of water, the scope for water trading, and resilience are all factors to take into account when determining a performance commitment for leakage.

Given the inherent uncertainty surrounding each of these variables it may be more appropriate, particularly with a longer term forecast of performance commitments, to use a range of values rather than a fixed point. This would be similar to the way in which headroom assessments are made within water resource management plans.

**If a company is not committing to a downward trend in leakage, then it will need to provide robust evidence for why this is the case.**

The consultation document makes it clear that companies will be expected to propose further reductions in leakage levels in AMP7, and that it will be difficult for companies to justify not doing so.

We believe companies should be committed to meeting the SELL and to finding ways to drive the SELL down through innovation and efficiency.

We do not believe that companies should be required to operate below the SELL, however, as this would mean operating at a level of leakage that is not economic to maintain. This will not be in customers' interests as it will ultimately result in bills being higher than is necessary.

We believe that companies that wish to reduce leakage to below the SELL should provide strong evidence of customer support. If customers indicate that they are not willing to pay for the additional investment that is necessary to reduce leakage below the SELL, then the company may wish to operate in line with customer preferences rather than proposing further reductions.

It should be noted that the calculated SELL might actually increase once investment has taken place to address a supply-demand imbalance. So, for example, if a new reservoir has been built or an existing reservoir's capacity has been increased, the SELL would typically increase because there is a fall in the value of the water that is lost. This could then be used as the justification to allow leakage to increase. Once the headroom is sufficiently reduced the SELL will reduce once more. Although this is technically how the SELL calculation works we think it is a very difficult message for customers when they learn that leakage can be allowed to rise after investment in resources has taken place. Furthermore, we believe that allowing leakage targets to rise and fall in this way would be neither politically acceptable nor economically efficient.

Our ESW region is currently operating significantly below the SELL for precisely the reasons described above. We do not think it would be sensible to allow leakage to rise beyond current levels although equally it may be difficult to justify further reductions in leakage in this region.

**Companies should explicitly state that their performance commitments are consistent with water resource management plans or should explain any differences.**

Leakage management is an integral part of the long-term water resource management plan. We agree that long-term commitments should be consistent with water resource management plans and that any differences should be explained.

**Companies should consider comparative information on leakage/property/day and leakage/km of main/day and explain why their leakage commitment level is appropriate in this context.**

Leakage estimation is complex and no single measure in isolation is appropriate for comparative purposes. We agree that leakage performance commitments should be viewed in the context of the two key measures identified and possibly other comparative measures or contextual data. It should be for companies to justify their proposed performance commitments based on robust analysis, including appropriate comparative analysis that includes but may not be restricted to the measures that Ofwat identifies.

**We expect companies to provide a long-term projection for leakage levels – consistent with Ofwat policy on long-term performance commitments.**

We support the development of long-term planning to deliver long-term commitments. The assumptions can differ between companies. They may even differ between water resource zones within an individual company's water resource management plan. In our view, it would make sense if the level of uncertainty within long-term projections were reflected in the performance commitment (see also our response to Q1).

**Companies will need to justify why they have adopted a whole company commitment level or regional commitment level of leakage.**

We agree that companies should justify why commitments have been adopted at a company-wide or sub-company level. There may be valid reasons for both. For instance we have two operational areas some 300 miles apart in the North East and in Essex & Suffolk. We currently report leakage separately for these two areas. For the purposes of a performance commitment we could conceivably aggregate these to a company-wide figure or indeed set commitments at a more local level. There would be pros and cons to any such change and we would engage with our CCG on this issue.

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

We agree with the observations, outlined in the consultation document, about the way that WTP research was used at PR14. We welcome the opportunity to use a wider and richer evidence base so that bespoke performance commitments more fully reflect customer priorities. We welcome the opportunity to work with our CCG on this aspect. We also agree that comparative information has a role to play in this area.

In our view this approach is likely to require a higher degree of judgement than simply relying on a numerical equation that balances marginal costs with incremental WTP. However, if company proposals are subject to robust challenge from their CCGs, this approach should result in more meaningful commitments.

We remain open minded about the results of our customer engagement, and whether it will result in all cases in more stretching performance commitments.

As regards the proposal to set a profile for performance commitments, we recognise that seeking year-on-year improvement can drive a continuous focus from companies. It can also, however, reduce the scope for innovation in that it could encourage companies to focus on initiatives that deliver smaller incremental improvements rather than more transformational activity.

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

Our customers are at the heart of everything we do and they tell us that providing excellent service is important to them. We therefore welcome the continued focus on this area, and the opportunity to review and potentially enhance SIM by creating a new customer experience measure.

We wholeheartedly agree that customers should be given the opportunity to participate in the co-creation and co-delivery of solutions and we live by this principle. For example, we co-created our *Unrivalled Customer Experience Strategy* by working with our customers, our employees and our supply chain partners. We would welcome the opportunity to co-create a customer experience measure in this way, one that is fit for the future, with customers and other stakeholders. We would therefore encourage and support such an approach.

We consider below the eight sub-questions in relation to the development of a new customer experience measure for PR19.

**The scope of the future experience measure; on which outcomes we should be targeting; and on the appropriate level of measurement.**

We believe that the scope of a future experience measure should include both quantitative and qualitative elements, and should cover both experience and perception based metrics. The weighting should continue to be in favour of qualitative elements.

While on the face of it the current SIM focuses specifically on the satisfaction of the last transaction that a customer had with their service provider, their response will invariably be influenced by their overall experience to date. The current measure therefore includes to a degree a reputational assessment.

In research that we carried out in spring 2016, our customers told us that although it is important that "we provide excellent service and impress our customers" there are other outcomes that are equally important. Customers want to have the opportunity to engage with us on these outcomes and to have some influence over them. These outcomes are:

- Our customers are well informed about the services they receive and the value of water.
- Our customers consider the services they received to be value for money.
- Our finances are sound, stable and achieve a fair balance between customers and investors.
- We are a company that customers can trust.

Some of our current measures of success reflect these priorities for customers. We use net promoter score, trust and the value for money metric in CCWater's 'Water Matters' research. We also carry out independent surveys of our customers' levels of overall satisfaction, and their views on value for money, trust and keeping them informed.

We would welcome the opportunity to develop an industry-wide customer experience measure that incorporates outcome priorities as seen by our customers.

In line with our *Unrivalled Customer Experience Strategy*, we are placing a greater emphasis on contacting customers proactively (outbound contact). The current SIM only considers those customers who contact us (inbound contact). It may be valuable to consider including these outbound contacts within the customer satisfaction survey.

We would welcome the opportunity to develop an industry-wide customer experience measure that includes appropriate proactive contact with customers.

We believe that one of the most important factors is that any new customer experience measure is transparent and meaningful to customers. We believe for households it should continue to be measured at a company-wide level, covering both retail and wholesale service provision, so as not to burden customers with the complexity of which service aspects are allocated to which price control.

We think it is very important that any new customer experience measure is completed through a short survey approach so that customers stay interested and are not under pressure to rush their answers.

**The wholesale-retail focus and split. We also particularly welcome views on whether any of the other key questions explored, such as which outcome(s) to measure or which customers to target, could differ from a retail and a wholesale perspective.**

We agree that it is important to maintain household customer service measurement for both retail and wholesale operations. As mentioned earlier, it is also inevitable that customers' responses to either wholesale or retail experiences will be based in part on their overall experience of the service provider to date.

We consider that the current 50:50 split that is used in the SIM survey between water/wastewater and billing is appropriate. However, the sample size needs to increase if the scores for each aspect are to be representative.

The ability to consider wholesale water and wastewater operations separately is also useful and provides us with areas on which to focus improvements. Further consideration could be given to comparing these operations separately across the industry.

**The question of whether a future measure should incorporate cross-industry comparisons.**

When it comes to the provision of excellent customer service, we believe that looking outside the water and wastewater sector can 'raise the bar'. Innovation can often come from other sectors. We do this as a matter of course when looking to enhance and improve the services we provide to customers.

As previously noted, one of our measures of success is net promoter score and we benchmark ourselves against the leading companies both within our industry and beyond. Net promoter score could possibly be included in a new customer experience measure.

We also participate in the UK Customer Service Index (CSI) benchmarking. However, we have reservations about using this index to compare performance as we think that the survey methodology and sample size could be more robust. For this reason we do not think the current UK CSI measure should be included in a future customer experience measure.

While it is useful to look both within and beyond our sector for ways to improve customer experience, we believe it is also important that in terms of comparative performance we are measured fairly and transparently within our industry. This ensures that reporting is clear and simple to understand for customers and other stakeholders.

An option in the future could be to include the net promoter score question alongside the SIM consumer experience survey. The points on consistent measurement made elsewhere in this response are also applicable here.

**The question of which subsets of end-user customers should be targeted or included for a future measure.**

Measuring the opinions of customers who have had a recent transaction with a company provides valuable information. We would welcome the opinions of a larger number of these customers within a future customer experience measure.

At present, SIM does not include interactions with 'the silent majority' of customers who have not had any contact with their company. In our Domestic Tracking Q3 2016 survey, for example, 74% of respondents had not had any contact with us in the previous 12 months, other than paying their bills.

Customers who have been proactively contacted in relation to retail operations (for example, when the company provides reminders or advice regarding payments) or wholesale operations (for example, when the company notifies customers about work that is shortly to start in their areas) could also be included within the SIM survey.

The consultation suggests that self-service customers would not feature within the survey. This misses an opportunity to measure the customer experience in self-service contacts, which are an important and increasing element of overall contacts. We believe that if customers transact in such a way and we can identify that they are genuine customers (eg they are making a payment), then they should be included. Customers who self-serve by accessing FAQs or simply by visiting websites may not be genuine customers and should not be included, as doing so could give rise to concerns about consistency across the industry.

A proportion of the transactions at our call centres are outbound. The exclusion of these customers could be considered a missed opportunity to understand whether or not the customer service and overall experience we provide in these cases is welcome and useful.

**The question of adopting a more multi-channel approach to identifying and gathering the voice of the customer.**

We agree that methods of holding two-way communication with our customers are far broader than they were when SIM was first introduced. Any new customer experience measure should encompass all genuine customers, regardless of the way in which they choose to interact with us. The key to this will be making sure that definitions are clearly understood and that company practices are audited so that a consistent approach is used across the industry.

In July 2015, the Institute of Customer Service reported that customer complaints had seen an eight-fold increase on social media. We actively use social media and other digital channels to communicate with our customers.

It may be beneficial to start to measure areas such as social media sentiment and web service satisfaction levels on a consistent basis across the industry with a view to incorporating this into a future development of any customer experience measure.

**The continued inclusion of a quantitative component in a future measure.**

We believe that the quantitative component of any future measure should focus on customer complaints alone. There is a well-established definition for complaints across the sector, and this allows comparisons and benchmarking to be carried out with other industries.

We do not consider that unwanted contacts, as are currently used, should be included as a measure in the future. In our experience the definition and classification of unwanted contacts is open to broad interpretation across the sector and this results in inconsistent approaches. We know that some companies classify contacts as unwanted at contact category level while others leave their contact centre agents to decide. In our experience, unwanted contacts will manifest themselves through complaints and dissatisfaction levels, both of which can be measured in other ways.

**Using a future measure to help support a focus on consumer vulnerability.**

We agree that it is essential to understand and respond to the distinct needs and requirements of different customers. In our *Unrivalled Customer Experience Strategy*, we recognise that this applies to all of our customers, not only those in circumstances that may make them vulnerable.

We also recognise that vulnerability can be difficult to define and that it is very personal. Two individuals in identical circumstances may or may not consider themselves to have circumstances which deem them to be vulnerable. We would therefore approach self-identification of vulnerability with caution.

We recommend ensuring that the sample size for a new customer experience measure is sufficiently wide and broad, and encompasses a range of different channels of communication, so that a statistically robust sample of customers is included. It may be worth exploring whether or not this would mean that a representative sample of customers in vulnerable circumstances is likely to be included.

We offer a range of enhanced services to customers who may be deemed to be in circumstances that may make them vulnerable. These include, for example, our Priority Services Register and the financial advice and support that is available through our partners. An alternative approach could be to benchmark the services such as these that companies offer.

This is a complex area and we would advocate further research and discussion to determine the most appropriate approach.

**How we can make sure the provision of excellent customer service also extends to the wider set of a wholesaler's customers.**

We already use a range of measures to monitor and enhance our wholesale services. SIM has helped us improve the wholesale service we provide. We use feedback from the consumer experience survey to focus our efforts where service improvements need to be made. Monitoring some of the other measures, such as discoloured water and sewer flooding, allows us to target investment in our assets to improve service.

The industry Strategic Dashboard contains a number of measures that incorporate elements of the provision of excellent customer service. Our approach to achieving these measures is to provide a great customer experience; it is not simply about operational (wholesale) performance.

We agree that there will need to be a way to measure satisfaction of the customer service provision from wholesalers from April 2017 when the non-household retail market opens to competition. The needs and wants of retailers will be significantly different from those that are provided to individual customers or individual businesses. A range of Service Level Agreements (SLAs) is being proposed as part of the wholesale service provision that is offered to non-household customers from April 2017 (ie those through the market performance framework and the operational performance standards).

Appendix 5 of the consultation notes the possibility of an industry-wide initiative linked to outcomes to measure the qualitative service offered to groups such as developers and self-lay organisations. Having seen the improvements in performance that companies have made since quantitative measures were included in the Developers' Charter, it seems a logical progression to introduce a customer experience measure to augment this. Reflecting on how the industry has responded to the Developers' Charter work since its introduction in 2015, we believe that the Water UK Infrastructure Policy Group (IPG) could play an important role in leading the dialogue to explore this further and help shape and deliver a consistent, industry-wide initiative.

As with the quantitative measures that have already been delivered we believe that Ofwat could play an important role in setting the key principles, leaving companies to develop a proposal. As Ofwat is represented at the IPG meetings, it would be able to challenge and influence where required.

## 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 aim to deliver leading company performance in both totex efficiency and outcome delivery. We believe that ambitious companies should be able to earn higher returns for delivering high performance. For common financial ODIs, powerful incentives for leading companies are particularly important to encourage stretching performance targets to be set for the industry.

We note that the 2015-16 industry ODI performance generates RoRE impacts that range from +0.6% to -0.7% across the industry. These are all below the desired minimum range of +/-1% in the PR14 guidance. We suggest that this is due to a combination of incentive dampening factors, which we consider below.

We welcome the commitment to common financial ODIs. As is proposed, these must be based on performance relative to other companies, not on a change in company performance over time. This ensures that rewards most closely match those of a competitive market, where the companies that provide the best service to customers make the highest returns.

This would also avoid any scenario where, for example, a poorly performing company earns a reward merely for improving its own performance to an industry average level. Such scenarios could well damage customer trust and confidence in the ODI regime.

The standard definition of common performance measures is of critical importance. Any suggestion that comparative data is not equivalent immediately undermines customer confidence in the comparative regime. We are currently leading the drive for standard definitions and measurements in these areas. As noted earlier, we have supported the development of the Discover Water website and are active participants on the steering group for the Water UK & UKWIR project to develop consistent measures.

We have set out our views on each of the nine proposals for increasing the power of reputational and financial ODIs. We are generally supportive of these proposals and have made suggestions as to how they might be applied.

We believe that there is a different approach to the variable cost of equity proposal that merits further consideration and we believe that this revised approach would allow companies to demonstrate their appetite for outcome delivery risk without the need for regulatory judgement.

### Enhancing the reputational impact of ODIs

We agree that the Discover Water dashboard will enhance the reputational impact of ODIs. We are strong supporters of the dashboard for precisely this reason.

For example, in the Northumbrian Water company-specific performance information, the Discover Water link takes the customer to a 'landing page' that shows our performance alongside the industry top, average and bottom results. This level of comparative information is at present industry leading in terms of transparency, as all other company links show only that company's performance without providing context.

Transparency is key to any reputational incentive. For this reason, we support a review by the regulator of performance by companies against their commitments. Highlighting good and poor performance will further enhance the profile of these ODIs.

In our view all companies should share and discuss their ODI performance data with their CCGs on a regular basis. This should include past performance and future plans.

If there are reputational ODIs that have comparable, consistent and assured data across companies, then we can see the reputational value of a league table.

We are not convinced that a reputational prize would add anything to this process, and may require significant levels of regulatory administration and co-ordination for few additional benefits.

## More powerful financial ODIs

**The greater use of in-period ODIs.**

We support the aim to increase the use of in-period ODIs and recently accepted the in-period licence modification. We agree that in-period ODIs do sharpen company performance incentives and accountability. In our view it is better for in-period ODIs to be linked to revenue, as in-period Regulatory Capital Value (RCV) adjustments are unlikely to register in any significant way with customers and investors.

We support the option of net present value (NPV) neutral smoothing of rewards and penalties where bill impacts would introduce excessive volatility.

**Linking end-of-period ODIs to revenue rather than the RCV.**

We generally support linking end-of-period ODIs to revenue rather than the RCV. All ODI performance for the last two years of a control period that would otherwise have had in-period revenue adjustments should have end-of-period revenue adjustments. In this way all years of a control period will be perceived as having the same value for performance.

The only ODIs where RCV adjustments may be more appropriate are long-term ODIs such as asset health and resilience. These ODIs are likely to deliver benefits over more than one price control period; they could therefore be spread over those periods by an appropriate use of RCV adjustments and the run-off rate.

**Removing the aggregate cap and collar on ODIs.**

We believe that ambitious companies should be able to earn higher returns for demonstrably high performance. For common financial ODIs, greater incentives for leading companies are particularly important to encourage the setting of stretching performance targets for the industry.

For this reason, we support the option to remove the aggregate RoRE cap and collar. We feel that this could be an area where a company declares its risk appetite for outcome delivery, as part of the outcome delivery choice.

We note that the consultation includes a proposal that the regulator might introduce some type of upper target range for rewards and penalties. However, we assume that this is to encourage rather than limit incentives.

**Encouraging companies to hit an overall range for rewards and penalties.**

We strongly support the proposals in this area, as companies need to know the extent of regulatory involvement in order to be able to have meaningful dialogues with their customers and CCGs. We suggest that the range should not be two fixed figures (e.g. +/-2% of RoRE) but instead be an envelope of ranges (for example, symmetric between +/- 2% to 4% of RoRE).

We welcome the proposal that Ofwat would publish early indications on the cost of capital and outcome RoRE ranges before company business plans are submitted. The choice of the RoRE range within the envelope could be part of the menu choice.

It is important to clarify whether this indicative RoRE range includes or excludes any bespoke outcomes proposed. We suggest that the published RoRE range should be for common ODIs, with scope for further bespoke outcomes as agreed with customers on an individual company basis.

We support the suggestion that the RoRE ranges should be symmetric between reward and penalties. We note that this would mean there would be no penalty-only measures. We would advocate setting the cost of equity at an industry average level but giving companies an opportunity to earn varying returns on equity based on the level of performance delivered.

We believe SIM or its replacement should be outside of the ODI range as it was for PR14.

**Issuing guidance on setting ODI rewards and penalties.**

As the consultation notes, precise marginal WTP information is not always easily available or may produce a wide range of values for similar outcomes across companies. For this reason we do not consider that the WTP approach is an appropriate instrument for setting incentive rates. We support the use of alternative tools for customer engagement and incentive setting.

We think there is much merit in the example that is provided in the consultation document where companies are able to take a top-down approach to setting common ODI rates. The top-down approach could include company choice of a target RoRE range within an envelope, as well as using customer engagement to determine the balance of incentives (and on bespoke incentives).

This would have the following advantages:

- It should produce similar incentives across the industry, while allowing local customer preferences to be dealt with through bespoke ODIs.
- It avoids potential conflict between the top-down expectations and any bottom-up data that does not aggregate to meet those expectations. Resolving this conflict in PR14 was difficult and time-consuming.
- It allows quicker and more transparent allocations to be made, with less of a technical 'black box' approach, which stakeholders such as the CCGs often find difficult to follow.
- As the consultation outlines, it would still allow customer engagement exercises to determine the allocation of incentives within the chosen range.

The bespoke outcomes should be excluded from any target RoRE range approach as the incentives for delivering these will need to be justified on a case-by-case basis.

**Using industry-standard ODIs for common performance commitments.**

We support industry-standard ODIs for the common performance commitments. We note that at PR14, customers across the industry generally identified the same outcomes but that the definitions and specific measurements varied from company to company. This has the effect of undermining confidence in the comparisons.

We also support the consistency of common ODI rewards and penalty incentives across the industry.

One variation could be to allow companies to choose their incentive rates within a range. This would reveal their appetite for outcome delivery risk. It would also allow local customer preferences to be taken into account.

**Increasing the proportion of ODIs with financial rewards.**

We support the proposal to increase the proportion of performance commitments with financial ODIs. These would be bespoke performance commitments using a wider evidence base from customers. These should be outside the envelope of the common ODIs and should be justified on a case-by-case basis.

**Guidance on the detailed design of ODIs.**

Although deadbands played a role at PR14, we feel that there may be significantly less need for them at PR19, given the better understanding of ODIs along with the potential to improve the design of incentive rates. There is a case that they should be retained on a much smaller scale to remove 'statistical noise', or financially trivial adjustments.

We do agree with the observation that, within the deadband, there is little incentive to improve service performance.

The choice of whether to use deadbands or not could be another part of the outcome delivery menu choice that is available to companies.

**Using a variable cost of equity alongside ODIs.**

Outcome incentives must be meaningful if they are to be effective in encouraging companies to deliver outperformance. This means they must be financially significant and companies should be firmly committed to them.

**Outcome Delivery Choice.**

We have not previously supported proposals for a variable cost of equity (as it was previously envisaged). However, on further consideration we feel that there is an opportunity for the principles behind these proposals to be applied in a different way. The critical issue is to differentiate between varying the **cost** of equity by a regulatory judgement (a technically subjective theoretical concept) and varying the **return** on equity by company choice over the power of incentives (a well-known observable metric).

We suggest that the cost of equity proposal could be changed slightly to become a company outcome incentive choice at the time when the company submits its business plan. This would allow companies to reveal their appetite for outcome delivery risk. This choice could be indicative, with a final choice made as part of the final determination.

The 'menu' choice might include the following:

- The total aggregate RoRE range from within the envelope that is used for the top-down incentive setting regime.
- A range for the incentive rate on common ODIs, from which companies could choose.
- The use or scale of any RoRE range cap and collars for ODIs.
- The decision on whether or not to apply deadbands to ODIs.

The decision would therefore be made by each individual company, with no need for regulatory assessment or intervention, beyond setting up the initial choices. This approach would give those companies that are confident about outperforming an opportunity to choose increased incentives and higher returns for delivering that outperformance.

This approach would, in our view, have the following advantages:

- It would incentivise **delivery**, rather than business plan proposals, and would mean that customers do not have to pay anything 'up front'.
- It would align with the totex menu choice approach that was used in PR14. (It might be noted at this point that the criticisms of the PR14 totex menu approach were more about its implementation than the principles behind it.)
- It would place the decision with the company and its customers rather than relying on a regulatory judgment.
- It would be an ex-post delivery incentive rather than a regulatory ex-ante decision.
- It would be a transparent 'menu' choice, with the choices and impacts clear to all stakeholders.

### Implications of more powerful ODIs

We agree strongly that performance commitments and ODIs need to be defined clearly and we support clear and consistent definitions for common ODIs. We are leading the project to deliver consistent performance measures on leakage, for example. For customers to have confidence in comparative measures they must be confident that the data is recorded on exactly the same basis for each company.

We agree with the observation that companies need to engage with customers and the CCGs on the overall balance of their ODIs. It is important to achieve a balance between immediate customer-facing ODIs and asset health or resilience ODIs. Similarly, the balance between operational performance and customer satisfaction ODIs will matter, as will the balance between the ODIs across price controls.

This is where customer engagement evidence is most valuable. It is much more meaningful to clarify the relative importance of a variety of issues with customers than it is to try to generate a technical value for marginal WTP, for example.

The consultation makes reference to Northumbrian Water's asset health 'gated' approach. It should be noted that this approach for PR14 meant that rewards or penalties would only be generated in relatively rare circumstances. This was a relatively cautious approach and we believe, given the confidence that has been built into the ODI regime since then, that this 'gating' approach is no longer necessary. Indeed, gating will often blunt individual incentives and can result in undermining the incentives to deliver individual components where the ODIs are part of a gated basket.

## Better reflecting resilience in outcomes

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

We see resilient services as a cross-cutting issue, and one that is fundamental to our business. It is our intention that resilience will underpin our own business planning at PR19. We are therefore fully supportive of the drive to better reflect resilience in the outcomes framework, as set out in the consultation document. We set out below our views on the more detailed proposals in this area.

**Resilience planning principles.**

We are supportive of the proposed resilience planning principles. We think it particularly important that companies consider a broad range of intervention options (including response and recovery) to arrive at cost-effective solutions, as detailed in principles 4 and 5.

**Customer engagement on resilience.**

We are also supportive of the increased emphasis on engaging with customers on resilience, and for the quality of this engagement to feed directly into the risk based review. This is important to maintain the trust that our customers already have in us to deliver resilient services.

**Long-term performance commitments.**

We welcome the introduction of longer term performance commitments, as long as these are set in a way that reflects the degree of uncertainty associated with longer term projections.

**Options for resilience metrics.**

We are supportive of a review of common performance commitments, to understand the degree to which they take account of resilience issues. It will be important that, in line with resilience planning principle 4, this review considers all aspects of resilience including recovery. The definition of performance commitments is important in this regard, simply removing all exclusions for severe events, for example, may encourage companies to focus disproportionately on prevention, rather than on recovery. This course of action may be neither efficient nor consistent with customer views.

We have reservations about the merits of introducing common resilience measures. Based on the examples seen so far, there is a risk that these measures will dictate the method, not the outcome, which could potentially undermine the resilience planning principles 4 and 5. It is also likely that different companies will have different resilience challenges, which means that bespoke measures will be more appropriate.

If the aim is to strengthen trust and confidence that companies are meeting their resilience obligations then this could be addressed through the assurance framework. Companies could highlight resilience risks in the 'risks, strengths and weaknesses' section of their assurance plans, for example. Ofwat's assurance assessments could reflect, in a consistent and evidence based way, the extent to which companies have identified and mitigated these risks.

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

Our preferred approach to introducing more standardisation on asset health performance commitments is option 1.

Partial standardisation addresses our concerns for industry-wide comparative information and for making performance commitments more transparent. We agree that partial standardisation will still allow scope for companies to innovate, which is key, and to address any circumstances that may be specific to them.

By contrast, full standardisation - in the form of a standard list of asset health measures with standard aggregation rules from the sub-measures - has the potential to stifle innovation. This approach could also restrict companies' abilities to reflect their engagement with customers and stakeholders in their business planning.

## Draft asset health outcomes expectations for PR19

**Companies should clearly present in their business plans their approach to asset health and which of their performance commitments and ODIs relate to it.**

We agree with this expectation. This is in line with our approach at PR14 where we identified four measures for both water and wastewater and then set out how our performance commitments and ODIs related to those measures.

**Companies should engage with their customers and CCGs on how their asset health measures protect current, future customers and the environment.**

We support this expectation. It is important that customers and CCGs support companies' proposals as to how they will look after assets in the long term. This approach will support alignment of the interests of current customers, future customers and the environment.

**Companies should ensure their asset health mechanisms are easy to understand and are well explained to customers, CCGs and Ofwat.**

A key factor in achieving trust and confidence is the ease with which measures are transparent and easy to understand. This is an important area for improvement at PR19. Asset health measured using serviceability during AMP5 was open to judgement and was not entirely transparent to customers. Companies developed a range of approaches at PR14 – from modifying the AMP5 serviceability approach to introducing bespoke baskets and measures. Some of the approaches were complex and the range of approaches may in itself have caused some confusion.

One way to address this issue could be through partial standardisation involving the use of industry-wide metrics and measures. This should create greater consistency and make it easier for customers to understand. In line with other industry-wide measures, these should be reported using existing channels and, specifically, through the Discover Water portal.

**Companies should explain to their customers, CCGs and Ofwat how their asset health penalties (and any rewards) relate to revenue and regulated equity.**

We support the approach for penalties and rewards to be based on revenue or regulated equity, as this should improve clarity and consistency. In addition, because asset health is a long-term measure we agree that this is a better way to evaluate penalties and rewards than using short-term instruments such as WTP. We agree that companies should explain the potential impact of rewards and penalties in relation to regulated revenue and regulated equity. This provides clarity on the range and magnitude of rewards and penalties and provides a consistent basis for comparisons across companies.

**Companies should submit their definitions and asset health mechanisms ahead of business plans.**

We agree.

**Companies must include water mains bursts and sewer collapses as part of their asset health measures.**

We support this expectation, which is in line with our current approach where both of these measures are included in our asset health baskets. The merits of these measures are that they are 'leading' (that is, they often occur before outcomes are affected), are measures of asset health, are relatively straightforward to define, and have been measured for many years.

It may not be easy to find other measures that fit these or other relevant criteria and this may limit the scope for standardised asset health measures to be used. Our AMP6 asset health measures are set out below:

| Measure | Water | Wastewater |
|---|---|---|
| Physical condition | Bursts | Sewer collapses |
| Network capacity | Poor water pressure | Repeat flooding |
| Network management | Discoloured water complaints | Pollution |
| Effective treatment | Drinking water compliance | Sewage treatment works discharge compliance |

While it is a change from our PR14 submission, we now consider a range of individual measures to be preferable to a basket approach. On reflection our AMP6 asset health baskets contain a mixture of 'leading' and 'lagging' measures and they therefore arguably conflate service performance with asset health. The inclusion of these or other such measures in a basket approach also restricts their use as performance measures for other outcomes, unless the risk of double counting is accepted. Furthermore, with individual measures there is a more direct link between performance level and incentive; this link is less direct (and therefore less transparent for customers) in the basket approach.

### Draft asset health performance commitments reporting requirements

**Companies must provide clarity on what the asset health sub-measures are.**

In addition to a set of agreed industry measures, additional sub-measures do provide the means to address company-specific circumstances and enable greater innovation. Where sub-measures are used we support the requirement for companies to be clear about what these sub-measures are. This should include providing clear definitions and explaining why they are different from any industry standard measures.

**Companies must provide clarity on the asset health sub-measure definitions, including an explanation of why they are different to the industry standard measures (if this is the case). For the common performance commitments related to asset health companies must use standard definitions.**

We agree. This is consistent with our drive for consistency, not only for the measures but also the ways in which they are defined. It ultimately undermines trust and confidence for customers if apparently similar measures have definitions that vary between different companies.

**Companies must provide a clear statement of the reference level and any trigger levels which affect rewards or penalties for each sub-measure, and the justifications for them.**

We agree.

**Companies must provide information on the AMP6 reference level and any trigger levels which affect rewards or penalties to compare with those at AMP7.**

We agree.

**Companies must provide data on sub-measure performance on the five most recent years to compare with proposals for AMP7.**

It is important that companies provide information on past performance. Asset health measures reflect longer term performance commitments and past performance is important to set the context, provide evidence of improvement and reward high performance. This requirement, however, should not be applied to the extent that it deters companies from introducing new, innovative measures.

**Companies must provide clarity on the weighting/scoring/aggregation rules to be used in an asset health index, matrix or points system.**

While we no longer support a basket approach, we agree that these principles should apply if such an approach is used.

**Companies must provide assurance that asset health mechanisms will operate automatically.**

We agree. Approaches that rely on judgment such as serviceability as used in AMP5 period are open to interpretation and can undermine trust and confidence.

**Companies must provide clarity on what mitigation rules apply to the asset health measures and why these are appropriate in the context of improving resilience in the sector.**

If the principles identified above are properly applied, there may be little need for mitigation rules. That said, mitigation rules might usefully be applied in instances where adverse weather could affect performance and where in extremes these impacts may not be fully addressed in the definition of the measure.

**Rewards for asset health ODIs.**

We agree that rewards should apply for stretching levels of outperformance on asset health commitments. The consultation document discusses the prospect of asset health penalties (and potentially rewards). In our view asset health is the same as other measures in that it should be equally open to rewards and penalties.

Two key measures are identified: bursts and sewer collapses. Neither of these are outcome measures that relate directly to customers' experiences. As such they should only be used for the purpose of assessing asset health performance and not as comparative customer service measures. They should also be subject to rewards as well as penalties and the same would apply to other measures of asset health.

## Making performance commitments transparent

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

**Principles to make performance commitments easier to understand.**

We welcome the suggested principles for defining performance commitments, and the suggestion of common definitions for common performance commitments. It is important that these common definitions are sufficiently detailed to ensure consistency, and are supported by a programme of independent horizontal checks.

**Making performance commitments easier to understand through reporting requirements on sub-measures.**

The proposals outline a sensible way to improve clarity. The need for sub-measures should be kept to a minimum by careful selection and design of performance commitments, and by minimising the use of baskets (see response to section 3.4.4).

**Disseminating performance information effectively.**

We welcome the opportunity to build on the way in which we have disseminated our recent assurance plan and the comparative information that is provided through the Discover Water website. We support the proposal for companies to explain in their business plans their approach to disseminating information, and for this to form part of the risk based review - as long as this does not constrain companies from innovating further in-period.

**Increasing the focus of performance commitments on outcomes (review of scheme specific performance commitments).**

We support the proposals. Company activity and performance should be judged according to what customers expect them to deliver. It is therefore logical that outcomes that have been shaped by genuine and open customer engagement should provide a focus for company performance.

**Northumbrian Water Group**

**January 2017**