SOUTH STAFFS WATER / CAMBRIDGE WATER

PR14 OUTCOMES

CCG TASK GROUP DISCUSSION PAPER – MARCH 2013

INTRODUCTION

Ofwat's PR14 "Framework and Approach" consultation issued at the end of January 2013 confirms a desire to adopt an outcomes-focussed approach to deliver and regulatory monitoring (rather than outputs) – on the next page of this paper a summary of the Ofwat proposals relating to "outcomes" is covered whereby companies will take more ownership of what they deliver and we will be expected to provide customers with some commitments.

Outcomes and the associated incentives need to be discussed with our CCG. At the last meeting on 13th February the CCG members noted the urgency of commencing this dialogue and a task group has been established (meetings are on 14 & 26 March) to report progress to the next full meeting on 11th April 2013.

It is intended that the proposed outcomes will reflect the feedback emerging from our customer engagement (through the CCG challenges and the various strands of customer research we have undertaken recently). Significant customer engagement has been undertaken and further work is on-going/planned which puts the Company in a good position to design outcomes that reflect the views forthcoming. However, whilst a compliment in part, it is also slightly frustrating that there is no one major concern or unexpected issues emerging from customers that we can address in our PR14 proposals.

The final issue to note with "outcomes" is the proposal that companies are required to consider appropriate incentives (rewards / penalties that may be financial or non-financial) associated with some or all of the outcomes proposed in business plans. This link to "incentives" therefore places the ultimate decisions with the Board of the water company who will need to authorise the outcomes / commitments / incentives that are proposed.

This paper is hence structured to cover these four issues:

1. Headlines from the Ofwat guidance
2. Proposals for CCG interface / emerging headlines from our Customer Engagement
3. Designing our Outcomes – Draft List
4. Proposed Incentives

Terminology – an example of an output under the previous regulatory monitoring approach would be to "build a new treatment plant at source X". We are now moving to outcomes not outputs – so in this example the outcome would be something like "good quality water provided to customers".

SECTION 1: OFWAT GUIDANCE

Outcomes will be high profile at this review. The Ofwat paper devotes a whole section (pages 30-44) on this topic. In summary Ofwat's position is:

a) Going forward there will be a move away from the previous output-focussed approach to delivery and towards an approach based on outcomes.

b) Securing CCG approval to our approach to customer engagement and the outcomes (with incentives) proposed will be very important.

c) Incentives/penalties structure will be case specific (i.e. financial or not, symmetric {rewards and penalties} or asymmetric {just penalties}, trade offs between various outcomes may be allowed or not). The assessment is made on a case by case basis by Ofwat depending on the outcomes and customer research.

d) The financial figures for the incentives & penalties are intended to be value based (not necessarily cost based) and come from Willingness to Pay surveys. Ofwat has not indicated a range of acceptable incentives (e.g. whereas at PR09 the SIM incentive was -1.0% to +0.5%, no such indication arises for PR14).

e) CCGs comment on our outcomes and incentives as well as commenting on customer engagement. This should be at the heart of the CCG's Assurance Report to Ofwat in January 2014. But Ofwat make the final decision.

f) Ofwat expect that he targets / outputs/ incentives within the Outcomes would only be set for AMP6 and not further into the future. There may be outcomes with expected future targets, but there would still need to be fixed milestones for the end of AMP6. Strategic Direction Statements had previously looked at 25 year periods (incorporating targets for 2040). We need to show performance in the 5 year period set in the context of the longer term.

g) It is not clear if companies can propose different outcomes in light of the Draft Determination (e.g. if less expenditure is allowed a company may wish to tone down the outcome to be achieved or the penalty proposed).

h) The move away from outputs to outcomes may allow companies to stop focusing on outputs that they feel are inappropriate.

i) While most outcomes would be company specific, there is an expectation that all companies would have leakage and SIM targets (the paper implies these will be set "consistently" by Ofwat – see page 36 of the Ofwat paper for this comment).

j) There will be flexibility for companies in setting their outcomes.

k) There is no clarification on how progress on outcomes is monitored or reported during AMP6 – possible CCG activity over the 5 years.

It should be noted that the Ofwat paper is a consultation and that this framework may change if they receive strong representations on their proposed approach.

SECTION 2 – PROPOSALS FOR CCG INTERFACE AND EMERGING HEADLINES FROM OUR CUSTOMER ENGAGEMENT

<u>CCGs</u>

In discussing the overall PR14 timeline, the South Staffs CCG members have noted the tight timescales of reviewing the proposed Outcomes. They have noted that this has been time consuming when undertaken with Severn Trent (many members of our CCG are on the Severn Trent Water Forum).

Two task group meetings are planned (14 & 26 March) before a progress report is presented to the full CCG on 11 April.

Severn Trent has published a tentative list of their proposed outcomes and some other water companies have also done this. None appear very radical or innovative, instead they seem very obvious referring to core activities that will be easy for customers to recognise e.g. “provide water that is good to drink” or “protect our water environment”. Crucially, the proposed incentives (rewards/penalties for over-under delivery) have not been published. This is sensible at this stage.

The number of outcomes to be proposed is likely to be around 6-10, though this is not stipulated by Ofwat.

At present there are separate CCGs operating at South Staffs and Cambridge. This reflects the need for local engagement and the fact the CCGs were set up prior to the licence unification. However, we are working to one combined business plan and one combined CCG assurance report, both due in January 2014. Therefore one set of outcomes should be forthcoming, albeit the measures of success may be tailored if appropriate. The overall incentives need to be for the combined company, we cannot offer a situation where under-performance in one area leads to a customer rebate for just part of the supply area. This would be too complex, as it would involve separate price limits at PR19. Note: this stance needs confirmation.

One issue to note is that Cambridge Water are yet to commission their willingness to pay research. They potentially lack evidence to construct “value-based” incentives, unless they adopt the results of research presently being undertaken in the South Staffs area (an alternative would be to use Anglian’s WTP findings).

Headlines from Customer Engagement

The following table summarises the customer engagement undertaken that can be used to inform our proposed Outcomes for PR14:

Strand of Customer Engagement	**Usefulness**	**Status**
2008 Willingness to Pay Surveys at SST and separately at CAM (both used MVA Research)		C
PR09 SDS – Strategic Direction Statement (a South Staffs version and a Cambridge version)		C
Monthly Customer Voice Surveys at SST		O
Quarterly Ofwat SIM Surveys at SST and CAM		O
Net Promoter Score benchmarking		?
Customer Service Network (CSN) – 3 surveys in 2010 and 2011		C
Above list is not directly attributable to PR14, but helps with tracking customer views over time and gives some insight to influences on our business strategy etc.		
Customer Challenge Group commenced April 2012 at SST and during XXX at CAM		O
Customer Priorities and Initial Willingness to Pay Research of 600 domestic and 100 commercial customers by MVA – Autumn 2012 (report and presentation available)	High	C
Stakeholder Views on Customer Services Priorities – MVA Research Autumn 2012 – output from specific CCG workshop on 13.9.13	High (but not necessarily representative)	C
Customer Focus Group held late January 2013 for dWRMP – Community Research (report and presentation available)	High (but with a specific focus on SDB issues)	C
Online Customer Panel of 500-1000 customers		F
Willingness to Pay Research 2013 – ICS Consulting with FACTS international and eftec	Will be High once available in early summer	O
Acceptability Research (after DBP and/ or FBP)		F
Customer Focus Groups at Cambridge using Community Research – Phase 1		C

Status column: C – complete; O – on-going; F - future

Omissions from the above list include the Brand Survey (since internal - mainly employees were surveyed) and mains rehab surveys (very specific activity). There may be other activities that Cambridge Water has undertaken to add.

What has the research and customer/stakeholder engagement told us?

Answering the question needs further work to bring together all the various strands of activity and reach some clear headlines. It will not be easy to do this and what we say will be commented on extensively in the CCG's assurance report, so we must think carefully about the challenges arising and our response to these.

Below the three text boxes show examples of the headline views arising:

Summary of Customer Views from Focus Group for dWRMP at South Staffs, Jan/Feb 2013 (Community Research)

SSW should consider the following possible changes to the draft WRMP and to its more general approach and work plan, based on the workshop feedback:

- After discussions, just over half of the workshop participants (14) wished to see the level of water meters increased more quickly than the company currently plans. This was also felt to be amongst the top 3 most important issues at the end of the workshop for 17 of the 27 participants. SSW should therefore consider whether to review this element of their WRMP and make its metering target more ambitious.
- Persuasion on meter take-up was favoured over coercion for the most part, but it was felt that many more customers could benefit from meter installation and that the benefits are not widely understood. Communications should focus on the fact that installation is free and that the cooling off period exists.
- Views were fairly evenly split about whether to go beyond the SELL in terms of leakage performance. Nevertheless, a slight majority of workshop participants were keen to see more ambitious leakage reduction, even beyond the SELL, and just over half were willing to see an increase in their bills to pay for this. This should be explored further in future willingness to pay research and considered carefully within the WRMP.
- There was no consensus in favour of either an improvement or a reduction in service levels on customer restrictions – the current service level should therefore be maintained.
- There was a very strong sense that SSW should significantly increase its activities and communications regarding water efficiency amongst the customer base.
- Customers wished to see SSW take its local environmental responsibilities seriously, but there was no broad based support amongst customers to pay more to support environmental improvements beyond those specified by the Environment Agency.
- More and better communication was called for across the board, with workshop participants feeling that the company has plenty of positive messages to communicate but that such messages are not currently getting through.

Summary of Customer Service Priorities and Initial WTP at South Staffs (600 domestic customers and 100 business customers interviewed by MVA Consultancy, Autumn 2012)

Customer Attitudes to Existing Service Provision

Evidence suggests that customers are not knowledgeable about the different facets of water supply, and many are either unaware of, or over-estimate, their annual water bill level. Without further information on services, customers' perceptions are based primarily on whether there is water when they turn on the tap. Despite, or perhaps because of, this relative ignorance, the majority of customers (domestic and business) are content with SSW's current service provision, with three in every four being fairly or very satisfied.
When more fully informed of the different aspects of service and wider environmental consequences, almost half of domestic customers, and around one-third of business

customers, changed their mind regarding their level of satisfaction with services. Overall, the provision of factual information about existing services led to a small drop in satisfaction levels, which nevertheless remained high - with three-quarters of domestic customers, and two-thirds of business customers being fairly or very satisfied. Only one in fourteen customers are dissatisfied with the existing service provision and price.

Customer Willingness to Pay for Service Improvements

When uninformed, customers appear content with existing service quality and over-estimate their current bill level. At a superficial level, therefore, there is little appetite for bill increases and service improvements. When fully informed, very few customers identified unsatisfactory aspects of service; and the majority of domestic and business customers were content with existing services, preferring the status quo over paying more for service improvements or accepting bill savings and quality reductions.

The service areas where there was most support for an improvement (and bill increase) amongst domestic customers were: softening the water; reducing leakage; abstracting less from rivers; and reducing the risk of environmental pollution. However, fewer than one in ten support such improvements, if they have to be paid for by customers, or incur quality reductions in other service areas. There was some willingness amongst domestic customers to accept a reduced level of service regarding consumption levels. Around one in six customers were willing to endure more frequent hose-pipe bans in order to secure an improvement elsewhere and one in ten would tolerate less emphasis on water efficiency measures amongst customers.

Similarly, most business customers also preferred the current offering rather than one or more improvements (at a cost), or one or more deteriorations of quality (at a saving). Improvements in leakage and water hardness were the main priorities amongst a minority of business customers, as was the case amongst a minority of domestic customers. Other improvements preferred by a minority of business customers were reducing the risk of long and short interruptions in supply. The business community is most supportive, however, of a more tailored service with two in every five business customers wanting a more dedicated service with a single point-of-contact (or account manager), consolidated accounting, water efficiency audits and on-site leakage detection. Many are willing to pay for such services.

If there were to be some service improvements, and associated bill increases, the majority of customers would prefer to have them introduced gradually rather than from immediate effect. Gradual bill increases are easier for budgeting purposes, and are particularly favoured by businesses.

Customer Preferences for the Longer Term

Overall, customer views are mixed when it comes to providing more strategic steer, such as whether SSW should focus efforts on reducing consumption (e.g. reduce leakage, increase metering and/or water efficiency measures), keeping bills down at every opportunity or accepting reduced service levels (e.g. accepting an increased risk/frequency of a hosepipe ban).

Similarly, there were fairly equal levels of support, and opposition, for water-trading, greater emphasis on technology, and increased metering; and more limited support for tackling leakage beyond the sustainable economic level (SELL).

Customer Engagement Phase One project- qualitative research undertaken by Community Research at Cambridge Water, January 2013.

Key findings :

Many domestic customers, who have had no reason to contact the company, have little impression of the company. Not needing to contact the company is a positive.
There was an overwhelmingly positive view from those who have had contact (both domestic and non-household).

There were a small number of issues raised:
- Issue with incorrect billing
- Queried charging admin fee when payments missed
Lack of information about:
- Soak-aways (leading to over-payment)
- Responsibility for pipes meaning that insurance is taken out needlessly
- More frequent meter reading for larger accounts
- Perceived increase use of contractors
- More potential for referrals to CAB

Domestic customers' main priorities are for the provision of a consistent supply of good quality, affordable water, encouraging use of water meters and water conservation, tackling leakage, managing peaks and troughs and meeting future demand.

Non-household customers focus on the retention of competitive pricing structures, robust water resilience plans and water conservation measures.

Leaks and Leakages:

- Leaks and leakage come up spontaneously

- Positive views of CW's responsiveness to fixing leaks from those who have had an issue
Water Meters:
- Some customers feel strongly that more focus should be placed on encouraging installation of water meters. Concern about poor communication about free installation and the trial period.
- Most feel that paying for water used is fairer but had no appetite for compulsory metering

Tariffs and Affordability:
- Price and affordability are priorities for all
- There is a positive response to the schemes helping customers manage debt on offer by CW
Two specific policies tested did not resonate:
- Compulsory contributions to a Hardship Fund
- A change to seasonal pricing

Competition:

- The lack of competition in the domestic market was raised spontaneously by some

- Some non-household customers were not aware of the introduction of competition in their market (or the timings)
- Most indicate that they would consider switching if this offered a better price
- Others that they would see switching as a potential risk

Water Quality and Pressure:
- There were few issues with water quality and no issues with water pressure raised

Environment, efficiency and water use restrictions:
- Very mixed views and behaviours amongst domestic customers
- Generally there was a call for CW to do more to educate and encourage conservation

Water Resources:
- All customers are concerned about the future security of supply
- The vast majority are happy for water to be supplied to neighbouring companies if required as long as this does not jeopardise their own supplies

Communication:
- High level of satisfaction with responsiveness when contacted but feeling that general communication could be improved

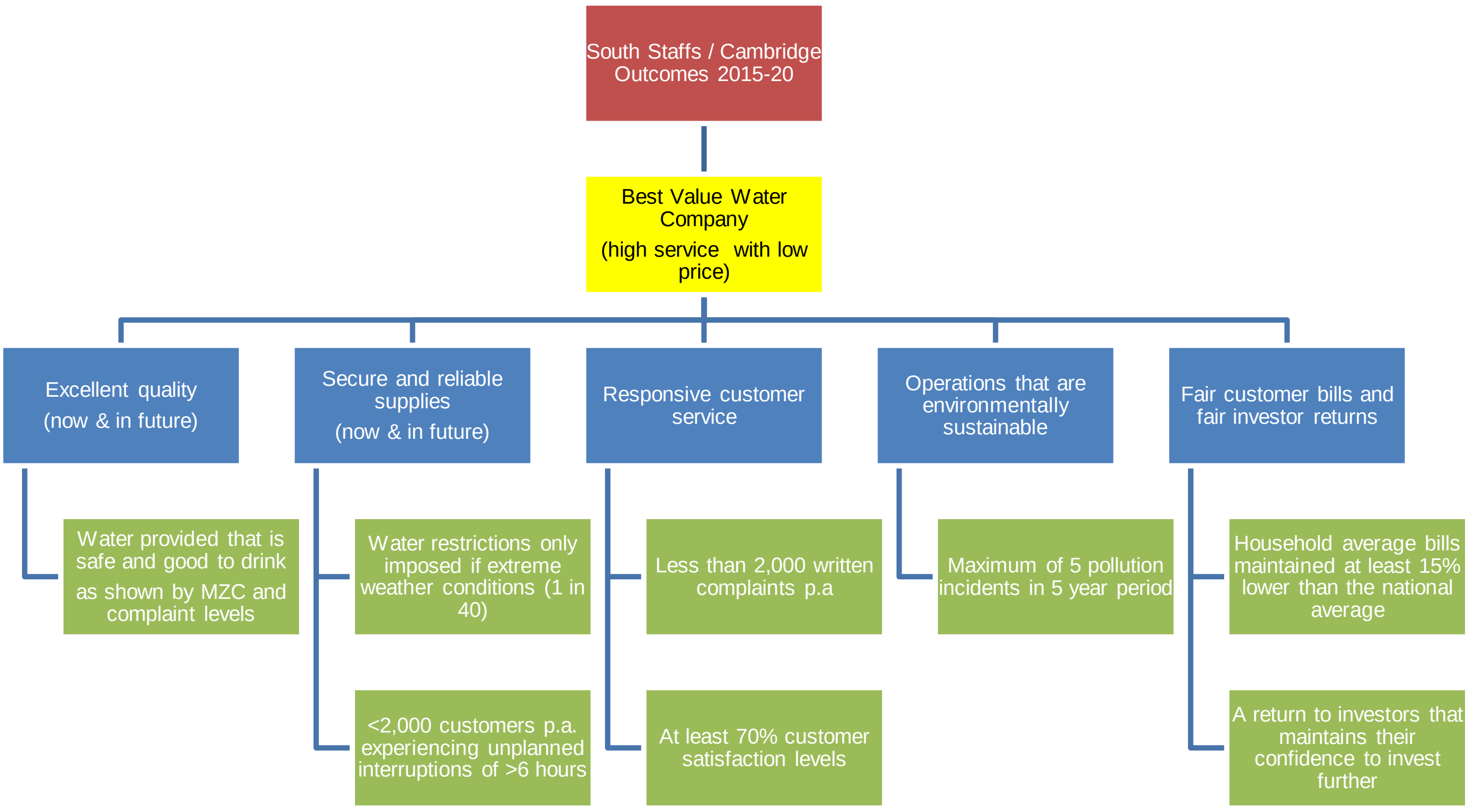
These three summary's do hopefully show some of the challenges arising from using customers views to influence business plans and proposed outcomes. It is hard to do this when there are no overarching areas for action arising or where customers views are mixed (no strong consensus of opinion or worse, different views from different research strands). Also, some issues may not be significant price review issues insofar as they are unlikely to be material investment drivers, such as the issue arising for a need for clearer communication to customers.

SECTION 3 - DESIGNING OUR OUTCOMES – DRAFT LIST

The previous sections have provided background. Here we get to the core task – defining potential outcomes for South Staffs / Cambridge to progress in the period 2015-20 and beyond as part of a long term plan. The next section considers associated penalties and rewards (“incentives”) where these are considered applicable.

The analysis in this section deliberately puts aside the issues of SIM, AIM and Leakage targets that Ofwat are likely to set centrally (see page 36 of their Jan 13 paper). We could add these in, but for now they are deliberately not within our proposed outcomes.

This hierarchy attempts to map the core functions of the business and reflect the priorities of our customers / main stakeholders. The yellow box refers to our principal objective in all that we do. The blue boxes are the proposed outcomes. The green boxes are <u>examples</u> of associated “commitments” or “measures of success”.



This example raises the following issues:

- <u>Measurable?</u> There is no need to be too concerned with the precise wording in the green boxes at this point, it is for illustration purposes to show possible ways to track if the five outcomes here are been achieved. However, some of the wording is measureable (e.g. how many customers experience supply interruptions), others are not (e.g. maintaining investor confidence). We could seek to add a new tier to the hierarchy above with specific metrics, and keep the green boxes to words only.

- <u>Are they customer focused?</u> If we were to include issues like maintaining investor confidence, is this really a concern of customers? Alternatively it could be argued customers need to be aware of the importance of attracting low cost finance and that some balance is needed, it's not just about customers as there are other important stakeholders.

- South Staffs / Cambridge Specific? The 5 outcomes here (blue boxes) could be described as too obvious / very generic - but this may be the approach to adopt, it reminds the customer of what we are about and it is future proof rather than flavour of the day.

- How many? The risk with too many outcomes (blue boxes) or too many measures of success (green boxes) is that the incentives become complex and the focus of the business is diluted. Incentives would be hard to track if some measures were positive or others were adverse. Likewise, the more targets (measures of success) that we set ourselves the more chance of failure (invoking penalties / negative reputation).

- Too vague? We may need to be cautious about setting outcomes that are wide open to interpretation. The above example of "operations that are environmental sustainable" could be interpreted at an extreme of using green energy sources, giving up spare abstraction licences, not using sources that could be in a future NEP programme but not yet agreed etc. If this is then not delivered we'd possibly be in a constant battle with the environmental lobby. This particular outcome could therefore be re-worded – "delivered a measured pace of environmental improvement".

- Omissions? Having just 5 outcomes runs the risk of stakeholders being frustrated that certain issues are not prominent. The above example does not include anything like:

    - Contributing to local society
    - Biodiversity
    - Water efficiency
    - Our people – safe working; skilled workforce, culture that goes the extra mile etc.
    - Compliance with legal obligations

  A supporting commentary may help to deal with the potential criticism of omissions.

Here is a list of other potential outcomes to consider (caution is needed as some of these are potentially "measures of success" or are "delivery approaches" rather than outcomes):

1. An outcome around the start of the "live and intelligent network" – though we'd need to be clear it is limited to a trial of 2 zones in AMP6. Could say: commencement of a live and intelligent network to proactively resolve problems before customers become aware and to reduce leakage levels as desired by customers".

2. Energy efficiency outcome – a 1% reduction in energy use which keeps customer bills low and reduces our carbon footprint / environmental impact.

3. Fit meters but don't impose measured charges to assist customers desire to be water efficient (help them learn about their actual consumption levels). This idea has stemmed from a customer focus group in Cambridge.

4. Replace / refurbish the assets that present an unacceptable risk of poor reliability or risk of water quality problems. We could merge this with item 5 below and call it an outcome such as "sustainable business". This also could bring in the need for long term planning – we are also looking after our assets so that they are available for the next generation of customers.

5. Gradually move away from sweating our assets to building new ones that are more economically to run and require less maintenance. Newer assets look better and are more reliable during extreme weather events.

6. Manage levels of lead in line with our risk assessment policy that ensures at least 95% of customers in each of our water quality zones receive water at tap with lead levels below the European Standards (this sounds bad – implies 5% of customers receiving water with lead levels above the standard).

7. By 2013 commit to establishing a social tariff (the Government are keen for water companies to do this. If we think it will work, why not show a commitment to progress this?) However, this may be too far as there are 2 obstacles to overcome first – gaining customer support and then designing a fair tariff (given the industry's lack of data on customers).

8. Consider extending on our "Customer Service Promise" commitments. For example, commit to deal with 95% of written customer complaints in 5 days (rather than 10 days, retaining 100% for 10 days). Other examples: commit to a tight window for customer appointments, or offer evening/weekend appointments.

9. An outcome linked to the merger – e.g. take the best of both approaches and enhance service to customers.

10. An outcome linked to a policy change – e.g. respond to customer's dislike of estimated measured bills by introducing twice-yearly meter reads at domestic properties.

11. Add something about our local agenda – using local knowledge for excellent / efficient service provision and pursing local community links to maximise our positive contribution to the local economy and community.

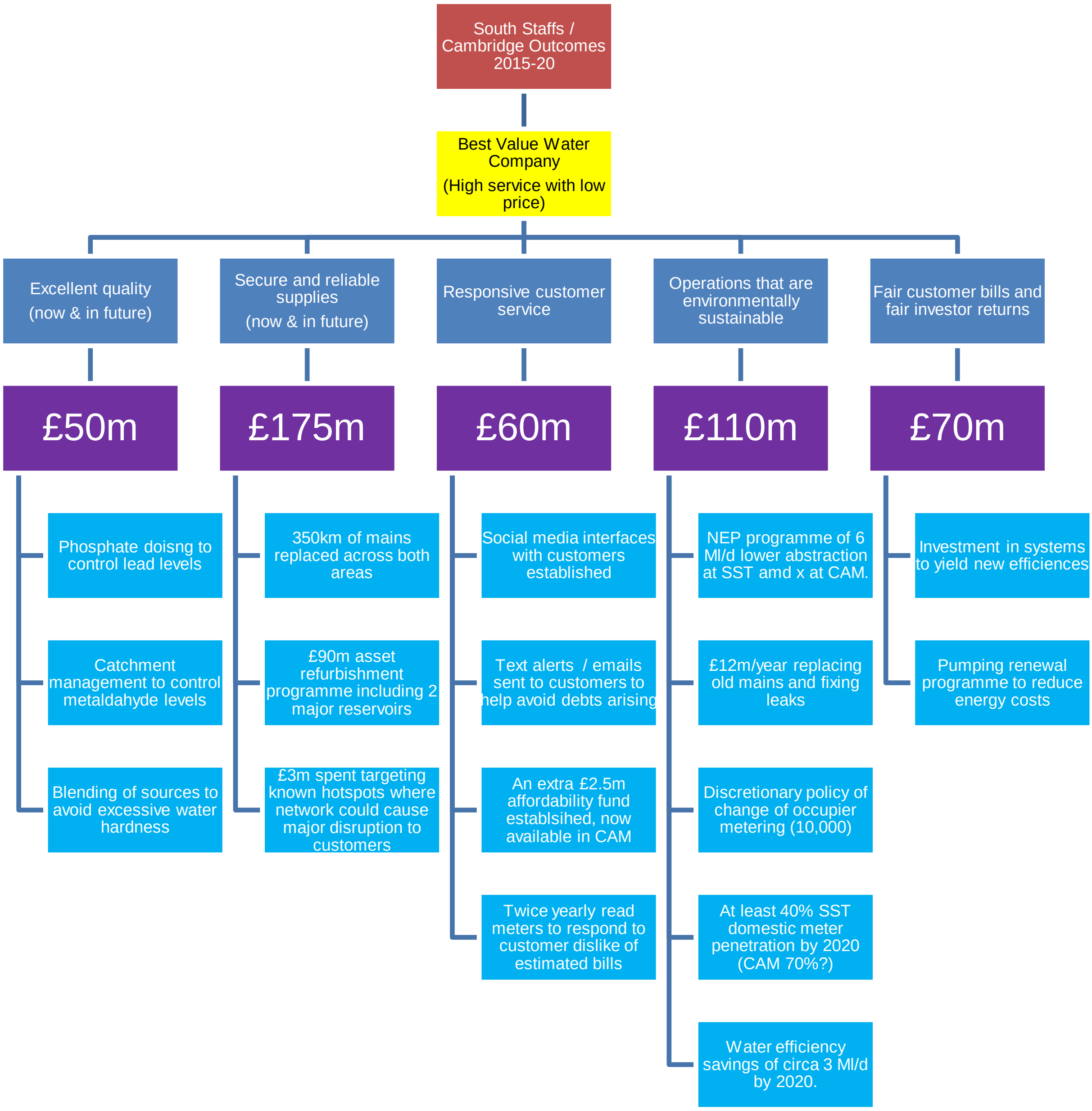
12. Water efficiency targets (these may go under the banner of the environment)

It should be noted that once we undertake the exercise to assign costs of delivery to the selected outcomes, this leads us to realise they need modification (if an outcome has virtually no opex/capex should it be there at all?).

Explaining our Delivery Approach

Once our proposed outcomes are defined it is important to communicate something more specific regarding our emerging business plan proposals and be more aligned to the customer / stakeholder views we've gathered. It is here that we would differentiate ourselves from the other water companies. If it emerges that we have to put up customer bills, then we'd need to be in a position to explain why this is. We also need to articulate the forecast costs of meeting the various outcomes.

In the next diagram the yellow box (our vision) and the blue boxes (our proposed outcomes) are as above. But rather than show the measures of success (green in previous diagram), we show the costs of delivery and examples (not a complete list) of what we will be doing to achieve the desired outcomes.



The purple boxes show the total costs of delivery for each outcome. These will constitute both annual operating costs (circa £55m/year) plus our 5-year capital programme (£170m-£210m), based on combined SST/CAM figures. The figures quoted above are far from confirmed, they are just for illustration.

It is a difficult task to map costs to each outcome. Many schemes/projects we undertake are for multiple reasons rather than specific to just one outcome. If we were installing a new water quality treatment plant at a source, this would be straightforward as the full costs would be assigned to the “excellent quality” outcome. But there are few simple examples like this. When we install meters, this is for many reasons – to respond to customers who want a means to lower than individual bills; to contribute to demand reductions so that supplies are reliable; to take less from the environment so that our operations are sustainable. Thus with metering spend, this cuts across at least three of the proposed outcomes.

SECTION 4 – PROPOSED INCENTIVES

It is not appropriate to progress the issue of incentives too far at this point, since:

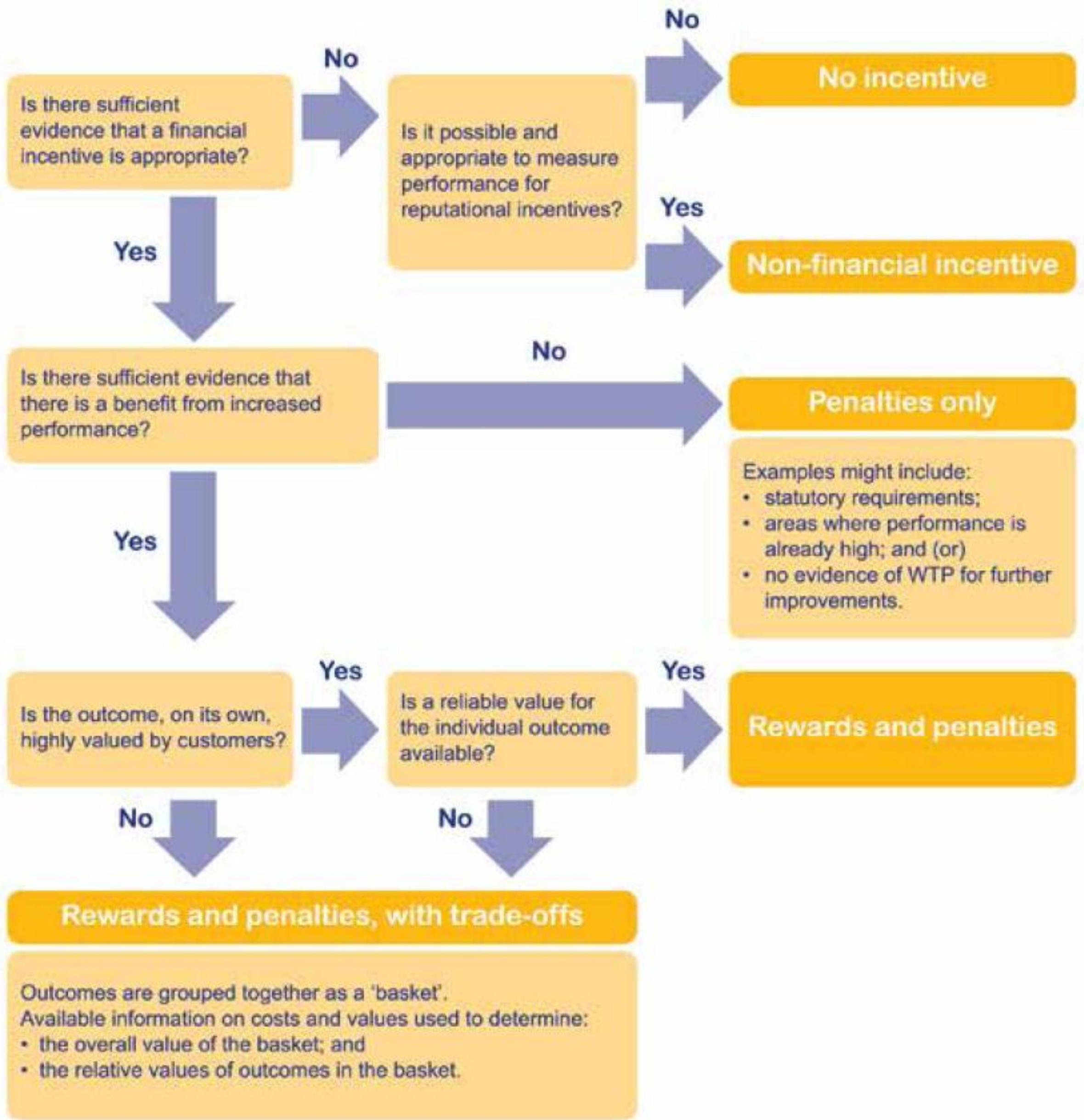
- The financial valuation needs to be based on customer valuations of the service provided – these values will be taken from the Willingness to Pay (Wtp) research currently ongoing.

- The level of incentives we propose will ultimately be decision of the Board of Directors and our owners, who to date have not discussed this subject in detail.

- The Ofwat guidance needs clarification since some aspects are open to wide interpretation.

Ofwat's paper (see page 38) allows companies to put forward a mix of different forms of incentives, i.e. some financial (either penalty only or reward plus penalty), some non-financial, and some allowing trade-offs (whereby under-performance in one area can be offset by over-delivery in another outcome).

The following diagram is extracted from the Ofwat paper and sets out their framework for designing / reviewing outcome incentives:



To illustrate this, below we set out four potential outcomes that cover the 4 scenarios:

1. Penalties only outcome
2. Reward and penalties outcome
3. Outcome with trade-offs
4. Non-financial incentive

This does not necessarily mean that the incentives we put forward in our 2014 Business Plan linked to our outcomes will cover all 4 scenarios. It is for illustration purposes.

Example 1: Penalties only outcome/incentive

Here the customers do not value over-performance, so no reward is put forward. They do however value the standard of performance the Company puts forward and so if this is not delivered, they would expect some compensation (a penalty the company pays).

With the outcome "secure and reliable supplies", this implies that no significant water restrictions are imposed (such as a hosepipe ban). There is no real scope for over-delivery of this outcome (so a reward is not proposed). But the Company should not be discouraged from imposing restrictions in extreme weather conditions. Hence a potential penalties only outcome could be:

- Up to 1.0% bill reduction to customers in following year (rather than wait to PR19, i.e. 2020/21) if a hosepipe ban is imposed on customers provided that the average rainfall in the last 6 months is >80% of the long term (20 year) average.

A sliding scale could prevail: a hosepipe ban of less than 1 month leads to a 0.5% water bill reduction, beyond 1 month it is 1.0% water bill reduction.

The above outcome has the caveat of the rainfall level. This is to penalise the Company for poor management of its operations rather than an 'act of god' beyond management control.

Example 2: Rewards and penalties outcome/incentive

Here it can be demonstrated that the customers are willing to pay for service provision beyond the expected performance level associated with the outcome. The Company may not be sure it can achieve the desired very high performance level (it is likely it has not been reached to date), either because the technology to do so is not confirmed or because at the time of the business plan it may not be cost effective (determined by Cost-Benefit analysis) to do so but there is scope to review the efficiencies in the period 2015-20 of delivery approaches.

With the outcome "operations that are environmentally sustainable", a leakage target for the period 2015-20 will be set by Ofwat having reviewed the Company's Sustainable Economic Level of Leakage (SELL) analysis. Let us assume the leakage target is 70 Ml/d at SST and 14 Ml/d at CAM.

n.b. SST is the acronym for South Staffs; CAM = Cambridge.

As with example 1 above, some tolerance is again needed for weather impacts outside of management control – here a pro-longed severe winter could lead to a leakage target being missed in the year but the Company would be expected to spend more to reduce leakage levels so that the next year's target is reached. A penalty could apply if the leakage target was missed by more than 5% (hence SST's penalty applies if leakage of >73.5 Ml/d is reported, CAM if leakage of >14.7 Ml/d applies). Likewise the reward would not kick in immediately, as customers would not really value a small leakage reduction. Here a symmetrical reward is triggered with a 5% leakage reduction (95% of 70Ml/d = <66.5 Ml/d at SST; 95% of 14 Ml/d at CAM = <13.3 Ml/d). However the leakage reduction would need to be sustained in future years (the Company should not be rewarded for a one year only reduction).

Just to complicate this example!, we assume that the valuations of customers are not symmetrical. So whilst the trigger levels are symmetrical at +5 per cent or -5 per cent, customers would be more dissatisfied if leakage targets were missed than they'd be satisfied if leakage targets were over-achieved.

- A 1% bill reduction to customers if leakage levels are greater than 73.5 Ml/d at SST or 14.7 Ml/d at CAM; a 0.5% bill increase to customers if leakage levels are less than 66.5 Ml/d at SST or less than 13.3 Ml/d at CAM.

The length of the bill change will be equal to the numbers of years the target is missed / exceeded. So if the leakage target is missed for 2 years, customer bills are lower for 2 years in AMP7 (the period 2020-25); or if the target is over-achieved for 4 years then the company is rewarded for 4 years in AMP7.

<u>Example 3: Outcome/incentive with trade-offs</u>

Here the companies may avoid a penalty for under-delivery on one outcome by over-delivering on another one.

Continuing the example of leakage targets. Let us assume that the Company breached it's leakage target by more than 5%. Without trade-offs there would be a penalty invoked.

- Scenario 1 (within outcome trade off): The Company may have done other activity to reduce demand (e.g. installed more meters or undertaken more water efficiency activity). These would probably fall within the same outcome ("operations that are environmentally sustainable"). It is not clear from the Ofwat guidance if this was a recognisable trade-off, i.e. if the leakage target was breached by 4 Ml/d but the Company had spent extra on metering and water efficiencies reducing demand by 5 Ml/d from these areas then the penalty is not applied.

- Scenario 2 (separate outcomes traded off): if the above is not a legitimate trade-off, a different example would be where the outcome of "responsive customer service" was exceeded. The Company may have targeted 70% customer satisfaction levels. It could be argued that if very high numbers of customers are saying they are satisfied with their service, then if the satisfaction levels are very high then it is not appropriate to invoke a specific penalty for leakage targets being breached. We could state that each 5% increment to this is equivalent to 1 Ml/d of leakage at SST, so if the leakage target is missed by 4 Ml/d then a penalty applies unless satisfaction levels reach at least 90%.

  At Cambridge the equivalent value could be 0.2 Ml/d trade against incremental customer satisfaction of 5%. So if they missed their 14 M/d leakage target by 0.8 Ml/d, they'd need to have satisfaction levels of 90% or more to avoid the penalty on leakage.

<u>Example 4: Non-financial Outcome/Incentive</u>

The Ofwat paper is very light on it's commentary here. They state that "*companies should propose using non-financial delivery incentives where it is not practical to measure outcome delivery or the necessary data to set a financial incentive is not available*".

- The outcome of “fair customer bills and fair investor returns” may be applicable to this, since the definition/determination of what is “fair” may be open to interpretation.

There may be other reasons why the Company puts forward outcomes without any proposed financial reward and/or penalty. These include:

i. The outcomes are significant reputational issues – for example poor water quality performance would lead to very negative comments by the DWI that were made public (e.g. in their annual Chief Inspectors Report). This alone is an incentive on the Company to perform well as we do not wish to have negative publicity or see our customers lose confidence in the safety of the water they consume. Furthermore, we can also be fined in magistrates courts for breaches of water quality safety and incur costs for our defence.

ii. The Company is already achieving very high service provision which customers value. There is little or no scope to improve further (e.g. numbers of failures are at or close to zero), so a reward is not applicable. The Company then considers it would be unfair for a penalty to apply for a deterioration if standards were much higher than that nationally. An example here is the number of customers experiencing low pressure or supply interruptions. Here the numbers of customer affected are very low. If numbers doubled, we’d still be well below national standards even though the existing bill is more than 20% lower. So suggesting a further bill reduction as a penalty is not proposed. Whilst it could be argued that a penalty only outcome/incentive could apply at a certain threshold, this could risk credibility if the threshold was much different to current standards.

iii. For some outcomes, it may seem “odd” to expect customers to pay more or less for their water in the future. In other markets it is not always the case that prices rise when a company delivers higher performance than planned. Furthermore, rewarding what customers see as “failure” may be odd. If we reduced leakage to levels below the target, two issues could prevail. We could have spent too much money doing this (gone beyond the economic level), which customers ultimately pay for. Secondly, some customers would see any level of leakage as unacceptable. Trying to explain to customers that their bills are rising because leakage is now “only” 65 million litres of water a day could receive a serious backlash. Whilst this logic may suggest a penalty only incentive should apply here, the Company may argue this creates too many unbalanced incentives (if we’re just faced with penalties and few/no rewards).

iv. Likewise it may be sensible to avoid confusing customers or complicating future price reviews by proposing a host of incentives that could impact on future bills. The Ofwat guidance does not stipulate the ceiling of proposed incentives. At the extreme, if a Company had 5 outcomes and over-delivered on them all, then the aggregate price rise for customers may be “too” high. Conversely, if a company under-delivers on all five outcomes, the aggregation of all the penalties could risk the company’s overall financeability (especially as even before the penalty was imposed they would have probably over-spent in pursuit of hitting their targets).

v. Whilst not likely to be applicable to South Staffs / Cambridge, another example of where a financial incentive may not be warranted is when customers suggest they’d wish to see service levels deteriorate (presumably in pursuit of lower bills as the high service currently provided is not valued).

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