

# Towards Water 2020 – policy issues: customer engagement and outcomes

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## Customer engagement and outcomes

It is essential that companies understand what their customers want, and that customers have trust and confidence that this will be reflected in the decisions that companies take on an ongoing basis, rather than just at the five-yearly price reviews. It is imperative that the relationship between companies and their customers should not be one in which customers are seen as passive receivers of services, but one in which there is a continuing dialogue, in which customers are genuinely engaged and empowered and become part of how the sector delivers. The more companies can build a responsive and effective relationship with their customers' that fosters trust and confidence, the more opportunities they will have to work with customers to create value that can then be shared with those customers as well as with investors and potentially with the environment and wider society. The relationship between companies and their customers should be at the heart of everything.

The focus on outcomes, so that our price control focusses on, **what** companies deliver, rather than **how** they deliver it was one of the key innovations of the 2014 price review (PR14). It was the first time we, and the sector, had applied outcomes reflecting customers' priorities. We want to build on the success of PR14 at the next price review in 2019 (PR19) reflecting on the experience we and others have gained. In this paper, we consider the extent to which we should develop our approach to customer engagement and outcomes for PR19.

As we set out in '[Towards Water 2020 – meeting the challenges for water and wastewater services in England and Wales](#)', our framework for customer engagement and outcomes can help to address some of the key questions that we need to resolve in order to improve the way we regulate the water sector in the future.

### Key questions for our future regulation of the sector

**KQ1** How do we regulate to encourage companies to focus on their customers over the **longer term**, rather than focusing their effort around periodic price reviews?

**KQ2** How do we build on the **customer-focused** approach to the 2014 price review (PR14) and promote and maintain genuine customer engagement that drives companies' businesses and supports companies integrating customers into how they deliver?

**KQ5** How can we best **align the interests of investors, management and customers**?

This paper aims to encourage a strategic debate about the future role of customer engagement and outcomes in the sector, and – in particular – for the price review process.

Our vision for Ofwat is a trusted and respected regulator, working at the leading edge, challenging ourselves and others. In line with this we have encouraged a “market place of ideas” with stakeholders contributing to shaping the regulation of the future through their work and proposals. A number of water companies and stakeholders have submitted reports on the future development of the regulatory framework, including issues relating to customer engagement and outcomes. We welcome these contributions and provide links below.

#### **Marketplace of ideas:**

[The potential for direct negotiation for price setting in the water sector in England and Wales, Wessex Water/Frontier Economics, July 2015](#)

[Continuous customer engagement, Yorkshire Water July 2015](#)

[Improving the outcome and delivery incentive regime, Northumbrian Water, July 2015](#)

Any additional papers released by companies will be published on the Water UK website (<http://www.water.org.uk/policy/future-water-sector>).

We are similarly seeking opportunities to work in partnership with other organisations and regulators on these issues, including, for example the ‘New-Pin’ project that we are supporting through [Sustainability First](#) with Ofgem and various companies across the water and energy sectors.

#### **The ‘New-Pin’ project:**

The ‘New-Pin’ project will seek to create a space in which to build a stronger and more coordinated voice among consumer, citizen and environmental advocates on the long-term public interest in the energy and water sectors - and promote more informed engagement with companies, service providers, sector regulators, investors and policy-makers. This new network will seek to ensure that long-term public interest issues are ‘heard’ at senior level and sit at the heart of company, regulator, and investor decision-making.

In this policy paper we discuss a range of issues.

- Why customer engagement is important and how it may need to change in the face of other changes going on in the sector such as the reforms being introduced through the new legislation.
- How customer engagement might evolve in circumstances where customers do not have choice, including how we improve the quality of customer engagement, drive a more ongoing and dynamic process, the role of Consumer Challenge Groups and the Consumer Advisory Panel in future price reviews and the Welsh Water forum.
- How our approach to outcomes might need to evolve in light of the learning from PR14 and the experience we gain in the next five years, including:
  - how we could have outcomes that span multiple price controls;
  - how we strike a balance between common and bespoke outcomes; and
  - how we make outcomes work across disaggregated price controls.
- How we might alter the approach to Outcome Delivery Incentives including for example changing the strength of these incentives, their structure, form and the cap and collar arrangements.
- How we might go about encouraging a two-way conversation with customers to involve them more in the delivery of services in a way that might improve trust and confidence in the sector and deliver better overall outcomes.

## 1. Customer engagement

### 1.1 Why it matters

Understanding customers and their preferences is critical to how management teams run their businesses. In the broader economy failing to understand customer preferences and then respond to those preferences can be the difference between running a successful business that encourages new customers to buy its products and services and grows its customer base from one which loses customers and exits the market. This customer understanding is deep and dynamic, with companies continuously seeking to understand their preferences in greater detail and creating a strong and continuous feedback loops into the products and services they provide and how they provide them.

Whilst the context of water and wastewater service delivery is different, good quality customer engagement is nevertheless a crucial part of running any business that meets the needs of its customers. Whilst the water and wastewater services companies provide are generally not provided in a competitive environment, the strong essential service characteristics of these services arguably place even greater importance on how companies engage with their customers- this is critical to build trust and confidence in the provision of these vital public services.

Whilst the historic regulatory model may have encouraged more passive and less dynamic customer engagement PR14 placed customers at the heart of the development of water companies' business plans, and the outcomes that they were seeking to deliver within those plans. This resulted in the biggest customer conversation the sector had ever seen, with companies engaging with more than 250,000 customers as well as interacting extensively with their CCGs, which included customer representatives and other regulators. For our part, we consulted our customer advisory panel extensively in the development of our price review methodology and subsequently ahead of issuing draft and final determinations. We believe that this unprecedented consultation of water sector customers will have led to business plans and final determinations that much better reflected customers' views.

### 1.2 Improving engagement in the face of change

Maintaining a link between customers and service providers is also important in keeping that dynamic feedback loop and retaining and building greater trust and confidence in the delivery of those services. In PR14 we set separate price limits for

‘retail’ and ‘wholesale’ services and this disaggregated approach may have delivered some benefits to end customers in the form of greater efficiencies and management focus on these services, whilst also supporting the introduction of choice for non-household customers in England over their retail services from 2017.

Going forward, these changes, in conjunction with legislative change being taken forward by the UK Government, will start to create **‘wholesale’** and **‘retail’ companies** each with different interactions with **‘end customers’** (i.e. the people that ultimately use and pay for the water and wastewater services that companies provide). Regardless of the impact of this work we believe that it is important not to lose the link between customers and wholesale service providers, lessons from other sectors may suggest that this could damage customer trust and confidence in these arrangements.

They will also create different forms of customer engagement between **household customers** (whose retail services will continue to be provided entirely by their local water company) **and non-household customers** in England (who will have choice over these services from April 2017). In considering this distinction we will similarly need to be mindful of our approach to regulating price and service in both retail areas. For the non-household market in England our ambition remains to roll-back regulatory protections in line with the emergence of an effective retail market that protects customers but this may take time and some protections may continue to be sensible for certain customer groups. However, in Wales we will need to recognise that the vast majority of non-household customers will continue to receive these services via their local monopoly supplier and so some form of customer engagement will continue to be needed.

Finally, we are investigating the potential benefits from further separate price controls and other cost discovery in the wholesale business, either to support better regulatory outcomes or the introduction of new upstream market arrangements, in line with new legislation. As we do so we must think very carefully about how we see customer engagement evolving to support those arrangements. In particular how engagement between those different **wholesale services** and any alternative providers of those services could work to ensure that this retains and builds trust and confidence rather with customers and other stakeholders rather than damaging it. Indeed, these changes could create new customers in relation to those services and new relationships between different service providers within the value chain, for example between the network service provider and an upstream new entrant seeking to provide water, and we will need to understand how customer engagement works in those contexts.

The approach to customer engagement will therefore depend critically on the context within which that engagement takes place including whether the service is competitive or not, the relationship with the end customer and the relationship between different parties at different points in the value chain. In the following sections we discuss:

- engagement with end customers where they do not have choice;
- engagement with end customers where they have choice;
- engagement between wholesalers and end customers; and
- engagement between different service providers.

Obtaining and maintaining genuine, dynamic and ongoing customer engagement remains challenging. Given its importance, coupled with the large amount of effort put into customer engagement by companies, regulators, consumer bodies and customers, it is worth considering for our part how our regulatory approach, including at PR19, can better incentivise good customer engagement.

### **1.3 Engagement with end customers where they do not have choice**

In many markets competition provides suppliers with an incentive to produce a range of products differentiated by both quality and price – and customers are able to choose products which represent their preferred combination of quality and price. Since privatisation of the water and wastewater services, the vast majority of services are provided to end customers by regional monopoly undertakers and there is very little choice over the services provided. The nature of this arrangement is at the core of the rationale for independent economic regulation of the sector. In the absence of competition and market forces, we must ensure that customers are protected through price and service regulation and this rationale is reflected in our primary statutory duty to **protect customers wherever appropriate by promoting competition**. Through our regulatory framework we therefore want to incentivise companies to engage effectively with their customers in the absence of market forces which drive them to do so, to mimic the way that the market would encourage this engagement.

There are lots of ways that companies in the water sector can go about undertaking customer engagement and understanding the preferences of their customers. Beyond traditional consumer research techniques many companies capture data, intelligence and insight from day to day interactions that their customers have with them to inform the delivery of services to those customers. Getting to this more

dynamic arrangement may be challenging but is likely to deliver significant benefits to customers.

Customer research played a key role at PR14, including in assessing customer support for outcome performance commitments and the calibration of incentives. Given the importance of customer research to the development of business plans and determinations, we need to consider how well the process worked at PR14 and how it might be improved in the future. We also acknowledge that customer research is a means to an end and is not a substitute for customer choice. That research suggests that customers care about both the quality and price of the goods and services they purchase and consume, as well as about the environment and resilience.

Both we and companies have taken account of customers' views in setting price controls using a range of customer engagement strategies, including, for example, through the CCGs, 'town hall meetings' and 'roadshows', and customer research and willingness to pay' (WTP) surveys.

All companies carried out research to understand what customers were willing to pay for during this control period. The results were important for developing outcomes and setting the penalties and rewards for under- and over-delivery of those outcomes. But there are a number of methodological difficulties with WTP surveys, and there were some significant variations in the WTP results between regions.

There is an opportunity to consider how best companies can engage with their customers throughout the 2015-20 period (including the role of CCGs). For companies to serve their customers effectively, they need to engage with them continually on the service they provide and the resilience of that service, not just for developing business plans. This relationship will itself foster trust and confidence but will also create opportunities for companies to work differently with customers and communities to provide services in new and different ways. We should also question what the best approaches to gathering and using WTP information are. Furthermore, we should put greater emphasis on other sources of information on customer preferences that could be used to help inform our final determinations. Building on our focus on outcomes and totex; we should also ensure that our regulatory approach appropriately incentivises and does not prevent the delivery of services in innovative ways, in partnership with customers and communities.

### **1.3.1 Alternatives to using willingness to pay**

All companies carried out WTP surveys for PR14. These involve asking customers 'how much' they would pay to receive different levels of service. The results were

important for assessing whether outcomes had a higher value to customers than the cost of providing them. The results were also used to inform company investment decisions and set the outcome delivery incentive rewards and penalties – that is, how much companies would make or lose for delivering or not delivering outcomes.

Companies identified variations in the WTP results between regions, which in some cases were quite marked. This raises the issue of whether the differences reflect true differences in customer opinion, differences in survey design or the customers surveyed.

Willingness to pay surveys can be helpful and can usefully complement more deliberative approaches to draw out customers' relative priorities. But they have limitations. The absolute values that customers ascribe to particular outcomes are not always robust, as they may depend on other circumstances beyond the scope of the survey, such as income levels and other competing demands on incomes. And survey results are sensitive to the 'framing' of the questions and the other information that may be available to respondents. For example, customers may be willing to pay a certain amount for a, say, 20% improvement in a certain service but should they then learn that the 20% improvement would still be substantially below the average level of service, their willingness to pay more for the improvement would fall. A further example of a particular difficulty with using stated preference information is that customers can find it hard to work out what they are willing to pay to reduce the probability of a bad, but unlikely, event from occurring. In areas such as resilience expenditure other methods of discovering customers' views might be more appropriate - as some companies found at PR14.

We know that a 'one size fits all' approach to customer engagement does not work, and this is also true of willingness to pay surveys. In PR14 we welcomed some of the approaches companies took to engage with customers who would not generally respond to surveys, and we would be keen to see this continued and built upon.

As well as considering ways in which stated preference surveys could be made more robust, we consider that it is important to reflect on the scope for using alternative approaches to stated preference research, such as revealed preference research<sup>1</sup>. In particular, we are aware of interesting field research techniques that allow customer preferences to be explored in more ‘real world’ settings than the traditional survey approach. We would be keen to see such approaches picked up and developed by companies. We would also encourage companies to look at how digital technology may provide new scope to better understand customers’ views.

### **1.3.2 Current and future customers**

There are some very significant issues of intergenerational fairness, which must be tackled if we are to continue to build levels of trust and confidence in the delivery of water and wastewater services. At one level the lives of many of the assets maintained by companies will span generations, failing to invest in services today could reduce our bills but result in a deterioration of those services for our children requiring new investment or potentially leaving them exposed to greater risks, for example from drought or flooding. Furthermore, there is a complex and symbiotic relationship between the services provided by water companies and the natural environment and a responsibility to ensure that the natural capital of that environment is retained for future generations. In engaging with customers, companies need to grapple with these issues and we need to consider how we can support and encourage that through our regulatory tools. In PR14 we gave companies new tools to manage revenues and therefore financeability and affordability issues across price control periods by setting ‘pay as you go’ (PAYG) and regulatory capital value (RCV) run-off rates. As part of our PR14 methodology, we required companies to engage with customers to support the setting and adjustment of these rates. In some cases, companies found it difficult to engage on the implications of the changes and what they meant for customers.

While some companies have told us that it can be more challenging to engage customers on long-term issues, there are examples of where companies have done this successfully and we are not persuaded that this cannot be done effectively. For example, most CCGs were involved in developing companies’ 25-year strategic

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<sup>1</sup> Stated preferences are identified by asking people to respond to a hypothetical question about which of a set of options they would prefer, or how much they would be willing to pay for a particular result. Revealed preferences are identified by asking people to make choices that have a real consequence for them. Because revealed preferences are identified through a process that is closer to how ‘real life’ choices are made, they may be considered to give more robust results. On the other hand, it may be difficult to obtain revealed preferences for customer views on particular issues such as levels of additional resilience.

business plans and we are keen to see this long-term approach in the context of PR19. Also during PR14 some companies:

- engaged with customers about their long-term ambitions for their performance commitments;
- discussed future challenges around charging and water resources with their customers; and
- engaged with future customers such as school pupils- given the significance of the intergenerational fairness issues in the sector.

We see this longer-term engagement as imperative and vital to the longer term sustainability of the sector.

### 1.3.3 CCGs

CCGs played an important role during PR14 in providing assurance on customer engagement in company business plans. In PR19 we will continue to put the onus on companies to own the relationship with their customers and to inform their business plans through good customer engagement. So, we need to consider how we can best gain assurance on the quality of customer engagement and on how it has been incorporated into company plans at PR19.

We note that companies have elected to continue with a role for CCGs in delivering their PR14 business plans. In many cases, this was a commitment made as part of their final determinations in relation to outcome delivery and reporting. We welcome the continued role of CCGs and consider that this provides a valuable means of ensuring ongoing customer engagement and assurance around the delivery of companies' plans. We support companies taking further ownership of their customer relationships and having a continuing dynamic conversation with their customers rather than focusing engagement around the five-yearly price review.

We are also aware that the Consumer Council for Water (CCWater) is considering what role CCGs should play in the future and what its role in relation to CCGs should be.

In considering the potential role of CCGs for PR19, there are a number of issues to address.

- **The role of CCGs.** We believe that CCGs played an extremely valuable role in PR14 and we are considering whether we should continue using CCGs in PR19 and if so what role they should play.

- Should we consider engagement with a CCG to be a form of customer engagement or only ask CCGs to play an assurance role?
  - Should we mandate the use of CCGs or leave it open to companies as to how we receive assurance on the quality of customer engagement, and factor the quality of that assurance into our assessment of plans?
  - What is the relationship between CCGs and any successor to the Customer Advisory Panel?
  - How should we factor the CCGs' role during the control period and the information available from the performance of that role into our assessment of companies at PR19?
- **Interaction with Ofwat and the role of comparators.** Company ownership of engagement with their customers and their CCGs is central to a customer-oriented price review process. However, we will always have an important role to play to protect customers' interests, not least because of our access to comparative information, for example in relation to wholesale costs and our setting of the sector-wide cost of capital. We need to understand how our role interacts with the CCGs.
    - For example, where we find that company business plans include inefficient levels of cost, how could this information be best reflected back to CCGs to enable them to scrutinise the business plan most effectively? This could take the form of multi-phased engagement by the CCG with explicit recognition that a further round of engagement is required when we have assessed business plans.
    - Another example is the comparative assessment of the outcomes proposed by companies in their plans, which occurred late in the PR14 process and therefore did not allow for CCG input ahead of us issuing draft determinations. Could the comparative assessment be brought forward to enable more effective CCG scrutiny or indeed direct customer engagement on plans?
- **Cross-CCG collaboration.** Given the commonality of the issues that CCGs face, there is a question about how to maximise benefits from collaboration and learning between CCGs.
    - For example, could collaboration play a role in enabling CCGs to compare companies' approaches to outcomes and customer engagement?
    - Could any successor to the customer advisory panel be involved in supporting collaboration?
    - Should there be more meetings between CCG members?
    - Would there be benefit in a small number of people sitting on all or several CCGs?

- **Maintaining independence.** It is vital that CCGs remain independent of companies to ensure that their challenge is robust and that they are able to represent customers' interests effectively. This raises the question of how to best maintain and reinforce their independence and avoid the risk of capture.
  - How should CCG chairs and members be appointed?
  - How should they be remunerated?
  - What secretariat support do they need and how should this be provided and paid for?
  - What information should they have access to?
  - Should they be able to commission work themselves or only comment on work done by others?
  - Would there be a benefit in having specific members on a company CCG who did not have ties to the local area?
- **CCG membership.** There are a number of questions about what the membership of CCGs should be – including whether regulators or non-government organisations (NGOs) should be represented, what time commitment is required from members and whether membership should be rotated to bring fresh views of company performance.
- **Ofwat guidance.** We provided little formal guidance on the role of CCGs during PR14 with a view to ensuring company ownership of their relationship with customers.
  - Would additional guidance be useful, and if so on what?
  - How would we ensure that such guidance did not unduly restrict companies and CCGs from doing the right thing in their local areas and reflecting their customers' interests?
- **Communication.** During PR14 we periodically met with CCG chairs. This was valuable for both sides.
  - How best should we communicate with CCGs or any successor bodies during the process and in a way that does not undermine company ownership?
  - Are there particular issues on which a different approach to communication would be useful?
  - How best can we articulate the value that the CCGs or their successors add to the price review process and the outcomes for customers?

We have had valuable feedback from CCG members on a range of issues in our [PR14 lessons learned report](#), including the time commitments required and the technical nature of the work. We welcome views from all sector stakeholders on the role of CCGs going forward. These issues are also relevant to the work that we are

sponsoring with Sustainability First on the 'New-Pin' project that is discussed in the opening section of this document.

#### **1.3.4 Customer representation and the role of the customer advisory panel**

As the economic regulator, it is important that we understand customers' views and that we have independent input from customers.

Our customer advisory panel ('the panel') advised us on many areas of our PR14 methodology. The panel comprised:

- consumer group representatives;
- business organisations; and
- large business customers.

It had an important role in feeding customers' views into the development of our price review methodology.

The feedback from members of the panel suggested that it could have been better linked to the CCG process and to CCG Chairs.

In addition to the panel, we note and appreciate the valuable role that the Consumer Council for Water (CC Water) plays in representing the interests of water and sewerage customers and through its specific role in representing the interests of consumers and individuals who are disabled or chronically sick, of pensionable age, with low income, residing in rural areas and consumers who are ineligible to change their water supplier.

In looking towards PR19, we need to consider whether a central customer advisory panel is the best means for us to obtain independent customer views and if so, what role it may have in developing the methodology and in developing upstream<sup>2</sup> markets, as well as in assessing companies' business plans. We recognise the question raised by panel members about whether there could be a role for the panel in liaising with or supporting CCGs or their successors. We would also welcome views on the composition of any future panel.

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<sup>2</sup> The new legislation creates scope for entry in upstream services, including water resources and sewage/sludge disposal. It complements existing arrangements that allow for competition in network services in the new appointments or 'inset' framework, but this is a different model and the legislation does not extend the water and sewerage supply licensing framework into those network assets.

### **1.3.5 Wales Water Forum**

In Wales, the Welsh Government ran a Wales Water Forum ('the Forum') throughout the PR14 process. The Forum included members from:

- the Welsh Government;
- all water companies in Wales;
- other relevant regulators in Wales; and
- customer representatives, including CC Water and the CCG Chairs.

It proved to be a successful means of engaging a range of stakeholders in water issues in Wales, and has continued to run.

The Forum did not have an official role in our price review process. But it did provide a useful platform for discussing issues relating to water regulation in Wales. Looking ahead to the next price review, we would not want to undermine the customer engagement process undertaken by companies in Wales or their use of CCGs or successor bodies. But nonetheless we will consider whether the Forum should have any formal role, and whether there are useful lessons to learn that could be applied in areas of England. For example, in south-east England, Water Resources South East (WRSE) brings a range of stakeholders together to discuss and find solutions to water resource management issues in this area of water scarcity.

## **1.4 Engagement with end customers where they have choice**

From April 2017 we expect that non-household customers in England will have choice over the retail services that they provide to end customers. The replacement of monopoly regulation and price controls with competitive market arrangements changes the incentives on companies operating in those markets creating the opportunity to remove price and service regulation over the relevant services over time. As those protections are removed the regulatory incentives around customer engagement can similarly be removed. We do not see any role for us in incentivising customer engagement once price and service regulation is removed.

However, reflecting the different policy position of the Welsh Government, we will continue to set price and service limits for non-household customers in Wales after 2017, potentially requiring an ongoing need for engagement with non-household customers there in a regulated context. Non-household customers' preferences may also be different to the preferences of households, and indeed may be different between different groups of non-household customers- the preferences and needs of a manufacturing industrial company with a large consumption from their water

supplier may be very different, for example, from a small corner shop. Similarly, many non-household customers may also have more significant buyer power and be represented by business and other groups and there may be questions about the extent to which this may make alternative approaches to consumer engagement more sensible or appropriate.

Finally, since non-household customers in England will have choice over these services, there may be important information and experience that could be gained in that market which could be used to inform the delivery of these services to Welsh customers.

In considering the potential approach to consumer engagement for non-household customers in Wales, there are some important questions to address in relation to the scope and form of any customer engagement arrangements:

- Should the arrangements for engaging with non-household customers in Wales mirror those for household customers?
- Are there alternative options that could be considered for these groups of customers?
- How can we best ensure that information gained in the non-household market in England can be used effectively to support customer engagement with non-household customers in Wales?

## **1.5 Engagement between wholesalers and end customers**

As part of PR14 we set separate wholesale and retail price limits for wholesale and retail services, in part this was to facilitate the introduction of choice for non-household customers in England over their retail services. Similarly, the UK Government in the Water Act 2014 included provisions to allow incumbent undertakers in England to ‘exit’ from their non-household retail services. Were undertakers in England to choose to exit from these retail services, they would become ‘wholesalers’ to non-household customers and would lose any direct contact that they have with their end customers through those retail activities, which represent the majority of customer interaction with the water company.

Whilst these wholesalers would no longer be undertaking these retail activities, in line with the draft codes produced by the [Open Water programme](#), they would continue to have important interactions with end customers, for example in fixing faults, dealing with leaks, installing meters and other network activities. We think that it is important that wholesalers retain linkages with the end-customers they serve, we do not want them to become distanced from those customers. This raises questions

for customer engagement going forward including how we should seek to capture customer views on the services and outcomes that the wholesaler is providing to the end customer.

In considering the potential approach to consumer engagement at the wholesale level, some of the key questions might include:

- How should wholesalers who have exited the non-household retail market in England engage with those customers over the wholesale services that they are providing?
- How can we ensure that wholesalers retain a link with the end customers that they serve and do not become distanced from those customers?

## **1.6 Engagement between different service providers**

Beyond engagement with end customers, following the introduction of choice for non-household customers in England, wholesalers will be providing services to a range of retailers. These retailers will effectively become customers of the wholesale business. In considering how we take forward customer engagement in future price reviews, we are also considering the role that these retailers could play in any future customer engagement process. These retailers may be well informed and better resourced than end customers and indeed may have strong incentives and buying power to negotiate wholesale service improvements on behalf of their customers and so they could play an important role in the customer engagement process.

Similarly, as we take forward upstream reforms in England, in line with the legislation and guidance from the UK and Welsh Governments, we should consider whether there are similar issues in other parts of the value chain where new upstream customers of the incumbent network business may enter the market and be able to provide similar input to a customer engagement process.

In considering the potential approach to consumer engagement between wholesalers and retailers and with a view to further upstream reform, some of the key questions might include the following.

- How should wholesalers engage with their retail customers in the setting of wholesale prices and service levels for non-household customers in the next price control?
- Should we adopt a similar approach to customer engagement in upstream areas in the future?

## 2. Outcomes

Where price and service regulation persists there is an important question about how service levels are set. At PR14 we took an outcome based approach to setting service levels, this represented a step change in the regulatory framework with companies:

- focusing on the delivery of customer priorities;
- taking ownership of their business plan commitments; and
- being held to those commitments through financial incentives.

This was the first time that we had applied an outcomes-based approach in the sector. As such, it is appropriate to consider the extent to which this approach can be refined for future price reviews given our experience at PR14.

### 2.1 Learning from PR14

The experience with outcomes during price limits at PR14 and as they are delivered over 2015-20 will help guide future development. We consider that outcomes and ODIs are a key element of enabling a more customer-focused, innovative and efficient sector and we expect them to form part of the PR19. We also acknowledge that there is considerable scope to think further about how effectively companies' performance commitments and outcome delivery incentives (ODIs) reflect the aspirations and intentions of the outcomes approach. As we set out below, there is scope for improving the longer-term focus of outcomes and enabling more effective comparisons between companies.

### 2.2 Looking beyond the regulatory period

One of the main purposes of the move to outcomes and ODIs is to focus companies more on delivering what their customers want. Given the long-lived nature of assets in the water sector, the sector's intrinsic link to ecosystems, and the need to provide resilient services now and in the future, it is important that our regulatory framework enables and incentivises companies to take account of the longer term. Crucially, this includes outcomes and ODIs.

At PR14, in nearly all cases, we set performance commitments and ODIs that lasted for the five-year period from 2015 to 2020. There were some exceptions around major scheme performance commitments where the scheme was due to complete

after 2020. We tested each performance commitment against the criterion of whether it was in the long-term interests of customers and the environment, and many companies have reputational targets for 2025 and beyond in their business plans.

For PR19, we need to consider whether we should require or encourage companies to commit to outcomes for a period longer than five years. This could include a subset of their performance commitments that are likely to endure over the long term and where long-lived investment is required. We also need to consider whether rewards that last for a maximum of five years provide appropriate incentives for companies to invest in initiatives, which may include for example new assets or behavioural changes, which deliver benefits to customers over a longer period.

## **2.3 Striking a balance between common and bespoke outcomes**

Companies should propose outcomes that reflect their customers' priorities – these might differ between company areas. However, differences across companies could also reflect a lack of transparency for customers about their company's relative performance.

During PR14, we introduced comparative assessments for five performance commitments<sup>3</sup> (in addition to leakage and the service incentive mechanism, or SIM) because there were considerable differences in companies' proposed targets for very similar service measures that, in our view, reflected a lack of such information. The SIM is a comparative outcome that we introduced as part of the 2009 price review (PR09) to reward good customer service performance and penalise poorer performance.

Some companies, regulators and customer groups considered that the PR14 comparative assessments, and the associated upper quartile efficiency challenges, were a useful tool that could be applied again at PR19. We acknowledge that increasing the number of comparative performance commitments reduces scope for companies to engage with customers and to design tailored commitments and incentives reflecting their preferences. To the extent that preferences vary between company areas, there is a risk that comparative outcomes may not be closely aligned with customer preferences. On the other hand, comparative information is extremely valuable information for customers and CCGs to understand the stretch of the proposed commitments and relative performance of their company.

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<sup>3</sup> Water supply interruptions, water quality contacts, drinking water standards compliance, internal sewer flooding and pollution incidents.

As noted above, we are considering whether more comparative information should be made available to inform customer engagement earlier in the process and if so how this might be achieved. If we do this, we will need to consider whether we should still undertake comparative assessments ourselves and intervene to secure alignment to upper quartile. If we do these assessments, we should consider which outcomes are susceptible to them. There are also questions around whether the use of historical upper quartile benchmarks are sufficiently challenging and whether a more forward-looking approach would be more appropriate.

There is a specific question about whether we should use glide paths to allow companies time to get to targeted performance levels before ODIs are fully applied. We would not expect to give any company in the next control period the benefit of a glide path to get to a level of performance it should have reached in this control period. Beyond this, we should consider whether any use of glide paths is appropriate – there inevitably being a link to whether we are using historic upper quartile as a benchmark or something more forward looking. There is a wider question about the comparability of outcome metrics. In PR14 we were aware that companies' measurements of performance commitments that are apparently susceptible to comparisons (such as internal sewer flooding) varied, sometimes significantly. We are concerned that if customers and their representatives try to compare performance on the basis of different metrics this might undermine trust and confidence in company reporting. As a minimum, we think it is important that companies are transparent as to how they are measuring their performance on outcomes. Beyond this, we are considering whether, in relation to those outcomes where comparisons would be useful, a more standardised approach to measurement would be appropriate.

We will also need to review the SIM as part of this broader review of comparative outcomes and ensure that it remains appropriate and fit for purpose, given:

- the changes in customer experience since 2009;
- increasing customer expectations; and
- customers' increased use of digital channels.

## **2.4 Delivery outcomes across disaggregated price controls**

At PR14 we set price limits for:

- wholesale water;
- wholesale wastewater;
- household retail; and

- non-household retail (for those companies that operate wholly or mainly in Wales).

Most companies allocated their performance commitments to one of these elements, with some allocating a performance commitment to two or more elements. In one case, a company allocated a percentage of each of its performance commitments and the associated ODIs to wholesale water and to household retail.

In ‘[Towards Water 2020 – policy issues: promoting markets](#)’ and ‘[Towards Water 2020 – policy issues: regulating monopolies](#)’, we discuss the possibility having more price controls across a disaggregated value chain at PR19 and this is also discussed in section one. This raises the questions of whether the approach to allocating outcomes across price review elements at PR14 will be appropriate for PR19 and whether we should take a view on the appropriate approach when we develop our price control methodology. In particular, should companies develop outcomes for the whole range of services and then seek to allocate them to specific price controls or services, or should business plans be set for separate services.

## **2.5 The strength and structure of Outcome Delivery Incentives**

In PR14 we took a very flexible approach to the setting of Outcomes and Outcome Delivery Incentives (ODIs) and companies were able to define the nature, scope and form of a very broad range of outcomes and ODIs. We wanted companies to grasp the opportunity to move to an outcome based approach and also have the flexibility to respond directly to the views and preferences of their customers in setting their service levels.

This approach has resulted in substantial variation across companies. This means that, even after our interventions, companies in the sector have very different incentive regimes in place for the 2015-20 period. We will be very interested to observe the outcome of these different arrangements and in particular the effect these differences appear to have on the incentives on companies and the outcomes for customers.

### **2.5.1 The form and structure of the incentive regimes**

In line with the significant variation amongst companies from PR14, some companies have more significant financial reward opportunities than others and some are at risk of greater penalties. Similarly, some have incentive structures that reward or penalise them on a cumulative basis and others on a more ongoing annual basis.

The experience of this period will then help to inform the approach we take at the next price review. In particular, does the form and nature of any particular incentive regime appear to have driven different and better outcomes for customers to another alternative arrangement? For example, does the existence of a symmetrical reward and penalty regime drive the right behaviours in relation to particular outcomes versus an asymmetrical regime that could provide a greater potential for reward or penalty in particular circumstances? Or does an annual reward or penalty regime better incentivise performance in the early part of the price control period versus a cumulative reward basis?

### **2.5.2 The aggregate caps and collars**

At PR14 we introduced an aggregate cap and collar on the financial impact of outcome delivery rewards and penalties. This also recognised that the outcomes framework was an innovative approach to incentives for the water sector, and there was therefore a degree of uncertainty in companies' estimates of outcome delivery rewards and penalties. The aggregate cap and collar therefore provided an additional safeguard to customers and companies to reduce the risks associated with individual incentives.

Similarly, based on the experience over the next five years it will be important to decide how much of companies' financial returns should be dependent on their delivery of outcomes and whether it would be appropriate to increase the financial importance of delivering outcomes.

We recognise that the aggregate cap and collar is not ideal as it will reduce or remove the incentive effects of penalties as companies get close to, and then pass, the aggregate collar on penalties. The same is true for rewards when companies near the aggregate cap on rewards. However, our estimate at PR14 was that only three companies would be affected by the aggregate penalty collar at P10 and no companies would be affected by the aggregate reward cap at P90<sup>4</sup>. We also allowed for the aggregate cap or collar to be amended in-period, with our agreement, if it could be clearly demonstrated by the company and/or the CCG that the arrangement was working against the long-term interest of customers.

As time progresses during 2015-20, we will be able to collect evidence about the extent to which the aggregate cap and collar are creating issues for service delivery

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<sup>4</sup> We asked companies to express the risk range on a P10/P90 basis such that there is a 10% probability of an outturn occurring below the identified range (P10) and an equal 10% likelihood of achieving a return above the identified range (P90).

for customers. We will need to address questions such as whether we should remove, loosen or retain the aggregate cap and collar for PR19.

### 3. Involving customers in service delivery

We believe that it is important that engagement with customers is a two-way street. Customer engagement is not about engaging customers as passive receivers of services but about actively engaging and educating customers about how they can support the delivery of services in a different way that meets their preferences and creates value that can then be shared amongst different recipients- customers, investors and the environment.

During the formulation of their business plans for the next price review it is important that companies can properly assess and consider the different ways that the outcomes customers want can be delivered. Where the delivery of those outcomes requires customers to change their behaviour they may be willing to do this in order to deliver that overall outcome in a more cost effective or better way. We saw some good examples of this kind of two-way engagement through PR14, for example Affinity Water's community water plan.

As we discussed in section two we are keen to see companies understand outcomes, the risks around outcomes and to appraise options to mitigate those risks to achieve the best solution. We would generally expect to see changing customer and community behaviour feature in that risk mitigation options appraisal.

This is an ambitious change, companies will need to engage dynamically with their customers on an ongoing basis to build trust and confidence so that during the formulation of their business plans there is the opportunity for these more in-depth and two-way conversations to take place effectively. If companies can do this, we see huge potential for a positive, virtuous circle here that could deliver benefits to be shared between customers, investors and the environment. If companies are able to build good relationships with customers then in turn they will be able to ask their customers to work differently with them. This then allows them to deliver services in a better or more cost effective way sharing those benefits with customers. This would in turn build more trust and allow for further opportunities to be discussed and taken forward with customers further strengthening the circle of trust to the mutual benefit of companies, customers and the environment.

## 4. Next steps

In this policy paper we have discussed a range of issues at a high level associated with:

- Why customer engagement is important and how it may need to change in the face of other changes going on in the sector such as the reforms being introduced through the new legislation;
- How customer engagement might evolve in circumstances where customers do not have choice, including how we improve the quality of customer engagement, drive a more ongoing and dynamic process, the role of Consumer Challenge Groups and the Consumer Advisory Panel in future price reviews and the Welsh Water forum;
- How our approach to outcomes might need to evolve in light of the learning from PR14 and the experience we gain in the next five years, including:
  - How we could have outcomes that span multiple price controls;
  - How we strike a balance between common and bespoke outcomes;
  - How we make outcomes work across disaggregated price controls;
  - How we might alter the approach to Outcome Delivery Incentives including for example changing the strength of these incentives, their structure, form and the cap and collar arrangements.
- How we might go about encouraging a two-way conversation with customers to involve them more in the delivery of services in a way that might improve trust and confidence in the sector and deliver better overall outcomes.

We welcome your responses to these issues, and the key questions set out at the beginning of this document by 5.00 pm on **10th September 2015**. Appendix 1 explains how to respond.

We will engage further with stakeholders over the summer and early autumn and we hope your response will be only one part of an iterative conversation that has already started with such initiatives as the “[market place of ideas](#)”. A number of water companies have contributed to this and we welcome anyone with an interest to contribute further ideas. We will also carry out a number of workshops and other forms of engagement to build on this paper as well as the wider sector conversation. We cannot make progress alone and need the sector and everyone interested in it to work to consider the way ahead.

In October, we expect the independent “task and finish group” to publish its report on resilience.

In November as part of the Water 2020 programme we will publish:

- our approach to the review of the retail non-household price control in 2017; and
- charges scheme rules.

In December, we then plan to

- consult on initial proposals for our approach to the regulation of water and wastewater wholesale controls at PR19; and
- publish our final approach to our resilience duty.

## Appendix 1: Responding to this discussion paper

We welcome your responses to this discussion paper by close of business on **10th September 2015**.

You can email your responses to [Water2020@ofwat.gsi.gov.uk](mailto:Water2020@ofwat.gsi.gov.uk) or post them to:

Water 2020  
Ofwat  
21 Bloomsbury Street  
London WC1B 3HF.

Information provided in response to this discussion paper, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1988 and the Environment Information Regulations 2004.

If you would like the information you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory ‘Code of Practice’ with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances.

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