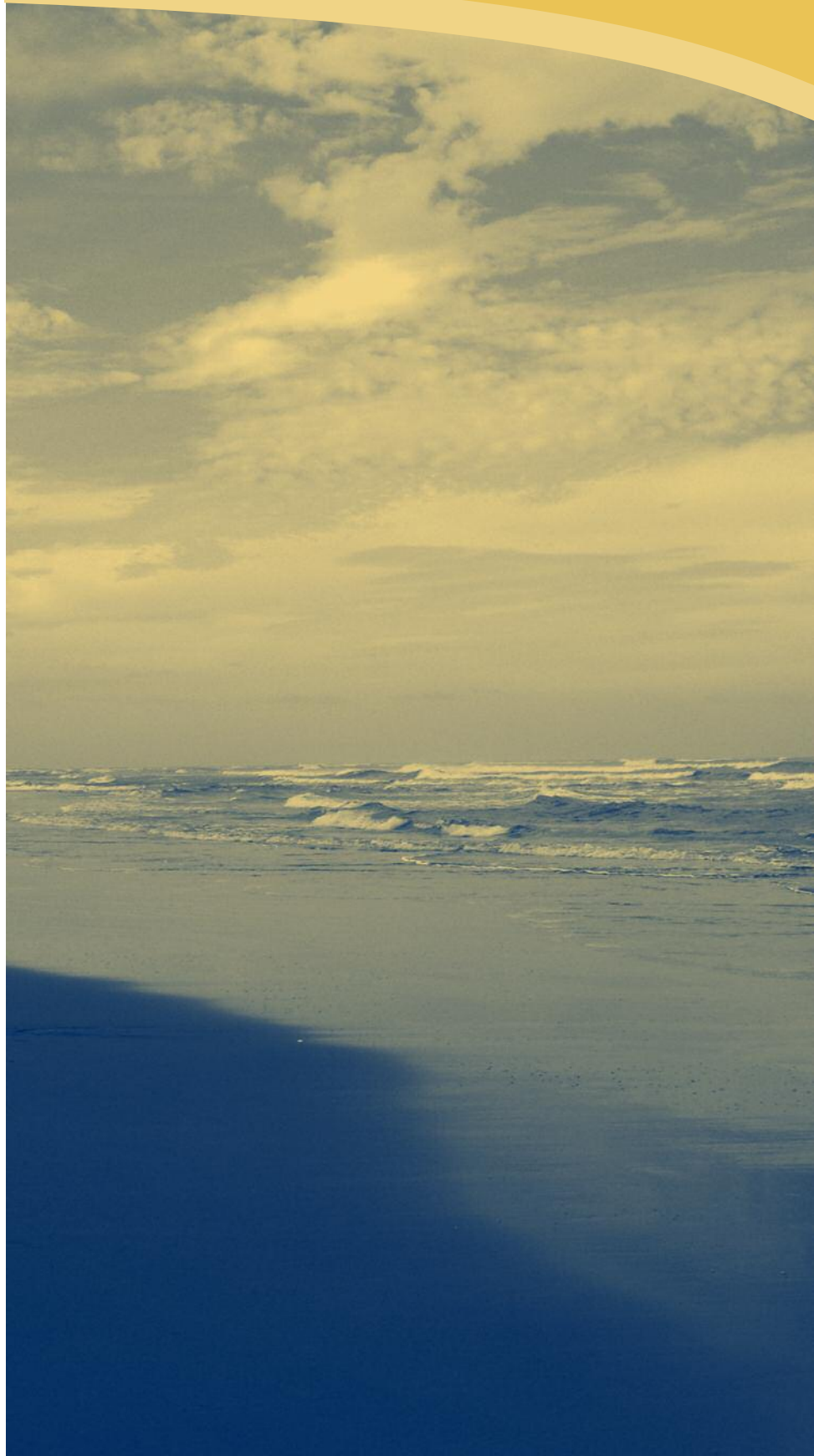


Water today, water tomorrow

Involving customers in price setting – Ofwat's customer engagement policy statement



About this document

This document sets out our approach to customer engagement during the price-setting process.

In developing this approach, we have taken into account the responses we received to our consultation on ‘[Involving customers in decisions about water and sewerage services](#)’, which we published in April 2011. We are publishing the responses we received alongside this document on our website.

We have also taken account of experience and developments in other sectors, both here and overseas. Our approach is designed to help deliver effective engagement without introducing an intrusive new role for the regulator or burdensome new processes.

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Key messages

- Water customers are at the heart of the price-setting process – they need to know that the bills they pay are fair and legitimate.
- We expect the companies to take responsibility for engaging more with their customers. We will not prescribe how they do this, but will provide high-level guidance and expect the companies to use good practice.
- We understand that the issues that shape the companies' business plans are varied – customers' views can inform and influence some of these more directly than others.
- We wish to see a three-tiered approach that will enable customers to engage with and influence all parts of their companies' business plans.
 - Through direct engagement with their water company on issues including local services and tariffs.
 - Through challenging the shape of the overall plan and the way the companies meet their legal obligations (for example, on drinking water quality and the environment).
 - Through influencing and informing our decisions.
- We want our approach to engagement to provide:
 - greater customer focus;
 - more incentives on the companies to innovate; and
 - more efficient use of water resources.
- Customer engagement will be an important factor in determining whether we will accept the companies' business plans. How much evidence of customer support we need, and how detailed our scrutiny of plans is, will be proportionate to the scale of changes to bills and services that an individual company is seeking. Customer acceptability is a key factor in our decisions.

1. Executive summary

Water customers are at the heart of the price-setting process – they need to know that the bills they pay are fair and legitimate. Good engagement is essential to achieving this. Responses to our consultation confirmed that the water companies, customer representatives and other stakeholders agree.

When we next set price limits in 2014, we expect the companies to take responsibility for engaging effectively with their customers. We will provide high-level guidance, but the companies must be accountable for the quality of their engagement and the way they respond in their business plans.

We still have decisions to take on how we will set price limits in the future. But we want to give the companies and others an early view of how we will take customer engagement into account so that they can start to plan how it will work in practice. We will consult on our overall approach to price setting later this year.

Customers' views will feed into the price-setting process in one of three ways.

- Through direct local engagement between each company and its customers to understand customers' views, to inform development and test acceptability of the company's plan.
- Through customer challenge (based on evidence from the company's engagement) to ensure that the overall package is acceptable to customers and that the work required to deliver outcomes – including legally prescribed standards and other regulators' requirements – is socially, economically and environmentally sustainable.
- Through a sector-wide customer advisory panel to influence Ofwat's thinking on those issues where we will apply consistent policies or assumptions across the water and sewerage sectors.

Good local engagement between the companies and their various customers is essential. But we also need to understand customers' views on the issues we must consider at a sector-wide level. For their part, customers want to know that their views have influenced the bills they pay and the services they receive.

The range of issues that make up the companies' business plans are varied. The views of customers can shape some of these more directly than others. For example, customers may take a view on the level of service they prefer but the cost of delivering that service will be affected by decisions on sector-wide issues such as financing costs, on which few individual customers are equipped to engage.

So, we envisage a three-tiered approach to enable customers or their representatives to engage in different ways and to influence the wide range of decisions that affect the service they receive and the price they pay.

The first is **direct local engagement**, typically on local priorities and issues that could have a significant impact on the service customers receive or those that affect the local community (such as local service levels, investment in sustainable drainage solutions, or variable tariffs). Although these issues may not account for a large proportion of bills, they are often very important to customers. The companies will also need to test customers' views on the acceptability of their overall plan. They will be responsible for designing and managing the local engagement process effectively and for taking account of their customers' views. The companies will also need to gather quantitative evidence of the acceptability of their overall plan.

The second is through a **company customer challenge group** to ensure that the company's business plan reflects a sound understanding and reasonable balance of customers' views, and whether the phasing, scope and scale of work required to deliver outcomes – including legally prescribed standards and other regulators' requirements – is socially, economically and environmentally sustainable.

It will help ensure that outcomes are defined in a way that enables the company to seek out the most acceptable, cost-effective and sustainable means of delivering them. It will advise and challenge the company as it explores and considers innovative solutions, including catchment management.

The group will also play an important part in considering evidence of a company's direct customer engagement, discussing and challenging how the company has responded in its business plan. The group will advise us on how well this has been done.

The customer challenge group will build on the quadripartite and Wales PR09 forum discussions at the last price review. But its broader role requires a more diverse membership. As well as other regulators and the company itself, it should include:

- consumer representatives, such as the Consumer Council for Water (CCWater);
- customer and community stakeholders (including local authorities and businesses); and
- those that represent particular segments of customers, such as Age UK.

While the companies will be responsible for setting up and running the challenge group, it should have an independent chair.

We will provide information to the group during the price-setting process. This is so that the engagement and challenge to the companies' business plans can be meaningful – for example, on assumptions around costs. We will work closely with the Environment Agency and the Drinking Water Inspectorate (DWI), and provide shared input on the policy framework for environmental and drinking water obligations. We will take account of the group's advice when we consider the companies' business plans. We may attend the group occasionally, but we will not be full-time members of the customer challenge group.

When the companies submit their final business plans to us, we will expect the challenge group to tell us how effective a company's engagement has been and how it has taken account of customers' priorities. We will ask for the group's views on the company's plan and for it to highlight any contentious areas.

Finally, there will be a **sector-wide customer advisory panel**, which we will set up and run. This panel will comprise members with the expertise and experience to inform and challenge us on a number of key sector-wide assumptions, such as the cost of capital, and provisions for pensions and energy. Membership will include CCWater as the statutory (legal) water consumer representative. It will also include other customer representatives, such as big businesses, which are also often customers of several water companies. The panel will not duplicate the companies' own engagement with business and other customers. Nor will it advise on or challenge individual company business plans.

We look to the companies to take responsibility for engaging with their customers and responding to these in the plans they develop and the prices they wish to charge. We also look to them to provide us with the appropriate level of assurance and evidence to support their proposals. But we do not intend to prescribe the exact arrangements.

Customer engagement will be an important factor when we consider whether to accept a company's business plan. But it will not be the only one, as some things cannot be determined solely by customers' views. And sometimes, we have to consider the interests of future customers, as well as those who are able to express a preference now. So how much weight we place on customer engagement will depend on several factors. We will define this in more detail as we develop our approach to future price limits, but the following paragraphs give an indication of our current thinking.

Broadly, we intend to follow an approach that is proportionate and that focuses on the material issues. Overall, if the company demonstrates that its customers support its plan, that it can comply with its obligations and meet cost assumptions, and we are confident of its track record of effective planning and delivery, we should be able to accept that plan with minimal scrutiny. In these circumstances, less extensive assurance may be needed as long as we have sufficient and quantitative evidence that customers accept the company's business plan. And we will need to know that the company has considered and tested innovative solutions where these are appropriate.

On the other hand, if a company's proposals would have significant impact on service levels or customers' bills, then there is more onus on that company to demonstrate that it has engaged effectively and that customers understand and support its plans. In such cases, the company will need more robust evidence and may also wish to have a more independent and comprehensive assurance process in place. In turn, we will put more weight on the need for effective assurance by company and customer challenge group so that we can have confidence in the views attributed to customers.

We think that engagement in the business planning process is only the start of good customer involvement and service. We hope that the arrangements we outline in this document will also provide the companies and their customers with a framework for ongoing engagement as they deliver their business plans.

2. Setting customer engagement in context

In [‘Future price limits – a preliminary model: informal consultation’](#), which we published in March 2011, we said that we were considering changes to the way we set price limits. This is so that the water and sewerage sectors would have:

- greater customer focus;
- improved incentives to innovate; and
- the ability to make more efficient use of water resources.

The framework for customer engagement set out in this document will make an important contribution to delivering these benefits. It will also underpin the legitimacy of the companies' business plans and our own regulatory decisions.

This document explains how we expect customers and other key stakeholders to have a say in the planning and decision-making process when we next set price limits in 2014.

We are still developing our overall approach to setting price limits, and will consult on this later in the year. Next year, we will consult on our detailed methodology for setting price limits in 2014.

This means that we are not yet in a position to set out in detail how we will take account of customers' views when we set price limits. But we are committed to incentivising greater customer focus. And we know that we must set out a broad framework at this early stage so that the companies, customer representatives and other stakeholders can begin to make appropriate arrangements. Whatever we decide about future price limits, the companies will need to engage effectively with their customers.

We are also working on a new approach to setting the outcomes that the companies will deliver for customers. We explained this in more detail in our discussion paper on [‘Inputs, outputs and outcomes – what should price limits deliver?’](#), which we published in March 2011. This will give the companies greater freedom to innovate and develop sustainable approaches. In early autumn, we will consult on a more proportionate and targeted regulatory approach to holding the companies accountable for meeting their obligations.

All of this points to the importance of the companies engaging with their customers, an approach which was also endorsed in the [independent review of Ofwat and consumer representation in the water sector](#) led by David Gray (the ‘Gray review’).

Over the past year, we have debated with our stakeholders the best approach to customer engagement. In October 2010, we published a discussion paper on 'Involving customers in the price-setting process'. We followed this in April 2011 with a consultation on 'Involving customers in decisions about water and sewerage services'.

The approach we set out here takes account of the views and responses we received to these two documents. We will publish the individual responses we received to our consultation and a summary of those responses on our website shortly.

We have also taken account of the consultation and conclusions of the Gray review, and our approach aligns with the recommendations in that report.

Throughout this document, we refer to CCWater as the current statutory water consumer representative. We are aware that the UK Government is considering possible new arrangements for consumer protection and advocacy that may change this.

2.1 What we want to achieve

2.1 1 The principles that will shape our approach

In our consultation on involving customers in decisions about water and sewerage services, we proposed a number of principles that would shape our approach to customer engagement (see opposite). The companies, CCWater and other stakeholders broadly supported these principles.

Principle 1	Water companies should deliver outcomes that customers and society value at a price they are willing to pay.
Principle 2	Customer engagement is essential to achieve the right outcomes at the right time and at the right price.
Principle 3	Engagement should not simply take place at price reviews. Engagement means understanding what customers want and responding to that in plans and ongoing delivery.
Principle 4	It is the companies’ responsibility to engage with customers and to demonstrate that they have done it well.
Principle 5	Customers and their representatives must be able to challenge the companies throughout the process. The engagement process should ensure this challenge happens. If this is not done effectively, we must be able to challenge on customers’ behalf. In doing so, we will fulfil our duty to protect customers.
Principle 6	Engagement is not a ‘one-size-fits-all’ process, but should reflect the particular circumstances of each company and its various household and non-household customers.
Principle 7	The final decision on price limits is entrusted to Ofwat. We will use a risk-based approach to challenge company plans if this is necessary to protect customers’ interests.

So, we have designed a framework that is intended to:

- help deliver our objectives for future price limits;
- meet our principles for customer engagement;
- keep the regulatory burden proportionate to the materiality of issues to customers;
- be non-prescriptive, while holding the companies accountable for managing and shaping customer engagement and assurance processes appropriate for their particular circumstances;
- engage effectively with the other regulators whose decisions have an impact on price limits; and
- hear customers’ views on all aspects of a company’s business plan, while recognising that their views cannot solely dictate or necessarily be the biggest influence on such issues as how legal outcomes are delivered and the regulatory decisions we make.

This approach is consistent with the recommendations of the Gray review and the views that stakeholders expressed during our consultation.

2.1.2 Purpose of customer engagement

Customers have said that they want a voice on all issues that affect their bills. And where they are less able to engage individually – for example, on more technical issues – they want someone to represent their interests.

A large proportion of customers’ bills is spent on maintaining current services or meeting legal requirements – for example, to protect the environment. And technical decisions that we make at a sector-wide level on things such as financing costs or efficiency also affect customers’ bills – often significantly. Although these issues are more difficult for customers or their representatives to engage with, and their views cannot be decisive, it is important that their interests are considered properly.

In our [consultation](#), we explained why we do not favour negotiated settlements where the companies and customers negotiate the overall package of outcomes and prices. Experience from other sectors shows that such a process would be onerous on the companies and their customers. The monopoly nature of the water and sewerage sectors and the vertical integration of existing wholesalers and retailers mean it would not add sufficient challenge to justify the bureaucratic burden needed. Our stakeholders agreed that this approach was not currently appropriate in the water and sewerage sectors.

Nor are we identifying and separating out a narrower set of issues that customers could agree without Ofwat’s input. We understand that what customers care about most is the package as a whole and its overall effect on bills. So, our approach provides for customers to influence (directly or indirectly) all aspects of their company’s plan.

We would expect customers’ views to carry particular weight on issues, such as:

- billing;
- complaints handling;
- tariffs;
- metering; and
- local service levels (for example, sewer flooding or reliability of water supply).

And on other issues, customers still need to understand what their company is planning – and why – both over the short and longer term. This is particularly important if customers’ bills will be materially affected by decisions over which they have limited influence when prices are set.

If expenditure is required to meet legal obligations or to protect services for future generations, current customers – or their representatives – still have an important role to play in influencing how these services are delivered and legal obligations are met (for example, on drinking water standards, sustainable drainage or security of water supplies). They will also need to understand the implications not only for their own bills, services and environment but for their children's and grandchildren's.

As the companies consider how to meet the challenges they face in the future, they will need to engage their customers and other stakeholders actively – not simply as recipients of services, but as participants in innovative and sustainable solutions. The companies need to have long-term strategies in place to provide the essential context for the short-term business plans that we review at price setting. These short-term plans also provide the means by which the different legal and regulatory timetables can be integrated.

The companies will need long-term strategies if they are to rise to the challenges of the future. We expect the companies to talk to their customers about the long term, as well as about their immediate priorities. We also expect them to present their business plans in a long-term context.

Different customers in different areas have different concerns and priorities. Communities that experience flooding or discoloured water would wish to see investment to resolve this, while some groups may favour work to enhance the local environment. Business customers may care most about a constant supply and pressure. Others want help managing water use. Those who spend a higher proportion of their income on water may need help to pay bills without getting into debt. Some people may need help communicating with their company. So, it is important that the companies understand their different customers' views on service priorities and bills.

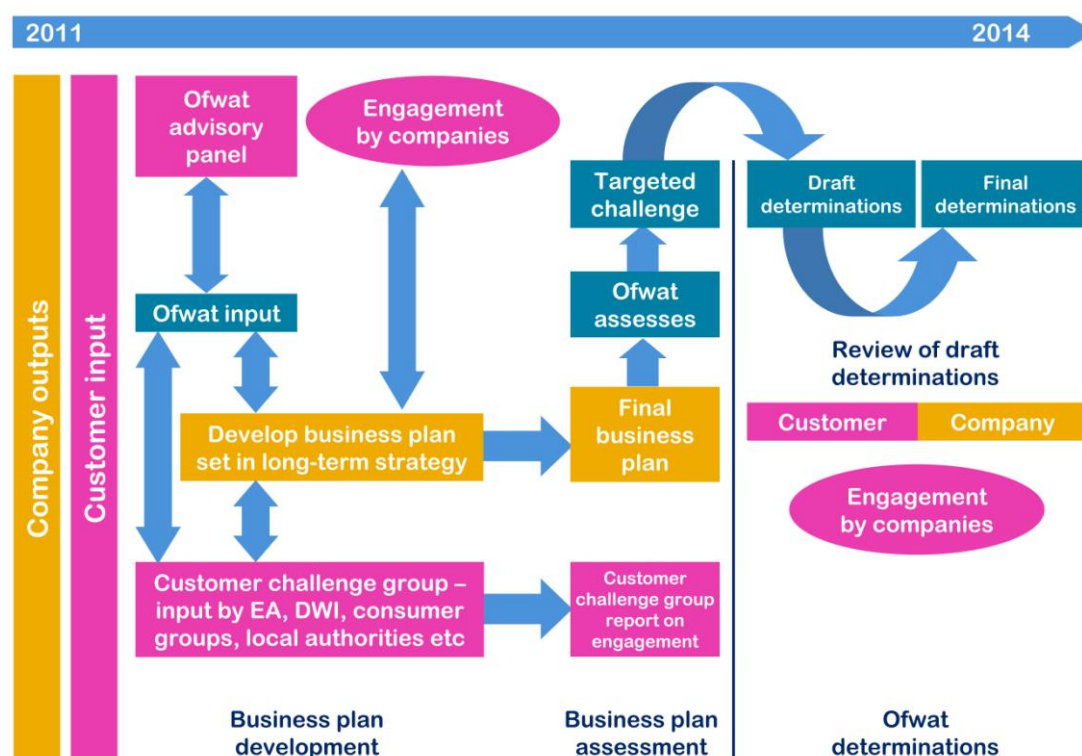
And our engagement framework needs to incorporate the views of all customers and stakeholders in two ways.

- **Directly**, so that customers' views inform and influence the companies' long-term strategies and business plans.
- **Indirectly**, influencing and informing the decisions Ofwat makes, supporting their legitimacy.

3. How we expect customers to be engaged in price setting in 2014

We envisage a three-tiered approach comprising:

- **direct local engagement** between each company and its customers to understand customers’ views, and to influence and test acceptability of the company’s business plan;
- a company-supported **customer challenge group** to ensure that its business plan reflects a sound understanding and reasonable balance of customers’ views, and whether the outcomes – particularly those prescribed by Government or the quality regulators – are being delivered in the most socially, economically and environmentally sustainable way; and
- a **sector-wide Ofwat customer advisory panel** to inform our thinking on those issues where we will apply consistent policies or assumptions across the water and sewerage sectors.



3.1 Direct local engagement

The companies will be responsible for establishing and running effective arrangements for local customer engagement. This should address issues such as retail services or tariff structures. It should also address those that require new investment – for example, sewer flooding or discoloured drinking water.

Effective engagement with customers and other local stakeholders will be important if a company is to explore properly the most sustainable solutions and investment approaches to delivering the outcomes that customers want.

For example, sewer flooding can be tackled in a number of ways. The company could increase its underground assets to store more run-off during storms. It could work with customers or local authorities to introduce sustainable drainage systems that manage rainfall close to where it falls. Or it could help customers to reduce the impact of flooding.

Tariffs that incentivise customers to reduce drainage demand may also be relevant. Finding the most effective outcome will depend on a sound understanding of customers' views and well-informed engagement with affected communities and businesses.

It is not for us to prescribe how the companies should engage their customers. Our consultation confirmed our view that it is for the companies to build this relationship, taking responsibility and accountability for creating effective new ways to communicate and understand customers' views, and to provide innovative solutions to meet their needs. But respondents said that it would be helpful to have high-level guidance on what good engagement looks like.

So, we have set out below what we consider to be the key characteristics of good engagement.

The key characteristics of good customer engagement

Scope

- A continuous process, which builds knowledge, insight and understanding between the companies and customers, not just one-off at planning time.
- Proportionate to the materiality of likely impacts of overall plan or particular major items on bills or service levels.
- Engaging with customers on all elements of the plan – both retail and wholesale services.
- Segmenting different customer types where appropriate and using the right tools to elicit the views of each type, including business customers and those with concerns about affordability or the proportion of income that they have to spend on water and sewerage.
- Seeking the views of those representing different local customer interests (such as CCWater, business organisations, local authorities, Citizens Advice, Age UK, the National Farmers' Union, and others).
- Considering the wider context and pressures on customers' budgets, particularly where customers have different suppliers for their water and sewerage services.

Approach

- Evidence based, with facts gathered through an appropriate range of tools (such as market intelligence and insight from customer complaints or feedback, surveys, focus groups, existing market intelligence, or revealed preferences).
- Understanding and balancing the differences between different customer segments, including current and future customers.
- Working with customer representatives and stakeholders, not only in planning and conducting the engagement, but also in interpreting the responses.
- Objective and impartial – with an open approach to understanding and reflecting customers' views on a range of issues, rather than consulting to generate support for a particular course of action.
- Offering choices and seeking views on priorities and preferences, both on what a company could do, and how it might achieve the things it must do in the most sustainable and cost-effective way.
- Informing the development of business plans at every stage, not merely a validation tool once a plan is developed.
- Based on a realistic set of price–service trade-offs, informed by clear and reasonable assumptions on costs and bill impacts.
- Exploring the full range of operating and capital solutions (such as demand management through changes in customer behaviour, as part of the overall supply/demand balance).
- Using reputable contractors (for example, members of the Market Research Society), and taking account of current good practice (such as that published on willingness to pay surveys and cost-benefit analysis).
- Providing quantitative evidence of the acceptability of a company's overall business plan and its impact on bills.

We expect the companies to use the full range of information at their disposal and to carry out robust new customer research where appropriate to establish their customers' priorities for services and their views on bills. They should use good practice – taking account of reports and guidance published by us and other bodies such as UKWIR, and the Equalities and Human Rights Commission. They should not seek simply to establish customer support for the business plans they have already designed. Instead, they should genuinely seek to shape their plans to reflect the desires and needs of current and future customers.

The companies told us that they wanted to own their local engagement with customers. We agree that this is right. To avoid any confusion, we do not intend to commission our own research to test the acceptability of the companies' business plans (although we will use research where necessary to inform our sector-wide policy). But we will be clear about holding the companies accountable for testing their customers' support and for providing proportionate justification and assurance.

The results from the company's local engagement will be an important input to discussions at the customer challenge group, which we describe in more detail below.

3.2 Company customer challenge group

Each company should set up a customer challenge group with an independent chair. The role of this group will be to:

- review the company's engagement process and the evidence emerging from it. This is to ensure customers' views are considered as the company develops its business plan;
- challenge the phasing, scope and scale of work required to deliver outcomes, including legally prescribed standards and the requirements of other regulators; and
- advise us on the effectiveness of the company's engagement, and on the acceptability to customers or otherwise of its overall business plan and bill impacts.

A key part of this will be a debate between the company, customers, other local stakeholders and the quality regulators to establish whether the scope for sustainable delivery of any legal outcomes has been properly considered.

The group will also have an important role in considering those issues that are more complex or technical. For example, direct engagement may expose individual customers' views about what outcome they want in relation to security of supply or restrictions on water use. But the challenge group may wish to discuss this to establish how the particular outcome can be delivered most sustainably and integrated with metering, water efficiency measures and requirements to restore sustainable abstraction.

Such thinking will also need to be integrated with the companies' work on their water resources management plans. It is likely that discussions within the group will need to be supplemented with more detailed bilateral conversations. But it is important that such work informs the group's discussions rather than replaces them.

So that we can apply a more targeted and proportionate scrutiny to the business plans that the companies submit, we will also ask the group to tell us how well the plans reflect customers' views. We will want the group's views on how well evidenced the company's understanding of customers' views is, and how effectively the company has balanced and reflected those views in its plan. We will also ask it to highlight any aspects that we should challenge.

We do not expect the customer challenge group to provide expert technical assurance of a company's use of willingness to pay surveys, for example, or the way it has translated data into its analysis of costs and benefits. But we will expect the companies to provide proportionate assurance (such as peer reviews or technical assurance) so that they can convince the customer challenge group that their results are robust.

We will not prescribe exact membership or terms of reference for the customer challenge group. The companies will need some flexibility to reflect local circumstances and the availability or priorities of local stakeholders. So, for example, different stakeholders may choose to attend particular discussions. The company will need to manage the balance between its engagement activities and the challenge group work programme to ensure that customers' and stakeholders' views are captured effectively, and that they can participate in discussions to shape and challenge the company's developing overall plan.

We expect the group to include:

- CCWater;
- business customers and their representatives;
- other key stakeholders, including local authorities and local community representatives;
- representatives of customers with particular needs, such as Age UK, Citizens Advice and Action on Hearing Loss; and
- the quality regulators.

This builds on the quadripartite process at the last price review and the Wales Water Industry Forum, but provides for a broader group of customers and stakeholders to discuss all elements of a company plan, not just the quality programme.

The onus is on the company to establish a group that gives it sufficient assurance that its plan is robust. We also need to be assured that the company has taken customers’ views into account and that the group has challenged the evidence for this. If the group is not satisfied that the process has been chaired and managed effectively, we would expect that to be reflected in its report to us. We would take that into account when considering the company’s business plan.

The company will be responsible for administering the group, including providing timely information or distributing information from other bodies. It will also need to ensure that the group is content with its terms of reference and ongoing operation. We would expect any concerns that members of the group have to be tackled directly with the company in the first place.

In appendix 2, we set out an example of what we would expect to see in any terms of reference.

In response to comments made during the consultation process, we will play a more active role in the customer challenge groups. We will provide earlier input to the engagement and business planning process, and reduce uncertainty on key parameters. The Ofwat customer advisory panel will help us develop this early input, as explained below.

We will also work with the DWI and the Environment Agency to provide early guidance on our shared expectations on how the companies should meet their environmental and drinking water obligations. This will include:

- how we expect to reconcile the timetables;
- stakeholder engagement and policy framework for other processes, such as water resources management plans and river basin management plans; and
- any necessary guidance on how the regulatory framework will treat innovative solutions, such as catchment management schemes.

This early input is designed to address our stakeholders’ concerns that we should reduce unexpected differences between the companies’ business plans and our determinations. We also wish to respond to the Gray review’s recommendations that we and the other regulators work together to make a more formalised joint input into the price review process and decision-making, and that we build on the previous quadripartite process.

We will work with our stakeholders over the coming months to identify the issues on which early input would be helpful and to establish a work plan to deliver it.

This early input will give the customer challenge group the support it needs to work with the company and the quality regulators. It will also increase transparency. We may attend as occasional observers or if we are asked to clarify particular issues. But we do not think we should be a permanent member of the group since debate should focus on customers rather than the regulator.

3.3 Ofwat customer advisory panel

There are some issues that the companies and their customers cannot decide locally. These include decisions that are made at a sector-wide level and that we apply across all the companies we regulate. These include:

- financing;
- pensions policy;
- energy; and
- future efficiency.

Companies are well placed to make representations to Ofwat on these topics and have a number of opportunities throughout the price setting process to do so. Providing views on these types of issues is more difficult for customers. It is appropriate to develop a mechanism to allow a proportionate input of customer views to inform our decisions on these sector wide issues. So, we will provide an opportunity for customers and their representatives to challenge, inform and engage with us as we develop our thinking on our regulatory policies and assumptions. We will do this through a sector-wide customer advisory panel, which we will set up and run.

The panel will include CCWater, as the statutory consumer representative, as well as other consumer bodies and business customer representatives or experts. We will also ensure that the companies and other bodies have appropriate opportunities to influence our thinking alongside the panel.

We will make appropriate arrangements for the exchange of information between the panel and other forums, such as the Wales Water Industry Forum. We do not envisage a need for separate panels in England and Wales. But we will ensure that there is appropriate representation – particularly when discussing issues that have specific or different implications in Wales.

We are clear that the Ofwat customer advisory panel must enhance rather than undermine the local engagement between the companies and their customers. It will inform our thinking so that the sector-wide assumptions that we feed into the local challenge and engagement processes are legitimised by customer challenge. This early input on key parameters, alongside the joined-up input on quality obligations we will make with the other regulators, is designed to reduce uncertainty for the companies and their customers, and support local engagement. But the panel will not review the companies’ business plans – that is a role for the local engagement and challenge process.

4. How we will take account of customers' views when considering company plans

Customer engagement will be a key factor in helping us to decide which companies' business plans – or which elements of those plans – we need to challenge so that we can protect customers. But it will not be the only factor.

For those issues that affect customers directly, such as billing or local service levels, we can expect their views to have a significant influence on our decisions. For elements of the plan that relate to meeting a legal obligation – for example, the Water Framework Directive – we will consider the outcomes of the discussion between customer groups and the quality regulators in the customer challenge group when deciding if we need to challenge the scope or cost of the companies' schemes.

How much weight we place on customer engagement when considering a company's business plan in its entirety and how much assurance we need on the way customers' views have been taken into account, will depend on a range of factors. The extent of evidence and degree of assurance we expect from a company will need to be proportionate and depend on the materiality of the things the company wishes to do.

In practice, this means the following applies.

If a company's proposals would have a **significant impact** on bills or service levels, the onus will be on that company to demonstrate that it has engaged its customers and stakeholders effectively and that its plans are acceptable. The burden of evidence and need for robust assurance will be considerably higher in these cases.

In such circumstances, we will place more weight on the need for assurance of customer buy-in when we consider whether to accept the company's proposal. Even so, customers' views alone will not be the only determinant. Every company will need to show that it is complying with its legal obligations and is operating efficiently. We will also consider impacts on particular types of customer, including future customers.

If a company's proposals do not have a significant impact (on bills or service levels), and as long as it can demonstrate adequately its compliance with required outcomes and cost effectiveness, then less extensive assurance of the engagement process may be adequate.

But we will still expect the company to show it has engaged its customers sufficiently to establish that:

- current services are satisfactory and customers seek no changes; and
- its business plan(in the context of its long-term strategy) is acceptable.

The company will also need to ensure it has considered properly the scope for more innovative and sustainable approaches to delivering its legal outcomes.

So, in summary, if a company were to put forward a well-evidenced business plan that was shown to be acceptable to its customers and stakeholders, that delivered the required outcomes (including legal obligations), that was cost-effective and we were confident of its track record of effective planning and delivery, then we would be able to reduce significantly our scrutiny and challenge. This should result in a draft determination that closely resembled the company's business plan.

But if the customer challenge group tells us that engagement has been poor, or where it has concerns with the quality or content of the company's plan (or its consistency with the longer-term strategy), we will use that as evidence to target our challenge. We will take account of the group's advice as we confirm that the company is complying with its obligations and operating efficiently. We will also take account of a company's track record – for example, one with a history of poor management or inadequate information can expect greater scrutiny.

The document on our future approach to price controls, on which we will consult later in the year, will set out how we intend to approach price setting. It will set out an indicative timeline for the next review of prices. This may include earlier submission of companies' final business plans and greater transparency in communicating where our draft determinations differ markedly from the companies' proposals. This will enable further engagement between the companies and their customers to inform their representations on our draft determinations. It is not intended to provide an opportunity for companies to submit a revised business plan.

We will develop our overall approach to assessing the companies' business plans as we consider our proposed methodology for setting price limits in 2014. Our approach will take account of our continuing work on the future approach to defining the outcomes and regulatory compliance.

5. Next steps

The companies can now begin to plan their customer engagement ahead of preparing their business plans for 2014. We do not intend to approve this process, nor sign off the arrangements the companies put in place.

In the meantime, we will:

- develop our more detailed methodology for setting prices in 2014. We will consult on this in autumn 2012 and confirm our approach in spring 2013;
- set up an Ofwat customer advisory panel to enable customers to contribute to our developing thinking on policy decisions and technical assumptions for the 2014 price review. The group will begin its work after we have published our consultation on the form of future price controls in autumn 2011;
- work with CCWater, the companies and other stakeholders over the coming months to identify the issues where companies and customers need support or guidance from us;
- develop a work plan for the Ofwat customer advisory panel and our own work so that the companies and their customer challenge groups understand when we will be able to provide information or advice and in what form. We will develop a 'ready reckoner' to illustrate the possible implications for bills of different expenditure levels;
- work with the Environment Agency and the DWI to reconcile price review processes with other planning processes (such as the water resources management plans) and also agree what and when we can communicate about our shared expectations on meeting outcomes driven by legal obligations; and
- explore with CCWater whether we might facilitate a workshop or similar event in which businesses that are customers of more than one company can share with interested companies their expectations and particular service priorities.

Appendix 1: Roles and responsibilities in customer engagement

A1.1 The companies

At a company level – design and run direct local engagement with customers and stakeholders, including gathering existing evidence and seeking out views. Set up and support an independently-chaired customer challenge panel. Submit to us a proportionately evidenced and assured business plan that takes account of customers’ views.

A1.2 Ofwat

At a sector level – set up and run a customer advisory panel, and provide guidance on sector-wide regulatory policies and cost assumptions (including a bill impact ready reckoner) to inform the companies’ developing business plans and to support the company customer challenge groups. Through the price control methodology, and working with other regulators as appropriate, define any necessary policy framework or guidance for particular issues (for example how the regulatory regime will treat innovative solutions) to inform the group’s discussion of options.

At a company level – provide advice or input on request to support the local challenge group. Take account of the views of the local customer challenge group on issues of concern or risk to customers in targeting the scrutiny of the companies’ business plans.

A1.3 Customer advocate (CCWater)

At a sector level – through our Ofwat customer advisory panel, inform and challenge our thinking on sector-wide regulatory policies.

At a company level – through the customer challenge group, ensure the companies reflect their customers’ views by:

- contributing to and quality assuring each company’s direct engagement process;
- advising and challenging them through the customer challenge group to maximise the acceptability of bill impacts and services levels to current and future customers; and

- advise Ofwat on the quality of the companies’ engagement with their customers and with the customer challenge group.

A1.4 Customers and customer representatives

At a sector level – inform and challenge our regulatory assumptions or policies through the Ofwat customer advisory panel and our public consultations.

At a company level – give customers’ views to their company using the direct local engagement process. Challenge their company’s developing business plan and advise us through the company customer challenge group.

A1.5 Other regulators

At a sector-wide level – work with the UK and Welsh Governments, Ofwat and customer representatives (CCWater and others) to give guidance on implementing standards, including:

- integrating different timetables for legal consultation processes and price setting;
- high-level outcomes and performance measures; and
- scope for innovative and sustainable solutions.

At a company level:

- identify socially, economically and environmentally sustainable approaches to deliver required quality standards and outcomes and respond to customers’ views on how best to achieve these;
- ensure the company’s business plan is consistent with other strategic plans, such as:
 - water resources management plans;
 - river basin management plans; and
 - local flood risk management strategies); and
- confirm through the customer challenge group to us that the companies’ plans deliver the required legal outcomes.

Appendix 2: Illustrative terms of reference for the company customer challenge group

A2.1 Role

Advise and challenge the company as it develops its engagement and research plans.

Advise and challenge the company as it interprets customers’ views and decides how to reflect them in its longer-term strategy and business plans.

Advise and challenge the company and other regulators to consider:

- the opportunities for using innovative or sustainable means of delivering the required or desired outcomes;
- the scope, justification and cost-effectiveness of the preferred delivery mechanism; and
- phasing delivery or outcomes to maximise the affordability and acceptability of the company’s overall business plan.

Provide a report to Ofwat alongside the company’s business plan on:

a) The company’s engagement process

- the effectiveness of, or any concerns with, the company’s engagement with its various customers and with the local customer challenge group (taking account of the characteristics of good engagement set out in chapter 3 and any further advice Ofwat provides to the group); and
- whether the level of engagement and assurance is proportionate to the materiality of the company’s business plan proposals.

b) The company’s strategy and business plan

- whether the plan delivers the required legal outcomes;
- whether the company has actively considered the opportunities for more innovative and sustainable approaches to delivering the required or desired outcomes;
- whether the company’s longer-term strategy and business plan is an appropriate response to customers’ views;
- whether the company’s business plan strikes a reasonable balance between the views of different customers and stakeholders, highlighting any areas

where particular segments of current or future customers are likely to have outstanding concerns;

- whether the company has explored the range of cost-effective solutions and phased delivery of its various outcomes to maximise acceptability to customers; and
- whether the company’s overall final business plan appears likely to be acceptable to a majority of customers, highlighting any areas of concern.

A2.2 Membership

Members with a statutory remit:

- the Environment Agency;
- the Drinking Water Inspectorate;
- Natural England/Countryside Council for Wales; and
- CCWater, the statutory consumer body.

Local members (exact composition as appropriate to local circumstances):

- business customers and their representatives;
- other key stakeholders, including, local authorities and local community representatives; and
- representatives of customers with particular needs such as Age UK, Citizens Advice, Action on Hearing Loss.

A2.3 Governance

The chair should be sufficiently independent of the company to be able to ensure it can be challenged effectively, to give proportionate assurance to Ofwat.

The company will provide secretariat and administrative support and costs, including examples where appropriate.

Work programme and modus operandi (approach) will be agreed with members of the group.

Agendas and other materials will be provided in a timely and accessible way.

Minutes will be kept and made publicly available.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water and sewerage sectors in England and Wales provide customers with a good quality and efficient service at a fair price.



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