

Response to:  
“PR24 and beyond: Reflecting customer preferences in future price reviews – a discussion paper”

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## **Response to “PR24 and beyond: Reflecting customer preferences in future price reviews – a discussion paper”**

I have set out below my response to some of the questions raised in Ofwat’s consultation. The key points are:

- Before deciding on the approach to customer engagement there need to be decisions on what areas engagement will influence. This will avoid wasted research and ensure that appropriate research is carried out.
- The current research approaches do not always produce credible values, and this would probably not be eliminated by collaborative research. I have set out an alternative approach which would be likely to produce more reliable results.

**Q1:** Do you agree with the goals we have proposed for customer engagement at future price reviews? If not, why not?

**Q2:** Are there any other goals which you think we should have for customer engagement at future price reviews?

I agree with the proposed goals. However, I think the goal of proportionality needs to be extended to ensure that research is focused on those areas which will be influenced by customer engagement.

At PR19 much of the research was directed at determining customer preferences in terms of levels of service. However, for many aspects of service, Ofwat set targets on the basis of achieving or moving towards a common target, which was based on a forecast of future performance. These measures account for about 80% of the total potential outperformance or underperformance payments (as measured by impact on the P10/P90 range which companies estimated). Some of the other performance targets related to statutory requirements, unaffected by customer engagement. Therefore the proportion of targets affected by customer engagement was relatively small.

The framework, in terms of what will be affected by customer research, needs to be set before deciding what research to carry out – both aspects of service to be covered and the type of research which is needed. Research only to determine valuations for incentive rates, or research to determine relative priorities, would be different from that required to assess valuations for setting service performance targets.

The options are set out in the table below. Whichever option is chosen, improvement is needed in the approach to customer research.

**Role of customer engagement in the price review**

| Role of engagement  | Issues  |
|---|---|
| Customer engagement to determine performance targets and incentive rates  | This would require much greater Ofwat confidence in reliability of customer research and in companies setting sufficiently stretching targets.  |
| Guideline targets to be set nationally. Companies having some flexibility to vary targets around this based on local engagement and cost assessment – providing there is a balance between local targets being above and below national targets | An index approach to combining company targets (similar to that used previously in the Overall Performance Assessment for assessing service performance) could be used to assess whether overall the targets were sufficiently ambitious. The approach would require increased confidence in valuations, if local differences are to be justified.  |
| Incentive rates to be set based on customer research, subject to moderation of extreme values, with targets based on national comparisons   | This is broadly the PR19 approach. However, if valuations are not sufficiently reliable to set performance targets, then nor are they reliable for setting incentive rates. If this is the role of customer research, There needs to be a review of the approach, focused on the best customer research method to derive valuations for incentives. |
| Incentive rates and targets to be set nationally, with a top-down comparative assessment  | The assessment could use customer research to contribute to the setting of rates and targets. Research would be about relative priorities for different aspects of service, and the balance between service improvements and bills, rather than determining absolute valuations.  |

**Q3:** Do you agree with the principle that in areas that are of common concern to all customers within a nation, evidence of customers' preferences should be generated in a consistent manner such that results are comparable? If so, why? If not, why not?

The choice experiment approach to assessing willingness to pay creates clear anomalies, such as, in some cases:

- Valuations which appear excessive, such as a valuation of several thousand pounds for a short-duration interruption.
- Very large differences in valuations between companies, where the highest valuation may be 50 times the smallest value.
- Anomalous differences such as long interruptions being worth less than short-term interruptions or external flooding being valued higher than internal.

A consistent approach will reduce differences between companies. However, some anomalies are still very likely. The choice experiment approach is valuable for understanding what a service failure, such as an interruption, is worth to a customer experiencing it. But customers being given choices with a range of different services and different company-wide increments of improvements, in aspects of service of which they have no experience, may not produce meaningful results. For example, customers tend to focus on the aspect of service e.g. sewer flooding, rather than the scale of improvement, because there is too much information to be able to absorb it all. This means that a small increment of improvement tends to lead to a larger unit value – the “denominator effect”.

I have set out an alternative approach in the response to Q8/Q9.

**Q4:** If we make use of collaborative nationwide research in future price reviews:

- Which aspects of business plans do you think should fall within the scope of this research?
- Which organisations do you think should be involved in steering this research?
- When should this research be undertaken?
- How should this research account for differences between England and Wales?

The collaborative research should include all common / comparable measures, where they are suitable for customer research. As set out in the response to Q10, this should not include the serviceability measures.

A UK Water Industry Research project could be used to develop a common approach.

The required timing depends significantly on the role of engagement, discussed in the response to Q1/Q2. The greater the role in determining service levels, the earlier the research is required.

**Q5:** To what extent do you think it would be necessary for us to provide guidance on customer engagement, assurance and other issues at future price reviews if we made – or did not make – use of collaborative nationwide engagement?

**Q6:** To the extent that you consider further guidance is necessary, what areas should this cover?

Whether or not there is collaborative engagement, there needs to be guidance on what aspects of service will be influenced by engagement.

If engagement is not nationwide, then there should be guidance on research approaches to be used and the way in which choices should be put to customers in order to make results more comparable.

**Q8:** To what extent do you think that the research techniques which have previously been used in the water sector are suitable to enable companies' business plans and our final determinations to reflect customer views? Do you think any particular approaches should be revisited?

**Q9:** Do you think that there are alternative approaches that we might usefully adopt in water, including those used in other sectors and potentially outside the area of economic regulation? If so, which techniques and why? If not, why not?

As set out in the response to Q3, the choice experiment approach to obtain customer values for company-level service improvements does not produce reliable results.

I consider that a better approach would be to carry out customer research on:

- Relative rather than absolute values, e.g. how much one interruption is worth relative to one sewer flooding incident. Severn Trent has carried out such research to derive relative values for different sewer flooding incidents, in terms of location, frequency and severity, and United Utilities has used it in relation to repeat flooding compared with one-off flooding. This gives customers more meaningful choices than making choices between increments to overall company-wide levels of service.
- Customers' overall willingness to pay higher bills for service improvements in general.

The results from these two research studies could be combined to produce values which could be used to set incentive rates and/or targets. The potential overall impact of service improvements on bills would constrain the overall level of service valuation and incentives, and within that constraint valuations would be determined by the research on relative values between different aspects of service.

**Q10:** Are there any areas of the price review where the scope to solicit informed opinions from customers is intrinsically limited?

Customer views on serviceability measures are not really meaningful and the use of values creates double-counting with values for the measures which serviceability failures ultimately affect. Customer research tends to show that customers feel this is an area for companies to make judgements on. Research should, therefore be focussed on measures directly related to service delivery.