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Public Value evaluation and integration into PR24
A contribution to the PR24 Future Ideas Lab

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Executive Summary

The water sector is not alone in making progress with public value. In some respects, the sector has always recognised the wider impact on communities, environment, regional economies and the supply chain. Today though customers, stakeholders, regulators and investors increasingly expect companies to consider these issues more systematically, and many are supportive of companies that communicate progress in realising their purpose led ambition. The sector has been quick to embrace the corporate governance changes which reflect wider sentiment shifts around ESG and sustainability. Changes in governance, decision making and engagement are important foundation steps.

There is ambiguity in what public value is and isn't. It's unavoidable. Consequently, models and conceptual frameworks have blossomed, each trying to encapsulate and group the various dimensions. Business leaders may wonder whether the protracted search for consensus on the 'lead' framework is worthwhile, not least because these frameworks typically accommodate all possible dimensions in some way or another.

So long as the policy discussion remains stuck in 'battles of definition and organising framework', this diverts focus from remaining challenges around evaluation, integration and incentives. These we believe are the three critical enabling steps to landing public value more definitively in PR24:

1. Measurement & Evaluation: Developing and applying innovative, replicable techniques to measure and evaluate these wider impacts, with insight that executives can have confidence in for the purpose of decision making in their specific company context, and which are accessible to regulators.

2. Integration: How Ofwat will evolve its evaluation of business plans to give due regard to - and potentially additional funding for - strategies part predicated on achieving wider, longer term and more sustainable impacts. And associated to that, the evidence companies can reasonably amass and synthesise to ensure any public value justification has as much teeth at PR24 compared to conventional cost benefit analysis.

3. Incentives: Determining whether companies should be incentivised for social value delivery above minimum requirements and exploring different mechanisms for how this could be implemented. (Experience from the energy sector suggests introducing incentives for social value delivery can be a catalyst for positive change.)

In designing their customer engagement for PR24 we believe companies will rightly be considering the public value impacts. We have undertaken a benchmarking assessment of social value maturity in the water sector to inform our thinking in this area and have provided an overview in this paper. Our findings suggest that while companies have made a strong start in defining purpose and appear to be delivering some strong environmental and social outcomes, the sector has the opportunity to progress further in terms of measurement (quantification) and transparency.

Ofwat has identified 'credit for public purpose' as a key area for input in its PR24 consultation and poses important questions around how it can better reflect longer term ambitions including increasing public value in its assessment of costs.

We see 2021 as an opportunity for the sector to come together and form its own proposals for how this might be done, before engaging with Ofwat on this in the run up to the draft methodology. This paper sets out these opportunities and ideas to move these topics forward.

Q10.3: How can we take account of longer-term ambitions such as delivering net zero and increasing public value in our approach to assessing costs?

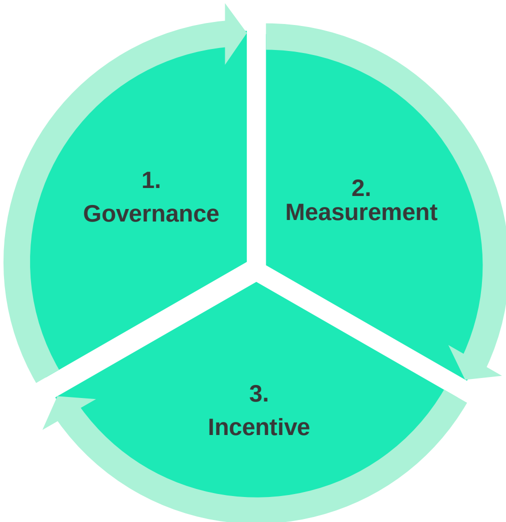
Introduction

By its very nature, the water sector is a long-term stakeholder in communities and recognises it has an important role to play in protecting and enhancing the nation's natural capital. The sector has made progress in incorporating wider social impact thinking into its own business, and the regulatory dialogue. Growing expectations from customers, investors and stakeholder in this space, and a step up from Ofwat in this area has also created momentum for change.

While Ofwat has sought to catalyse consideration of the issue, perhaps understandably it has been wary of defining the 'right' approach and actions companies should take, believing it is for companies to take the lead in establishing their own "social contracts" or frameworks to deliver their social purpose. Sceptics argue that without clearer guidance or incentives, there is a risk that social value delivery risks becoming a communications exercise, lacking truly meaningful actions or measurable benefits beyond current obligations.

Looking outside the water sector, there is a lot we can learn (most notably from gas and electricity) about how to drive social purpose and consistently evaluate impact. At the end of this paper, we detail a case study of how a common social value approach has been adopted by Distribution Network Operators (DNOs) for RIIO-ED2.

Our analysis identified three areas which underpin the take up of public value principles:



1. Governance

Companies ensuring they are set up for success and have the right internal structures in place to deliver public value.

2. Measurement

A consistent social value measurement framework that enables comparison and evaluation of company performance.

3. Incentive

Incentivising companies and holding them accountable for social value delivery may be required to drive change at pace.

Below we outline what we mean by each area, why we think these are important, and where we considered further progress in the lead up to PR24 may be valuable.

Section 1 – Governance that drives social impact

We believe that for governance to be effective in driving the delivery of social value, it needs to be built up of four parts:

Clearly defined purpose

1. *Does the company have a clearly defined social purpose?*
2. *Is there evidence that this is co-defined with customers?*

Approach and delivery

1. *What social initiatives does the company propose (both core activities and those above BAU)?*
2. *Do they provide meaningful evidence on delivery and impact?*

Business model & culture

1. *Is there evidence that the company embeds social value?*
2. *Have any legal or structural changes been made?*

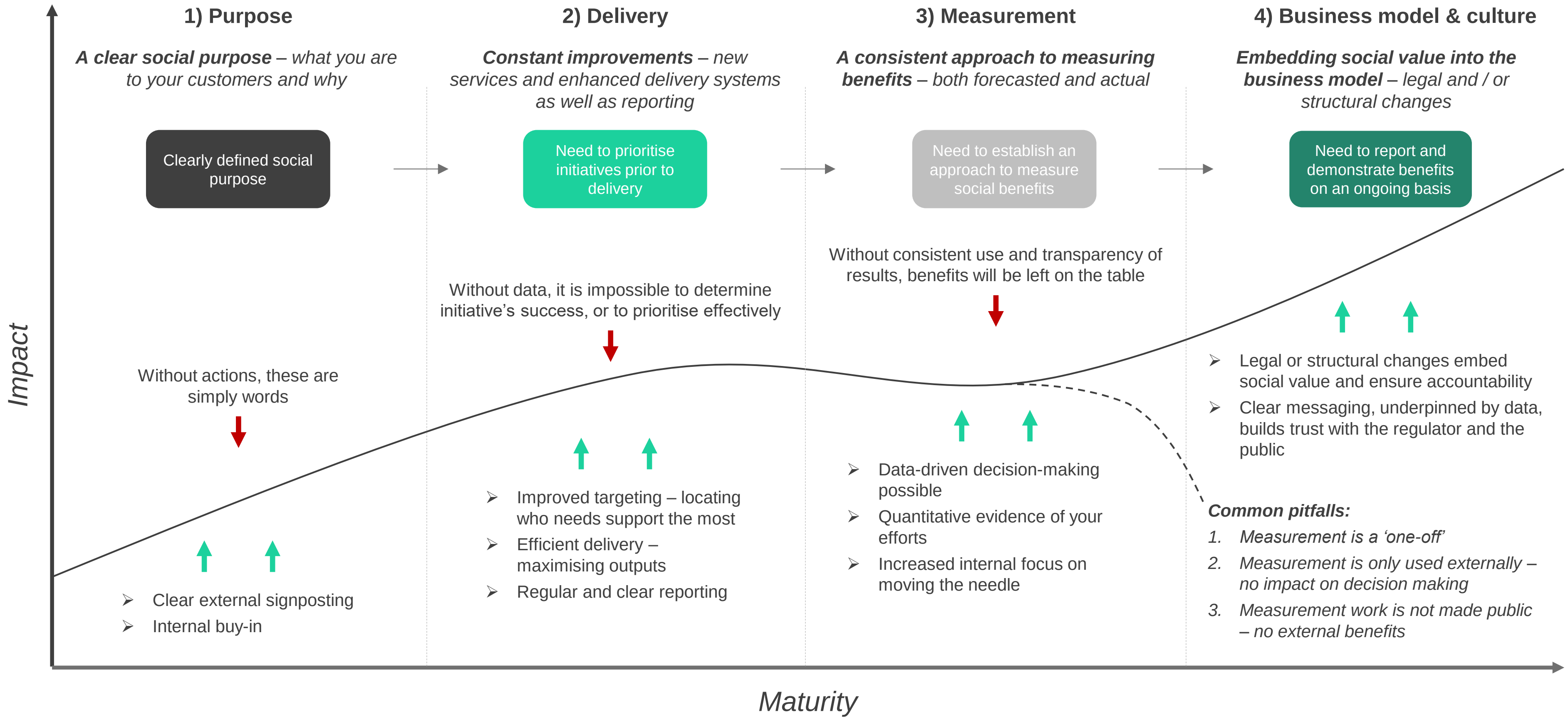
Measurement

1. *Does the company measure the social impact of its activities?*
2. *Is the measurement ongoing and used to inform decisions?*

By considering these four areas systematically we have sought to gauge the sector's maturity, and where there may be gaps requiring common solutions.

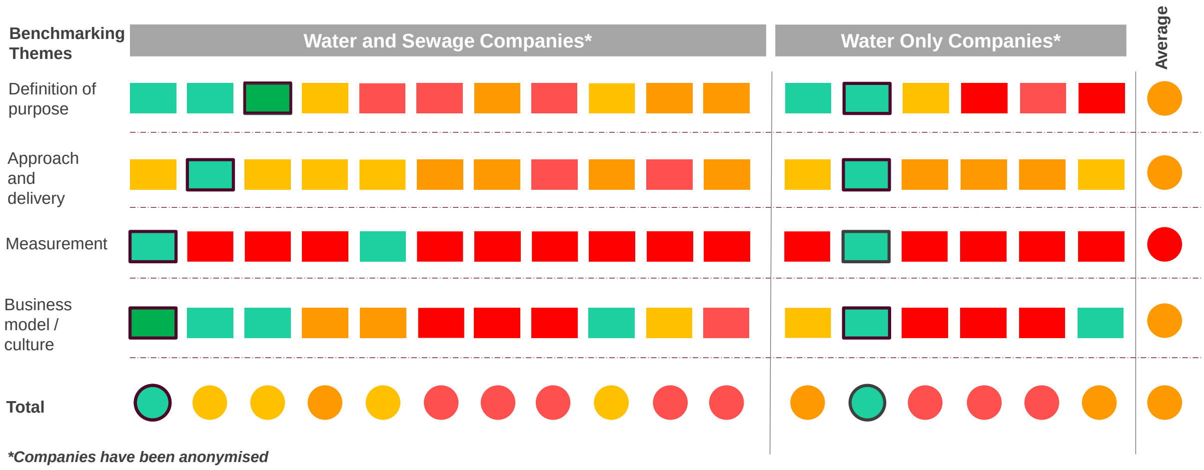
- First, does the company have a clearly **defined social purpose?** Some companies already acknowledge this and have a well-articulated purpose that incorporates their social principles. Others are less well formed. The Purpose Union and Impact Institute surveyed companies in 2020. They found that most companies that were reviewed articulated a purpose. A number were precise about why they existed and what societal value they aimed to create.
- We then consider the **approach and delivery**. Are companies delivering services aligned to their purpose and how strong / clear is the evidence of delivery of social value? This includes both 'business as usual' activities and those that aim to go beyond regulatory requirements.
- Thirdly, does the company **measure the social impact** of its actions? This should be both prior to delivery (forecasting potential impact to inform decision making) and on an ongoing basis (to track performance).
- Lastly, we consider whether the **business model and culture** are set up to deliver on the purpose, and how this exists not just at the top, but throughout an organization.

All four dimensions are important enablers to change. Having a clearly defined purpose, delivering on it, measuring the impact and embedding the principles in the business is not straightforward, but in our view is the right ambition (and what we would consider illustrations of higher maturity).



In 2020, Sia Partners developed a framework and key criteria to benchmark the social impact of UK utilities. The framework was shaped to be aligned with out interpretation of Ofgem and Ofwat's evolving policy statements and communications on this topic, as well as our view of best practice in other sectors.

Using this approach, Sia Partners undertook a snapshot benchmark and evaluation of England and Wales water companies around defining, delivering, measuring and embedding social value. We conducted this review based on publicly available information (akin to what an informed and engaged customer or private investor would have access to). Below we provide a summary of our findings:



**Companies have been anonymised*

Overview of scoring

5	**Best in class demonstration** - stretching beyond minimum requirements
4	**Above industry average** demonstration - exceeding minimum requirements
3	**Industry average** demonstration – satisfying some requirements
2	**Below industry average** demonstration - not satisfying requirements
1	**Poor** demonstration – well below expectations

While at first glance the scoring may appear harsh, it is important to note that this is a relative benchmark of maturity and to score above expectations, companies would be providing clear signposting or evidence for each area *in their publicly available reports*. We recognise there may be evidence within the company that would go beyond this.

But from an 'outside in' view, company maturity across the sector would appear uneven and there is a lack of consistency in approach and demonstration of social value.

While **most companies report a social purpose**, only a handful articulate this in a clear way and are specific about why they exist and the social impact they aim to deliver. In most instances we found it difficult to see evidence that companies have co-defined their social purposes with their local stakeholders and customers, which undermines whether the public understands and is bought into the companies' social objectives. By moving towards a co-defined social purpose with stakeholders, companies will help ensure they are setting a balanced mission and position themselves to deliver not only societal but also shareholder benefit beyond the intrinsic value of the service they are providing.

In our review of companies' **approach and delivery**, we found that the sector is mostly focused on environmental rather than social value themes. There is also a lack of evidence of clear ambition to drive initiatives that go beyond 'business as usual' in supporting communities, compared to other regulated sectors such as gas and electricity. That's not to say that companies aren't delivering in this area, but the lack of clear reporting of inputs, outputs and outcomes of social projects dampens company scoring in this area.

Our findings suggest that the area where the sector may be struggling most is a lack of **measurement.** Only 3 companies (2 WASCs and 1 WoC), were found to be quantifying (or at least reporting quantification) social value delivered from its activities. Those that are measuring the social value of their actions mostly appear to be doing this retrospectively, that is, after delivery. Ideally, companies would move towards assessment both before delivery (forecasting potential impact to inform decision making) and on an ongoing basis (to track performance, report value delivered and refine proposals) to ensure social and environmental value is considered in long term planning.

Several companies demonstrated positive steps in **embedding social principles in their business models**. Most have one or more 'strategic pillars' related to social value in their business models and dedicated board committees focused on these activities.

A key framework that has been gaining currency in the sector is the concept of the "six capitals" (financial, manufactured, human, intellectual, social, natural), with several companies stating they are beginning to incorporate this thinking into their business model and decision-making frameworks. However, evidence of actions taken or how these changes are driving the social agenda throughout the organisation is limited. We believe that for models such as the six capitals to be embedded, they need to be supported by an ongoing dialogue from leadership, consistent measurement, and transparent reporting (both internal and external). This in turn should progress the sector's culture of innovative thinking and ambition in tackling social and environmental challenges.

Section 2 – Measurement and evaluation

In Ofwat's July 2021 publication Public value in the water sector: a supporting set of principles, Ofwat recognise that this is the beginning of the journey to adopt a more integrated evaluative approach for many companies. Some companies suggested that there isn't a common approach to reporting public value so experimentation should continue for a while. Ofwat appears to agree and has suggested a flexible approach to enable this experimentation to take place, taking a principles-based approach to guide the sector's approach to public value.

We recognise that there are differing levels of maturity across the sector in terms of how companies evaluate the social value of their actions, as well as varying social/community needs/contexts around the country. Our benchmarking suggests that this is currently an area of low maturity across the sector.

Our view is that measurement is fundamental to both growing maturity in approach, and to delivering sustainable outcomes.

However, it is likely that the sector will do well to avoid a situation in which each company has a different evaluation methodology/framework. This could result in a 'battle of frameworks' of sorts, with companies competing to land the methodology they have already adopted. From the regulator's perspective, having value measured and evaluated through 17 substantially different lenses would make any decision around additional investment for wider benefits making very difficult. This risks that the great opportunities that companies propose in PR24 being overlooked, for want of a consistent framework.

Instead, **we think this is a crucial moment for the sector to come together to explore and establish a consistent sector wide methodology/framework for evaluating social value**. There are lessons to be learned from the electricity and gas sectors on how this could be progressed – we provide a case study at the end of this document outlining the approach that has been adopted by DNO's.

As detailed by **ICE** here, there are a myriad of frameworks and methodologies to evaluate social value, some more conceptual, others more quantifiable. We are not at this stage proposing that a given framework should be adopted by the sector as a 'now and forever' approach. Instead, the sector needs to come together to better understand their requirements and then adopt a suitable, somewhat bespoke approach, in a way that can bridge to the specific integration points with PR24.

Regardless of the tools or metrics used, **lessons learned from the energy sector suggest that the process should be kept as simple, consistent and transparent as possible**. The framework should aim to enable companies to clearly demonstrate the value of the initiatives being delivered and how they measure up against their targets on an ongoing basis, which in turn will enable Ofwat to better evaluate performance against costs.

Section 3 – Incentives

Thus far, Ofwat have adopted a flexible approach to setting a framework within which company performance will be evaluated. The approach set out in the July 2021 paper is to lay out a set of principles for the sector to follow. This leaves a large degree of ambiguity in how strong performance would be credited or how companies could be held accountable for poor delivery. The question remains whether attaching financial consequences or incentives (beyond regulatory ODIs) to social impact delivery is the appropriate approach, or whether good governance, corporate reputation, shareholder pressure is enough to drive change.

Our experience from the energy sector suggests the former will be most effective – companies are more likely to progress at a faster pace if they have skin in the game. But we are also cognisant that in competitive markets, companies rarely seek or receive incentives for conducting their core business activity in a manner consistent with public value. This suggests an interesting policy dilemma: provide incentives to accelerate progress (and risk getting the sector out of step with non-regulated sectors who deliver public value as a business choice), or to maintain the principles-based approach and use reputational pressure to catalyse change, accepting the risk of slower movement.

Ofgem's introduction of Consumer Value Propositions (CVP) as part of the business plan incentive for RIIO-2 is an example of how focusing on delivery of social value beyond minimum requirements can be incentivised and how this can drive positive change in the sector.

We believe the water sector should consider exploring the introduction of similar mechanisms or explicitly assessing social value (demonstration of above and beyond) as a key criterion for companies to achieve fast tracked or equivalent status at PR24.

Case Study: Development of a DNO wide social value measurement framework

Background

As part of the RIIO-1 regulatory framework, Ofgem introduced the annual SECV (Stakeholder Engagement and Consumer Vulnerability) incentive to encourage network companies to engage proactively with stakeholders in order to anticipate their needs and deliver a consumer focused, socially responsible and sustainable energy service.

Through the SECV Incentive, Ofgem aims to reward high quality activities undertaken by the network companies and outcomes these activities deliver. These activities and outcomes must go beyond the network companies' Business As Usual activities.

Sia Partners was engaged by Ofgem to establish the methodology to assess company submissions, a key part of which was to assess how well companies demonstrate that 'initiatives result in measurable benefits for customers and wider society'.

The challenge

Early in the price control period, companies struggled in demonstrating measurable benefits. Several different approaches were adopted to demonstrate benefits mostly focused on using Willingness to Pay (WTP) research and qualitative evidence. The lack of consistency and also limited quantification of societal benefits versus costs (and evidence of how this had been considered in decision making) was challenged by Ofgem and companies were encouraged to look at ways to develop their approaches in this area.

In response to the challenge (and with a clear incentive to improve), several Gas Distribution Networks (GDNs), Transmission Network Operators (TOs) and electricity Distribution Network Operators (DNOs) began introducing Social Return on Investment (SROI) as a tool to measure customer, environmental and wider societal benefits of their activities against costs.

Acknowledging that no social value measurement technique is without limitation, top performers used this tool alongside other methods such as WTP and customer research.

While this approach was welcomed by Ofgem, a key challenge that remained was the difficulty in comparing companies, as there was no consistent application of SROI or the associated metrics.

During working groups in early 2020, DNOs discussed potential changes to the SECV process for RIIO-ED2. One topic discussed was the (quantitative) measurement of social value, and how it could be improved as part of how the DNOs were reviewed and how a consistent framework could be introduced.

For the Customer Value Proposition (CVP) as part of the business plan incentive, Ofgem also requires DNOs to demonstrate social value. The issues associated with a lack of consistent framework were highlighted in the GDNs CVP proposals for their RIIO-2 business plans (two years prior to DNOs), where companies used different values and reporting structures leading to results that were difficult to compare.

The solution

In preparation for ED2, Sia Partners was engaged by the 6 DNOs and Ofgem to develop a common approach to measuring social value – a consistent mechanism based on Social Return on Investment (SROI) that will allow for straightforward assessment and comparison of initiatives.

To meet the DNOs' and Ofgem's requirements, the common approach needed to:

- Provide robust, consistent measurement of all social benefits DNOs deliver through their services
- Deliver a framework for DNOs to measure their CVP values in 2021
- Act as an ongoing solution – a framework applicable for the full ED2 period
- Drive innovation and ambition in the social value space

Over a period of 6 months in 2020, Sia Partners worked in collaboration with the 6 DNOs and Ofgem to build a social value measurement framework. One of the keys to success was ensuring the framework suited the varied needs and desires of all parties, including Ofgem, all DNOs, and a number of expert stakeholders. Sia Partners therefore carried out extensive engagement with all parties and collated the feedback to help shape the framework, as well as further testing on initial versions of the framework.

Based on stakeholder feedback, and the DNO's and Ofgem's expectations, a framework was designed around three guiding principles:

1. **Consistent** - The framework has been designed to allow for regular, dependable measurement, using an approach and research that is consistent across the industry.
2. **Comparable** - The central goal of the framework is to provide figures for Ofgem's incentives that allow for the effective comparison of the various outcomes delivered by DNOs.
3. **Conservative** - Key feedback from stakeholders was to ensure figures were conservative wherever possible. The framework has been designed with this principle at its core.

The framework developed is currently being used by all DNOs in their business planning process and is also being applied to the annual SECV incentive process. Industry collaboration, support from Ofgem and a clear incentive have been key success factors in driving this change.

On the back of the successful introduction of the standard methodology for DNOs, the gas and transmission networks are now in process of exploring how they can adopt their own version of a consistent social value measurement framework for RIIO-2.

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