

Water 2020

Customer engagement: lessons and opportunities

Executive summary

Most stakeholders would agree that the PR14 process was a huge success in terms of ensuring that business plans reflected customer views more than ever before. This short paper presents some perspectives on the lessons to be learned from the success of PR14 and sets out a vision for the role of customer engagement in the sector, addressing the challenge of how to keep customers engaged through delivery and how to harness engaged customers to reduce the need for regulatory intervention in companies' business plans at the next price review.

From our review of the experience at PR14 we have identified five key lessons for the next price review. These are summarised in Figure 1 below.

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| <ul style="list-style-type: none">(i) Independently-chaired Customer Challenge Groups (CCGs) can help drive high-quality business plans and reduce the need for regulatory intervention through strong challenge and oversight of companies' engagement activities(ii) Successful engagement must be focused on issues that customers can influence; and requires a feedback loop to customers(iii) The switch to Outcomes was key to improving acceptability, ensuring customers could clearly see how their priorities were reflected in company plans.(iv) Early sight of key regulatory parameters including the WACC, and any requirements for cross-cutting measures facilitate higher quality engagement with customers(v) Willingness to pay (WtP) research remains an important aid to decision-making, but there needs to be a debate about its benefits and limitations and a willingness to broaden the evidence by using alternative methods to augment WtP |
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Figure 1. Lessons from PR14

The sector now faces a real challenge to build on the good work done at PR14 and embrace ongoing engagement with customers through the delivery phase as business-as-usual. In particular, we have identified the need to reconcile the different information needs of stakeholders, making better use of social media and ensuring we are responsive to changing customer priorities outside of the normal five-year cycle as key priorities for AMP6.

Finally, we have set out some initial thoughts on how customer engagement can play an even greater role at PR19. We believe the common ambition for the sector should be to harness engaged customers to remove the need for regulatory intervention in companies' business plans. We have identified five key enablers or building blocks that we think are vital to delivery of that ambition. These are set out in Figure 2 below.

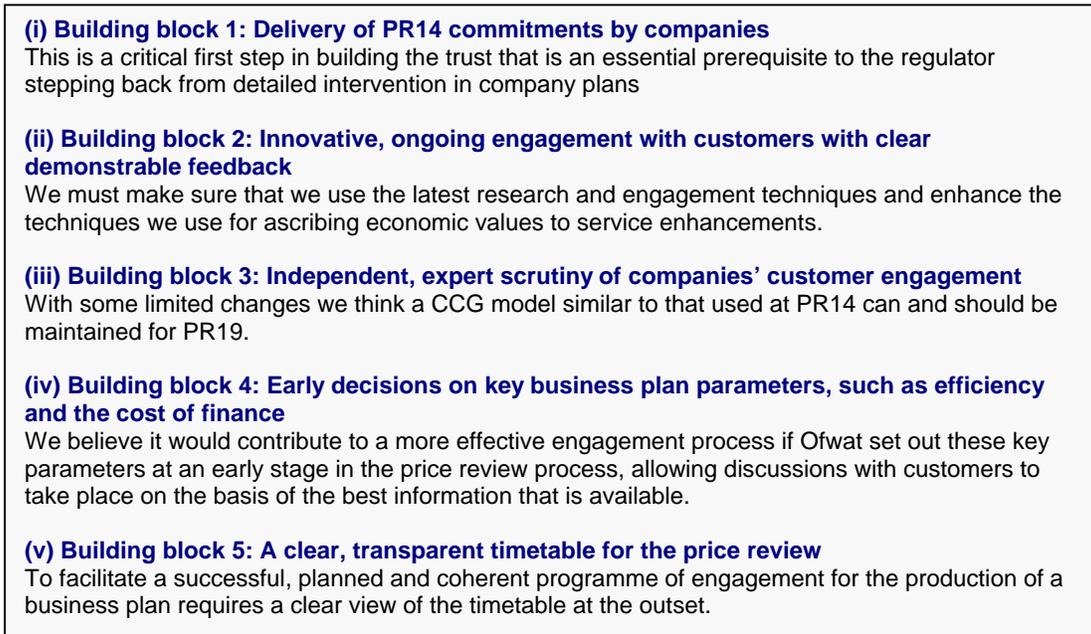


Figure 2. Engagement building blocks for PR19

There are also key changes that could be made to the sequencing and timing of key parts of the price review process to move closer to our ambition to build business plans which fully reflect customers' priorities and that Ofwat does not need to intervene in. Figure 3 below sets out an initial view of a possible timeline for PR19.

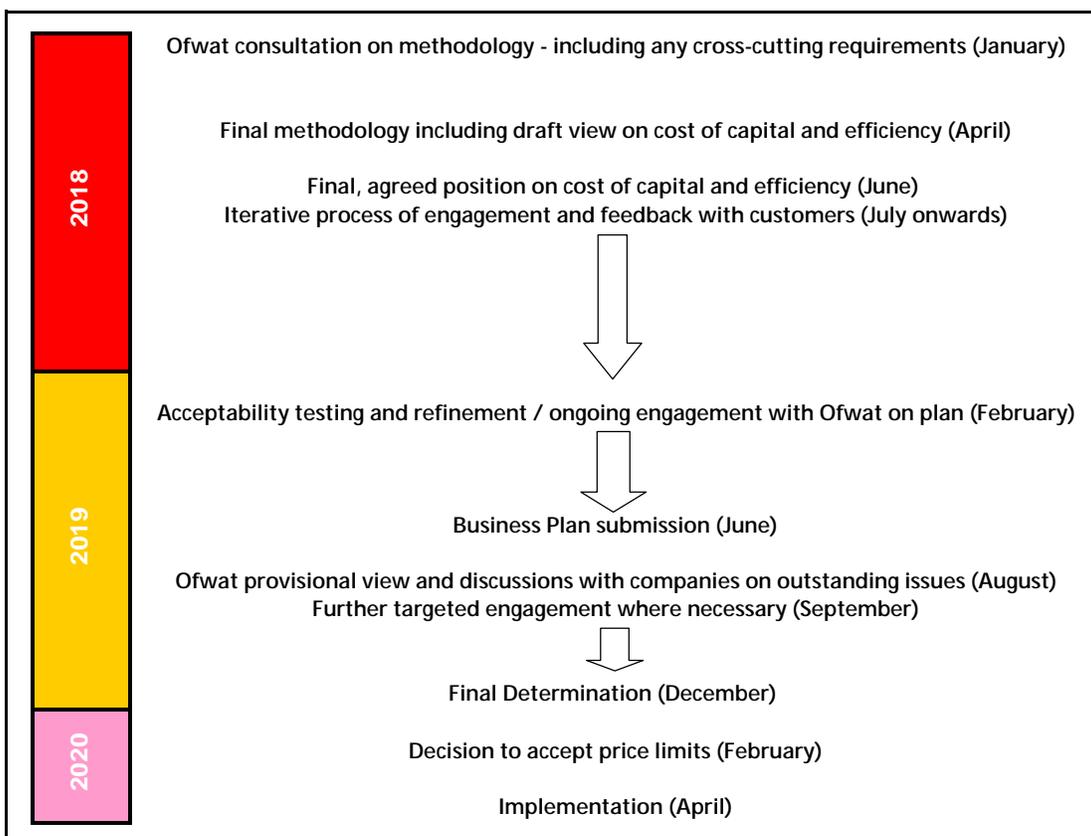


Figure 3. Indicative timeline for PR19

1. Introduction

The 2014 price review (PR14) saw a significant leap forward in the quality, quantity and impact of companies' engagement with their customers.

According to Ofwat's Final Determination, water companies had engaged with more than 250,000 customers, making PR14 "the biggest-ever customer conversation in the utilities sector"¹. Southern Water engaged with over 35,000 of its customers, during the business plan process, representing almost 2% of its entire customer base.

The introduction of the Customer Challenge Groups (CCGs) was a major driver of the quality and impact of engagement at PR14. These independent groups consisted of a cross-section of members from statutory regulators, the statutory customer representative body CCWater, as well as representatives from local businesses, community groups, local authorities and charities. Their role was to ensure that the customer engagement carried out by companies was of good quality and, most importantly, that the findings of this engagement were reflected in companies' business plans, including in their outcome delivery incentives. The groups reported their findings to Ofwat at the same time that companies submitted their business plans. The mandating of CCG reporting to Ofwat was one of the major successes of PR14.

As a result of the extent and quality of engagement with customers, all companies' business plans were clearly built on outcomes that had at least been informed by, and in most cases directly reflected, customers' priorities. This was reflected in the remarkable degree of customer acceptance reported by companies. Southern Water's business plan was regarded as acceptable or very acceptable by 90% of households and 91% of businesses. This level of acceptance was far in excess of the 70-75% indicative acceptability threshold set by CCWater on the basis of its own research with customers².

The challenge now for the sector is to build upon the success of PR14 and ensure that we keep customers engaged through the delivery phase of company business plans and going into the next price review.

This short paper presents some perspectives on the lessons to be learned from the success of PR14 and sets out a vision for the role of customer engagement in the sector, addressing the challenge of how to keep customers engaged through delivery and how to harness engaged customers to reduce the need for regulatory intervention in companies' business plans at the next price review.

It is intended to inform Ofwat's Water2020 programme, which is looking at the water sector of the future, and to contribute to the wider water industry's thinking about the role of customer engagement in the future

Comments should be sent to: Water 2020, Southern Water, Southern House, Yeoman Road, Worthing, West Sussex, BN13 3NX or by e-mail to Regcorrespondence@southernwater.co.uk. We would like to express our thanks to Northumbrian Water, who assisted in the preparation of this paper by providing comments and challenge as well as insights from their own PR14 experience. The contents and the views expressed in the paper are those of Southern Water alone.

¹ Setting Price Controls for 2015-20: Overview, Ofwat, December 2013

² Threshold of acceptability, SPA Future Thinking for CCWater, July 2013

2. Lessons to be learned from PR14

Ofwat requirements for PR14

Following an initial discussion paper in October 2010 and a further consultation in April 2011, Ofwat published a clear policy statement on customer engagement for PR14 in August 2011.

This set out a three-tiered approach to customer engagement within the price review:

- through companies' direct engagement with customers
- through the establishment of customer challenge groups, which would include the quality regulators, Environment Agency (EA), Drinking Water Inspectorate (DWI) and Natural England, to ensure company plans reflect customer views and statutory obligations
- through a sector-wide Ofwat customer advisory panel, consisting of customer representatives, including big businesses, and CCWater.

Further information, in particular with respect to the role of CCGs, was provided in Information Notice IN12/05, published in April 2012. This made clear that the CCG's role was to challenge company business plans if they did not reflect customers' views, but it made very clear that "this does not mean reaching a negotiated settlement", whereby the plan is agreed with the CCG.

Companies' responses

Companies responded to the challenge laid down by Ofwat by conducting the biggest programme of customer research and engagement ever seen in the utility sector, with over 250,000 customers. Southern Water engaged with over 35,000 of its customers, during the business plan process, representing almost 2% of its entire customer base.

Formal willingness to pay research continued to be a core part of this engagement, providing an objective basis for shaping companies' investment programmes.

All companies appointed independent CCGs, but these varied significantly in their composition. Most CCGs were originally chaired by the local CCWater Chairman. Southern Water, along with a handful of other companies took the step of advertising for an independent paid chair of the group. This process enabled the appointment of Anna Bradley, a nationally recognised consumer expert and former Chief Executive of the National Consumer Council as independent Chair of our CCG. As well as CCWater, the EA, DWI and Natural England, membership of the Southern Water CCG consisted of representatives from East Sussex County Council, Citizens Advice, Waterwise and WWF.

What worked well?

The breadth and quality of engagement at PR14 was clearly one of the biggest successes, capturing the views of more customers than ever before in the process. Taken together with the introduction of an outcome-based approach to business planning, customers were clearly able to see how their priorities were reflected in companies' business plans.

One of the key tools adopted by Southern Water was the "Engagement Wheel" (see Figure 4). This embodied the crucial steps of listening to customers, taking action and feeding back on the results.



Figure 4. The Southern Water engagement wheel

Fundamental to the engagement wheel is the playing back to customers of the findings of earlier research to validate that the interpretation of customers' views is one that they recognise. The result of this approach and the breadth of engagement undertaken was a level of acceptability for the business plan that, at 91%, was higher than any we had seen previously at price reviews. The CCG process was also a notable success and contributed to better quality business plans.

Key to this for Southern was a clear commitment to the CCG process at the highest level within the company – the CEO attended all meetings and the CCG Chair regularly attended Southern Water Board meetings. This commitment, coupled with a strong, independent Chair and a broad-based and knowledgeable group of members contributed significantly to the strength of our plan.

Of particular note was the CCG's insistence that we act quickly on customers' desire for bathing water improvements and that we did not wait until the next five-year period, after which the necessary investigative studies would have been carried out – the cycle that would normally have been followed. This presented some challenges for both the company and Ofwat as we needed to develop mechanisms to deal with the inherent cost uncertainty, but was a clear example of the CCG driving change to ensure that we delivered on what customers had told us were their priorities.

The process of engagement was also helped by the publication by Ofwat in January 2014 of guidance on the likely level of the cost of capital – a key parameter in the price setting process and one that has a material influence on the level of future bills and thus the level of customer acceptability. Publication of an even earlier view from Ofwat would have enabled the impact to be reflected in engagement with customers at the initial stages of the planning process. This is particularly important in the context of the formal Willingness to Pay research, which due to the time such research takes, was one of the earliest pieces of engagement carried out.

What did not work so well?

In contrast to the clear success of the CCG process, the role of the central Customer Advisory Panel and the influence it had on the outcome of the price review was much less clear, at least from a company perspective. The panel met nine times over a period of two years, with the final meeting taking place in May 2014, prior to the draft and final determinations. It is notable however that there is no reference to the panel or its input in either the draft or final determinations, suggesting it was not a significant factor in Ofwat's decisions.

There were also occasions where Ofwat required companies to consult with customers on specific stand-alone technical issues which may have been better discussed in alternative fora. This research was often required to be completed within a very short space of time, with implications for the reliability of the findings. For example, at the draft determination stage, we were instructed to consult with our customers on "the extent to which the benefit of a lower cost of capital should pass to customers in the period 2015-20 (rather than in future periods)." This was a difficult discussion to have with customers in isolation and it is not clear that the findings had any impact on the final determinations. It is important that engagement with customers is on the right issues, in the right context and as reflected in our engagement wheel i.e. that there is a feedback loop to customers so that they can clearly see how their views have influenced the outcome. In this example that feedback loop was missing.

Similarly, water only companies were asked to gain explicit customer support for the allowance of a 'small company premium' to financing costs. Whether such a premium is required should be a matter of market evidence not customer opinion.

As at previous price reviews, there remained a strong bias towards formal, stated preference, willingness-to-pay research (WtP) to justify investment plans. At PR14, WtP values were also used for setting financial outcome delivery incentives. While WtP research in its current form provides a strong evidential basis for capital investment planning, there have been challenges, not least from a number of CCGs, on the extent to which customers really understood the stated preference exercises or whether they were too detached from real-world decisions. There are also questions as to its appropriateness for use in setting incentives, not least that it does not reflect the move to totex and is based on an assumption of an RCV/capital expenditure funding model. Further thinking around the most appropriate basis for setting ODI incentives is required, along with how to augment WtP with other forms of evidence to provide a richer and more rounded picture of customer priorities.

Finally, a number of companies have expressed concern about the overlay of common performance commitments beyond those that customers had identified. Ofwat had made it clear from an early stage in the price review that all companies should include an ODI for leakage. However, at the draft determination Ofwat took the decision to introduce a number of additional consistent measures across the sector, based on comparative analysis of performance. These included water supply interruptions, water quality and pollution incidents. While there may be a legitimate role for such baseline standards, they broke the link between the discussions companies had had with their customers about their priorities.

Five key lessons for PR19

- (i) Independently-chaired Customer Challenge Groups can help drive high-quality business plans and reduce the need for regulatory intervention through strong challenge and oversight of companies' engagement activities**
- (ii) Successful engagement must be focused on issues that customers can influence and which they wish to engage on; and requires a feedback loop to customers**
- (iii) The switch to Outcomes was key to improving acceptability, ensuring customers could clearly see how their priorities were reflected in company plans.**
- (iv) Early sight of key regulatory parameters including the WACC, and any requirements for cross-cutting measures facilitate higher quality engagement with customers**
- (v) Willingness to pay research remains an important aid to decision-making, but there needs to be a debate about its benefits and limitations and a willingness to broaden the evidence by using alternative methods to augment WtP**

3. Keeping customers engaged through delivery

A fundamental part of the engagement wheel that Southern Water developed for PR14 was the feedback loop to customers (see Figure 1 above). This feedback needs to occur both within the engagement phase - to validate findings - and subsequently during the delivery phase, creating an ongoing cycle of engagement rather than sporadic, one-off research.

As a sector we need to ensure we maintain a constant flow of insight from customers, in all its forms, throughout the delivery period and that this solid base of insight is harnessed in the development of future business plans. This is vital to give all stakeholders confidence that these plans reflect a deep understanding of what our customers expect, not just a snapshot of preferences at a point in time.

All water companies have committed to maintaining their CCG in some form during AMP6. In this short section we set out Southern Water's planned approach to keeping customers engaged during delivery and discuss some of the engagement challenges facing companies in the future.

Southern Water's proposed approach

As noted above, the CCG process was one of the key successes of the PR14 process, bringing an additional challenge which manifested itself in more customer-focused business plans.

Southern Water has committed to maintaining a similar group through the delivery phase. However, the focus of the group will change from one of challenging the robustness and translation of engagement into business plans, to being an independent scrutineer of the delivery of the promises set out in our business plan and a critical friend. This is reflected in the new body's name, the Southern Water Customer Advisory Panel (SWCAP)).

We have asked the SWCAP to work with us to report to our customers on the delivery of our promises. They will publish an independent report each year, addressed to our customers and stakeholders, on how we are doing. Progress in the delivery of our promises will be discussed regularly with the SWCAP and any changes to our plans will also be reviewed with them.

We believe the continued involvement of an independent body will help build trust and reinforce to our customers that their voice will be heard. The SWCAP will also act as a key consultative group on customer-related issues, giving customers a strong voice to supplement our direct engagement.

The Chair of the SWCAP will continue to have regular access to our Board, enabling them to ensure that their views are represented directly at the highest level within the organisation. This level of access and buy-in from the Board was one of the key successes from the PR14 process and we are committed to continuing that.

While the SWCAP will issue their independent report to our customers and stakeholders, that does not remove our primary responsibility to explain our performance to our customers. Ofwat has set out some requirements for reporting of performance within the Regulatory Accounts, but these were not developed in conjunction with customers and inevitably, therefore, reflect the requirements of the regulator, rather than customers.

To keep customers engaged requires open, honest and accessible reporting of delivery. We will be exploring with the SWCAP and our customers how we can do that best and would expect to continue to evolve our performance reporting through the delivery period.

Key challenges for the sector during AMP6

We believe there are three key challenges that the sector has yet to successfully address, which will become increasingly important during AMP6.

Challenge no. 1: Reconciling the different information needs of stakeholders

One of the defining features of the water sector is the broad array of stakeholders. As well as providing vital services to every home and business in the country, we have four statutory regulatory bodies (Ofwat, the Environment Agency, Natural England and CCWater). We also engage with a host of highly knowledgeable environmental and amenity groups, work with local authorities, provide services to new entrants to the sector and developers and work closely with Central Government.

Each of these stakeholders, and groups within them, will have different information needs and a one-size-fits-all approach to publishing performance and delivery information will leave all of them dissatisfied, with some being overwhelmed and others needing more, or different detail. The challenge for the sector is to ensure we understand the information needs of each group and work to satisfy them, harnessing technology to deliver a tailored experience, which will foster further, informed engagement.

Challenge no.2: Harnessing the power of social media to deliver our objectives

Social media has already been a transformational force in many areas of our life. Many in the water sector have recognised and sought to embrace social media as a source of specific customer insight, through complaints, trend monitoring and so on. But there is more to do and huge potential for the sector to fully embrace social media to engage more effectively and responsively with customers. During AMP6, social media will continue to shape and influence customer expectations and the sector must embrace this as a key opportunity to broaden engagement with our customers.

Challenge no.3: Being responsive to changing customer requirements between business plan periods

Alongside capturing this real-time insight is the challenge of responding to changes in customer expectations outside of the five-year price review blocks that the industry has historically worked within. Customer expectations are moving ever-more rapidly, with technology driving huge changes in the way that we all engage with the organisations that serve us.

A sector that is demonstrably responsive to customers' changing priorities is essential to maintaining positive engagement from customers. This will require a degree of flexibility around, and evolution in, customer outcomes during price review periods. If we are seen to not respond (for up to five years), then customers will dis-engage, become disenfranchised and the hard work that has been done in engaging so many customers in the PR14 process will be wasted.

4. Developing a customer-centric price review process

A vision for PR19

The quality of engagement – and hence company business plans - took a step change at PR14. But, Ofwat still felt the need to protect customers and intervened significantly in the setting of deliverables for AMP6. That is understandable because the process was new. However, our shared goal should be to build business plans which fully reflect customers' priorities so that Ofwat does not need to intervene.

We believe a successful price review would be one where Ofwat's involvement is restricted to (i) satisfying themselves that we will deliver our statutory obligations (ii) ensuring that our delivery plans are efficient and (iii) ensuring efficient financing of our plans. The setting of deliverables should be based solely on high quality engagement with customers, overseen and reviewed by independent customer challenge groups, with sufficient expertise, access and authority to genuinely challenge companies to deliver what customers want.

Such an approach will require a deep level of trust from all parties. Customers will need to be able to trust that their companies will listen to them and will deliver what they promise. Ofwat must trust companies to conduct a genuinely inclusive engagement process, to turn those findings into coherent business plans and to deliver what their customers want, without the need for the regulator to intervene. And finally, companies must trust that if they do the right thing and build plans that reflect a genuine conversation between them and their customers, that the regulator will not intervene in that relationship.

That is an ambitious goal, but significant progress towards it was made at PR14 and many of the building blocks are already in place. In this section we set out what we think are the key ingredients for achieving this ambition at PR19, along with an indicative timeline for the key engagement milestones for PR19.

Key building blocks for delivering a customer-centric price review process

Building block 1: Delivery of PR14 commitments by companies

We have said that trust is vital to achieving the ambition we set out above. The first step in that process is for companies to deliver on the promises they have made to customers in their PR14 business plans. Without this we can not expect customers to continue to engage fully in the process. Alongside delivery, there needs to be transparent, pro-active and innovative reporting of delivery against the promises made. Customers should be clear in their expectation that, as a sector, we will deliver what we say we will. We see our commitment to independent reporting by the SWCAP as a key building-block in that process. But as a sector we need to ensure we are communicating effectively with our customers on the issues that matter to them.

Building block 2: Innovative, ongoing engagement with customers with clear demonstrable feedback

A huge amount of good work was done at PR14 in broadening the engagement with customers. This breadth of engagement must be maintained and we must make sure that we use the latest research and engagement techniques and all of the available evidence to shape our plans. Formalised, stated preference, willingness to pay research must continue to play a part in building the evidence base, but we must acknowledge that it is just one form of evidence and may not always tell the whole story. We must look to develop and enhance the techniques we use for ascribing economic values to service enhancements.

We firmly believe that successful customer engagement should be a continual dialogue with feedback to customers during the business plan development process. The engagement wheel we developed for PR14, which puts this feedback loop at its core, provides the foundations for a model of best practice engagement.

Building block 3: Independent, expert scrutiny of companies' customer engagement

One of the most successful innovations of PR14 was the mandating by Ofwat of the establishment by companies of independent CCGs. There is clear evidence that their involvement led to a step change in the quality of both companies' engagement with customers and the quality of their business plans. We think a similar model can and should be maintained for PR19.

We would suggest two important changes to the CCG process. First, Ofwat should set some clear expectations of the criteria against which CCGs should report, so that all stakeholders can be clear whether these have been met and therefore on what basis Ofwat might then intervene in companies' plans. We should also consider whether the statutory regulators (principally the EA, DWI and Natural England) should be mandatory members of the groups. We believe the relationships with these key stakeholders are more effectively managed on a bilateral basis, that respects these key stakeholders' specific statutory duties, rather than as a wider, customer engagement-focused group.

Building block 4: Early decisions on key business plan parameters, such as efficiency and the cost of finance

Having helped shape the priorities within companies' plans, the key issue for customers then becomes the acceptability or otherwise of the price / service package that they are being offered. Fundamental to the price element are decisions which Ofwat make, in particular on efficiency and financing. These decisions are historically made at the end, rather than the beginning, of the process of engagement with customers. This means most discussions with customers are based on company assumptions or forecasts of what the regulator might do in these key areas.

We believe it would contribute to a more effective engagement process if Ofwat set out these key parameters at an early stage in the price review process, allowing discussions with customers to take place on the basis of the best information that is available. This, of course, would not fetter Ofwat's discretion in responding to very material changes in circumstance once they had set these parameters, but these should be the exception, not the rule. What this critical enhancement would do would be to open up the possibility that the company business plans that customers had engaged in the development of would be precisely those that would be delivered.

Hand-in-hand with these key decisions, it is important that Ofwat set out any cross-cutting requirements, either for specific topics for engagement with customers or for specific performance measures. This was done at PR14, in respect of leakage being a required ODI, but others were introduced later that cut across the promises that companies had made to their customers. Other papers will consider the merits or otherwise of such cross-cutting measures, but what is important from the perspective of customer engagement is that these must-haves are known about at the start of the process, so that customers understand the base package they will receive.

Building block 5: A clear, transparent timetable for the price review

We argue above that engagement must be ongoing. Nonetheless, to produce a business plan it is necessary to augment this ongoing engagement with some specific research. To facilitate a successful, planned and coherent programme of engagement for the production of a business plan requires a clear view of the timetable at the outset. One of the challenges for all parties at PR14 was that the degree of change meant there was a significant amount of learning as we went along from all sides, meaning that engagement on some key topics, such as ODI incentives, was done in an ad hoc way and not as an integrated programme.

The additional challenge for Ofwat to set out some of the key price review parameters in advance, to facilitate more informed engagement, and allowing some time for these to be discussed and agreed, necessitates a fresh look at the timetable. We set out below an initial view of a possible timeline for PR19. This assumes that the final determination date of December 2019 is fixed, but all other dates can be flexed. Particular points of note are:

- The process starts at the same point in January 2018, with a consultation on the detailed methodology.
- There needs to be an upfront process of consultation, challenge and discussion with companies on key business plan parameters including efficiency and the WACC. This could take place immediately following publication of the final PR19 methodology in early 2018.
- Submission of the final business plan can take place later than at PR14 (which happened in December 2013). However, there should be ongoing discussions with Ofwat prior to the final submission to ensure no surprises.
- We have not included a draft determination. Consideration should be given as to whether a draft determination is necessary, or whether a provisional Ofwat position, akin to the risk-based review, would add more value to the process, enabling, as the risk-based review did at PR14, more targeted discussions with Ofwat on areas of contention.
- We have not included an enhanced or fast-track process within the timeline. This is for two reasons: (i) such a process may cause companies to focus on the regulator rather than customers' views of what represents a good business plan; and (ii) the goal is that all companies' business plans should reach this standard and regulatory intervention in company plans should be by exception rather than intrinsic to the process.

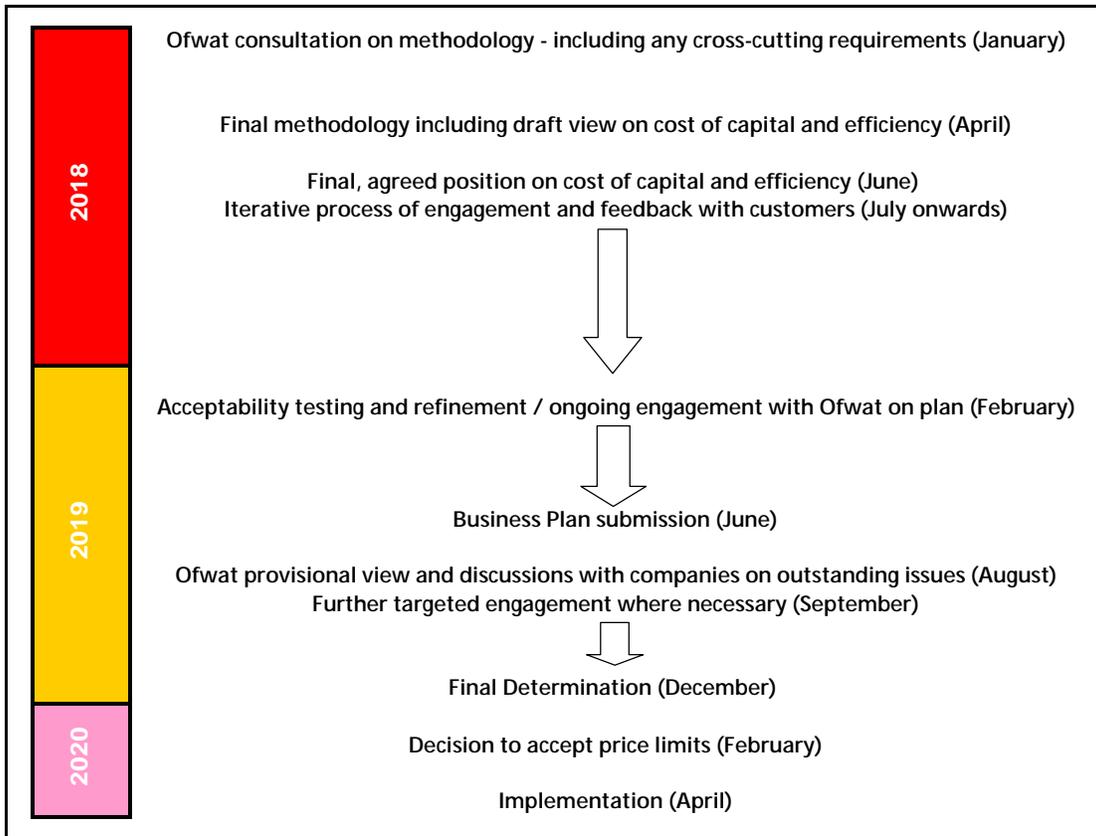


Figure 5. Indicative timeline for PR19

5. Conclusions

Most stakeholders would agree that the PR14 process was a huge success in terms of ensuring that business plans reflected customer views more than ever before. The introduction of CCGs, with a clear mandate to challenge the quality and interpretation of companies' engagement activities, also resulted in significantly better quality business plans than at previous price reviews.

For Southern Water, the creation of our 'Engagement Wheel' was fundamental to ensuring we took a disciplined approach to engaging with customers, ensuring we incorporated a feedback loop into every round of engagement. We believe it provides the foundations for an engagement model that could be used across the sector.

There are also lessons to learn from what did not work so well at PR14 and we have set out above five key lessons for the next price review.

The sector now faces a real challenge to build on the good work done at PR14 and embrace ongoing engagement with customers through the delivery phase as business-as-usual. In particular, we have identified the need to reconcile the different information needs of stakeholders, making better use of social media and ensuring we are responsive to changing customer priorities outside of the normal five-year cycle as key priorities for AMP6.

Finally, we have set out some initial thoughts on how customer engagement can play an even greater role at PR19. We believe the common ambition for the sector should be to harness engaged customers to remove the need for regulatory intervention in companies' business plans. We have identified five key enablers or building blocks that we think are vital to delivery of that ambition. First and foremost amongst these is companies delivering on their PR14 commitments. Without this, the mutual trust that is necessary to achieve the ambition will not be won. There is more work to do to improve engagement methods and ensure that we do not focus excessively on particular research techniques but take a broader look at the evidence base. And we should build on the success of the CCGs at PR14, with a small number of improvements to the process.

There are also key changes that could be made to the sequencing and timing of key parts of the price review process to move closer to our ambition.

There is a real opportunity for the sector to make a further step change in putting customers at the heart of the next price review, one which will contribute enormously to achieving the shared aim for the sector of "trust and confidence in water".