Anglian Water Customer Engagement Forum Report

Response to Anglian Water IAP submission

1 April 2019

Summary

This report comes as an addendum to the report submitted on 3 September by the independent Customer Engagement Forum (CEF) on Anglian Water's Business Plan for 2020-2025. The report is being shared with Ofwat as a commentary on Anglian Water's revised business plan, which is due to be submitted to Ofwat by 1 April 2019.

CEF members acknowledged that there was a short timeframe available for customer engagement between 31 January (when Ofwat's Initial Assessment of Plans was published) and 1 April. They were satisfied, however, that the new round of customer engagement showed broad support among customers for any proposed changes to Anglian Water's business plan in light of the IAP, including two new proposed performance commitments on vulnerability and affordability.

CEF members were also reassured that the exemplary customer engagement carried out by Anglian Water prior to the 3 September submission provided a firm bedrock for the company's revised business plan.

In addition, CEF members were pleased to note that an external audit of Anglian Water's customer engagement during this period by Jacobs also found that the customer engagement on Initial Assessment of Plans (IAP) changes was appropriate, following Anglian Water's industry-leading approach to engagement. The CEF noted Jacobs' conclusion that the results obtained were robust and meaningful.

Background

The CEF noted in its 3 September submission that it was impressed by the length, breadth, depth and innovative nature of Anglian Water's customer engagement for PR19 – which gathered the views of more than 500,000 customers from across the Anglian Water region through 38 different platforms.

Over the past two years, the CEF and our four subpanels[1] have challenged the company to come forward with plans for PR19 that genuinely placed customers at the very heart of the way the company does business and develops its plans. We were therefore gratified to see that Ofwat had recognised the high quality of Anglian Water's customer engagement by awarding the company's work in this area with an A rating in the initial assessment of Anglian Water's Business Plan.

We were also pleased to see that Anglian Water was ranked highly by Ofwat for its outcomes package – with specific praise reserved for how the company had engaged and used customer and stakeholder feedback to help shape the company's suite of performance commitments.

[1] These four subpanels covered: affordability and vulnerability; sustainability and resilience; economics and valuation issues; and customers in Hartlepool.

Since 31 January 2019, engagement with the CEF on the part of Anglian Water has continued to be exemplary. We had the opportunity to meet with Senior Executives from Anglian Water, including the Chief Executive, on 15 February to hear the company's proposed response to Ofwat's challenges and plans for customer engagement in response to suggested revisions to the business plan. We also had a follow up call with Anglian Water executives on 25 March to make sure we had the latest information available from the company in order to scrutinise customer engagement and to draft this report.

In addition, the CEF's Affordability and Vulnerability Subgroup met on 15 March to discuss the proposed two new ODIs – one on affordability and one on vulnerability. And CEF members also attended Anglian Water's Customer Engagement Steering Group (CESG) on 21 February and 14 March to discuss the company's more specific plans related to customer engagement. Members of the CEF who attended the CESG had the chance to comment on all of the additional customer engagement activities.

The CEF's Sustainability and Resilience Subpanel also met on 11 February to take part in a natural capital workshop with key Anglian Water staff, which was a chance to discuss Anglian Water's proposed metrics in this area.

Customer Engagement

Anglian Water did not have any specific actions to complete in relation to the customer engagement test for the IAP. However, the company did ask customers for their views regarding any changes to the business plan proposed in response to Ofwat's IAP. The company also obtained additional evidence from customers relating to areas such as executive pay, the WINEP adjustment mechanism and deadbands for ODIs. More details on this are outlined below.

In the short timeframe available between 31 January and 1 April, and given the relatively small changes proposed, and the few areas for which further evidence was required on customers' views, Anglian Water did not need to utilise the full range of innovative engagement channels that were involved in drawing up the initial business plan that was submitted in September 2018. Pragmatically, in this new round of engagement, considerable emphasis was placed on the engaged and informed input of its online community. This includes 500 customers who are broadly representative of the company's customer base in terms of demographics[2] and many of whom have a body of knowledge on the issues as they have been involved during the PR19 consultation period. They were consulted on the following topics:

- **Two new ODIs on vulnerability and affordability**: To explore reaction to two new ODIs, one on affordability (proposing additional measures to identify those with affordability needs) and one on vulnerability, proposing additional accreditation around aligning with communication standards;
- **Bathing water**: To gather further evidence in relation to Anglian Water's proposed five-year measure of bathing water quality and potential bill impact;

[2] It should be noted here that the online community does not include customers from Hartlepool and that no customer engagement was carried out with customers from Hartlepool during this time period. However, the CEF noted the company's assurance that any changes proposed to the business plan would not affect the bill profile for customers in Hartlepool.

- **Deadbands**: To identify the value customers place on Anglian Water's proposed deadbands around leakage, sewer collapses, external sewer flooding and bathing water quality;
- **WINEP**: To gather further evidence around Anglian Water's incentive mechanism;
- **Bill projections**: To inform and garner responses to the changes to Anglian Water's plan and the effect on bill projections.
- **Executive remuneration**: To gather customer views on company proposals.

Acceptability research – Accent carried out a quantitative survey of 1,122 household customers and 73 non-household customers, on behalf of Anglian Water, focusing on the company's revised bill profile.

Customer board – Anglian Water's customer board met on 4 March. Minutes of the meeting were shared with CEF members.

In the following section, we will look at each area of customer engagement in more detail:

New Vulnerability ODI

Customers support the idea of the yearly BSI accreditation reporting, seeing it as an additional 'quality check' around communications with vulnerable customers. Customers did not like the use of the words 'credit check' in the proposed ODI and wording was revised as a result of this input.

A minority do question the impact the accreditation will genuinely have on the ways AW communicates with customers and what this will add beyond what AW has already proposed in its plan.

New Affordability ODI

The notion of providing greater proactive measures in order to identify affordability issues is valuable to most.

There are some concerns around the idea of external credit checks being used to identify 'affordability issues', primarily as these are not necessarily a reflection of needing support around water bills, or may not help identify those in 'genuine' need.

Bathing Waters

A majority of customers agree that the 5-year measure is logical, customers place value on greater consistency in bills rather than year to year fluctuation.

A third of customers, however, have some concerns, either based around a rejection that their bills should be influenced by something as volatile as water quality or a minority preferring a yearly bill impact out of concern for a high 'lump sum'.

Deadbands

All 4 deadband areas were thought to be valuable, with more positive than negative reactions. Whilst customers express not being experts in this space, the overall perception is that there is still drive towards improvement. The CEF was encouraged to note that meaningful customer engagement was possible around apparently complex areas such as this, through careful design of scripts for briefing customers on the topic and relating it to bill profiles.

Deadbands that have kept the current 2020 forecast as the 2025 target as a minimum received high value ratings as suggested consistent or better performance (i.e. Leaks and Bathing Waters). Deadbands that have wider buffer zone received lower value rating as the performance felt as if it could decrease.

However, a majority of customers still placed high value rating on these (i.e. Sewer Collapses and External Sewer Flooding).

WINEP

There is customer support for AW being incentivised in order to challenge Environment Agency programmes deemed no longer fit for purpose, seen as more honest and worthwhile than simply going ahead with the project.

Approximately two-thirds of the 97 customers surveyed by AW on this question are happy with AW keeping 10% of the allocated cost, with the remainder going back to lower customer bills. The main area of resistance is around a preference for the incentive amount to be the exact value AW spent during the investigation of the project as a more accurate reflection of the money spent (versus a one-size-all approach).

Bill Profiles

Overall, lowering bills and banning metaldehyde has increased customers' already high perception of value in Anglian Water.

The majority are pleased to see bills going downwards, even if only slightly, with savings passed on to customers. Only a small minority question the data and accuracy of predictions, or found it difficult to assess the value of the decrease.

Executive Remuneration

In addition, AW briefed the CEF about ongoing engagement with customers on the topic of executive remuneration, specifically the proposal to link executives' pay more closely with sustained delivery of good outcomes for customers.

The CEF reviewed AW's proposed new executive remuneration policy, under which all variable elements of executive pay would be linked 100% to company performance on outcomes which are important for consumers.

The CEF welcomed the customer engagement undertaken on this issue (and it encourages further engagement work – see below). In commenting on the material being used to prompt customers' responses and the questions posed, the CEF did raise concerns that this was at such a high level of generality that it was not designed to generate useful insights into customers' views about the specifics proposed for executive remuneration. It may also overstate the change implied (by understating the extent to which in practice executives are currently held accountable for company reputation including delivery of the business plan agreed with the regulator). The CEF welcomed acknowledgement from the company that it would seek to take customers' views on the more specific details of its new executive remuneration policy as it developed this further.

The CEF strongly encourages the company to build on the customer engagement undertaken to date, to draw on further customer views as it refines the design of its new remuneration policy, and the company has indicated that it intends to do this.

Customer protection

CEF members were briefed on the additional measures which AW proposed to put in place to protect customers, by reducing allowable expenditure, and hence reducing customer bills, in the event that circumstance during the period 2020-25 reduced the demand for investment by the company.

With regard to the WINEP adjustment mechanism (to return expenditure associated with investment in current "Amber" schemes which do not in future receive ministerial support), the CEF queried whether, as described, this financial incentive could create an overly adversarial relationship between AW and the Environment Agency. There were strong concerns among CEF members that this might lead the company to press for scaling back of an individual scheme in AW's territory, on the grounds of marginal cost benefit analysis, which might nevertheless be valuable as part of a wider set of schemes proposed by the Environment Agency (EA) to meet broader environmental objectives.

In response, AW reassured the CEF that it did not consider that this incentive measure would, per se, undermine the constructive relationship that it maintained with the EA: AW would continue to work closely with the EA to agree a prioritised programme of works that would deliver the agreed environmental outcomes.

AW agreed to revise the wording describing this measure to avoid any misunderstanding of its intent or likely impact. With regard to the principle of sharing the benefits with consumers of the costs avoided where projects do not go ahead, AW noted that this received good support in customer engagement. The majority of customers, among those who accepted the principle of financial incentives, considered a retention rate of 5-30% to be acceptable, and therefore most supported the company's proposed rate of 10%. However, it should be noted that this was an outstanding CEF challenge to the company and prompted some concern among several members.

Cost efficiency

CEF members were briefed by the company on the explanation for the very substantial gap between AW's estimates of the efficient level of costs needed to deliver the business plan and Ofwat's own smaller estimate. It was noted that around 17% of the gap (c£100m of £592m) related to enhancement projects where Ofwat required further justification, which the company was confident it could provide.

One important aspect of Ofwat's approach to assessing cost efficiency is its ruling, in the IAP process, to remove all operating expenditure from AW's proposed enhancement expenditure, and to transfer such opex to the base expenditure estimates, which were then assessed using standard econometric models. There are two effects of such an approach:

1) the company's strategy of moving progressively towards natural capital solutions to water quality and catchment management is undermined, as this strategy relies upon a broader mix of operating solutions and physical investments, rather than simply 'hard' engineering solutions, which are all classified as capital expenditure.
2) the transfer of enhancement opex to base expenditure artificially inflates the company's botex, which is thus some way above Ofwat's model-driven estimates of efficient botex given the company's basic cost drivers.

The CEF and its Sustainability and Resilience Subpanel note the strong support for AW's natural capital approach, which has been developed over the past decade. This has been supported at the PR14 regulatory review by the CEF's predecessor, endorsed by customers and other stakeholders in the development of its Strategic Development Statement (SDS) for 2020-2045, and further validated by customer engagement to inform its September 2018 business plan.

Given the extent of customer support for this fundamental plank of the company's long-term strategy, the CEF is fully supportive of the company's efforts to ensure that the proposed level of enhancement expenditure is fairly assessed by Ofwat, without creating incentives against natural capital solutions which are more likely to be opex rather than solely capex based.

Outcomes

Overall ODI package

Ofwat feedback was that the company should provide further explanation of how its ODI package incentivises it, through better aligning the interests of management and shareholders with customers, to deliver on its Performance Commitments to customers.

The CEF can validate that customers' priorities, as identified through the engagement process, were reflected into AW's business plan. The CEF's August 2018 report identifies the small number of cases where the 'golden thread' from customer engagement to business plan was less obvious.

The CEF noted that company had, in some instances, rejected the application of standard Ofwat parameters for certain Performance Commitments and ODIs, on the grounds that its own evidence base on customers' views and willingness to pay pointed in a different direction. While noting that, in general, across the UK consumers tend to prefer consistent service levels, the CEF considered that it was reasonable for AW to tailor its own ODI package to the firm evidence from its own customer base, and the context of the particular supply-demand and other challenges faced in this region.

In general, the CEF is satisfied that the package of ODIs is constructed from estimates of customer benefits that are well evidenced, and that the formulae applied are consistent with Ofwat's methodology. That being said, in cases where the chosen PC level has costs exceeding the benefits, application of the Ofwat formula would give a <u>financial</u> incentive for companies to deliver a lower-than-target PC level rather than the submitted PC level.

There could consequently be a misalignment in some cases between the financial incentive faced by the company and the desire to deliver to its target PC levels. This situation arises because Ofwat's methodology mandated companies to consider reasons beyond pure cost benefit analysis (CBA) when setting PC levels, e.g. ensuring upper quartile performance as a minimum, but proposed an ODI formula that implicitly assumed a CBA-derived outcome and accordingly disincentivised meeting the non-CBA target where costs exceed benefits. (The converse is also true in that the formula incentivises companies to exceed the target when benefits exceed costs.)

In response to this challenge, the company noted the steps it had taken to ensure strong financial incentives, by diverging in some cases from the Ofwat methodology. For example, it had used the outperformance rate for some measures where the performance level is not cost beneficial and the resulting penalty rate would be too low. In other areas where the customer valuations were low or not available, AW used additional sources of customer evidence, its ODI survey, to set larger penalty rates for asset health performance commitments (e.g. treatment works compliance, sewer collapses).

Considering the broader corporate and societal context in which AW operates, the CEF notes the complementary reputational incentive on AW to meet its PCs, even where there may be a marginal financial disincentive to doing so. It also notes the proposed much stronger alignment between delivery of good customer outcomes, as measured by PCs, and the medium term financial incentives for AW's executive management. The CEF is thus assured that AW is appropriately incentivised to deliver customer outcomes.

ODI deadbands, caps and collars – overall approach

The CEF endorses the statement that the company's overall approach to caps, collars and deadbands reflects customer engagement. According to the Customer Engagement Synthesis Report, several pieces of research carried out in the past suggested that customers generally preferred to avoid sudden increases in their bill. For example, participants at two future customer workshops had emphasised that careful phasing and planning of new initiatives and investments was important, to avoid bill increases that were too large, or too sudden. In the consultation on the draft PR19 plan with members of the online community, participants had also expressed concerns about rapid bill increases, especially on the vulnerable, and those on low-incomes. In discussion with the CEF, AW noted that this preference for bill stability was seen to take higher priority over one-off reductions in bills, arising from AW's failure to meet one or more PCs.

The CEF noted that, since 31 January, the company had conducted more specific engagement around a number of deadband levels following Ofwat's request for further information about why these were in customers' interest. The results from this engagement provided further broad support for the concept of deadbands, their application to the four measures (leakage, sewer collapse, external sewer flooding, and bathing waters), and the levels proposed by the company. AW commented that, while this evidence was helpful, given the technical nature of the subject matter, it was considered to be at the limit of what might reasonably be distilled from customer engagement, i.e. it would not be reasonable to place much more weight on this, or to try to extract more detailed responses. For that reason, the company had not proceeded with a parallel engagement exercise to take views on caps and collars, as this topic was deemed to be too complex to convert into meaningful questions for customers.

Given the technical limitations in seeking further customer feedback on specific deadbands, caps and collars for particular PCs, the CEF considered that AW had a broader evidential base from its earlier wide-ranging customer engagement on the topic of bill volatility and acceptable ranges for customer bill upside / downside and company RoRE range. In combination, the latest customer engagement and the earlier results did, in the CEF's view, support AW's proposed approach on caps, collars and deadbands.

Setting caps and collars for individual measures

The CEF agrees that the approach adopted by AW, and described in the Outcomes chapter of its IAP submission, is economically sound and in line with best practice. The company, its customers and Ofwat can therefore have confidence that the resulting ODI rates are fairly based on good evidence about customer preferences.

Leakage

Ofwat commented that the company has set its enhanced rates as a multiple of 4.29 over its standard incentive rates, for both outperformance and underperformance. This may exceed customer willingness to pay for leakage reduction. The company should provide further evidence to justify the enhanced rates proposed, which are a multiple of 4.29 over its standard rates, or consider downwardly adjusting the enhanced incentive rates proposed.

The CEF commented on the proposed enhanced rates for leakage in its August 2018 report:

> "The [economics and valuation] sub-group recognised that AW sought to interpret and apply the Ofwat guidance objectively to arrive at an enhancement factor of 4.29. Nevertheless, they considered that the derivation of the factor was somewhat arbitrary, and that there was not a specific foundation of customer support for this level of enhanced financial incentive, which would be paid by AW customers even though the benefits were supposed to spill over to other water companies' customers. The sub-group noted, however, that the bill impact of the enhanced incentive for leakage was included within the overall bill profiles which were accepted in customer engagement."

The further material provided by AW on this topic in its IAP response was a summary of the methodology previously applied to derive the enhanced rate. As such, it did not address the specific concerns raised previously by the CEF. As before, though, the CEF noted that the company <u>did</u> have customer support for the overall impact on bills of the ODI package, to which the enhanced leakage incentive contributed.

Bathing waters

Ofwat commented that the company proposes to apply this ODI at the end of the 2020-25 period to revenue; and that this is not sufficiently justified based upon customer support

The CEF noted the recent specific customer engagement on this topic, which provided further evidence that customers did support the proposed end-period measure. In discussion with AW, it was also observed that, throughout the period 2020-25, AW's progress towards the 2025 target for bathing water would be transparently reported on an annual basis, and subject to comment and critique both from external stakeholders and, for company management, from the corporate governance mechanisms. As executive pay would in future be more closely aligned with the sustained delivery of customer outcomes, this would add to the reputational incentive on the company to maintain a trajectory consistent with meeting an end-period target.

Overall, the CEF was content with customer engagement and other evidence in support of AW's proposal in this area.

Pollution incidents

The CEF reiterated its earlier robust challenge on pollution incidents, where the company is still proposing a financial incentive for this common performance commitment (in line with Ofwat guidance for common measures). However, CEF members argued consistently that the company should not be rewarded in circumstances where pollution incidents are still happening. While the company noted the CEF's concerns regarding the perception of outperformance incentives while still incurring some serious pollution incidents, it argued that the performance commitment level was based on only category three incidents, in line with the company's ambition for no category one or two incidents.

Affordability and vulnerability

The CEF Affordability and Vulnerability Subgroup had the chance to meet on 15 March to scrutinise the two new proposed ODIs for affordability and vulnerability in more detail. The subgroup acknowledged that customer engagement seemed to be supportive of the two new ODIs, with a few minor caveats. The subgroup was broadly satisfied with both the customer engagement carried out and the company's proposals in these areas.

Affordability

- The subgroup welcomed the idea that there was an ODI attached to the company's previous proposals to offer holistic support to customers who might be struggling to pay their bills.
- They welcomed the fact that CCWater would be involved in an annual review and sense check of the outcomes achieved by this performance commitment, but suggested the terms of reference for this review should be guided by engagement among those customers most likely to be affected.
- However, they acknowledged there was some detail missing due to short window between 31 January and 1 April.

Vulnerability

As it was based on extensive customer engagement, the subgroup felt strongly that Anglian Water should continue to go for the higher proposed levels of Priority Services Register registration than those proposed by Ofwat for the industry-wide mandated ODI. However, as already highlighted in the subgroup's submission to Ofwat, members pointed out that there was no clear support for the reward only mechanism proposed under this ODI.

While continuing to welcome the fact that any earned reward under this ODI will be reinvested into the measures designed to benefit those in vulnerable circumstances, the subgroup suggested that more customer engagement should be carried out in future among the affected target group, to guide the areas where reinvestment would be must valuable and effective.

Hartlepool

There was no specific customer engagement research carried out with customers in Hartlepool between 31 January and 1 April 2019. However, the CEF noted the company's assurance that any changes proposed to the business plan would not affect the bill profile for customers in Hartlepool

Conclusion

In overall summary, the Anglian Water Customer Engagement Forum continues to commend the company on the length, breadth, depth, scale and innovative nature of its customer engagement programme for PR19.

The CEF and its subpanels have worked hard over the past two years to scrutinise the degree to which that engagement has fed into the company's proposed PR19 Business Plan. It is satisfied, with a number of minor caveats noted above and in the CEF's original report (submitted on 3 September), that Anglian

Water's PR19 Business Plan is indeed driven by the requirements of the company's customers, and that it recognises the challenges faced by customers across the region.

In terms of bill profile, the continued decrease over time and recent adjustment downwards help maintain good value perceptions with customers, which is to be commended.