CUSTOMER ENGAGEMENT FORUM

Customer Engagement Forum (CEF) Valuation Sub-Group

Date: 21 June 2018
Time: 10.00-12.00
Location: Lancaster House, Ermine Business Park, Huntingdon, PE29 6XU

Present:

- Daniel Storey – Director, High Point Economics (Chair)
- Beth Corbould – Economist, Civil Aviation Authority – by phone
- Bernard Crump – CCWater – by phone
- Jeff Halliwell – Independent Chair of Customer Engagement Forum (CEF)
- Paul Metcalfe – MD, PJM Economics – by phone
- Darren Rice – Anglian Water
- Helen Dunn – Anglian Water
- Arun Pontin – Anglian Water
- Mark Coulson – Anglian Water
- Sophia Ronketti – Anglian Water
- Lisa Gahan – ICS Consulting – by phone
- Vicky Anning – CEF Report Author

Agenda Items	Action
1. Review of previous minutes	
Anglian Water annexes and other requested papers had been circulated, as agreed in previous minutes	
Daniel Storey asked if a ShareFile could be set up for all valuation papers so these were easily available in one location	**HD**
Helen Dunn said she would also update the microsite	**HD**
Paul Metcalfe reported that a final version of his company's industry benchmark report would be circulated asap	**PM**
Darren Rice and **Arun Pontin** had two minor revisions to the minutes, which	

were otherwise approved. **VA to revise**

Daniel introduced the meeting: we're getting tantalisingly close to the valuations but haven't seen how they're applied in earnest to help Anglian Water prioritise their business planning. He would like to see:

- cost-benefit analysis
- how this has impacted decisions

2. Overview of application of valuations in cost benefit analysis (CBA)

Mark Coulson gave a comprehensive overview of AW's CBA approach. AW uses the HM Treasury Green Book. Although Ofwat does not prescribe it, the company uses this methodology – and has done this for several price reviews (PR09 & PR14).

Darren said that Ofwat has an expectation that CBA will be used to help set ODIs. Ofwat uses econometric forecasting models to predict relevant allowances for companies within their PR19 settlement, based on a suite of explanatory factors. On the enhancement side, there was a recent note published by Ofwat that could be circulated to CEF. See link **VA to check this**

Mark said that the reason for adopting this approach was that the water industry was accused of using rough methods of forecasting costs and intellectual neglect in the past.

When looking at risk framework, AW looks at root cause or historic data on deterioration of assets. This will give likelihood of failure of service. This two-factor component gives pound figures and risks.

Costs are calculated using whole-life costs. AW looks at non-financial impacts and negative impacts, such as nuisance and carbon. They also look at avoided costs due to business failures. All costs are considered and the impact with and without investment is also considered.

AW has an extensive library of value/service measures. Some have private and some have societal values, depending on nature of value. Things like water quality, which is driven by WINEP or NEP, only have a societal value because there's no current cost to company for not meeting that future obligation.

These are split into water, water recycling/waste water and common services that go across all price controls to calculate service values.

Daniel asked what % of these values are AW driven and what is imported from standard industry numbers

Lisa Gahan said about 80% of measures are from AW's own valuation research – 20/10% are external. These are cross checked against what's in the public domain.

Mark said the company always calculates the whole-life cost of a project. Normally assume that projects finish half way through the year. AW has locked in a 40-year time horizon for majority of investments.

AW costs are largely built up on a cost estimating system, which looks at all projects delivered over last 15 years – drawing on a library of over 3,000 projects/cost models.

Every cost that's going into the business plan will have been through internal review.

When looking at benefits side, AW looks at baseline (pre-risk) and post-risk position - the benefit is difference between the two. A 40-year time horizon is also used for benefits.

Jeff Halliwell asked about status of WACC?

Darren said that Ofwat have produced an indicative WACC – as it stands, AW will be submitting a plan using Ofwat's indicative WACC (subject to board approval).

Mark presented a diagram of Copperleaf C55 system, which is:

- Structured around process steps and workflow (errors will be obvious very early on)
- Transparent and auditable
- Flexible and future proof – all configuration via application
- Supports scenario planning (will return the same portfolio every time for a given set of input assumptions)
- Browser based for easy deployment (commercially available)
- Is configured to auto-generate solutions – i.e. replace, repair, upgrade – with rules set on the benefits of solutions

The process and the C55 system is subject to AW's PR19 assurance process, by both Jacobs and Deloitte.

AW can arrange a 1-1.5 hour session for panel members, if they wish.

Bernard Crump: In terms of relevant link between work on societal valuation and Copperleaf system: are valuations from this library incorporated into overall costs? For example, if you're looking at something with a statutory requirement, does that override all of the valuations?

MC

Mark: valuations from library go into code in background. Can circulate an example of that after the meeting.

In WINEP programme, for example, something like a flow requirement at sewage treatment works, we apply the benefit (in many cases, there's very little benefit from customer point of view so valuation is low and sometimes zero). The only times we'd add extra value into that is where there's an approach that might use a natural capital-type solution. It's difficult to get to a cost beneficial programme but the EA require companies to do that.

Can look for other values other than cost too (e.g. carbon, disruption, affordability, financeability, deliverability etc.).

Bernard: for final business plan, would you have insight into what proportion of programme is informed by societal valuation and what's to meet mandatory requirements, irrespective of cost-benefit analysis?

DR

Daniel: can we leave this with Anglian colleagues to consider?

Paul: do the non CBA drivers and non-statutory enter in as constraints or do they not appear in models? How far are you departing from cost beneficial considerations in response to direction from Ofwat? Where are you using CBA and where not, and what impact does that have?

Mark: it's constrained in more than one way because we can't go outside our forecast ceiling that Ofwat will apply.

Darren: customer engagement helps to inform constraints/levels of service. In an unconstrained world, you'd be spending billions on water quality maintenance because of consequences of failure. This is across the sector and is driven by valuation.

3. ODIs

Arun Pontin presented a slide pack on PR19 performance indicators – the aim was to give an overview of proposed ODIs and to provide practical examples of how valuations have fed through to these performance outcomes.

i. *Recap of the position to date*:

- AW's proposed suite of ODIs contains 34 individual performance commitments. The short-list and associated definitions were tested with customers and submitted to Ofwat on 3 May. The suite includes:

    - 14 common performance commitments,
    - 20 bespoke performance commitments,
    - Of these 24 are financial performance commitments and 10 are reputational performance commitments.
- AW has been engaging in significant detail with customers on the further detail of performance commitments.
- They have sought customer views on 1) understanding and 2) the level of stretch in the performance commitments through the Accent research on the outline plan and through the online community.
- They have been applying marginal costs and customer valuations to calculate incentive rates. They have also sought customer views on the appropriate range of incentives and relative priority of measures through research with ICS.

AW recognise societal valuation is bottom up driver of ODIs, but need to find out if it's acceptable to customers and constrains bill volatility.

There are some clashes where some of performance commitments are very stretching. Some of those measures like sewer flooding can be quite volatile and weather dependent. So you can have extreme volatility.

Some of the costs are being locked down today and Jacobs are doing assurance on this.

Darren: Ofwat is giving feedback on 3 May submissions. They are looking to ensure that companies have not proposed unnecessary exceptions in the definitions of their measures. AW expects feedback in early July – should be high level feedback only.

ii. Setting Performance Commitment Levels

AW's approach to setting Performance Commitment Levels, in line with Ofwat's guidance, has been informed by:

  - Cost benefit analysis
  - Comparative information (comparing to other companies)
  - Historical information
  - Minimum improvement
  - Maximum level attainable
  - Expert knowledge
- Customer support for the proposals remains critical.
- AW has sought customer views on the level of stretch in the performance commitments through the Accent research on the outline plan and through the online community. Overall there was a reasonable level of support, with support for individual PCLs ranging from 51-81%.
- In the focus groups on ODIs as part of ICS research, it became clear that while the balance of incentives should be equally between asset health and

service – customers believe improving performance is more important for service.

Jeff: there was an outstanding issue from CESG where people were claiming understanding of complex definitions on natural capital or leakage, but it didn't seem credible.

Action in CESG was to circulate questionnaire and to consider weighting as evidence to support the ODI.

Action: this issue should be diarised for 9 July meeting (look at the questionnaire and outstanding challenges).

DR to follow up

Darren: all ODIs were tested in terms of how easy they were to understand and how stretching as a target.

AW asked Accent to go back and recut the analysis to capture customer views on stretch only for customers who had confirmed their understanding of the proposed measures.

Company is proposing to repeat one-pagers underpinning 3 May submissions at end of process (showing level and valuation). Arun is working on this currently.

AP/DR

Daniel: it would be good to be explicit and honest about areas where there may be some doubt or caution.

Arun: One of actions from last meeting was to include Ofwat default calculation on setting incentive rates (which is prescribed).

By default this results in asymmetry in terms of rewards and penalties.

AW have undertaken an extensive mapping exercise to map costs from C55 to ODIs and to identify which expenditures result in improvement in levels of services.

Caveats: For asset health measures incentives, AW must take account of the interaction between service and asset health and that societal valuations have concentrated on service rather than asset health. This work is still underway.

For some performance commitments, such as supporting customers in vulnerable circumstances and retailer satisfaction, there is no customer valuation to determine the incentive rate. For these measures, AW will use evidence from customers and estimate from the range of performance to set the incentive rate.

Bernard: I think this area is confused in Ofwat's guidance. Doesn't know how customers are expected to form a view on this.

Arun: one of things AW explored in research is whether customers expected service to improve and for assets to be maintained or stay stable.

iii. Setting incentive rates:

- Ofwat expects the RoRE range of company's ODIs to be between 1 and 3%.
- The results from customer engagement from both research on incentives and asset health and suggests an indicative RoRE range of incentives of 2.2% (roughly +/- £350m over AMP7).
- Results from research on the outline plan put customer acceptability of this range at 59% (with 25% reporting this was neither acceptable nor unacceptable).

iv. *Indicative AMP7 performance commitment package:*

Daniel said he found this summary very helpful

Bernard asked if there could be an appendix with detail for each measure that shows how you've determined upper quartile level and historic performance

Jeff: a waterfall presentation might be useful to present visually the relative importance of C-mex vs D-mex

Arun: has started pulling together this information for more detailed one-pagers, which will allow panel members to see breadth of information and follow up areas of interest **AP**

Daniel: would also be helpful to see historical data in terms of achievements in PR14 vs PR19 proposals

Action: Anglian colleagues to come back with visual representation to present to CEF **AP/DR**

v. Performance commitments in detail

Arun gave an overview of leakage performance commitment and rewards/penalties – AW is a frontier company in this area.

Bernard: Ofwat's regime is poorly thought through, and resulted in companies being able to propose very high enhanced incentive rates, at many multiples of the standard rate. CCWater have made this point and will carry on pushing it.

Arun: AW has been fairly conservative in what's proposed, a multiplier based on our number of customers would be around 11 times (much higher than what is being proposed). We've had advice from Frontier Economics on this approach.

78% of customers supported pushing AW's frontier performance on leakage. There was strong support through Be the Boss customer feedback

AW's chosen value 4.29 comes out at lower incentive rate than at PR14

Action: will circulate table to show this number after meeting **AR**

Daniel: why were these special factors on leakage not fronted up in triangulation approach? This is stands out as the only place you've gone against that.

Helen: in the range on graphs and tables, the main focus on scaled gains values is across the full range (values for first range are higher than across subsequent improvements).

With the triangulation process, we were receiving different data at different times and had various triangulation points.

Lisa: the triangulation process is iterative. If you find a number that doesn't look and feel right, you need to go back and possibly do some more work. AW saw that the leakage data doesn't quite fit and have done some extra triangulation.

Daniel: how did you deal with the second stage water resources study evidence in the first stage of triangulation in first round? Why is it given greater weight in the second round?

Lisa: this doesn't undermine process, it's just that the process isn't finished.

Action: Anglian Water to address this question and bring back to next meeting **DR/AP**

Bernard asked about deadband range (on slide 22). All rewards are at enhanced rate?

Arun: enhanced reward is unlocked as a frontier company. At end of AMP6, AW are still targeting a big reduction in leakage. AW's PCL is a reduction on current leakage rate so it's still stretching; this would be enhanced reward

Bernard: the whole concept of frontier in relation to leakage is flawed. The measure used to compare companies is flawed because of different typology and hydrology etc.

I would object quite strongly to this proposal because you're exposing customers to significant bill increases for the chance you'll improve beyond these performances.

Jeff: consumer acceptability on this is questionable and it's hanging an awful lot on Be the Boss customer engagement, unless there are other pieces of customer engagement that's been overlooked – this is a very substantial reward opportunity.

Arun: In addition to the Be the boss game (where 78% of customers supported pushing the leakage frontier and the associated bill impact from enhanced incentives) we engaged with customers about the ODI range they are prepared to see. If we overlay this and strongly outperform to the maximum on all ODIs, it would still be below what customers would be prepared to accept in terms of bill impact.

Daniel: there are some outstanding challenges that will feature in the CEF report. There are some strong views on that point

Action: Anglian Water to rewrite triangulation process as two-stage process. Panel members to follow up by email and address any outstanding questions at 9 July meeting. **AP/HD**

4. **Societal valuation update and close out of final comments on valuations**

Helen Dunn gave a brief update on the societal valuation programme to date.

- AW has delivered final Valuation Completion Report – full set of reports and well-being report now sent to CEF sub-group.
- AW has provided written responses to:
    1. questions in CEF sub-group draft note (4 June) summarising the group's preliminary assessment of the valuation work
    2. PM challenge on use of other company valuation data

The final valuation completion report and annexes have now been completed and delivered.

Recent progress on triangulation steps:

- Updates to **Steps 2 and 3** incorporating new primary valuation evidence
- Completion of **Step 4** (Assess & Test Valuations) of the triangulation

process and moving forward to **Step 5** in use in business planning.

Step 6 is integrated into all of the steps as part of the continuous review process: (CEF and Halcrow)

Helen presented a simplified flow chart of Step 3 of the triangulation to illustrate how the PR19 values have been triangulated using the available data from the studies which will be included in the final VCR

Halcrow assurance review has in general given a green light from the two reviews (phase 1 in January and phase 2 in June)

Vicky Anning had circulated the draft Halcrow report to Daniel and Jeff this morning and would circulate a final version when approved.

Helen: gave a summary of responses to challenges from panel members. On Paul's challenge, AW's review (set out in separate note) demonstrated they have looked to follow best practice guidelines (on unit size). But happy to take further questions on that.

Daniel: found the response document from AW was a helpful way to build a dialogue and would be useful input material for CEF report. **VA**

Paul: totally disagrees with what's been written (by Ken Willis). It's not about risks, it's about households in general.

Lisa: Ken Willis, who provided his thoughts on the challenge in the response, is an expert in this area. His approach was quite balanced and can see no evidence that changing the approach would be better – as both have some flaws. It is seen as a good compromise

Jeff: we can reference this difference of methodological opinion in final report and move on. (It's not CEF's position to be final arbiter.)

Helen: noted the importance from this discussion of considering how we can improve our comparisons of societal values between companies in the future.

What's left to do:

- Finalising the societal valuation narrative for business plan
- Delivering a detailed write up of societal valuation programme
- Review and lessons learned including options for on-going programme of valuation work

5. **AOB**

Next Valuation Subpanel meeting set for Tuesday, 9 July.

Darren asked for any challenges and comments to be received as soon as possible to give AW colleagues enough time to address these.

Daniel will email around a schedule following this meeting for sub-panel's report and then have all outstanding questions on the table.

Any written follow up can be done by email.