The Customer Challenge Group for Dŵr Cymru Welsh Water

Supplementary Report on the Company's Revised Business Plan For the 2014 Price Review

For submission to Ofwat

02 May 2014

Contents:

1.0 Background and Overview

In December 2013 Dŵr Cymru Welsh Water submitted its Business Plan to Ofwat as part of the price review for the period 2015-2020. It was accompanied by a report from Dŵr Cymru Customer Challenge Group, which had examined the Company's proposals.

The Customer Challenge Group (CCG) of Dŵr Cymru was created to help ensure that customers have a strong voice in the regulatory process. It is entirely independent of the Company and Members have been drawn from a wide cross section of customer representatives, regulators and stakeholders.

The CCG challenged the Company on the quality of its customer engagement, and on how well the proposed outcomes, associated commitments and delivery incentives reflect customers' wishes and priorities.

The CCG report of December 2013 confined our examination to issues within the collective competency of Members. Of particular concern is the 'affordability' of future water services during a period of economic difficulty and welfare changes, as well as the quality of services customers will receive.

The CCG was pleased that in the light of our observations the Company modified several of its proposals. In particular, the Company moved from its position of maintaining 'flat bills' over the five year period to a target of reducing bills in real terms – while maintaining in full its planned investment programme.

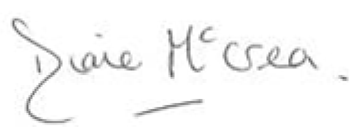
However, CCG Members were concerned that, despite the very extensive research it carried out, the Company had not satisfactorily provided evidence of links between all of its spending proposals and the data it had collected.

Dŵr Cymru has now responded to Ofwat's review of its Business Plan and is presenting its revised submission on 2 May. This brief CCG supplementary report gives an overview of our opinion of the Company’s responses to several key issues that have been highlighted by the Regulator. In addition to these, the CCG has been updated about the development of the Company’s social tariffs, due to be implemented in 2015, and recognises that these include increased scope and scale of support to vulnerable households.

This report has been prepared over an extremely short timescale to enable the Company to accept Ofwat’s invitation to resubmit its Business Plan on May 2nd and has been informed by two CCG meetings, one in February and one at the end of April 2014.

As the Chair of the CCG I wish to thank CCG Members for their time and commitment in contributing to this second report in difficult circumstances.

Our first report and information on Members can be seen on the Company’s website at www.dwrcymru.com.



Diane McCrea
Independent Chair of the Customer Challenge Group, Dŵr Cymru Welsh Water

2.0 Ofwat's response to the Business Plan.

Ofwat has examined the Company's Business Plan and agreed with the CCG's view that it had, overall, delivered a highly comprehensive programme of public and customer engagement. It had also seemed to respond appropriately to its customers' wishes on price and service levels – as expressed through key findings of its research programmes.

However, Ofwat also agreed with the CCG that the Business Plan failed to provide sufficient evidence to justify and explain some of the decisions it had taken.

The CCG has focused on three key points of the Company's resubmission. It has not been possible, nor has it necessarily been within the scope of the CCG's remit, to review all other issues identified in Ofwat's risk based review.

The CCG had the opportunity to comment on the draft 'gap analysis' and the Company verbally confirmed that it was able to take on board the CCG's comments in its final report, as presented to Ofwat on 17 April.

The pertinent issues for the CCG at this final stage were:

- Changes to the cost of capital and 'Pay as You Go' (PAYG) ratio
- Amended Outcome Delivery Incentives (risk and rewards)
- Additional research asevidence to support decisions

The following pages summarise these issues, the Company's responses, and the CCG's opinion of them.

3.0 Ofwat's evaluation, the Company's responses and the CCG's opinions

3.1. Changes to the cost of capital and PAYG ratio

Following the publication of Ofwat's 'Risk and Reward' guidance on 27 January 2014, the Company planned a CCG meeting in February to discuss the implications for its Business Plan. The purpose was to ensure that the Company was in a position to respond positively to Ofwat - should it be designated as *'pre-qualified for enhanced status.'* In light of the new guidance the Company proposed a number of changes to its plans. These were discussed at the CCG meeting on 18th February. Revisions included:

- Reducing the cost of capital from 4.5% – as proposed in the December Business Plan submission – to 3.7%, in line with Ofwat's guidance.
- Increasing the PAYG ratio from 44% to 49%, making it comparable with the industry average.
- Reducing bills by a further £6 by 2020 (in 2012/13 prices)

At the February meeting Members of the CCG asked whether the Company had considered an even greater bill reduction by proceeding with the cost of capital reduction but keeping the same PAYG ratio. The Company explained that this option had been considered but that it would adversely impact its interest cover ratios, thereby making them "unsustainable", and as a consequence the Company's credit rating could be at risk of downgrade. This, it was stated, would have an adverse impact on customer bills in the long term.

CCG Members agreed that the revised proposals seemed to be the better option for customers because they proposed a lowering of bills by a further £6 in real terms. Also, in the Company's assessment, they enhanced the security of credit cover, thereby reducing the risk of credit rating downgrade and finance ability, and also consequent future increases to customers' bills.

3.2. The Company's response

Although the Company was not '*pre-qualified for enhanced status'* it has confirmed that the changes outlined at the CCG's February meeting are included in its May 2 re-submission to Ofwat.

3.3. The CCG's opinion

The CCG was assured by the Company that it has conformed to the guidance from Ofwat in its resubmitted Business Plan.

The Company has revised its proposed cost of capital from 4.5 per cent to 3.7 per cent. It has stated that it must ensure an appropriate balance between maintaining 'affordability' for customers while ensuring that it can adequately finance its investment and operations over the regulatory period. It wishes to ensure, as far as possible, that its financial resilience will help to maintain its high credit rating, which reduces finance costs and is therefore in the best long-term interests of its customers.

The CCG accepts the Company's rationale that this revision, coupled with a PAYG ratio increased to 47 per cent (44 per cent in Dec 2013), is an appropriate response that will protect the Company's financial position while delivering a benefit to customers – in the form of an additional bill reduction of £6.

3.4. Amended Outcome Delivery Incentives

In its 'Risk and Reward' guidance, Ofwat stipulated that returns to companies should be more dependent on outperformance incentives than on the cost of capital.

As Dŵr Cymru operates a 'not for profit' business model there was considerable discussion at the February CCG meeting on the merits of introducing 'rewards' when the company would, in any event, return them to customers. The Company was at the time considering its options and presented some potential amendments to its incentives.

The CCG suggested that any changes to the Company's targets and ODIs should be well evidenced and further research should be commissioned to gauge customer opinion and inform any amendments.

The Company commissioned qualitative and quantitative research on ODIs and acceptability. The initial qualitative research indicated that the concept of ODIs was seen as complex by many customers and the majority of participants raised questions and concerns over the approach, rationale and principles. However, a minority responded positively and suggested that it could encourage better performance and increase investment in services.

The subsequent quantitative research produced a different result, indicating that the majority of customers think that linking bills to performance is a good idea. It showed that the majority would prefer bills to vary according to performance, and that any 'reward' for over-performance is reinvested in services.

The research also indicated that customers would prefer variable levels of rewards and penalties, in line with improved performance.

3.5. The Company's response

In the light of Ofwat's guidance and its new research Dŵr Cymru has reviewed its ODIs and substituted a 'variable' scale for the introduction of penalties and rewards, instead of its earlier 'bullet point' approach. These would be measured against outcomes that depend on levels of performance. They include variable penalties for seven measures and rewards for three. The ODI revisions can be seen in the table below.

Measure	Sliding Scale Penalty	Sliding Scale Rewards
A1 Safe Drinking Water	£0 - 10m	£0 - 10m
B3 Preventing Pollution	£0 - 10m	£0 - 10m
D3 Properties Flooded in the Year	£0 - 10m	£0 - 10m
D4 Business Customer Satisfaction	£0 - 5m	-
F1 Asset Serviceability	£0 - 10m	-
F2 Leakage	£0 - 5m	-
F3 Asset Resilience	£0 - 5m	-

3.6. The CCG's opinion

The CCG noted the Company's further ODI quantitative research that indicated customer support for performance being linked to bills, and that the Company has amended its ODIs. The CCG also noted CCWater's earlier research on ODIs[1].

The CCG does not, in principle, support rewarding the Company for outperformance for its day to day job and for targets that do not exceed the industry's best performance levels.

However, we acknowledge the Company's ODI research results and the proposed amendments to risks and rewards. We welcome the company's clarification that improved service levels attracting a reward would exceed the industry's best. Of particular note is the commitment not to increase prices to customers to fund rewards. Under its 'no-shareholder' model ODIs will operate differently and will be used to benefit customers through additional investment or short term price decreases. All rewards earned by the company will be returned to customers through their bills or will fund

[1] CCWater's research on Outcome Delivery can be accessed here: http://www.ccwater.org.uk/wp-content/uploads/2014/03/Outcome-and-Delivery-Incentives-Report-FINAL.pdf

increased investment to improve services. Any penalties will result in reduced bills to customers.

The Company's ODI research gave an indication that customers thought any financial rewards for outperformance should be reinvested in the business. Whilst this seems sensible and the CCG could support this view, we suggest that the Company further develops its commitment to engage customers through appropriate mechanisms, such as customer research or forum, engagement with the CCG, CCWater and other interested stakeholders to refine implementation. This would help to inform its decisions on which areas of the business should benefit from additional investment resulting from this process, or whether customer views on this change over time. The company agreed to this suggestion.

Following a determination on the Company's proposals, the CCG would welcome further involvement on how these ODIs will be used for the benefit of customers. The CCG welcomed the Company's commitment to transparency through publication of its performance reviews and outperformance rewards, through annual reports and the provision of customer information.

The Company's revised ODI proposals intend rewards and penalties be introduced on a sliding scale in response to customer feedback. The Company assured the CCG that the sliding scale of rewards and penalties was realistic and would better deliver for customers than the initial 'bullet point' proposal. The format would ensure that the Company could not be rewarded simply for meeting targets and would be further incentivised to outperform - as expected in Ofwat's guidance and feedback. The Company also assured the CCG that rewards would be triggered only if the level of performance achieved put it among 'best in class' of industry performers.

The CCG was presented with the results of the new quantitative ODI research, but due to severe time constraints Members were unable to scrutinise or provide any detailed comment on it or its interpretation to underpin proposed amendments. The CCG reiterated its expectation that the Company makes clear the links between its quantitative research and its ODI proposals. We were assured that a solid case based on evidence from customer research would be made in the submission to Ofwat.

3.7 Additional information explaining the links between customer research, outcomes, investment and performance commitments

Ofwat considered that more evidence was required on the Company's customer research - especially for linking 'willingness to pay' to the development of outcomes, performance commitments and ODIs. This was an issue the CCG highlighted strongly in our first report.

3.8. The Company's response:

Dŵr Cymru has submitted two new documents to Ofwat that it claims evidences the link between the customer research and the development of outcomes, performance commitments and ODIs. One document outlines the development of the Company's eight target outcomes and explains how they were revised in line with customer research. The second describes how the targets were set for each of the 22 measures of success, including the role of customer research, past performance and cost benefit analysis.

3.9. The CCG's opinion

The CCG has previously noted concerns about the Company's linkage of evidence to decision making on outcomes, measures of success and other targets.
Although very extensive research has been carried out there has, in several areas, been a lack of clear and specific linkage between its findings and Business Plan proposals.

The Company has acknowledged this shortcoming and endeavoured to address it through the provision of additional evidence and new research. The findings were presented to the CCG meeting of 28 April.

We have not had time to examine the supplementary information in detail and therefore we cannot provide an opinion on its merits.

The CCG challenged on the transparency of performance data, how these would be verified and how customers would be kept informed. The Company has stated that much of this information is already supplied to regulators and that it would be published on an annual basis. This was welcomed by the CCG.

However, we are mindful that previous research findings show very strong overall customer support and acceptability for the Business Plan as presented in December 2013.

4.0 The CCG's conclusions

The CCG has reviewed the Company's emerging responses to Ofwat as best it could over a very short period, and time constraints have therefore limited the scope of our scrutiny of the revised elements of its Business Plan. Whilst this very tight timescale has put a lot of pressure on both the Company and the CCG, we welcome the opportunity for an early determination by Ofwat, as the Company assured us that it would be in the best interests of its customers, enabling it to focus on preparing for the delivery of the Business Plan and improving services for customers. Whilst limited in our considerations by this strict time constraint, we agree with this approach.

The CCG welcomes the revisions of the Company's cost of capital and PAYG proposals because they result in a further reduction to customer bills without compromising the Business Plan investment proposals and services for customers. We were assured that these amendments will help to maintain its financial resilience - for the best long-term interests of customers.

We also acknowledge the amended ODI proposals, the regulatory rationale that required their introduction, and the Company's customer research which indicates support for the principle of linking bills to performance. The ODI proposals offer incentives and penalties; with potential benefits but no financial risks to customers - given the Company's 'no shareholder' model and its commitment not to increase bills.

We welcome the Company's assurance that rewards will be awarded for performance targets above the industry average, indeed for 'best in class'.

We note the Ofwat's agreement that the Company's research has been extensive, and in particular that it has robustly tested the affordability of its Business Plan. We have been unable to assess in detail the relevance of new research to the Company's decision making processes. We are, however, encouraged that the Company is committed to a programme of ongoing research with its customers and further engagement with relevant stakeholders on how its ODIs and potential rewards and penalties will inform the use of its customer reserve fund for the benefit of customers.

The transparency and proposed involvement of CCG Members and customers on outperformance, and on how decisions to use the customer reserve funds are made (informed by ODIs and additional customer research), are supported. They build on the Company's commitment to continue its customer-focused approach to underpin policies for returning gains to customers.

In conclusion, the CCG has of necessity, and given the time constraints for resubmission, focused its deliberations on what the proposed changes mean for customers.

Accepting all of the above, we are of the opinion that these amendments have the potential to improve the Business Plan and deliver a better outcome for Dwr Cymru's customers now, and in the future. It is now for Ofwat to scrutinise the detail of these proposals and the company's resubmission.