

Sembcorp Bournemouth Water's Customer Engagement Planning Forum

Report to Ofwat on Sembcorp Bournemouth Water's Amended 2015-2020 Business Plan

Executive Summary

This report is an addendum to that issued by the CEPF in December 2013 and has been designed to address the issues raised by Ofwat in its risk-based assessment of the Company's Business Plan as far as they affect customer facing issues.

Since the December 2013 report, the CEPF has engaged with the Company at three full meetings, at four customer consultation workshops, in individual discussions and by telephone and email communications.

The CEPF Research sub-group has maintained close contact with the Company and its research consultants to enable effective challenge and to enhance the quality of the research material.

The CEPF has reviewed and challenged the Company's resubmission with key changes to the 2015-2020 Business Plan being: **Willingness to Pay information**

The main clarification sought by Ofwat arises from its view that the conclusions from the 'Willingness to Pay' survey carried out by SBW were not sufficiently transparent and that Ofwat therefore was not yet convinced a) by its findings and b) how the values were used in the cost-benefit analysis (CBA) for investment proposals.

To meet the CEPF's and Ofwat's concerns, SBW has responded as follows:

- the software company (Nuance) has now provided further assurance regarding the reliability of its model.
- SBW has also obtained further assurance from its peer reviewer – Dr Scott Reid

The CEPF has reviewed the assurance reports and considers that they resolve any doubts which it may have had before regarding the reliability of the model.

In addition SBW had erroneously entered some small costs against some investment activities in its Business Plan proposals and as there had been no Willingness To Pay (WTP) values or accompanying CBA analyses, Ofwat queried the lack of supporting evidence.

The Company has now removed these costs from its revised business plan. The CEPF agrees that for activities with no additional costs, WTP values and CBA are not applicable.

Wholesale costs

SBW is not forecasting a supply deficit in its draft Water Resources Management Plan and Ofwat has therefore challenged the Company's full metering strategy (part of which includes for installing meters at properties which for the immediate future will not be charged on a metered basis).

In response to the indicative findings of additional deliberative research carried out in May 2014, the Company proposes to continue its current metering policy of installing meters at customers' request and upon change of occupier, but will offer those customers who are selectively metered the opportunity to revert to rateable value charging within 12 months of the metering being installed. The CEPF is satisfied that SBW has revised its metering strategy to reflect customers' views and is supportive of the Company's proposals.

Ofwat also challenged SBW on the rate of mains replacement proposed in its Business Plan. Independent assessment as part of the Business Planning process has found that historically SBW's rate replacement has been sub optimum. The CEPF strongly supports the concept of not storing up problems for the future. The Company has adequately demonstrated the need to increase its rate of mains replacement to the CEPF. The CEPF is satisfied that SBW has convincing evidence to this effect and therefore supports the Company's proposals.

Outcome Delivery Incentives

The CEPF is supportive of the specific outcomes (and the service performance measures for each outcome) that the Business Plan sets out. The package of outcomes and specific service measures for each one are reflective of customer priorities and preferences revealed through extensive research in the development of the Company's Business Plan, and challenged where required by the CEPF.

For its December Business Plan, SBW didn't feel that rewards for service delivery performance were appropriate – a view which the CEPF supported – but the Company has now needed to respond to Ofwat's Risk & Reward Guidance published in January 2014¹.

Ofwat had expressed concern that SBW had only provided provision for 'penalties' for its two performance commitments supported by WTP/CBA analysis ('leakage' and 'resilience'). SBW has therefore amended its Business Plan in response to Ofwat's Risk & Reward Guidance and now proposes 'rewards' as well as 'penalties' for these two performance commitments.

While the CEPF understands the regulatory rationale for applying financial incentives to encourage companies to outperform on service delivery (moving the emphasis for potential

¹ Setting price controls for 2015-20 – risk and reward guidance January 2014; pages 37 and 38
http://www.ofwat.gov.uk/pricereview/pr14/gud_tec20140127riskreward.pdf

company and shareholder returns from financial performance to service delivery), research by CCWater shows that there is a significant risk that customers may react negatively to having to pay for rewards in the future for company outperformance.

Performance monitoring and Governance

The CEPF welcomes SBW's proposed 'Customer View Group' which will have a role in monitoring the Company's performance against its committed service levels, as well as influencing how and when it is appropriate for SBW to take the reward should it outperform on the specific performance commitments This will allow good linkage to the customer input.

Overall views of SBW's updated Business Plan

The previous CEPF report had supported the Company's Business Plan submitted in December 2013. SBW's revised plan is now more beneficial to customers than in December as it proposes further reductions in bills, changes to its metering strategy in response to indicative findings from additional customer research and changes to the outcome delivery incentives applied to leakage reduction and large scale supply interruption. In addition bills remain affordable to most customers.

Members of the CEPF with a statutory remit, the Drinking Water Inspectorate, Natural England and the Environment Agency provided statements in December 2013 supporting the view that there was no inconsistency between SBW's Business Plan and its fundamental duty to meet its statutory obligations. The CEPF is satisfied that SBW's updated Business Plan continues to meet the required statutory obligations.

The CEPF considers that the additional explanatory documents produced by the Company are comprehensive, clear and relevant and that the conclusions of the relevant supporting documentation have been satisfactorily included in SBW's amended Business Plan. Detailed review and challenge of these - and the changes made as a result of these challenges - lead the CEPF to consider that SBW has satisfactorily answered the issues raised by Ofwat. The CEPF is supportive of SBW's revised Business Plan.

These conclusions are supported by all CEPF members.

Signed:

Date:

CEPF Independent Chair

Signed:

Date:

CEPF Deputy Chair

This report is an 'addendum' to the CEPF report of December 2013. Ofwat has provided comments on SBW's Business Plan and the CEPF Report. This addendum provides further clarification of the CEPF December report where Ofwat has requested it as well as the CEPF's views and challenges on further work carried out by SBW since the previous CEPF report.

CEPF has held three meetings with the Company since December 2013, and its Research Sub group on behalf of the CEPF has liaised closely with the Company throughout the preparation of its revised Business Plan including a meeting with the Company on 13th May. As with the previous report, the CEPF has strongly challenged the Company's approach and conclusions and the results of these challenges are contained in this report. The CEPF's challenge log is shown in **Appendix 1**.

For continuity, a summary of the key findings within the CEPF December 2013 report were:

- 79% of customers found the Company's proposed Business Plan acceptable with only 6% saying it was unacceptable
- 71% of the customers surveyed said that the proposed Business Plan offered good Value for Money (VFM)
- SBW responded to the challenge to clearly show the impact of inflation on bills in its Willingness to Pay research and in the testing of customers' acceptability of its proposed Business Plan
- Because the CBA tool couldn't be interrogated due to intellectual property rights, the CEPF was only able to inspect and challenge the results of the various runs of the model
- The CEPF had extensive dialogue with SBW in deriving and setting its outcomes and performance commitments for the December 2013 Business Plan submission to ensure these were based on its customers' priorities.

The CEPF's overall view was summarised in the 'Conclusion' section of the December 2013 report as follows:

The CEPF has engaged with the Company at ten full meetings, at customer consultation workshops, in individual discussions and by telephone conference and email communications. The CEPF customer research sub-group has maintained close contact with the Company and its research consultants to enable effective challenge and to enhance the quality of the research material.

The CEPF has made challenges across all areas of the Company's customer engagement process and in the development of outcomes, measures of success and performance

commitments in the Company's business plan proposals. Key challenges were accepted by the Company to improve the customer research questionnaires and the outcomes and performance measures. The CEPF also influenced the robustness of the business plan acceptability testing by insisting on quantitative research as well as the qualitative research proposed by the Company.

The CEPF believes that the overall package of research has been conducted in an effective and professional manner and has achieved the objectives of identifying customer views and assessing and quantifying their future needs and priorities. These priorities have been carried forward by the Company in defining its outcomes, performance measures and commitments. The CEPF supports the Company's balance of commitments including application of financial penalties to the two high priority customer outcome commitments of reducing leakage and reducing the numbers of customers at risk of supply interruptions from a single source feed.

Members of the CEPF with a statutory remit, the Drinking Water Inspectorate and the Environment Agency have provided statements supporting the view that there is no inconsistency between the business plan and its fundamental duty to meet its statutory obligations.

These conclusions are supported by all CEPF members.

2 SBW and CEPF Actions since December 2013

Outcomes and Performance Measures

To address the issues raised by Ofwat, SBW has drawn up three documents in tabular form detailing each query and what action it has taken to resolve it. The Research Sub-group has met with the Company and reviewed and challenged these responses.

The first table details the 'Performance Measures' needed for the Company to achieve its specified 'Outcomes', whether these are 'statutory, reputational or both, and the potential rewards/penalties calculated using incremental Willingness to Pay values for achieving selected performance commitments.

The second table again details the 'Performance Measures' required to meet the required 'outcomes' but also includes the 'details' concerning how these are to be achieved, a record of 'past performance' of the particular measure and comments regarding the 'stretching performance target and long term interest of customers'.

The third table also lists the Company's Outcomes and the Performance Measures required to achieve these, but in this case concentrates on summarising the research (quantitative and qualitative) carried out by the Company – and refers to where the detailed research can be found (including page references to relevant documents).

The three documents were discussed in detail at the meeting of the Research Sub-group and the Company on 13th May 2014 when the Company took the Sub-group through each

item. These were reviewed and challenged by the Sub-group. Changes to the document were agreed at the meeting in particular:

- Revise some of the wording in the 'comments' section to be more factually/evidence based
- Clarify where and why the 'penalties/rewards' are applied – and why they are the numbers quoted
- Retitle 'inferred WTP' and 'implied CBA' to clarify when WTP and CBA are required and why
- Change to the colour coding used to provide more ease of reading.
- Clarify the wording 'incremental cost is borne by the Company'; i.e. to mean normal efficiency gains expected from the Company
- Value for money. The CEPF noted in particular the findings from the 'Customer Needs and Attitudes' telephone survey of 2012 which indicated that 19% of the household customers surveyed said they preferred bills to rise by slightly more than inflation and with service levels improved, with 63% of the household customers surveyed saying they preferred bills to rise by inflation only with service levels unchanged. Furthermore, 71% of customers surveyed found the Company's proposed Business Plan offered good value for money.

The conclusions of these tables were carried forward to SBW's '*Customer engagement and willingness to pay*' section of its supplementary Business Plan including a detailed Gap Analysis. This was reviewed and challenged at the CEPF meeting with the Company on 10th June 2014.

In addition:

- At the CEPF meeting on 10 April 2014 there was unanimous agreement that the research conducted in the development of the Company's Business Plan was wide-ranging and adequately captured customers' views and priorities, including 'value for money' and 'willingness to pay' for service improvements
- The CEPF was content for SBW to move the performance measures that were of lower significance to customers to an internal monitoring plan, which would still be available for public scrutiny.

3 Clarifications regarding the December 2013 CEPF Report

Willingness to Pay information

The main clarification sought by Ofwat arises from its view that the conclusions from the 'Willingness to Pay' survey carried out by SBW were not sufficiently transparent and that Ofwat therefore was not yet convinced a) by its findings and b) how the values were used in the cost-benefit analysis (CBA) for investment proposals. This issue arose for two reasons:

1 It was not possible to display all the outcome methods of the model due to the intellectual property rights of the Survey Company. Thus whilst individual 'runs' of the model were inspected and challenged, it had not been possible to 'verify' the model itself. This had been noted in the CEPF's December report and picked up by Ofwat in its risk-based review.

To meet the CEPF's and Ofwat's concerns, SBW has responded as follows:

- the software Company (Nuance) has now provided further assurance regarding the reliability of its model.
- SBW has also obtained further assurance from its peer reviewer – Dr Scott Reid

The CEPF has reviewed the assurance statements and considers that they resolve any doubts which it may have had before regarding the reliability of the model.

2 SBW had erroneously entered some small costs against some investment activities in its Business Plan proposals and as there had been no WTP values or accompanying CBA analyses, Ofwat queried the lack of supporting evidence.

The Company has now removed these costs from its revised business plan. The CEPF accepts that for activities with no additional costs, WTP surveys and CBA are not applicable.

4 Findings on work carried out since the December 2013 Report

4.1 Mains replacement.

Ofwat challenged SBW on the rate of mains replacement proposed in its Business Plan. The Company's proposals for asking for customers' views on the rate of replacement of mains were discussed. The Business Plan proposed replacing 13 kms of mains pipes per year. The Company originally proposed to further consult its customers on whether they would support an increase from 12 kms per year to 13 kms per year and at what price (independent assessment has found that historically SBW's rate replacement has been sub optimum).

The CEPF strongly supports the concept of not storing up problems for the future. The Company has adequately demonstrated the need to increase its rate of mains replacement to the CEPF. The CEPF is satisfied that SBW has convincing evidence to this effect and

therefore supports the Company's proposals. In the event, SBW decided not to go ahead with any additional research on this matter. The Research sub-group supported this position on the basis that this is a technical issue for which it would be difficult to obtain customers' views on. Additionally, SBW already has evidence from previous research for its Business Plan that reducing leakage and minimising interruptions to supply are key customer priorities.

4.2 Metering Programme

SBW also has carried out additional customer consultation to explore customers' views on its proposed metering programme. SBW is not forecasting a supply deficit in its draft Water Resources Management Plan and Ofwat has therefore challenged the Company's full metering strategy (part of which includes for installing meters at properties which for the immediate future will not be charged on a metered basis). SBW considers its metering policy is fully in line with modern water resource planning, is fair and benefits both customers and the environment.

The CEPF considers that the additional deliberative research carried out in May 2014 has been conducted in an effective and professional manner and has achieved the objectives of identifying customer views on the Company's proposed metering strategy. These views have been now carried forward by the Company in further defining its outcomes, performance measures and commitments.

The previous CEPF report supported the Company's proposal of an accelerated metering strategy as SBW's earlier customer research showed that over 80% of customers felt metering was the fairest way of charging and reducing leakage was one of their top priorities.

The findings from the additional research carried out in May indicated that customers remained of the view that metering is the fairest way of charging, but that customers should have the choice of moving to metered charges rather than this being imposed on them. SBW has therefore revised its metering strategy to reflect customers' views from this latest research. The Company proposes to continue its current metering policy of installing meters at customers' request and upon change of occupier, but will offer those customers who are selectively metered the opportunity to revert to rateable value charging within 12 months of the metering being installed. The CEPF is satisfied that SBW has revised its metering strategy to reflect customers' views and is supportive of the Company's proposals.

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4.3 Outcome Delivery Incentives

For its December Business Plan, SBW didn't feel that rewards for service delivery performance were appropriate – a view which the CEPF supported – but the Company has now needed to respond to Ofwat's Risk & Reward Guidance published in January 2014².

² Setting price controls for 2015-20 – risk and reward guidance January 2014; pages 37 and 38
http://www.ofwat.gov.uk/pricereview/pr14/gud_tec20140127riskreward.pdf

Ofwat had expressed concern that SBW had only provided provision for 'penalties' for its two performance commitments supported by WTP/CBA analysis ('leakage' and 'resilience'). SBW has therefore amended its Business Plan in response to Ofwat's Risk & Reward Guidance and now proposes 'rewards' as well as 'penalties' for these two performance commitments.

The CEPF challenged SBW on its proposal to apply a financial reward for achieving its committed service level of 20 MI/d by 2020 when the purpose of the outcome delivery incentives mechanism is to reward performance for exceeding the Business Plan performance targets. SBW responded to this challenge and confirmed it has amended its Business Plan accordingly.

The CEPF is supportive of the specific outcomes (and the service performance measures for each outcome) that the Business Plan sets out. The package of outcomes and specific service measures for each one are reflective of customer priorities and preferences revealed through extensive research in the development of the Company's Business Plan, and challenged where required by the CEPF.

While the CEPF understands the regulatory rationale for applying financial incentives to encourage companies to outperform on service delivery (moving the emphasis for potential company and shareholder returns from financial performance to service delivery), research by CCWater shows that there is a significant risk that customers may react negatively to having to pay for rewards in the future for company outperformance.

The CEPF welcomes SBW's proposed 'Customer View Group' which will have a role in monitoring the Company's performance against the committed service levels in its Business Plan, as well as influencing how and when it is appropriate for SBW to take the reward should it outperform on the specific performance commitments. This will allow good linkage to the customer input.

4.4 Cost of Capital and embedded debt

SBW's additional research carried out in May 2014 also asked for customers' views on whether they think the additional cost of being served by a small company represents value for money. Indicative findings from this research showed that 46 of the 48 participants felt that £1.30 offered good value for money for dealing with a small water company. The CEPF observed four of the six deliberative group discussions and agreed with the findings that SBW has included in its updated Business Plan report but informed the Company that this was a complex issue on which to obtain a helpful customer view and that this key issue should be determined in discussion between the Company and Ofwat.

The CEPF has also discussed the Weighted Average Cost of Capital (WACC) and debt (including embedded debt) with SBW and has noted the various discussions which the Company has had with Ofwat concerning the different values against those set out in Ofwat's Risk & Reward Guidance published in January 2014³.

³ Setting price controls for 2015-20 – risk and reward guidance; page 21
http://www.ofwat.gov.uk/pricereview/pr14/gud_tec20140127riskreward.pdf

CCWater felt SBW needed to provide more convincing and quantifiable evidence of the offsetting benefits to customers in seeking the actual cost of its embedded debt. CCWater was also keen to understand what the implications would be for SBW's customers should Ofwat not allow the proposed company specific uplift in the WACC. The Company advised that it would have to either: reduce customer service activities to compensate, or reduce costs elsewhere over and above all other cost reduction and efficiencies defined by the company or Ofwat, or reduce the return to the shareholder below the equity return that Ofwat consider to be reasonable. CCWater concluded that any reduction in services would not be in customers' best interests.

In summary, the CEPF would be concerned if SBW had to remove customer benefits from its Business Plan as a result of challenges to its assumptions on the Cost of Capital.

5 Conclusions

Since the December 2013 report, the CEPF has engaged with the Company at three full meetings, at four customer consultation workshops, in individual discussions and by telephone and email communications.

The CEPF Research sub-group has maintained close contact with the Company and its research consultants to enable effective challenge and to enhance the quality of the research material.

The process has been designed to address the issues raised by Ofwat in its assessment of the company's Business Plan as far as they affect customer facing issues

The CEPF has reviewed and challenged the Company's submission under two headings:

- 1 *Clarifications regarding comments made by Ofwat following the publication of its risk-based assessment of SBW's Business Plan in April 2014*

The main clarification sought by Ofwat arises from its view that the conclusions from the 'Willingness to Pay' survey carried out by SBW were not sufficiently transparent and that Ofwat therefore was not yet convinced a) by its findings and b) how the values were used in the cost-benefit analysis (CBA) for investment proposals.

To meet the CEPF's and Ofwat's concerns, SBW has responded as follows:

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The CEPF has reviewed the assurance reports and considers that they resolve any doubts which it may have had before regarding the reliability of the model.

In addition SBW had erroneously entered some small costs against some investment activities in its Business Plan proposals and as there had been no Willingness To Pay (WTP) values or accompanying CBA analyses, Ofwat queried the lack of supporting evidence.

The Company has now removed these costs from its revised business plan. The CEPF agrees that for activities with no additional costs, WTP values and CBA are not applicable.

2 Additional work carried out by the Company since the submission of its Business Plan in December 2013

The CEPF considers that the additional research has been conducted in an effective and professional manner and has achieved the objectives of identifying customer views on the Company's proposed metering strategy. These views have been now carried forward by the Company in further defining its outcomes, performance measures and commitments.

Our previous report supported the Company's proposal of an accelerated metering strategy as SBW's earlier customer research showed that over 80% of customers felt metering was the fairest way of charging and reducing leakage was one of their top priorities. The findings from the additional research carried out in May indicated that customers remained of the view that metering is the fairest way of charging, but that customers should have the choice of moving to metered charges rather than this being imposed on them. SBW has therefore revised its metering strategy to reflect customers' views from this latest research. The Company proposes to continue its current metering policy of installing meters at customers' request and upon change of occupier, but will offer those customers who are selectively metered the opportunity to revert to rateable value charging within 12 months of the metering being installed. The CEPF is satisfied that SBW has revised its metering strategy to reflect customers' views and is supportive of the Company's proposals.

SBW's additional research also asked for customers' views on whether they think the additional cost of being served by a small company represents value for money. Indicative findings from this research showed that 46 of the 48 participants felt that £1.30 offered good value for money for dealing with a small water company.

Members of the CEPF with a statutory remit, the Drinking Water Inspectorate, Natural England and the Environment Agency provided statements in December 2013 supporting the view that there was no inconsistency between SBW's Business Plan and its fundamental duty to meet its statutory obligations. The CEPF is satisfied that SBW's updated Business Plan continues to meet the required statutory obligations.

The CEPF considers that the additional explanatory documents produced by the Company are comprehensive, clear and relevant and that the conclusions of the relevant supporting documentation have been satisfactorily included in SBW's amended Business Plan. Detailed review and challenge of these - and the changes made as a result of these challenges - leads the CEPF to consider that SBW has satisfactorily answered the issues raised by Ofwat.

It was noted that the previous CEPF report had supported the Company's Business Plan submitted in December 2013. SBW's revised plan is now more beneficial to customers than

in December as it proposes further reductions in bills and remains affordable to most customers. The CEPF is of the view that SBW has satisfactorily responded to Ofwat's feedback and is therefore supportive of SBW's revised Business Plan.

These conclusions are supported by all CEPF members.