

Customer Engagement Planning Forum

Independent Chair: Charles Howeson
 Independent Deputy Chair: Philip Warr



MINUTES OF CUSTOMER ENGAGEMENT PLANNING FORUM MEETING HELD ON THURSDAY 18 SEPTEMBER 2014 AT 10.30am AT LONGHAM LAKES

PRESENT: Charles Howeson (Chair) – CH
 Roger Harrington (SBW) – RH
 Tracey Legg (SBW) –TKL
 Alan Logan (SBW) - AL
 Lindsay Cass (Christchurch & East Dorset BC)-LC
 Gillian Mayhew (CCWater)-GM
 Doug Kite DK (Natural England)
 Mike Holmes (Borough of Bournemouth) -MH
 Stephen Burrows (Environment Agency) - SB
 Ed Vidler (CCWater) - EV

APOLOGIES: Jacky Atkinson (Drinking Water Inspectorate) - JA
 Jonathan Holyhead (Dorset Blind Association) - JH
 Philip Warr (Deputy Chair) – PW
 Caroline Coleman (CCWater) - CC

Welcome and apologies	Action
Apologies were received from Jacky Atkinson, Caroline Coleman, Philip Warr and Jonathan Holyhead.	
Chairman’s introduction	
<p>CH gave an overview of the situation to date including discussions with Ofwat.</p> <p>CH CONFIRMED that the CCG had challenged SBW along the way of the business plan development and were satisfied and happy with the end plan, and with bill and investment levels. The CEPF’s report reflected this.</p> <p>CH felt that SBW’s plan had received good recognition in the draft determination (DD), for example the CEPF had recommended a small company premium and SBW received one, along with Portsmouth Water.</p> <p>CH felt that SBW has some relatively minor issues to address, they are not as large as other companies'. With fine-tuning and educated push-back on some issues SBW was in a good place.</p> <p>CH advised that during the meeting the <u>CCWater</u> research sub group would ask questions on behalf of the CEPF to challenge the company on behalf of customers. Questions would be directed to RH as MD and the CEPF needed to understand how SBW will respond. The CEPF’s perceived impact to customers will depend on the company’s response.</p> <p>Looking <u>aheadforward</u> to 3 October (10am) when SBW must put its</p>	

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<p>representation CH proposed that the CEPF will comment on SBW's representation paper rather than putting its own report in. Areas where the CEPF would focus its own representation comments will depend on SBW's responses to its queries.</p> <p>RH commented that timing is very tight but SBW is expects to have its representation finalised by end of September, subject to final loose ends such as the research results which will not be available until then and which will need to be fitted in to the document. CH requested that the CEPF have sight of the SBW representation the week before that and suggested that the CEPF will aim for a 24 hour turnaround.</p> <p>LC confirmed with the Chairman what Ofwat's expectations of the CEPF are. CH confirmed for assurance and that the onus was felt to be on ensuring that customers are still being well represented and considered.</p>	
<p>Paper 1 – overview of the DD</p>	
<p>CH asked RH to provide SBW's view of the DD. The key points were:</p> <p>On first read somewhat disappointing.</p> <p>Main concern is an over-reliance on econometric models.</p> <p>It has been difficult to understand and reconcile some of Ofwat's numbers, despite the transparency and it has taken a good couple of weeks.</p> <p>The wholesale cost gap isn't a million miles away from Ofwat and at the lower end of companies' gaps.</p> <p>Retail is harsher, particularly the impact of input price pressures.</p> <p>Fawley - got much of what we asked for.</p> <p>SBW are considering a number of smaller push backs/responses:</p> <ul style="list-style-type: none">• Disappointed at the stance on occupier change metering, which was not funded. SBW has been working hard with customers and felt it was getting there with change of culture towards metering. It has also driven changes in demand.• Not funding the National Environment Programme needs to be pushed back on.• Not funding cost pressures in retail, although Ofwat was complimentary of SBW's work. SBW is now doing more work on benchmarking outside the sector.• SBW is pleased at the cost of debt allowance. Ofwat acknowledged SBW's contribution to the industry but requires more research which has commenced.• Some Outcomes and ODIs have been normalised across the industry; SBW is reasonably comfortable with these.• Ofwat have asked the whole industry to consider the length of NHH price controls and to consult the CEPF and customers on its plans and tariff structure. SBW is minded to have a reopener after 2 years to allow a couple of years to work on the detail before 2017 but there is a question over whether Ofwat may require companies to have shorter control periods.	

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<p>GM agreed that it is a difficult call to consult customers. EV agreed that as a minimum SBW should consult the CEPF. It was AGREED that SBW will consult PW separately as a NHH customer.</p> <ul style="list-style-type: none">Ofwat challenged SBW on its gainshare proposals. RH confirmed that SBW propose a transparent process whereby audited data on turnover, opex, capex, financing costs and equity returns plus service performance are submitted to the Customer View group so that it can challenge on whether SBW is earning too much. RH commented that it was not something that an equation could be written on. The CEPF AGREED. RIH committed to data being in the public domain, including minutes of the discussions. CH commented to say RH's undertaking is a very welcome and enormous level of commitment for a private public sector company. <p>Chairman commented again on the gainshare proposals and reiterated that the level of transparency would not call for a formulaic approach. RH agreed that if, for example, tax advice is needed then independent experts can be brought in.</p> <ul style="list-style-type: none">Ofwat has reduced SBW's PAYG ratio from 80% to 75%. RH explained that it will change the timing of income it to long term value of the company. In fact value of company may benefit the shareholder in the longer term. RH explained that it is challenging explaining this to the shareholder. SBW will ask customers what their preference is to see whether there is an appetite to push back, but RH stated that he was unsure whether customers will want to take the longer term view.RH responded to the Chairman's question that the greatest pushback is retail costs. GM asked whether SBW had looked at YW's determination. RH confirmed that SBW has engaged the consultants that advised YW.EV challenged that RH had not mentioned the Cost of Debt and resulting cost of capital. RH confirmed Ofwat set WACC at 3.85% and SBW received 15 basis points uplift. However there are conflicting views from commentators whether the cost of capital will be squeezed further.LC queried the level of bill drop reflected on p 4 of SBW's document. RIH confirmed at first sight it was very alarming but that over half is due to the PAYG ratio, which will defer returns but add £8m to the RCV. SBW do not feel it will impact financeability. <p>CH commented that THE CEPF SUPPORTED THE 80% as it did end up with 'very predictable' bills for the 10 years. CEPF felt that the approach to smoothing over 10 years via PAYG ratio was innovative.</p> <p>RIH confirmed that that bill stability was the aim and SBW had proposed 80% PAYG because of the CEPF support and customers' preference for smooth bill profiles. CH commented that he noted the bill rises in 2020 with a 75% ratio.</p> <p>SBW will bring this argument back to Ofwat but will be transparent with the research results. CH suspected that customers will want the lower bill value (ie the lower PAYG ratio) but SBW and the CEPF will have to live with the circumstances.</p> <ul style="list-style-type: none">SB asked about Ofwat not supporting leakage. RIH explained that the modelling supported 30% and that the rest was below the 0.5% materiality threshold. RIH wants to pursue the performance commitment target but commented that it will be hard to find the cost reductions needed to do so.	SBW
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<p>GM raised concerns about potential slippage on other areas customer service and outcomes delivery as a result of companies not being funded for performance commitments and the introduction of additional penalties. GM voiced concern that customers' stated priorities may not be fully delivered if a company needs to reprioritise to avoid penalties.</p> <p>RH confirmed that SBW is already looking where to avoid future costs but will avoid compromising service. The one performance commitment SBW will not be able to deliver is meter installations. SBW is happy to commit to a number, but just not what is currently in the DD. Only this PC and the one for per capita consumption reduction (which is linked to metering numbers) will be challenged.</p> <p>CCWater raised its query numbers 2, 4, 6, 7, 8 and 10 (the original 11 queries having been split across the relevant SBW supporting papers). CCWater agreed with this approach and complimented SBW on the clear presentation of the papers and relevant questions.</p> <p>It was AGREED that where there was an impact on customers as a result of SBW's responses and the areas of the DD it intended to challenge the CEPF would comment in its response. SBW would record this in the minutes of the meeting.</p> <p>EV queried whether SBW agreed with the average bill calculations on page 4 of the SBW-specific document. Could SBW replicate it? TKL replied not yet, SBW were still working on it but there was some question over whether Ofwat had double-deflated SBW's numbers as SBW were under the impression they had deflated 13/14 data to 12/13, but following a query on the calculation methodology Ofwat stated that they had delated the data. CH queried whether there was an impact on customers. TKL replied possibly but it is unclear if there was a link between this calculation and the one for actual revenues. AGREED: SBW needs to follow the query up again with Ofwat before the representation.</p> <p>CCWater queriesCCWater challenge</p>	<p>SBW</p> <p>SBW</p>								
<table border="1"> <thead> <tr> <th style="width: 15%;">CCWater query number</th> <th></th> </tr> </thead> <tbody> <tr> <td>2</td> <td>Is SBW currently in a position to provide an indication of the impact of its menu choice on customers' bills and how this compares with the indicative average customers' bills for 2015-20 provided by Ofwat in your Draft Determination?</td> </tr> <tr> <td>Response</td> <td>This item was not discussed at the meeting but we are currently unclear how the menu choice will work in practice so are not in a position to respond to the query.</td> </tr> <tr> <td>4</td> <td>SBW proposed wholesale water totex of £136.4m which is £4.6m (3%) above Ofwat's DD threshold of £131.9m. Ofwat conducted deep dive assessments in 5 areas of your wholesale costs. In the case of meter installations and the NEP catchment management expenditure Ofwat felt that SBW had not provided sufficient evidence that the costs proposed for these schemes were efficient. [Ofwat failed the selective metering proposals based on inadequate CBA and</td> </tr> </tbody> </table>	CCWater query number		2	Is SBW currently in a position to provide an indication of the impact of its menu choice on customers' bills and how this compares with the indicative average customers' bills for 2015-20 provided by Ofwat in your Draft Determination?	Response	This item was not discussed at the meeting but we are currently unclear how the menu choice will work in practice so are not in a position to respond to the query.	4	SBW proposed wholesale water totex of £136.4m which is £4.6m (3%) above Ofwat's DD threshold of £131.9m. Ofwat conducted deep dive assessments in 5 areas of your wholesale costs. In the case of meter installations and the NEP catchment management expenditure Ofwat felt that SBW had not provided sufficient evidence that the costs proposed for these schemes were efficient. [Ofwat failed the selective metering proposals based on inadequate CBA and	
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	<p>no evidence that the proposed costs are efficient]. Ofwat also did not allow the amount sought for Fawley in full. Ofwat has allowed £2.6m – we note SBW requested an adjustment of £3.2m in its resubmission.</p> <p>Is SBW confident that the costs allowed for Fawley in particular will be sufficient or will it be challenging Ofwat's DD assessment?</p> <p>If so, what further convincing evidence will SBW provide in support of the amount sought, when considering the separate meeting you had with Ofwat and your consultants Oxera and the new evidence of costs against Ofwat's modelling provided in your resubmission based on Oxera's view?</p>	
<p><u>Response</u></p>	<p>Due to Ofwat's commitment to its models SBW is not minded to challenge the Fawley determination. EV challenged whether SBW will push back but RH thinks that probably not other than making comment. AGREED that no customer impact on this one so no further CEPF involvement.</p> <p>SBW will make representation against the NEP determination which passed on CBA but failed on need and robustness of cost. SBW has queried this with Ofwat and obtained more information. SBW has engaged a consultant to look at how atypical the work is, and whether the cost proposed is upper quartile. It was AGREED that TKL will provide SB with the comments extracted from the cost assessment model and with the name of the consults being used.</p> <p>DK ran through his understanding of how the NEP work will interact with Natural England. NE will fund the catchment officer on the Stour, which is an atypical approach that will sometimes require SBW to deliver objectives for NE that do not necessarily correlate with NE's. Because NE are hosting they expect a percentage of the work being focused on NE priorities rather than SBW's which will result in an equalised cost ratio because of the NE priorities. DK confirmed that it is not currently known what the ratio of priorities is as it has yet to be worked up. It was AGREED that SBW will follow up with its WQ team after the meeting to confirm the understanding that the role will be merged.</p> <p>SB asked why the DWI were not involved in supporting the work and SBW confirmed that as a formal Notice would be involved that remove some of the flexibility the NEP route provides this was not a preferential option.</p> <p>It was AGREED that there was not direct customer impact and so the CEPF as a group would not follow it up. SBW will communicate directly with the EA and NE.</p>	<p><u>SBW</u></p> <p>SBW</p> <p>SBW</p>
<p>6</p>	<p>Ofwat has set an aggregate cap and collar on outcomes at +/- 2% of RoRE a year with a cap and collar calculated over a term of five years. Does Ofwat's aggregated cap and collar affect SBW's RoRE range as a whole and the delivery of</p>	

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	your performance commitments?
Response	<p>EV queried the cap and collar impact of the outcome delivery incentives and what the impact of the changes will be. AL confirmed that SBW are not too concerned at the implication and that SBW is fairly confident <u>that it will not have a significant effect</u>.</p> <p>EV queried whether it would inhibit or change what SBW do but AL confirmed that the targets are within its capabilities to deliver.</p>
7	<p>Ofwat has rejected SBW's claim for an ACTS adjustment of £2.7m for the input price pressure. SBW has provided convincing evidence of wages relative to companies outside of the water industry but did not provide sufficient efficiency benchmarking evidence in other areas. Ofwat is also of the view that SBW is not upper quartile efficient within the water household retail so consider that SBW is not affected in a materially different way to other companies.</p> <p>Will SBW be providing further evidence to support its claim for an adjustment for input price pressure?</p>
Response	<p>GM commented that SBW's paper <u>1 and the discussion with the CEPF</u> had answered CCW's questions and that the answer is clear that SBW are conducting more work and pushing back.</p> <p><u>RH stated that</u> the main concern is inflation as SBW will be going from 2012/13 to 2019/20 with no reflection of indexation. SBW is not necessarily looking across the entire cost base, just where SBW has no influence, for example post.</p> <p>GM queried the IPP on bad debts. RH confirmed that SBW had not applied for bad debts per se, <u>only</u> the indexation in on bad debt. In real terms SBW commits to keeping debt flat.</p> <p>EV queried the approach of looking at certain areas and felt that would be preferable to go down a efficiency challenge route rather than Ofwat examining elements of cost in the minutiae. RH half-agreed as all companies can get more efficient, but that there are some costs that will increase though not necessarily by RPI, and others may not. CH queried of LC and MH what local government does and how it can be possible to look 7 years ahead. MH confirmed LG looks only maximum of 4 years ahead, but he and LC confirmed that in that time frame costs can be expected to be absorbed.</p> <p>RH stated that SBW has an additional challenge of staff attrition to other local call centres.</p>
8	<p>Ofwat also rejected SBW's claim of £1.2m for new costs on the basis that the need for the new costs is not justified, the costs have not been shown to be the most cost beneficial means of meeting the need, the costs are not shown to be</p>

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	<p>robust and customer protections is not discussed in relation to new investments.</p> <p>The costs are driven by increased metering costs per customers and increased depreciation. Will SBW be providing further evidence to support its claim for new costs?</p>	
<u>Response</u>	<p>GM asked 'What are the main issues regarding new costs?' RH confirmed that is more to do with the new costs and no indexation and SBW is strengthening the argument. [TKL comment: I don't think I've captured this correctly]</p>	
10	<p>Ofwat has intervened in your non-household retail costs seemingly due to SBW treating costs associated with reducing deficits in its defined benefits pension schemes different to Ofwat's approach. This resulted in your proposals being adjusted from £0.075 million over the control period, to £0.064 million. In total, your proposed costs were adjusted from £1.583m over the control period to £1.572m. Ofwat also noted that from 2013-14 through to 2019-20 SBW is proposing cost reductions of 20%. Ofwat have said that this is significantly greater than the proposed reduction for the household control and as part of your representations Ofwat has asked that you provide a clear explanation as to why you expect much higher cost reductions for your non-household retail activities than your household.</p> <p>Can you also please explain this significant variation to CCWater/the CEPF?</p>	
<u>Response</u>	<p>TKL explained that there £108k of atypical balancing costs arising such as 'living wage' increases in the 2013/14 data, which have not been reflected in the AMP 6 projected costs. This suggests a drop of 21% (£364K to £287K) between 2013/14 and 2019/20. The actual drop between 2014/15 and 2019/20 is 7%. As NHH retail costs are low this represents £22K over the AMP period.</p>	
<p>Paper 2 – cost of debt and bill smoothing – customer research</p>		
<p>EV requested an update on the research stimulus material which TKL provided. NHH research commenced 18 September.</p> <p>GM commented that it seems sensible that SBW has weighted returns on to PAYG as the business plan isn't asset intensive, what is proposed is more representative of the plan.</p> <p>GM described the potential bill impact in the case of the reduced PAYG as 'quite frightening' if there are additional investment requirements in 2020 in addition to the bill spike.</p> <p>GM commented that SBW had already presented that profile in February 2014 in and that the CEPF accepted the profile, but that it wasn't mentioned in</p>		

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the CEPF report.

CCWater challenge**CCWater query**

CCWater query number	
5	<p>Ofwat has allowed a company-specific uplift to the wholesale WACC for SBW (&PRT) of 15 basis percentage points for cost of debt against the 0.19 percentage points company-specific uplift (0.30% debt uplift) requested in your resubmission. Ofwat was of the view that SBW incur a higher notional cost of capital and there is evidence it is beneficial to customers for SBW to recover these costs. While SBW conducted research to identify customer support for an uplift, Ofwat said that it has identified shortcomings with this research.</p> <p>Therefore, Ofwat asks SBW (&PRT) to engage with its customers "to identify whether customers are content to pay the uplift through bills, taking account of the benefit the uplift generates for themselves and customers more widely as part of their response to the draft determination".</p> <p>With Ofwat's intervention in your PAYG ratio and the lower company-specific uplift allowed to that requested, is SBW confident that its business plan remains financeable and there will be no customer detriment in terms of service delivery?</p>
<u>Response</u>	GM confirmed that RH had answered the questions on financeability that even with the change the company is satisfied it will financeable.

Paper 3 - the length of the NHH price control and the structure of default tariffs

TKL provided background to Ofwat's Information Note IN 14/14 and explained that Ofwat are concerned at the variability in default tariffs and so have invited companies to consider the length of their NHH retail control or whether they would like a 'reopener'. TKL explained the requirements on companies to consult with CCGs and customers.

All NHH customers must go on to a default tariff from April 2015. SBW has been working on its default tariffs since 2012 and is confident in the data, which has been derived from a bottom-up approach to cost allocation. TKL presented SBW's tariffs as they stand and explained the rationale behind them. TKL also presented modelled incidence analysis which show 213 customers >5% worse off in 2013/14 terms ie before the price reduction.

RH commented SBW are happy with the bands and structure but are still fine tuning to avoid incidence impacts >5%. TKL advised that there was an option to use the wholesale tariff as another rebalancer.

TKL explained that while SBW is happy with the work to date it is only now that comparisons with other companies are available and so it is important to ensure that the company is not an outlier in terms and so could be at risk of

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margin squeeze. A reopener or shorter control period to 2017 would give SBW the flexibility to fine-tune its proposals and ensure that its default tariffs complied with all requirements. TKL explained the concept of an average revenue control and that a reopener would allow SBW to redress any imbalances across tariff bands while remaining in the overall set control. SBW was still considering the options but is clear that it would propose this until 2017 only.

SBW asked the CEPF if members:

- felt the proposed tariff structure and tariffs were reasonable
- felt the incidence impact analyses were reasonable
- agreed that a 2-year control or reopener to go to 2017 was appropriate.

EV commented that the tariffs as they stand meet Ofwat's requirements and that a shorter control period is logical.

RH commented that a lot of work has been done to ensure that cost allocations are correct and appropriate, in particular on bad debt across the bands, ~~about~~ which SBW has a lot of data.

GM asked whether SBW is still working with Dr Scott Reid of ICS Consulting and if so could he provide assurance of his work to the CEPF and this could help the CEPF to comment and so meet Ofwat's IN 14/14 criteria.

TKL confirmed that SBW are still working with Scott Reid but pointed out that he would be asked to assure himself. TKL suggested providing the CEPF with Scott Reid's methodology papers to date and would ask for an updated copy for the CEPF.

SBW

TKL pointed out that Halcrow Management Sciences assured the tariff model for the June submission and would also provide that work for the CEPF.

SBW

LC requested data on the 214 customers that would see a >5% increase and how SBW propose to manage the issue.

SBW

It was **AGREED** that in summary:

- the CEPF is content in principle with the proposals but wish to see the requested information before commenting on the representation
- the CEPF agree that 2 years for a control or reopener is appropriate
- the CEPF are supportive of either a shorter control or reopener so long as whichever is selected is in customers' best interest.

CCWater challenge~~CCWater query~~

CCWater query number	
11	Ofwat's Information notice IN 14/14 2014 price review – non-household customers engagement ahead of draft determination representations which sets out some general expectations Ofwat has for the information that companies will include in their representations. This includes evidence that companies have engaged with their customers about the possibility of reopening their non-household retail price control with the next five years. Ofwat states that as a

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	<p>minimum it expects to see evidence that:</p> <ul style="list-style-type: none"> • each company has engaged with its CCG and ideally local non-household customer groups as well on potential options to change the length or form of control, • there is customer support for the structure of its proposed average revenue controls and associated default tariffs, and • revenue levels appear acceptable to those customers. <p>Can SBW please advise how it intends to address and meet Ofwat's minimum expectations</p>
<u>Response</u>	<p>All areas of the query were covered in the discussion and covering papers.</p> <p><u>Actions outstanding on SBW to provide the CEPF with the required data to enable comment and confirmation of support of SBW's approach.</u></p>

Paper 4 – PAYG and bill smoothing

This discussion was conducted in conjunction with the discussion on paper 2. SBW presented the two research stimulus material graphs which illustrate the nominal bill profile over 10 years of a smoothed 75% ratio and SBW's proposed 80% ratio. After providing background information customers will be asked the straight question of which profile they preferred.

CCWater challenge~~CCWater query~~

CCWater query number	
1	<p>In your resubmitted business plan you proposed a PAYG ratio of 80% which Ofwat has adjusted to 75% in your Draft Determination 'as it was not clear that customers supported the approach of having higher bills in 2015-2020 to reduce the risk of price increases in 2020-25'.</p> <p>What is the impact of the 5% reduction in the PAYG ratio on customers' bills in 2015-20 and the impact of the bill profile over the two price control periods? [We note from your resubmitted business plan that you suggested that a PAYG ratio of 75% 'would also create difficulties in the future by increasing bills by 4.0% in 2020 for AMP7, which runs contrary to customers' preference for bill stability'].</p>
<u>Response</u>	<p>It was AGREED that this query was answered in SBW's supporting paper.</p>

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Paper 5 – changes to outcomes and incentives

It was **AGREED** that the supporting paper and general discussion early in the meeting had satisfied CCWater's concerns that SBW does not intend to

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compromise service levels as a result of the changes to ODIs.		
Paper 6 – pain and gainsharing in AMP6		
<p>It was AGREED that this is NOT a painshare in the proposal and customers can only gain from it.</p> <p>It was AGREED that the representation document must reflect that it is only gain.</p> <p>GM challenged whether there would be Board agreement for the proposal as presented to Ofwat in July 2014 and to the fact that it was gainshare only. RH confirmed that the Board had approved the proposal at the August 2014 Board meeting.</p> <p>CCWater challengeCCWater query</p>		SBW
CCWater query number		
3	<p>Ofwat does not accept your proposed pain/gain sharing mechanism as it is concerned that your proposal is not yet sufficiently well specified and that it exposes customer to pain share risk in the 2015-20 period and so does not protect customers' interests.</p> <p>Ofwat states that SBW has only “provided limited detail of the proposed mechanism and it provides for both pain and gain sharing with customers, in contrast to Water Share. We do not consider that the proposed arrangement as currently constructed adequately protects customers”.</p> <p>What improvements/further detail will SBW be providing to the CEPF and Ofwat to demonstrate and give confidence that your pain/gain sharing mechanism will be designed to protect customers?</p>	
	<p>It was AGREED that this query was answered in SBW's supporting paper and in the subsequent discussion.</p>	
Chairman's closing remarks		
<p>It was AGREED that the draft representation paper will be circulated out to the CEPF by the end of next week (26 September). It was further AGREED that the CEPF will accept the representation within 24 hours.</p> <p>It was AGREED that SBW's Board will receive the minutes and challenges to fully inform them in their considerations on representation.</p> <p>It was AGREED that CH will use the minutes of this meeting as agreed to form the CEPF commentary on SBW's representation.</p> <p>The meeting closed at 12.38pm.</p>		

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