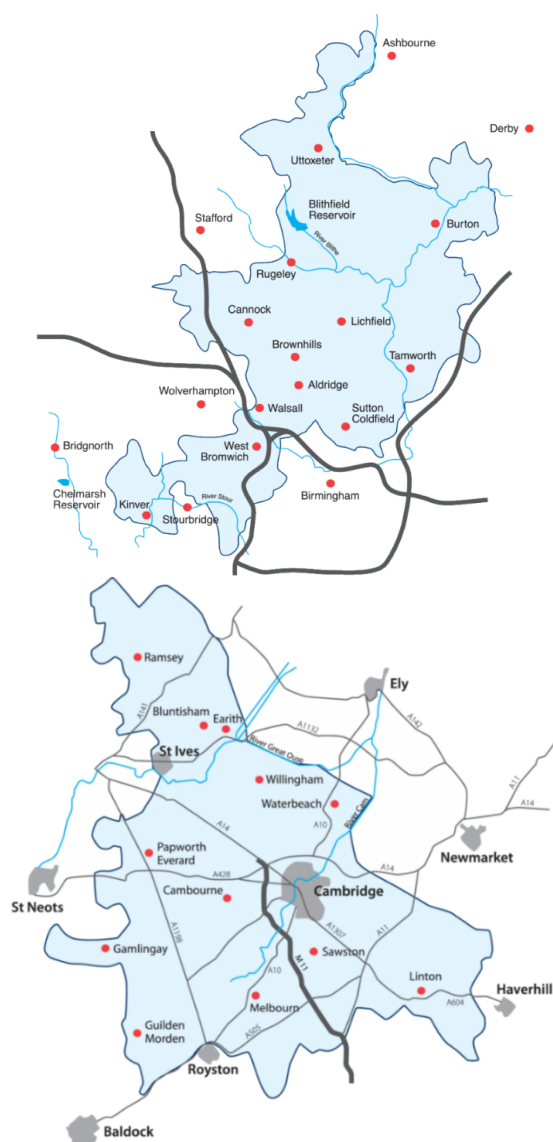


SOUTH STAFFORDSHIRE AND CAMBRIDGE WATER CUSTOMER PANEL

INDEPENDENT REPORT TO OFWAT

to accompany the amended PR19 Business Plan of South Staffs
Water (SSC)



1 April 2019

SOUTH STAFFORDSHIRE AND CAMBRIDGE WATER CUSTOMER PANEL

INDEPENDENT REPORT TO OFWAT

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SOUTH STAFFORDSHIRE AND CAMBRIDGE WATER CUSTOMER PANEL

INDEPENDENT REPORT TO OFWAT

1 INTRODUCTION

1.1 Purpose of this Report

This document is the Panel's Report to the regulator Ofwat, and offers independent assurance on issues related to customer engagement in the Company's response to Ofwat's Initial Assessment of its PR19 Business Plan.

1.2 The Company

South Staffordshire PLC acquired Cambridge Water in 2011 and, after clearance by the Competition Commission, merged South Staffs Water and Cambridge Water into a single company. The Company has operated under a unified license from Ofwat since 1 April 2013. In this report the merged water company is referred to as 'the Company'. We also use the three letter codes that Ofwat apply to each water company; in our case these are SSC for the operations of the whole company in both areas, SSW for the South Staffs area of operations, and CAM for the Cambridge area of operations.

1.3 The Panel

Every water company in England and Wales is required to set up a Customer Challenge Group or CCG, with the task of giving independent assurance to Ofwat on the quality of the company's customer engagement, and the degree to which the company's Business Plan reflects customer priorities. The Customer Panel which produced this report is the CCG for South Staffordshire and Cambridge Water. The Panel's make-up, method of working, and independence are all described in Section 3 of our Independent Report to Ofwat dated 3 September 2018.

1.4 The PR19 process

The Panel's September 2018 report accompanied the Company's proposed Business Plan and pricing proposals for 2020 to 2024 (the period known in the water sector as AMP7). On 31 January Ofwat published the results of its Initial Assessment of Plans (IAP) and gave companies until 1 April 2019 to respond. CCGs have been asked to submit their independent report on the re-submission by the same deadline. Draft determinations will follow in July 2019 and final determinations in mid-December.

1.5 Reference documents

The Company's PR19 Business Plan submitted on 3 September 2018 is here: <https://www.south-staffs-water.co.uk/about-us/our-strategies-and-plans/business-plan-2020-2025>.

The Panel's Independent Report which accompanied that Plan is here: <https://www.customer-panel.co.uk/media/1047/panel-report-final.pdf>.

Ofwat's IAP is here: <https://www.ofwat.gov.uk/wp-content/uploads/2019/01/PR19-initial-assessment-of-plans-South-Staffs-Water-company-categorisation-FINAL.pdf>

2 OFWAT'S IAP

2.1 The Company's rating

SSC was awarded slow track status, along with most companies. The 17 business plans were rated from A to D in each of 9 test areas. Of the resulting 153 ratings, only 3 were awarded A. SSC scored two B ratings, for engaging customers and for past delivery. In one test area (securing long-term resilience) the Company was rated D; the remaining 6 areas were rated C. There is no indication that the Regulator applied proportionality in its assessment of WOCs as compared with the much larger Water and Sewerage Companies (WASCs).

2.2 Actions List

The Appendix to this report summarizes the 93 actions that Ofwat have asked the Company to undertake in response to the Initial Assessment of its Business Plan. Many of them relate to methodology or the need for better explanation or more evidence. The largest group (57 actions) relate to performance commitments and Outcome Delivery Incentives (ODIs). Six relate to resilience. The regulator is seeking a reduction in TOTEX of £80m.

3 SCOPE OF THIS REPORT

3.1 Ofwat's expectation

At the quarterly workshop for CCG Chairs with Ofwat on 13 February 2019, CCG Chairs sought clarification of the Regulator's expectations of both water companies and CCGs in the short time allowed for response to the IAPs. Ofwat has invited CCGs to submit "a short and focused report covering any aspects of the company business plan re-submission that require comment on the quality and influence of related customer engagement".

3.2 The Panel's approach

The Panel met on Monday 25 February to consider the Company's reaction to the IAP and the process that the Company would use to prepare its re-submission, as well as to decide the Panel's role. Whilst recognizing that the whole Business Plan affects customers in the short or long term, the Panel has restricted its consideration to actions related to (a) the additional customer research (dealt with in section 4 below), (b) promises made to customers in the form of performance commitments or ODIs and (c) issues that affect customer bills. Against those criteria, the Panel has considered the following test areas as outside its remit:

- securing long-term resilience
- cost efficiency (apart from CE.A2 - see section 7.1 below)
- controls, markets and innovation (for which actions are not required until July 2019)
- aligning risk and return (given that action RR.A7 about bill profiles is covered by action AV.A2 - see 5.1 below)
- accounting for past delivery
- confidence and assurance (apart from CA.A1 on gearing policy – see 7.2 below)

4 FOLLOW-UP CUSTOMER RESEARCH

4.1 The project

A number of the challenges in Ofwat's IAP ask for more evidence of customer preference. The Company therefore contracted with Accent to carry out fast-track research aimed at the following objectives: to test acceptability and affordability of the plan so as to provide a benchmark against 2018 research results; to retest customer preference for bill profile at different levels of transition between AMP7 and AMP8; to measure the acceptability to customers of the RORE range proposed in the Business Plan for ODI incentives; to test customer support for in-period price rises caused by over-performance and; to test support for putting collars or caps on incentive payments for selected ODIs. The Company has also taken associated advice from Paul Metcalfe of PJM on the reconciliation of the RORE range for the incentive package with the willingness to pay research. The methodology of the research project is described fully in the Company's re-submission

4.2 Challenge and response

The Panel challenged the rationale for this additional research, given the scope and cost of the original customer engagement, the fact that its quality had been commended in the IAP, and the shortage of time now available, which would jeopardise the chance of adopting best practice. The Panel was sceptical about the value of asking the same questions again and about the reliability of asking supplementary questions of people who had not gone through the same journey of engagement as participants in the original programme. The Company felt that more research was a necessary response to the IAP and was confident that the follow-up research would be robust. To test for consistency between the follow-up and the original surveys, an anchor question would be included in both. The Company followed up the meeting with an email dated 26 February to the Chairman of the Panel, addressing these concerns.

4.3 Panel involvement

Panel representatives critiqued the draft questionnaire for the targeted 800 household customers. Detailed response was given by the Company, who took on board most of the Panel's suggestions, along with learnings from six cognitive interviews undertaken with customers to test understanding of the questionnaire. On 19 March the Panel took part in a de-brief by the research agency on the resulting final quantitative data. We challenged in particular the interpretation put upon customer preferences between different models of pricing over the ten years of AMPs 7 and 8. The Company undertook to revise the presentation of results.

4.4 Main findings

The headline results are as follows:

- satisfaction, trust and value for money scores remained high
- acceptability of core promises in the business plan was high, and in line with 2018 values
- acceptability of bill impact was also high, though lower than in 2018 as a result of fewer finding the plan "very acceptable" and more choosing neutral options
- preference for a flat bill in AMP7 remained strong, though when shown a transitional increase of £4 or more across two AMPs, a majority favoured smoothing the increase over the whole period
- customers objected to a penalty collar being less than a reward cap. Those not supporting the proposed rewards based their objection on opposition to the principal of ODIs.

5 AFFORDABILITY AND VULNERABILITY

5.1 Bill profile

A significant part of the follow-up research was aimed at addressing Ofwat's challenge that the Company had not gone with the customers' first preference for bill profile. The re-submission corrects this, and the follow-up research was critical in identifying at what level of uplift between AMP7 and AMP8 the preference for a flat bill in the first AMP was over-taken by a preference for smoothing over both periods. The research shows that transitional increases over £3 produce successively more support for smoothing across the two AMPs. The strongest support in both lots of research was registered for a flat bill in AMP7 and the Company is respecting that by committing to make corporate financial interventions if necessary to restrict the inter-AMP increase to no more than £3. The combined acceptability score across the original and follow-up research is 81%, above the CCW threshold; the combined affordability score is 73%.

5.2 Cross subsidy

Ofwat has perceived a lack of clarity about the current position on the level of cross subsidy that is in place from 2019/2020 and the Company's commitment to carry out further stand-alone social tariff research. As part of the retail research undertaken in 2018, questions were asked about customer support for increasing the current £1.50 cross subsidy to various amounts ranging from £2 to £5. Over half of the customers surveyed (53%) expressed support for £4, but the Consumer Council for Water (CCW) does not consider this as sufficient evidence of broad support as stipulated in Defra's formal guidance. 61% of customers surveyed supported an increase of £3, and this was approved CCW for implementation from April 2019. However CCW indicated it would have preferred the social tariff research to have been stand-alone research rather than part of wider PR19 engagement. To meet that need, the company has agreed to carry out new, stand-alone research during 2019.

5.3 Social Tariff

The company has fully involved the Vulnerability Sub-Group of the Customer Panel at all stages of its decision making about rolling out its social tariff. Annual and monthly targets have been consistently met, to the extent that all the monies available were allocated by April 2018 and many eligible customers have not been assisted in the last 12 months. The Panel Sub-Group has helped the Company to review the eligibility criteria, which have been changed so as to be fairer to families with children and so as to reach more households by introducing two steps in the level of discount. The imminent increase in cross subsidy from April 2019 will enable more customers to get help, but unless further increases are secured the Company will be unable to support all the estimated 42,500 customers who are eligible for support, and it is unlikely the Company will be able to achieve a stretched performance commitment. The forthcoming stand-alone research will establish whether there is customer support for a further increase in the cross subsidy to be implemented in April 2020.

5.4 Priority Services Register

For the last three years the company has been working with the Panel on developing and implementing a policy to improve its assistance to vulnerable customers, including those needing financial assistance. The research undertaken has been carefully structured to include hard to reach and vulnerable customers with a range of different circumstances. The revised performance commitments on PSR and financial assistance now distinguish between financial and non-financial assistance.

6 DELIVERING OUTCOMES

6.1 The incentives package

6.1.1 RORE range

In section 13.4 of our report to Ofwat dated 3 September 2018, we summarized the difficulties faced by the Company in trying to bring its incentives package into the RORE range expected by Ofwat. Ofwat's subsequent agreement to drop the Monte Carlo analysis has helped the Company hit the RORE range and the Company has now removed the scaling and balancing factors which were challenged in the IAP. However the resulting package is now skewed towards penalties, which is at odds with customer preference for symmetry, as confirmed by the follow-up research. Once again the Panel is of the view given in our September report, that "the Company has done its best to comply with a flawed system".

6.1.2 End-of-period payments

The IAP challenged the Company's proposals for end-of-period payments. The follow-up research reinforces the evidence that customers prefer end-of-period adjustments, even after the alleged benefits of in-period payment have been explained to them. The Panel supports the Company's compliance with customer preference on this matter. The Panel is not the only CCG to have challenged Ofwat's preference for in-period payments. We believe the regulator's role should be to protect customers against in-period price rises, not to impose them.

6.1.3 Level of stretch

With regard to the level of stretch in the Company's performance commitments (PCs), the Panel commended the Company in its September report for aiming at Upper Quartile performance in all measures. There are no cases in the re-submission where outcomes are reduced, and several where they have increased. In cases where the IAP called for evidence of customer support, the Company has responded in one of two ways: either by providing more evidence from the research done last year, or by addressing specific questions to customers in the follow-up research summarized in section 4 above. In one case, the IAP reflected a challenge already made by the Panel, about an apparently easy target set for education liaison. In its re-submission the Company explains that the number of pupils reached is not a fair measure in view of the depth of school engagement in the SSC programme.

6.2 Actions related to specific ODIs

To challenge the development of the original PR19 business plan, the Panel set up a working group to challenge the detail of targets, rewards and penalties. In the minimal time allowed for re-submission it has not been possible for the Panel to consider the over 50 actions related to ODIs that the Company was required to address. However, we see no cause to challenge the addition of a specific commitment about the **PSR**. Regarding the **Value for Money** ODI, the Company has committed to boosting the sample size of its quarterly tracker from 2019/20 and will be using an independent agency in line with best practice. We support the Company's adoption of a **separate performance commitment for trust** in addition to C-MeX. We doubt the value of the Net Promoter Score for a monopoly supply on which C-MeX depends; we favour the ability to compare SSC's trust score with CCW's industry-wide surveys and UKCSI's cross-sectoral benchmarking.

7 OTHER REQUIREMENTS

7.1 Environmental protection

The Panel has challenged the omission of a commitment to fund amber schemes in **WINEP** (the Water Industry National Environment Programme), mentioned in the IAP Action Log as CE.A2. We understand the Company is in discussion with the Environment Agency about this but as things stand it is not clear how the obligation to deliver these will be satisfied.

On a separate issue, the follow-up research tested customer support for the **ODI on protecting wildlife, trees etc.** The result was that 78% view the target as stretching and 71% support customers being charged up to 17p per annum in the event of out-performance.

7.2 Company gearing

The Company is urged in the IAP to set out its proposal for sharing with customers the benefits of gearing in excess of 70% (action CA.A1). The Panel understands that the Company will demonstrate to the regulator in its re-submission that gearing will not exceed 70% during the plan period. In the Panel's view, should sharing become necessary, the method should be subject to research into customer preference,

8 PANEL ASSURANCE

8.1 Customer engagement

In our independent report to Ofwat of September 2018 we commended the Company for a step change in customer engagement in terms of scope, professionalism and expenditure, for their encouragement of Panel involvement, and for their diligent response to challenge. We welcome Ofwat's recognition in the IAP of the quality of the Company's customer engagement. No actions were required of the Company in that test area.

Customer engagement has become business as usual. Even while its PR19 re-submission was being prepared, the Company has progressed improvements to its quarterly customer service tracker, started work to set up a Young Innovators Panel in CAM and to develop an online customer community, adopted a new bill design following co-creation with customers, trialed a new APP, researched customer views on nationalisation and legitimacy, and begun new research into improving customer experience at the point of contact with the Company.

8.2 Reservations

Given the quality and cost of the original research, the Panel doubts the effectiveness of Ofwat's pressure on companies to carry out more customer research in such an unrealistic time-scale as is allowed for their re-submission. Also we continue to question the validity of seeking customer preferences for the minutiae of an incentive regime which is complex, far from the customer's experience, and for which they express little support.

8.3 The research project

Despite these reservations, the Panel respects the Company's wish to produce more evidence as required by the IAP. The Company mitigated the Panel's concerns noted in 4.2 above by subjecting the new data to triangulation with the original research findings and with the insights of other companies regarding bill profiles.

8.3 Panel engagement

The time-scale precluded the thorough process of review, challenge and response which the Panel developed with the Company in the lead-up to its original business plan. Nevertheless the Panel was involved at key stages of the project and was able to challenge the interpretation of results. The Company has been diligent in responding to every challenge.

8.4 Conclusion

The Panel's September 2018 report makes clear the substantial moves the Company has made to put the customer at the heart of, not only the business plan, but the business itself. We are aware of nothing in the re-submission that counteracts that. We consider that the Company has done its best to address areas of challenge in the IAP by carrying out follow-up research which confirms customer support for its proposals on outcomes and price.

PR19 BUSINESS PLAN ACTIONS ARISING FROM THE IAP

Ofwat test area	Ofwat comments	Action ref (required or advised)	Action description (summary)
Customer engagement	"...no extensive evidence of ongoing engagement with customers prior to May 2017."	No actions	n/a
Addressing affordability and vulnerability	"...the company appears to go against customer wishes in its plans. It proposes relatively weak growth in the number of people on its social tariff ... and has not established the level of cross-subsidy to be provided. It also proposes insufficiently ambitious reach for its [PSR] and does not seem to distinguish between financial and non-financial vulnerability."	AV.A1 (required)	Evidence to justify including neutral responses in its reporting of bill support
		AV.A2 (required)	Choose the bill profile that is most acceptable to customers
		AV.A3 (required)	Customer engagement on different levels of social tariff cross-subsidies
		AV.A4 (required)	PSR growth in line with Ofwat's proposed common PC of 7%, along with a commitment to check 90% of PSR every two years
Delivering outcomes for customers	OC.A1 to OC.A5: PCs, ODIs, ODI risk/return package (multiple actions)	OC.A1 (required)	Package-wide scaling factors to reconcile incentives with RORE range
		OC.A2 (required)	Acceptability of ODI package to customers
	"...provides insufficient justification to use end-of-period [ODIs] and has not tested the potential benefits of in-period [ODIs] with customers."	OC.A3 (required)	In-period payments
		OC.A4 (required)	Asset health performance payments

Ofwat test area	Ofwat comments	Action ref (required or advised)	Action description (summary)
		OC.A5 (required)	Caps for out-performance payments
	Questions related to individual ODIs	OC.A6-OC.57 (required)	(multiple actions)
Securing long-term resilience	<p>“The company does not demonstrate its commitment to resilience in the round and provides no evidence to support the financial resilience scenarios [it] says it has assessed in its plan. The company offers little evidence of an integrated and systems-based approach to resilience and does not demonstrate how it quantifies, assesses or prioritises the resilience risks considered in the plan. It does not demonstrate the identification and assessment of risks to resilience is embedded in the oversight and decision-making processes.”</p>	LR.A1 (required)	Operational resilience PCs to be clearly defined, with line of sight between risks to resilience and the package of outcomes
		LR.A2 (required)	Commit to prepare and provide an action plan by 22 Aug on implementing a systems-based approach to resilience in the round
		LR.A3 (required)	Robust asset health metrics to be developed, with more transparency around how asset health indicators influence decision making
		LR.A4 (required)	Financial stress testing
		LR.A5 (required)	Assessment of financial resilience beyond 2025
		LR.A6 (required)	Commit to demonstrating financial resilience beyond 2025 in next long-term viability statement

Ofwat test area	Ofwat comments	Action ref (required or advised)	Action description (summary)
Controls, markets and innovation	"...provides limited information on bilateral markets. It lacks evidence regarding the use of markets for water network plus. ...it does not demonstrate an innovative culture. Its [BAF] falls short of demonstrating the key principles of transparency, equal treatment and proportionality...."	CMI.A1 (required)	Detail in the bid assessment framework on requirements for bidders and the process for providing feedback
Cost efficiency	"The company is not efficient compared to our baselines...."	CE.A1 (required)	Address areas of inefficiency or lack of evidence in revised business plan
		CE.A2 (required)	Exclusion of amber WINEP schemes
		CE.A3 (required)	Impact of the metaldehyde ban
Aligning risk and return	"It fails to demonstrate that its choice of target credit rating on the notional structure is appropriate in the context of its investment programme and funding needs. It fails to demonstrate the consistency of its plan with the proposed target credit rating on its actual structure.... It provides insufficient evidence to support its choice of RCV run-off rates. It does not adequately explain how it reconciles customer support for flat bills during the period 2025-30, with its proposal for flat bills in cash terms during 2020-25 and inflationary costs carried over	RR.A1 (required)	Alter business plan tables to bring WACC in line with Ofwat's early view of 5.47%
		RR.A2 (required)	Revised assessment of revenue risk in RoRE analysis
		RR.A3 (required)	Set out steps taken and assurance obtained by Board to assess the business plan's financeability
		RR.A4 (required)	Notional company credit rating
		RR.A5 (required)	More evidence on financeability of plan on actual structure – particularly around temporary weak financial ratios

Ofwat test area	Ofwat comments	Action ref (required or advised)	Action description (summary)
	into 2025-30. It does not justify its risk and risk mitigation measures in the assessment of RoRE for the notional company and the assumptions of exposure to revenue risk.”	RR.A6 (required)	More evidence to support the calculation of RCV run-off rates and to show they are consistent with the approach set out in the plan
		RR.A7 (required)	More evidence that bill profile is consistent with customers preferences
		RR.B1 (advised)	Clearer link between internal risk management/mitigation and RoRE analysis
Accounting for past delivery	“The company’s plan demonstrates high quality in accounting for past delivery.”	PD.A1–A6 (required)	PR14 reconciliations (multiple actions)
Confidence and assurance	“...the company forecasts gearing of about 70% at the end of the 2020-25 period and proposes a gearing benefits sharing mechanism that offers fewer benefits to customers than our default mechanism. There is insufficient evidence that the company’s dividend policy meets our requirements, in particular, on how dividends will be linked to delivery for customers and how future changes will be communicated to customers and other stakeholders.”	CA.A1 (required)	Gearing benefits sharing, along with evidence to support covenanted gearing
		CA.A2 (required)	Update on steps being taken to ensure dividend policy meets Ofwat’s expectations set out in ‘Putting the sector back in balance’
		CA.A3 (required)	Update on steps being taken to ensure executive pay policy meets Ofwat’s expectations set out in ‘Putting the sector back in balance’
		CA.A4–A7 (required)	Provide a revised financial model and associated data tables, inc. current performance data (2015/20) and actual data for the affordability/vulnerability assessment (multiple actions)

Ofwat test area	Ofwat comments	Action ref (required or advised)	Action description (summary)
		CA.B1 (advised)	Action relating to financial model and associated data tables to address inconsistencies with APR