Customer Challenge Group (CCG) Chairs meeting

Jon Ashley, Chair

Ofwat, 21 Bloomsbury Street, London
16 January 2017

Agenda

Time	Agenda item	Presenter
10.30	Welcome and introductions	Jon Ashley
10.35	WWF'S 'Flushed Away' report	Dani Jordan and Catherine Moncrieff (WWF)
11.00	W2020 Methodology and progress to PR19 (incl. aide memoire)	Jon Ashley
11.50	Break	
12.00	Preparing CCG Reports	Jon Ashley
12.30	'A view from the bridge'	Jonson Cox (Ofwat Chairman)
13.00	Lunch	

WWF Flushed Away report

Dani Jordan

Slides will be provided on the day.

Separate attachment on background information provided in the email.

W2020 Methodology and progress to PR19

Jon Ashley

Our approach for the 2019 price review

PR19 methodology

Sets our approach to PR19 and our expectations and requirements for company business plans

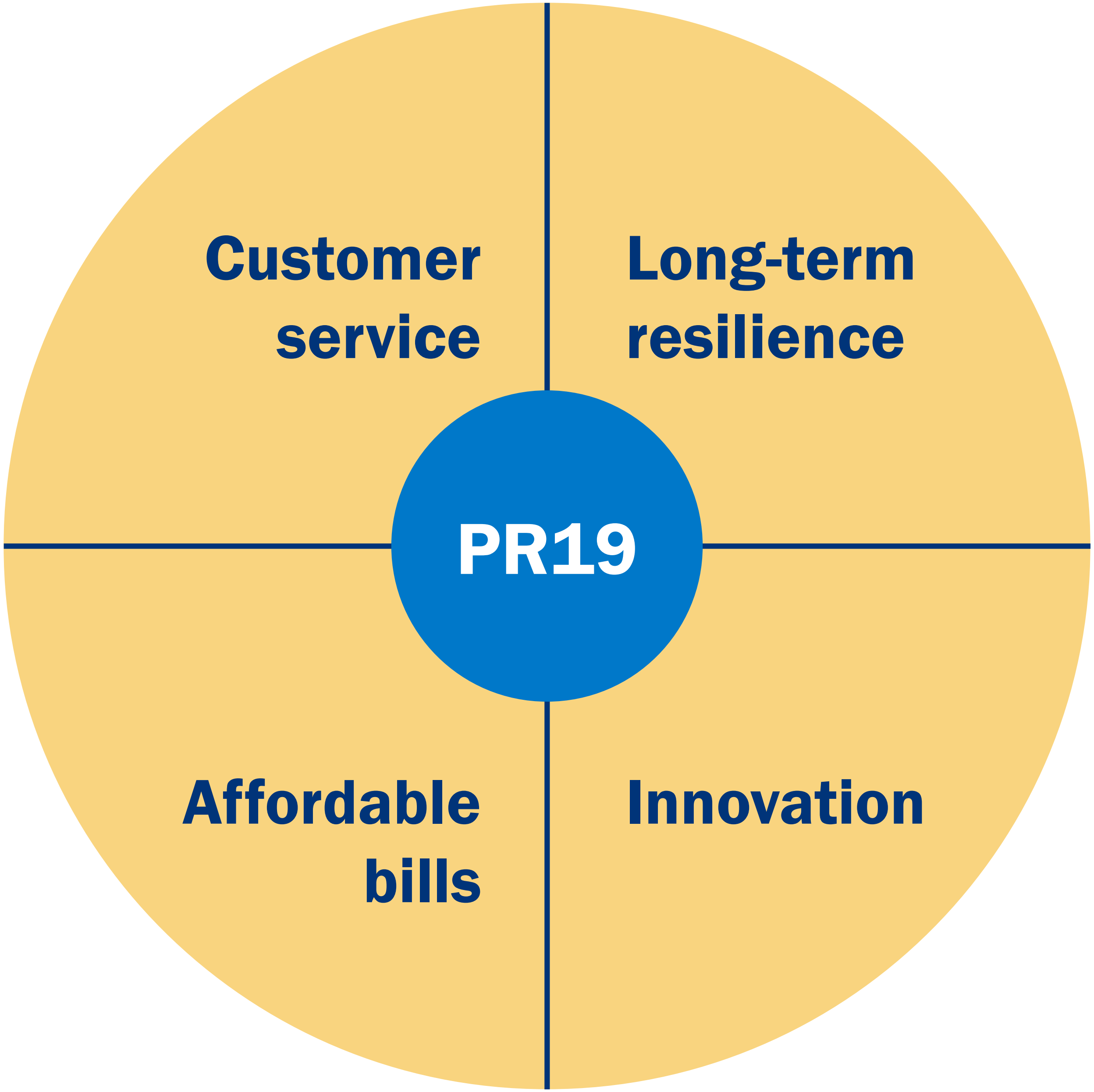
Initial assessment of business plans

Tests company business plans against our expectations and requirements

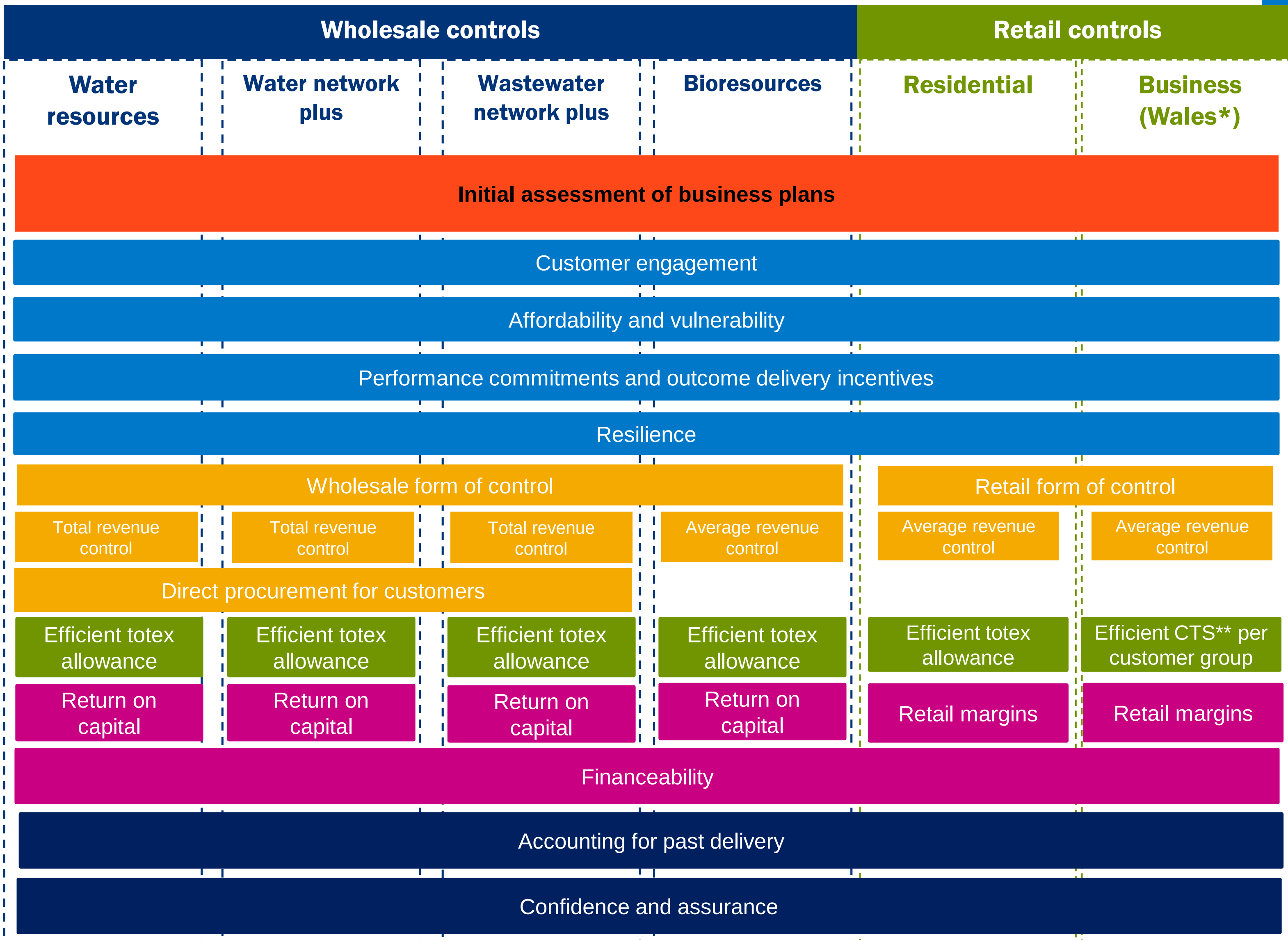
Draft and final determinations

Price, service and incentive package for each company. Based on company business plans, with our interventions to protect customers

Our key themes of PR19 remain the same



The structure of the PR19 final methodology remains the same



* We will set an average revenue control for all business retail customers in Wales and business retail customers of non-exited retailers in England.
** Cost-to-serve

We will continue to categorise business plans into four categories

Business plans

A **high quality** business plan will be efficient, resilient and affordable, and include stretching performance commitments that really deliver for customers.

An **ambitious** business plan will push forward the efficiency and delivery frontier for the sector, setting a new standard for the future.

An **innovative** plan will show capacity and readiness to innovate and reflect a culture that embeds innovation throughout the business.

We will categorise business plans into the following **four** categories:

Exceptional	Fast tracked	Slow tracked	Significant scrutiny
High quality plans with significant ambition and innovation customers that push the boundaries of the industry and set an example for others.	High quality plans with limited intervention required, but not ambitious or innovative enough for exceptional status.	Plans that require a level of material intervention to protect customers – partial resubmission or additional evidence required.	Plans that fall well short of quality required where extensive material intervention is required to protect customers.

Our IAP test will cover 9 test areas

Initial assessment of business plans: test areas	Initial assessment of business plans: key test areas, characteristics, categories and incentives
Engaging customers	Enhanced customer engagement; customer participation; engaging customers on long-term issues including resilience
Addressing affordability and vulnerability	Addressing affordability and vulnerability: affordability for all, now and in the long term, including those struggling to pay and services that are easy to access.
Delivering outcomes for customers	Stretching performance commitments, including new customer experience measures; powerful outcome delivery incentives
Securing long-term resilience	Resilience 'in the round'; clarified principles; focus through business plan tests and outcomes
Targeted controls, markets and innovation	Four separate wholesale revenue controls Encouraging use of markets with clarity on post 2020 investments where markets apply 5 year retail controls for all market segments and measures to address gap sites and voids
	Direct procurement for customers: focus through principles; tendering models
Securing cost efficiencies	Step change in efficiency; Increased efficiency challenge; more symmetric adjustment process; benchmarking with historical and forecast data; cost-sharing incentive; benchmarking retail costs
Aligning risk and return	Increased revenue at risk from service performance and sharper cost sharing incentives; cost of debt indexation; tax pass-through mechanism; increased focus on assessment of risk CPIH as a legitimate measure of inflation
	Financeability
Accounting for past delivery	2015-2020 reconciliation; confidence in business plans
Securing confidence and assurance	Business plan expectations: data and assurance

There are some key changes in the PR19 methodology from the July consultation

Some key changes set out in the following slides:

- **Outcomes**
- **Cost sharing incentive**
- **Balance of risk and return**
- **Early view on the cost of capital**

Other key changes include:

Bioresources: We have modified the average revenue control from the methodology consultation to align incremental changes in revenue with incremental changes in cost, rather average cost as proposed in draft methodology. This will better protect customers by removing incentive to under-forecast volumes.

Retail controls: We'll set five-year price controls (rather than three years) and have encouraged water companies to tackle gap sites and voids.

Confidence and assurance: We've introduced a new IAP test, requiring Board assurance on customers' trust and confidence through transparency and engagement on issues such as its corporate and financial structures.

Customer engagement, outcomes, affordability and vulnerability

We have not changed our approach to **customer engagement** from the methodology consultation.

Companies need to understand their **customers' preferences and priorities** and deliver the outcomes that matter to them over the long term. This includes all customers, including those in circumstances that might make them vulnerable and those that are hard to reach.

Customer challenge groups (CCGs) will provide **independent challenge** to companies and provide **independent assurance** to us on:

- the quality of a company's customer engagement; and
- the degree to which this is reflected in its business plan.

We expect a **step change** in customer engagement at PR19, with companies using a wider range of techniques.

Customer engagement will be central to our IAP at PR19 by **providing essential evidence for companies' proposals** in their business plans, such as their performance commitments to customers.

We are encouraging companies to take forward **customer participation**, to make better **use of data** and work with others to **share data** to drive better outcomes for customers.

Outcomes are the high-level objectives that matter to customers

We still have **14 common performance commitments** covering customer service, asset health and resilience.

We still expect companies to set **stretching performance commitments**, but have revised our approach in relation to the use of comparative information (see right).

Our **challenges for leakage** remain the same (upper quartile, 15% reduction and best achieved by a company in current period).

We still expect **in-period ODIs** as the default.

We are still removing the aggregate cap on ODIs and have an **indicative range of ±1% to ± 3% of RoRE for ODIs.**

We are still encouraging **enhanced outperformance and underperformance payments** for frontier-shifting performance on the common, performance commitments.

We have changed…

- One common performance commitment has changed to 'treatment works compliance' and we have amended three definitions.
- Our approach to setting **stretching** performance commitments. We were expecting companies to achieve upper quartile forecast performance for 2024-25 in 2020-21. We now expect forecast upper quartile performance for each year of the price control.
- Our **terminology**:
  Rewards = outperformance payments
  Penalties = underperformance penalties
- We are commissioning work with Water UK to improve the **consistency in the reporting and the definitions** of the common performance commitments.
- We now expect companies to consider **protections for their customers** if their ODI performance turns out above the top of their expected ODI ranges.

The 14 common performance commitments

1. Customer experience measure
2. Developer services experience measure
3. Water quality compliance
4. Customer water supply interruptions
5. Leakage
6. Per capita consumption
7. Customer property sewer flooding (internal)
8. Wastewater pollution incidents
9. Risk of severe restrictions in a drought
10. Risk of sewer flooding in a storm
11. Asset health: mains bursts
12. Asset health: unplanned outage
13. Asset health: sewer collapses
14. Asset health: treatment works compliance (WASCs only)

Customer experience

Day to day performance

Future performance/resilience

Area of focus

1 to 6 and 9, 11 and 12 apply to WoCs and WaSCs
7, 8 and 10, 13 and 14 apply to WaSCs only

Customer & Developer Services Measures of Experience (C-MeX & D-MeX)

C-MeX and D-MeX are mechanisms to incentivise companies to provide **a better customer experience**. C-MeX replaces SIM **for residential customers.** D-MeX is a new incentive for PR19 applying to **developer services customers** (developers, SLPs and NAVs)

What is the same – C-MeX will:

- Be based on both a customer service and a customer experience survey - each with an equal weighting.
- Include an element of cross sector-comparison and offer higher rewards for strong performance relative to other sectors.

What is the same – D-MeX will:

- Promote better customer service rather than competition in the new connections market (we promote competition in other ways)
- Be based on customer feedback.

What has changed – CMeX:

- Instead of applying a purely reputational incentive on complaints performance, we are adding a 'gate' that switches off the higher C-MeX financial rewards for poor performance on complaints.
- We will pilot the Net Promoter Score (NPS) in the C-MeX survey to test whether it is a better measure of the customer experience than satisfaction.

What has changed– D-MeX:

- We will include a quantitative element in D-MeX, based on a subset of existing Water UK metrics, following feedback from the consultation.

We are not making final decisions on the detailed design of either incentive. Our decisions on the detail will be informed by the pilots and the working groups.

Affordability

Our overall approach to assessing **affordability** remains unchanged from the consultation but we engaged further with stakeholders on the proposed common metrics. We revised the list from consultation to final methodology following feedback received. We reaffirm that we are considering common metrics in the round alongside other qualitative and quantitative information provided by companies.

What has stayed the same – approach to affordability:

We are incentivising companies to develop business plans that address:

- overall affordability – providing value for money
- affordability in the long term
- affordability for those struggling, or at risk of struggling to pay

We will use the following five principles to assess business plans

- good customer engagement;
- good customer support;
- effective approaches;
- efficient approaches; and
- financial assistance options that are accessible

What has changed – revised affordability metrics:

- Percentage of customers finding the level of their bills affordable.
- Percentage of customers finding their bills acceptable.
- Percentage of customers who are in debt and who have a repayment plan.
- Percentage of customers who have a repayment plan and who are continuing to pay.
- Benefits (in £m) of applying affordability assistance measures.
- Costs (in £m) of applying affordability assistance measures.
- Percentage of customers aware of affordability assistance measures.

Our overall approach to assessing **vulnerability** remains unchanged from the consultation but we engaged further with stakeholders on the proposed common metrics. We revised the list from consultation to final methodology following feedback received. We reaffirm that we are considering common metrics in the round alongside other qualitative and quantitative information provided

What has stayed the same – approach to vulnerability:

We will use our 2016 vulnerability focus report as the basis of our assessment on how companies plan to support customers who are in circumstances that make them vulnerable, including:

- how well companies use good-quality available data to understand their customers and identify customers requiring support;
- how well companies engage with other utilities and third parties to identify vulnerability and support those customers; and
- how targeted, efficient and effective companies' approaches to address vulnerability are.

Companies must have at **least one bespoke performance commitment** for addressing vulnerability in their business plans following customer engagement and challenge from their CCGs.

What has changed – revised vulnerability metrics:

- Percentage of customers aware of the non-financial vulnerability assistance measures offered.
- Number of customers on special assistance register / priority service register (SAR/PSR).
- Percentage of customers on SAR/PSR.
- Number of customers receiving the following services through the SAR/PSR:
  - Support with communication;
  - Support with mobility and access restrictions;
  - Support with supply interruption;
  - Support with security; and
  - Support with 'other needs'.
- Percentage of customers satisfied that the services provided by their company are easy to access.
- Percentage of customers on SAR/PSR contacted over the past two years to ensure they are still receiving the right support.

Cost sharing incentive

Cost efficiency incentive – stretching further

- As proposed in draft methodology, replace menu regulation with the cost sharing incentive, to provide an incentive to submit efficient cost forecasts in business plans.
- In a price control we set an expenditure allowance for each company. If a company overspends or underspends this allowance, cost sharing rates specify the proportion of the overspend that they have to bear, or the underspend that they get to keep.
- The incentive works such that more efficient plans (relative to our assessment of costs) will get more favourable cost sharing rates.

Since draft methodology, we have adjusted our proposed cost sharing rates to provide a stronger incentive for companies to submit efficient business plans and to ensure the scheme better protects customers against inefficient business planning and against perceived risks around gaming.

More efficient business plans ←

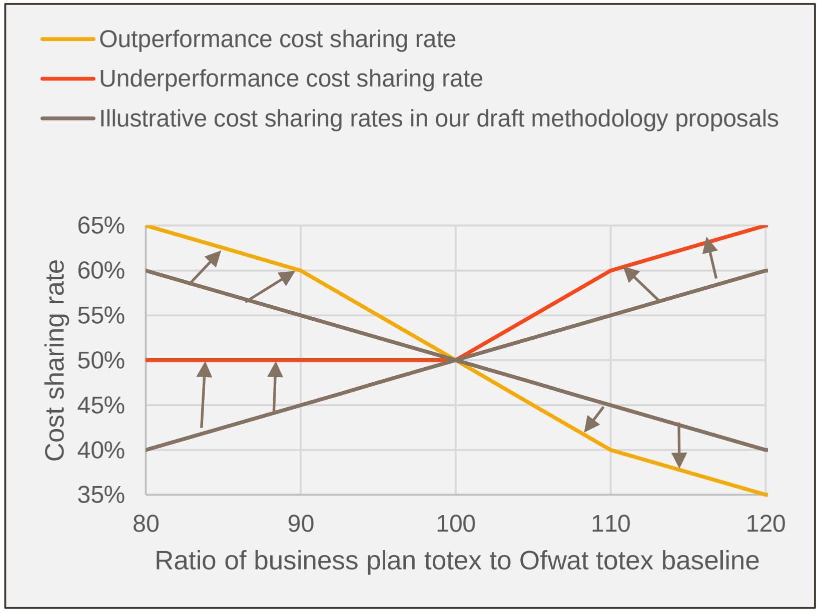
Totex ratio[1]	70	80	90	100	110	120	130
Cost sharing rate for outperformance[2]	65%	65%	60%	50%	40%	35%	35%
Cost sharing rate for underperformance[3]	50%	50%	50%	50%	60%	65%	65%

[1] Ratio of company's view to our view of totex (%)

[2] Percentage of outperformance company gets to keep. The remainder is passed on to customers through lower bills.

[3] Percentage of cost overrun company has to bear. The remainder is passed on to consumers through higher bills.

Source: Final methodology, Chapter 9, Figure 9.1: cost sharing mechanism for PR19



Source: Final methodology, Appendix 11, Figure 1: The PR19 cost sharing incentive mechanism

Balance of incentives and cost of capital

Balance of risk and return

The 'balance of risk and return' is how the overall package of incentives comes together to get companies to deliver for customers. Our aim is to **align the interests of companies and investors with those of customers** - so that the best cost and service outcomes are delivered to customers.

We have maintained our consultation position on:

Outcomes

Average performance in current period is not good enough for the future – and would incur penalties

Cost of capital

We'll set a cost of capital based on forward looking cost of equity and we'll index the cost of new debt. Some companies will find this challenging.

Costs (totex)

We will remove menu regulation and replace with cost sharing scheme to encourage efficient cost forecasts. We expect a step change in efficiency.

Tax

Reconciliation for changes in corporation tax rate and capital allowances.

But we have changed:

Outcomes

Our benchmarks will target upper quartile in each year – customers should not wait for service improvements.

Initial assessment of business plans

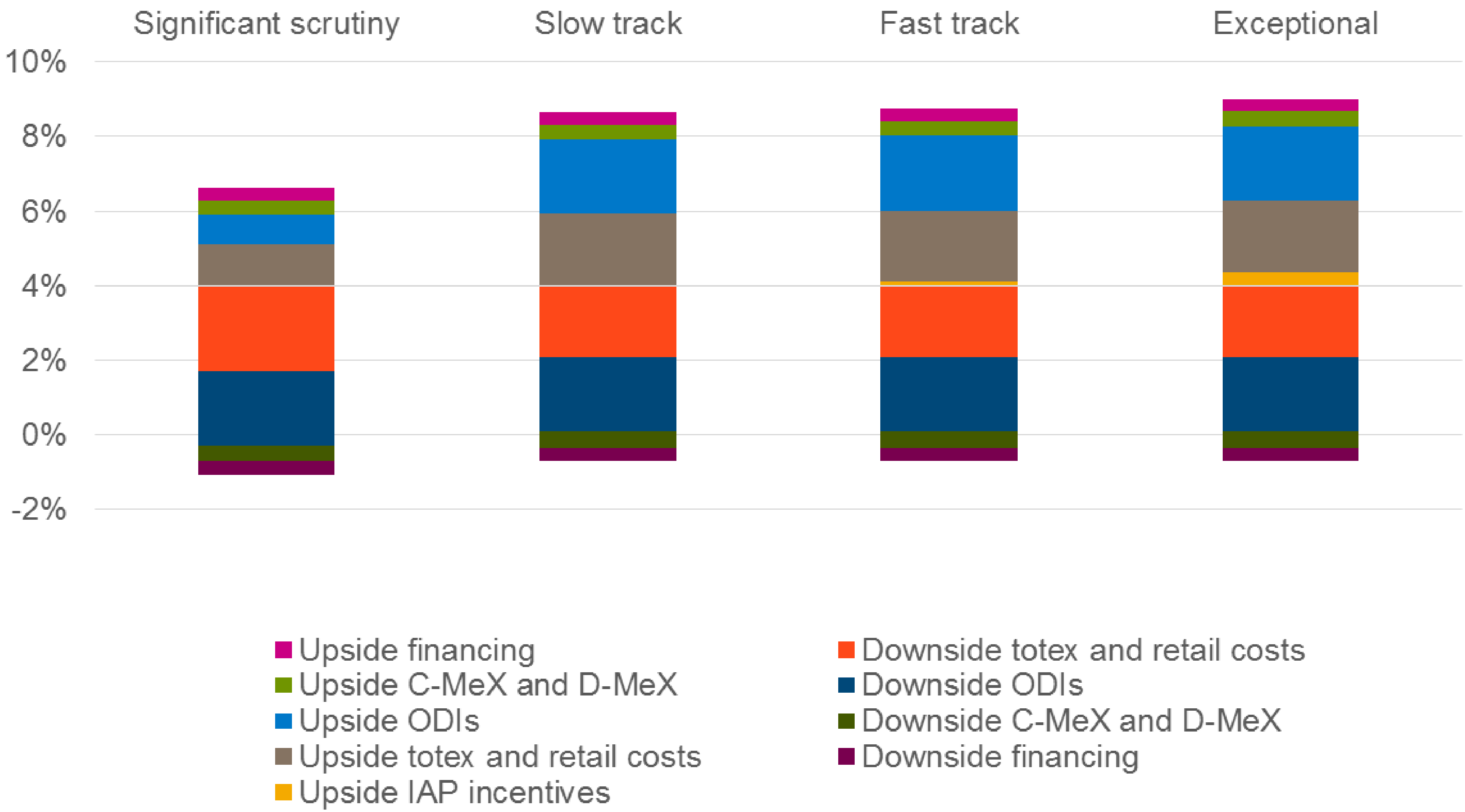
Exceptional companies will receive 20-35bp (RoRE) reward and early certainty.

Fast track companies will received 10bp (RoRE) reward and early certainty.

Significant scrutiny companies will have tougher cost sharing rates.

It will remain possible - if unlikely - for the whole sector to outperform the regulatory targets and so achieve rewards. Returns are not skewed to the downside.

Overall balance of risk and return



Cost of capital

We have published our initial view of the cost of capital for PR19.

Our overall approach has not changed since the draft methodology.

Cost of equity

Regulators have traditionally placed the greatest weight on long-run historical evidence.

But equity returns are currently low.

And there is good reason to expect significantly lower returns to persist to 2025.

So we are placing less weight on long-run historical evidence than we have in the past.

Cost of debt

A fixed allowance for embedded (existing) debt based on benchmarks and company balance sheets.

The allowed cost of new debt will be indexed to iBoxx indices for non-financial companies with a tenor of 10-plus years, adjusted for CPI(H).

This removes the premium associated with forecast error and provides protection where the cost of debt increases.

Companies can make a case for a company specific adjustment

As we are transitioning to a more legitimate measure of inflation – CPIH - we state the cost of capital and its components in nominal, RPI and CPIH real terms. In RPI terms it is lower than PR14, reflecting a lower interest rate environment and lower expectations of investor returns through 2020-25.

Our early view of the WACC for 2020-25:

PR14: 3.6%

Component	Nominal	Real (CPIH 2%)	Real (RPI 3%)	Range (real RPI)
Cost of equity	7.13%	5.03%	4.01%	3.41% to 4.69%
Cost of debt	4.36%	2.32%	1.33%	1.07% to 1.55%
Gearing	60%	60%	60%	60%
Appointee cost of capital	**5.47%**	**3.40%**	**2.40%**	**2.01% to 2.81%**
Retail margin deduction	0.10%	0.10%	0.10%	0.10%
Wholesale cost of capital	5.37%	3.30%	2.30%	1.91% to 2.71%

The retail margin deduction refers to the adjustment made to the appointee WACC to derive the wholesale WACC, assuming a 1% retail EBIT margin.

The new WACC represents a bill impact of £15-25 on customer bills for 2020-25. Within range priced in by markets (listed share price impact minimal so far).

Next steps

2017	
11 July	Draft PR19 methodology consultation published
12 July	City briefing
July-August	Continued engagement through consultation period
30 August	PR19 draft methodology consultation closes
13 December	Final PR19 methodology published
2018	
3 September	Companies submit business plans to Ofwat
2019	
January	Initial assessment of business plans
March	Draft determinations (exceptional and fast track plans)
April	Companies submit revised business plans (significant scrutiny and slow track)
July	Draft determinations (Slow track and significant scrutiny)
December	Final determinations published

More immediate next steps up to the submission of business plans

January	Ofwat publishes feedback on company bioresources RCV allocation proposals.
31 January	Companies propose their own allocation of historical RCV for water resources.
March	Ofwat publishes report on the external review of the financial model and a revised model (incorporating changes recommended by the review).
30 March	Final date for issues and clarifications on the updated business plan tables and financial model
April	Ofwat publishes feedback on company water resources RCV allocation proposals.
3 May	Companies submit: • definitions of their performance commitments; and • information on their expected cost adjustment claims. Publish further revised business plan tables and financial model (if required).
May	Ofwat releases updated version of the data capture system for use with the business plan tables.
by 15 July	Companies submit: • Annual performance report; • their populated PR14 reconciliation models
3 September	Companies submit business plans to Ofwat.

We are updating the Aide Memoire to reflect the final methodology and for the comments you provided on the previous version.

We will circulate the updated aide memoire to CCG chairs by the end of January for comment.

We will take account of your comments and publish the final aide memoire on our website, hopefully by the end of February.

We are happy to discuss any further thoughts on the Aide Memoire that we can reflect ahead of the version you will see later this month.

Break

Preparing CCG Reports

For discussion

Purpose of this session discussion

CCGs will now have seen the Final Methodology (December 207), a draft of the Aide Memoire (September 2017) and the Customer Engagement Policy Statement (May 2016). These provide extensive information on our expectations for companies, the purpose and role of the CCG and the information we expect the CCG to include in its report.

The session is to help:

- Understand how different CCGs are progressing in preparing their CCG reports.
- Understand any common areas of difficulty CCGs are facing or foresee facing in preparing their reports.
- Identify approaches to addressing common areas of difficulty through an exchange of views between CCG chairs.
- Identity if there is any additional support we can provide in accordance with our PR19 policy.

‘A view from the bridge’

Jonson Cox, Ofwat Chairman