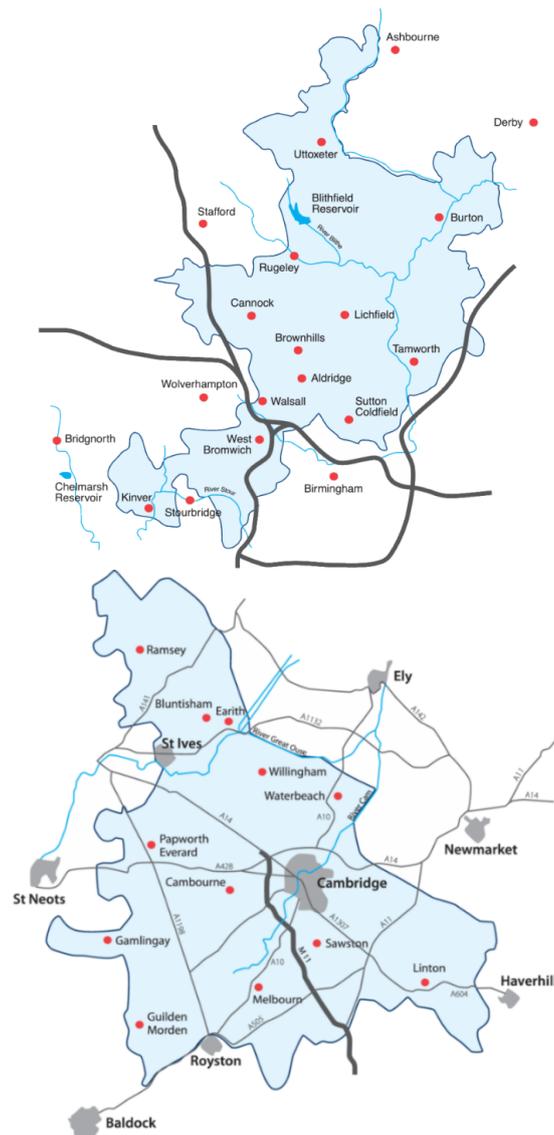


# SOUTH STAFFORDSHIRE AND CAMBRIDGE WATER CUSTOMER PANEL

## INDEPENDENT REPORT TO OFWAT

In response to the Draft Determination of the PR19 Business Plan of South Staffs Water (SSC)



30 August 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 The Report

This document is our third Report to the regulator Ofwat, and offers comment on issues related to customer engagement in Ofwat's Draft Determination (DD) of the PR19 Business Plan submitted by South Staffs Water incorporating Cambridge Water. The report includes independent assurance to Ofwat regarding the customer research carried out by the Company in response to the DD.

#### 1.2 The Company

South Staffordshire PLC acquired Cambridge Water in 2011. 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 applies to water companies: SSC for the whole company, SSW for the South Staffs area of operation, and CAM for the Cambridge area of operation.

#### 1.3 The Panel

The South Staffordshire and Cambridge Water Customer Panel (referred to in this Report as the Panel) was set up by the Company as a requirement from Ofwat. Similar panels are set up by all water companies in England and Wales, known generically as Customer Challenge Groups or CCGs. Our task is to give 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 Panel's make-up, method of working, and independence are all described in Section 3 of our first 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 2025 (the period known Asset Management Period 7, or AMP7). On 31 January Ofwat published the results of its Initial Assessment of Plans (IAP) and gave companies until 1 April 2019 to respond. The Panel submitted its second independent report on the same date. Ofwat published its Draft Determinations on 18 July 2019, giving companies until 30 August to respond. This Report is being submitted alongside the Company's response to its DD. Final Determinations are promised in December 2019.

#### 1.5 Reference documents

The Panel's first Independent Report submitted with the Company's original PR19 Business Plan is here: <https://www.customer-panel.co.uk/media/1047/panel-report-final.pdf>.

The Panel's second report which followed Ofwat's Initial Assessment of Plans is here: <https://www.customer-panel.co.uk/media/1062/customer-panel-second-independent-report-to-ofwat-april-2019.pdf>.

Ofwat's Draft Determination of SSC's PR19 Plan is here:

<https://www.ofwat.gov.uk/wp-content/uploads/2019/07/PR19-draft-determinations-South-Staffs-Water-draft-determination.pdf>

## 2 SCOPE OF THIS REPORT

### 2.1 Ofwat's expectation

When CCG Chairs met the Chief Executive of Ofwat on 22 May 2019, they asked about Ofwat's expectation of CCGs in respect of the Draft Determinations. The answer was: CCGs are at liberty, but not required, to submit a representation on their company's DD and/or the Draft Determinations as a whole.

### 2.2 The Panel's approach

The Panel met on 31 July to hear the Company's reaction to the DD and to agree the Panel's role. Since the Company had decided to carry out additional customer research in order to provide new evidence to Ofwat, the Panel felt that it would be appropriate to submit an independent report to Ofwat, as before. In this report we focus on issues around customer views and preferences. We comment on the references made in the DD to our previous report, and, in the Appendix, we offer our observations, as independent observers, on aspects of the DD which impact on customers.

## 3 CUSTOMER RESEARCH

### 3.1 The project

Additional research was carried out on behalf of the Company by Accent. Its purpose was to elicit customer views on the advantages and disadvantages of being supplied by a small water company and to explore customers' willingness or opposition to paying a small company premium as part of their water bill. The research was carried out in two stages, a qualitative exercise in each of the SSW and CAM areas involving 18 customers in all, and a quantitative survey completed by just over 400 customers. The project is described fully in the Company's DD response.

### 3.2 Panel involvement

The time allowed for response to the DDs was so short as to preclude our normal level of involvement, giving us little time to comment or challenge, and the Company little time to respond. In order to secure the preferred agency and book facilities for focus groups, the contract had been let before the Panel could challenge the project brief or the agency's proposal, and stimulus material for the focus groups had to be finalized without Panel involvement. However, Panel members observed both focus groups in SSW and CAM, submitted comments afterwards, were consulted on the agency's report on key learnings from stage 1, and critiqued the draft quantitative survey. A log of over 20 challenges was kept, with Company responses.

### 3.3 Main findings

The headline results are as follows:

- Findings from the quantitative and the qualitative stages were largely consistent
- The majority of respondents were satisfied with the Company's service and few have had any difficulties
- Preference for service provision by a small company is exceeded by a stronger preference for a local company
- A substantial majority in both regions support the principal of a small company premium – 69% in total
- A slightly higher proportion (83%) find £1 per annum an acceptable premium.

### 3.4 Assessment

The Panel's independent view of the quality and interpretation of the research is given in Section 8 below on Assurance.

## 4 AFFORDABILITY

### 4.1 Bill profile

A significant part of the follow-up research carried out by the Company after Ofwat's Initial Assessment of Plan (IAP) was aimed at addressing Ofwat's challenge about the evidence for the customers' preferred bill profile. We pointed out in our April 2019 report that "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." We note Ofwat's judgement in the DD that the additional research required by the IAP was "of satisfactory quality" and we question why Ofwat rejects the customers' preference revealed by the research.

In the DD, Ofwat questions the preferred bill profile and states that the Company did not measure the acceptability of combined waste and water bills or bills with inflation added. We do not believe that the charges for waste water are a legitimate concern of a water-only company, who correctly consulted customers on their own charges. From our observation of the quantitative research and our engagement in the qualitative research, we are confident that the concept of flat bills was favoured by customers in the full knowledge that waste charges would be shown separately, that the effect of inflation would change the amount on the bill, and that metered customers would receive bills that vary with consumption.

The Company proposed ways of removing price uncertainty by making ODI incentives payable at the end of the period and by a financial mechanism for smoothing inflationary fluctuations, both of which Ofwat has rejected. It remains the Panel's view that the customers expressed a preference for a bill that would remain constant for a five-year period, followed by one adjustment in the forthcoming AMP. It is our view that customers' clear preference for flat nominal bills should be respected by the regulator.

## 5 DELIVERING OUTCOMES

### 5.1 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. The Company achieved this by top-down adjustment of the amounts customers were willing to pay. The resulting compromise produced an incentive package which did not meet the customer's preference for symmetry between rewards and penalties. In the DD the Company is criticised for top down adjustment and Ofwat has made substantial changes to the incentives so as to skew the package even more towards penalty than it was in the IAP.

### 5.2 End-of-period payments

The IAP challenged the Company's proposals for end-of-period incentive payments. The follow-up research reinforced the evidence that customers prefer end-of-period adjustments, even after the alleged benefits of in-period payment have been explained to them. In the DD Ofwat has changed every financial incentive to an in-period payment. As the Panel was set up at Ofwat's initiative to give assurance on the degree to which customer preferences are respected in the Company's Business Plan, we continue to support the Company's efforts to act on the clear evidence of customers' preference for price stability. Ofwat states that the incentive should be paid closely in time to the performance. Whatever the merits of that argument, as a

customer-facing body, we believe that greater weight should be given to customer views than to economic theory.

### **5.3 CRI index**

The Company proposed to exclude from the Compliance Risk Index (CRI) the resilience works at Hampton Loade and Seedy Mill during the period of the investment. Ofwat has not agreed with this approach. We feel that the application of penalties to CRI needs further consideration so as to (a) take account of the scale of the Hampton Loade and Seedy Mill treatment works in relation to the size of the Company and (b) avoid disproportionate penalty for schemes under Drinking Water Inspectorate (DWI) Directions. The latter could be achieved by

- excluding elements under DWI direction from CRI calculations;
- amending CRI when used to set the level of regulatory incentive, or
- determining not to implement penalties until work at investment schemes is completed.

The third option would be preferable, and the Panel would like Ofwat to consider this prior to Final Determinations.

## **6 RESILIENCE**

### **6.1 Growth in CAM**

In our Report of September 2018, we expressed anxiety about the over-dependence of a supply/demand deficit in the CAM area on assumptions about factors outside the Company's control, especially population growth, and per capital consumption. The latter is least subject to influence by the Company, but demographic or economic factors like population growth are entirely external.

In its forecast of demand in the Water Resources Management Plan (WRMP), the Company correctly followed the method set out in WRMP guidance. We note that in the DD, Ofwat has adopted different growth forecasts, taken from the Office of National Statistics (ONS). For the CAM area, ONS figures suggest a lower growth rate than in any other water company area. This does not match what we are experiencing on the ground; it does not take account of existing demand for housing in a place where prices are close to London's, nor of the government's enthusiasm for a new growth corridor between Oxford and Cambridge. The Panel's previous concerns about supply/demand balance in CAM are exacerbated by both the surprisingly low ONS prediction and the use of inconsistent data between WRMP and Business Plan.

### **6.2 Per Capita Consumption**

The per capita consumption (PCC) reduction set by Ofwat in the DD is from 144 l/p/d in 2020 to 135 l/p/d in 2025. This target is not aligned with what is in the WRMP, which is to achieve a reduction to 131.9 l/p/d by 2025. The supply demand balance is based on achieving this reduction. Average PCC has shown an increase since 2014/15, and there is a potential risk to supply if Cambridge Water is not able to achieve the reduction that it plans. Coupled with the significant challenges relating to population and property growth highlighted above, and the need to move to sustainable levels of abstraction to reduce the risk of deterioration to the environment under the Water Framework Directive (WFD), we are concerned about long term resilience.

## 7 ENVIRONMENTAL PROTECTION

### 7.1 WINEP

In our April 2019 report, we challenged the omission of a commitment to fund amber schemes in WINEP (the Water Industry National Environment Programme). The risk this presents is referred to by Ofwat in the DD. We welcome the Company's commitment to use the cost adjustment mechanism to fund amber WINEP schemes.

## 8 ASSURANCE

### 8.1 The Company's 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. In their IAP, Ofwat acknowledged the quality of the Company's customer engagement. No actions were required of the Company in that test area.

For our meeting in July 2019 the Panel requested a presentation on the Company's ongoing customer engagement now that it has progressed beyond activity required for the Price Review and become part of business-as-usual. The Panel considered that the programme is driven by a clear strategy, with objectives set for each workstream, and robust linkage between customer insight and business priorities.

### 8.2 The Panel's assessment

The Panel was concerned that the **time allowed** for completion of the Company's response to the DD would not allow research of sufficient quality to be undertaken (see 9.1 below). However we understand the requirement that the Company provide Ofwat with evidence of customer preference and accepted the Company's confirmation that "we would not be undertaking this work if we did not feel we could do a robust piece of research at a company level".

The early deadline prevented large enough **samples** being taken to allow sub-segmental analysis. However a total of just over 400 respondents took part in the quantitative survey, which exceeded the target set. The consistency of response across the two areas (SSW and CAM) and across the qualitative and quantitative stages, gives confidence in the reliability of the result.

The **Panel's involvement** was less complete than is usual for the Company's customer research projects, again because of the tight deadline. Thereafter Panel members were able to observe and challenge every stage of the delivery, as summarized in 3.2 above. The Company responded to every challenge and has kept a log of all challenges and responses,

The Panel has reservations about consulting customers on matters far from their experience (see 9.2 below). We consider that the Company and the agency mitigated this by designing research that focused on two questions of direct **relevance to customers**, namely their feelings for or against being supplied by a small or local firm, and their willingness to pay a supplementary £1 on their bill in recognition of additional costs from being served by a small company.

**It is our view that, given the time allowed, the Company has carried out an effective piece of customer research which produced a convincing message.**

## 9 THE DRAFT DETERMINATION PROCESS

### 9.1 Deadlines

The time given for response to the DD (and for this report) was just 6 weeks, even less than the time for responding to the IAP, about which we expressed concern in our second report. Given a five-yearly schedule for price reviews, we question the need for such tight deadlines. As a body asked to provide assurance on the quality of customer engagement, we urge Ofwat to think again about asking companies to incur this unnecessary risk in the process of gathering and interpreting customer views.

### 9.2 Customer relevance

We support Ofwat's efforts to put the customer at the heart of business planning, and are glad to have been given a role in moving that forward. In previous reports we have suggested careful consideration of the sort of issues which are appropriate for customer engagement. We have questioned the effectiveness of willingness to pay research or seeking customer views on the minutiae of a complex incentive regime. Similarly, we question the wisdom of asking companies to engage customers in an abstruse matter such as a company specific adjustment to the cost of capital as assessed by Ofwat's CAPEX modelling.

### 9.3 Misleading terms

Given the level of public interest in the price reviews, it is important that terms used in the DD should be understandable by outsiders, who will not have read Ofwat's Methodology Statement. We consider that the use of "efficiency" to include not just the cost per unit but also the volume of activity, is confusing and misleading. A company planning to provide a greater number of new connections, for example, should not as a result be reported as less efficient.