

Customer Challenge Group for Thames Water:

Additional/addendum Report to Ofwat on Thames Water's PR14 Business Plan
submission

26 June 2014

Statement by the Chair of the Thames Water Customer Challenge Group

I, the Chair of the Thames Water Customer Challenge Group, submit this Additional/addendum Report to Ofwat for review and consideration.

A handwritten signature in black ink that reads "David Bland". The signature is written in a cursive style and is underlined with a single horizontal line.

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David Bland
Independent Chair

26 June 2014

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Summary

This report summarises the activity of the Thames Water Customer Challenge Group (CCG) in the first half of 2014 in reviewing with the Company new evidence and proposals which have contributed to the revised Thames Water PR14 Business Plan, submitted to Ofwat in June 2014. The key conclusions reached are:

- **Revised Plan has undergone thorough reappraisal:** The work of the CCG in the first half of 2014 has not in any sense been a repetition of that undertaken for the CCG's Report on the December 2013 Business Plan. It has involved a decomposition and reassessment of the previous work to ensure that the Company's revised proposals and their supporting evidence showed much more clearly the line of sight ('golden thread') back to customers' preferences. The CCG considers that this fundamental review has given greater coherence to the outcomes from the extended work.
- **Additional evidence on customers' views was gathered appropriately:** The new exercises with consumers were necessarily limited in scope and timescale by the need for Thames Water to deliver a revised Business Plan during June 2014. The CCG is satisfied that best practice was applied in specifying, commissioning and undertaking the work. The appropriate cross-sections of customers were questioned, in both hall meetings and wider consultations, with appropriate numbers of customers of the water-only companies for whom Thames Water provides sewerage services. This supported the conclusions that are built into the Plan.
- **Thames Water's customer research supports its proposed risk and reward balance:** Thames Water's research on ODIs showed that a narrow majority of customers accepted the Company's proposed package of rewards and penalties. Customers' opinions were mixed on the issue of rewards: customer survey findings suggested that they considered incentives should be weighted towards penalties. By contrast, the Consumer Council for Water found that, uninstructed, customers intuitively opposed reward packages being added to their bill. The CCG supports the Company in its decision to follow Ofwat guidance in framing the new round of customer research on ODIs. The CCG does caution, however, that customers may be confused if they receive higher than expected bills as a result of the approach taken.

1. Introduction

On 2 December 2013, Thames Water submitted its draft Business Plan for the 2014 Price Review (PR14) to Ofwat. At the same time, the Thames Water Customer Challenge Group (CCG) submitted its report to Ofwat. This followed extensive involvement by the CCG with Thames Water and other stakeholders in assessing the Business Plan as it developed over 2012 and 2013, to ensure that it reflected a sound understanding of customers' views and that their interests were reasonably balanced with those of the Company.

Ofwat issued guidance in January and April 2014 on risk and reward for water and sewerage companies as part of its 2014 price review process. This enabled Ofwat, the Company and the CCG to review Thames Water's December 2013 Business Plan against Ofwat's risk-based review (RBR) criteria. Feedback was provided by Ofwat on specific areas of the Business Plan via Scorecards which rated sections as: A – Exceptional, B – Acceptable, C - More evidence required, or D - Significantly more evidence required. Concurrently, Ofwat published its Policy and Information Update, 'Setting Price Controls for 2015-20', which identified a requirement for companies to provide Ofwat with a gap analysis, highlighting how each intended to respond to the concerns raised through the RBR process. Ofwat's expectation was that this would be submitted on 13 June 2014, ahead of the main submission.

The CCG was tasked to carry out further work in relation to Thames Water's draft Business Plan as the Company sought to undertake the requirements set out by Ofwat in its guidance. Thames Water indicated that it would only respond to those Plan elements rated C or D, and that it would not alter its Plan except in the light of updated Ofwat guidance, known departures declared to Ofwat in December 2013, and additional changes which breached materiality thresholds and had been approved through the formal Change Request process.

In the CCG's view, Thames Water has responded carefully to the Risk Based Review guidance. It has made significant efforts to accommodate what was required, recognising that there were weaknesses in certain areas in the draft Business Plan, such as the 'golden thread'/line of sight to customers' interests, and the balance of risk and reward.

This addendum report from Thames Water CCG focusses on:

- the changes proposed by the Company between the draft and final submissions; and
- outstanding areas of concern of the CCG from the CCG Report to Ofwat submitted on 2 December 2013.

2. Outstanding items from December 2013 CCG Report

2.1. Customer acceptability testing

In its December 2013 Report, the CCG concluded as follows with regard to Thames Water's approach to testing the acceptability to its customers of its proposed Business Plan:

*"In respect of **Final Acceptability Testing**, the Group was involved from an early stage in the process, commencing with the pilot testing through to final testing. Following challenge by the CCG, the Company included inflation, added an 'uninformed' question, made changes to quotas and agreed to consult with both business and waste-only customers in the final testing piece. The CCG remains concerned, however, that acceptability has not been tested*

with customers of all the water-only companies who receive their sewerage service from Thames Water.”

The CCG can confirm that the latest report from Thames Water regarding Final Acceptability Testing included evidence that customers of all the water-only companies serving more than 1% of the Company’s customers (Affinity Water, South East Water, Sutton & East Surrey, and Essex & Suffolk) had been included in surveying of customers’ views. Customers of Anglian and Severn Trent, which supply sewerage services to Thames Water’s water-only customers, were not included as the proportion of Thames Water’s sewerage-only customers served by each is 0.6% and 0.5% respectively.

2.2 Structure of Plan around Outcomes

In its December 2013 Report, the CCG concluded as follows with regard to the structure of Thames Water’s Plan around Outcomes:

*“With regard to **the structure of Thames Water’s Plan around Outcomes**, the CCG has seriously challenged the Company throughout the process. The CCG considers that it has helped the Company to develop a coherent Plan which is focused on Outcomes, carried through from high level statements to detailed measures. The CCG does have some concern, though, about how proposed incentives which apply to the Wholesale business will feed through into targets and incentives for the Retail business, and ultimately into better outcomes for customers.”*

Since December 2013, the CCG has been provided with more information on the linkages between incentives and targets for the Wholesale and Retail businesses, and how these are designed to encourage the Company to deliver better outcomes for customers. The CCG has now received sufficient information and assurance on this issue.

2.3 Customers’ views on rewards and penalties

In its December 2013 Report, the CCG concluded as follows with regard to the structure of Thames Water’s Plan around Outcomes:

*“The CCG is concerned that there is **insufficient evidence that customers support the final framework of financial rewards and penalties** as their views have not been specifically sought in relation to service out-performance and the use of rewards and penalties. The Company has committed to further working with the CCG to develop research in this area and will conduct this after the submission of their business plan.”*

The CCG can confirm that Thames Water has undertaken further customer research on the use of penalties and rewards. This is discussed in more detail in section 3.2 below.

3. Thames Water’s response to Ofwat’s risk-based review

Companies were asked to provide a gap analysis detailing the actions they each proposed to take to bridge the specific gaps identified for individual companies in Ofwat’s risk-based review. Thames Water and the CCG have worked closely on the following areas identified by Ofwat:

3.1 Finance balance between the Company and its customers

The period during which the CCG Report was being drafted in autumn 2013 was complicated by the fact that Thames Water was at the time applying to Ofwat (via a so called IDoK application) to allow a short term increase in customer bills for 2013-14 in light of additional costs incurred since the start of

the previous price control period in 2010-11. The rejection of the application shortly before the Business Plan was finalised meant that Thames Water had to re-run a large amount of financial modelling in the final stages of planning. This inevitably resulted in some data having to be re-worked subsequent to the submission of the Business Plan in December 2013. These revised data can now be incorporated. In this second round of reviewing and revising the Business Plan, the Company and the CCG have both benefited from the availability of a firmer dataset.

Thames Water has now produced a Business Plan with a starting assumption that the combined water and sewerage bill for a typical household customer should remain constant in real terms, before the impact of inflation, and excluding the impact on bills of the Thames Tideway Tunnel. This builds on the proposals for customer bill impact in the draft Business Plan. The CCG is content that this proposition is credible and that the Business Plan providing for a 'level bill' into AMP6 meets an acceptable level of customer acceptability (for the base plan 85%, however, when the Thames Tideway Tunnel is added, this drops to 59%).

3.2. Risk and reward

As the CCG and Thames Water worked to assess the guidance issued by Ofwat on the draft Business Plan, it became clear that Ofwat intended that the proposed Outcome Delivery Incentive (ODI) framework should serve to set the risk/reward balance for the Company. Outcome Delivery Incentives, combined with risk-sharing mechanisms to deal with divergence between outturn and planned costs, are intended to replace the 'truing up' mechanisms used in previous price reviews to cater for unanticipated changes in costs and/or outputs delivered.

Thames Water has strengthened the financial incentives in the plan and ensured that they are developed robustly from the bottom up. Results of these developments have been assessed against Ofwat's expectations that the combined effect of the proposed Outcome Delivery Incentives and risk-sharing mechanisms should limit the variance of the Company's expected Return on Regulatory Equity (RORE) to +/- 1%-2% around the allowed return. (Ofwat has confirmed that, while this range is a guide, and it is more concerned that incentives are robust, evidence-based and provide adequate protection for customers than necessarily be constrained to fit within this guide range.)

The CCG is pleased to note that there has been considerable dialogue between Thames Water and Ofwat since the December 2013 Business Plan was submitted. This has resulted in a much clearer understanding of the (considerably revised) criteria against which Business Plans should focus on revised Outcome Delivery Incentives combined with robust incentives for review by Ofwat. The CCG has been fully engaged with the Company as it undertook a review of the customer research that informed the December Plan and then initiated the additional research that is now reflected fully in the June 2014 Business Plan.

Thames Water has fully and fairly consulted the CCG and has commissioned appropriate professionally conducted research with the Company's customers to inform and support a revised Outcome Delivery Incentive Framework. This research forms a significant underpinning of the proposals contained in the revised Business Plan. The CCG is able to confirm that the research results¹ are incorporated in the Plan and the Company has, to the best of its ability in the time available, appropriately represented consumers' views within the new risk-reward framework set out by Ofwat in its guidance earlier in 2014.

¹ Presented by Thames Water's research consultants Eftec and ICS

Thames Water's research on ODIs showed a narrow majority of customers accepted the Company's proposed package of rewards and penalties. Customers' opinions were mixed on the issue of rewards: customers did not reject the notion of rewards, though the survey findings suggested that they considered incentives should be weighted towards penalties. Members of the CCG, including some from other regulatory bodies, have challenged the appropriateness of using a reward under the ODIs that provide for a company to meet regulatory requirements. Previous and current research shows that customers expect all regulatory requirements to be met. Thames Water has used its dedicated research of April 2014 to test desirability of incentives carrying rewards and penalties, and 'calibrated' its ODIs using this and willingness to pay research.

Customers and stakeholders have expressed the view that while penalties should attach to any failure by a service provider, rewards should only recognise performance that exceeds the Business Plan outcomes. Thames Water has adhered to the approach on risk and reward set out by Ofwat, whereby customers and the Company share the risks assumed and the associated rewards from out-performance against the Plan. This approach appears to challenge the views of customers in general across England and Wales as whole, according to research carried out by the Consumer Council for Water (CCWater), which suggested that customers were intuitively opposed to reward packages being added to their bills. There may therefore in due course be an adverse reaction from customers at the start of the next price control period in 2015-16 when prices are adjusted, as they may not have not appreciated fully the significance for household bills of the regulatory approach adopted towards risk and reward.

3.3 Final Acceptability Testing

Following Ofwat's risk-based review of the Business Plan, Thames Water undertook a second stage of testing to determine the acceptability of the amended PR14 Business Plan. The research sought to understand how acceptable and affordable the proposed plan would be to customers. It also sought to confirm that the proposed level of investment would not exceed the limits of what customers were prepared to pay for to maintain and improve services. The CCG is content that the sample of customers was representative of the Company's customer base and that it included water and waste customers and waste-only customers from the water-only company areas serving more than 1% of Thames Water's customers (parts of the customer base of Affinity Water, South East Water, Sutton & East Surrey, Essex & Suffolk). Customers of Anglian and Severn Trent, which supply sewerage services to Thames Water's water-only customers, were not included as the proportion of Thames Water's sewerage-only customers served by each is 0.6% and 0.5% respectively. Business customers were also consulted.

The CCG is content with the data, as presented by Thames Water to CCG members on 25 July 2014, which shows an 85% acceptability for the base Plan as now presented *without* any provision for the Thames Tideway Tunnel. Assuming that the effect of a separate Determination by Ofwat on the Thames Tideway Tunnel is to be aggregated with the otherwise flat water and sewerage bill, acceptability declines to 59%. While a very clear majority of customers support the development of the Tunnel as the preferred solution to a national problem, the impact of that cost on the customers of one sewerage provider raises a significant question of acceptability to customers. Given the adverse reaction to the cost of the Thames Tideway Tunnel, Thames Water needs to have a clear and dedicated strategy for communicating with all of its wastewater customers throughout AMP 6 its justification for the Tunnel and its cost. The CCG would also expect Thames Water to work in close co-operation with the water only companies that bill on its behalf.

3.4 Thames Tideway Tunnel

As part of Ofwat's risk-based review, Thames Water's Business Plan scored a D for its Wholesale cost assessment. The majority of the gap between the Business Plan and Ofwat's Wholesale Wastewater RBR cost threshold was in relation to the Thames Tideway Tunnel (TTT) Project. Ofwat indicated that

Thames Water should prepare a Business Plan for 2015-20 excluding the TTT Project and that a separate price control would be put in place for the TTT Project. The CCG has been briefed on the ongoing work to address this proposal, noting that work has been undertaken on the efficiency of cost estimates; the robustness of the proposed uncertainty mechanism; and a re-examination of the treatment of costs in relation to the Wholesale wastewater plan.

The CCG note the inherent high level of risk in the project and CCG members are strongly of the view that the cost of the TTT Project should be itemised specifically on the customer bill, at least during the construction period, until the cost of operating the completed Tunnel is incorporated into the normal running of the Company. The CCG recognises that it is not within the gift of the Company to show the cost of the Tunnel separately on the bill to its customers, and that presentation of the customer bill is not strictly part of the Price Review process. The CCG nevertheless remains of the opinion that customers need to see clearly and understand the difference between the constant real terms bill, without the Tunnel, and the materially higher cost to households when the TTT Project is included within customer bills.

3.5 National Environment Programme

Ofwat assessed, in its guidance on Thames Water's December 2013 Business Plan, that its 'model' company² would have a Wastewater budget for the forthcoming five year price control period (AMP6) of £724 million less than Thames Water's proposed Wastewater budget of £4307m (TOTEX). The CCG understands that the three significant items of concern to Ofwat were costs relating to the Thames Tideway Tunnel (TTT) Project, flooding (discussed in 3.6 below) and the National Environment Programme (NEP5). Taking the TTT Project into a separate price control sets that issue aside from the main Thames Water Business Plan, so this section of our Report concerns NEP5 only. Of the four tests to which Ofwat subjected the December 2013 Business Plan, the CCG was most interested in the test to ensure that customer protection was maximised. We also discussed the other three tests with the Company to verify that their treatment of need, of cost-benefit analysis, and of efficient and robust cost control were aligned with customers' expectations.

As a result of extensive work, the Company has produced a revised proposal that results in reduced total expenditure (totex) of £131m allocated to NEP5. The CCG considers this new plan to be acceptable. The revised proposal benefits from detailed input from the Environment Agency, which helped inform the Company of emergent problems and the potential changes required from the implementation of legislation. Arising from the discussion is also a revised proposal for dealing with 195 intermittent discharges, which have become a more significant concern of customers due to the extreme wet conditions during the winter of 2013-14. These proposals now form part of the June 2014 Business Plan.

Whilst the CCG were content with the uncertainty mechanism included in the December 2013 submission it recognises Ofwat's subsequent Risk and Reward Guidance meant this had to be changed. The CCG is content the Company has, under difficult circumstances, made the best provision it can in respect of NEP5 for the June 2014 submission. It is known from customer research, that customers expect all regulatory requirements to be met, and that risk and reward causes some concern for customers. However Thames Water has been steered by the Ofwat guidance into the position where they are required to use the reward/penalty concept to address the prioritisation on environmental measures according to the assessment of the cost/benefit outcome predicted for each

² Given customer numbers and conditions comparable with those of Thames Water

investment. The CCG feel that the Company has produced a workable Plan, managing the risk of uncertainty around the content of the programme, whilst remaining in line with Ofwat requirements. The CCG note any possible reward is small compared to penalties. The Environment Agency have not challenged Thames Water's investment plan for NEP5, but have stated that compliance with statutory obligations should not be dependent upon qualifying for financial rewards.

Under the test for customer protection, we note the Company's decision that it would be counter-productive for Thames Water to include a plan for a change mechanism. In light of discussions with Ofwat, the Company recommends that avoided cost will be returned to customers via the totex performance incentive. Research indicates that customers are concerned to ensure that returns to customers are transparent and have a prompt beneficial impact on bills. Thus, while there are strong arguments from a regulatory perspective for computing the outcome during AMP6 and making bill adjustments for AMP7, from research undertaken customers preference is that any benefit, however small, should come quickly.

3.6 Flooding

The CCG has been engaged with the Company in assessing extensive changes to the flooding ODI mechanism. This review has led, in particular, to the proposal for a single performance measure of the Company's actions to minimise the impact of flooding after rainfall events. The CCG considers this new measure to be robust and satisfactory for customers. In addition, following guidance from and discussions with Ofwat, the Company proposes a more flexible method of assessing the benefits to customers arising from investment. The CCG considers this methodology to be in the interests of customers, though it is to some degree experimental in the AMP6 period. The CCG is pleased also to note that specific proposals are made better to address the issue of flooding from Counters Creek (to which the CCG's Environment Sub-Group devoted a series of special meetings early in 2013). The CCG believes that these proposals will be in the interests of concerned customers who have been pressing for a viable and adequate solution to this specific problem for many years.

Relating to all Thames's Wastewater customers, the CCG has been pleased to note the research that has supported the development of methods to give assurance that costs and benefits of investment are properly computed and explained. The decision to bring in independent experts to support the analysis leading to the cost-benefit proposition is welcome. The CCG considers that the proposals to address flooding in the revised plan will be in accord with the expressed preferences of customers.

3.7 Customer Engagement

Thames Water scored C against Ofwat's test of Business Plans against the Consumer Engagement and Willingness to Pay criteria. Ofwat has required Thames Water to provide a clear explanation of the line of sight (the so called 'golden thread') between its customer engagement, its corporate strategy, and how this has informed the development of the Business Plan and, in particular, in relation to the performance commitment levels and ODIs. The Company has provided Ofwat with an overarching 'Customer Line of Sight' document, in addition to addressing the technical points identified in Ofwat's risk-based review feedback relating to specific performance commitments and ODIs.

The Customer Line of Sight report has been produced following a meticulous review of all significant aspects of Thames Waters' journey to ensuring the right plan and the right outcomes for customers and ensuring that the Business Plan is ultimately in line with customers' willingness to pay their bills.

In its December 2013 Report, the CCG concluded as follows with regard to Thames Water's engagement with customers:

"In summary, the CCG is satisfied that Thames Water has conducted an effective consultation of its customers in preparing the 2014 Business Plan."

The CCG recognises that these activities may not have been presented to Ofwat as clearly as they could have been. The CCG considers that Thames Water has used a variety of techniques to understand its customers. The Company has accumulated all the information that is required properly to inform its planning, which has been built up iteratively over time. Thames Water's Line of Sight ('golden thread') explanation was seen by the CCG as it was being developed, and the final version was reviewed by the CCG on June 25. The CCG takes the view that it convincingly links the evidence that has been accumulated on customers' views with the Company's proposed plan and outcomes for customers in the AMP6 period.

3.8 Stakeholder Engagement

In its risk-based review feedback, Ofwat commented that the CCG had not confirmed that it was satisfied that all relevant stakeholders had been engaged and that there was no specific statement on behalf of customer interest groups in the CCG Report.

In Thames Water's response to Ofwat³, the Company sought to address Ofwat's criterion 1.2:

"To what extent has the company demonstrated effective engagement with wider consumer interest groups, including environmental interests, generally and through their customer challenge group".

The CCG was presented with an early draft version of this response and queried the meaning of the wording "consumer groups". Thames Water had already raised this with Ofwat (bearing in mind the CCG had previously commented on the difficulty of retaining input to the group from small charity organisations), and was told it referred to nothing more specific than stakeholders. In light of that, the CCG observed that there was much more happening in terms of stakeholder engagement within the Company than was on the draft list, such as engagement with schools, meetings held on flooding, water efficiency, Thames Tideway Tunnel, Tap Water Campaign and community meetings. The CCG felt all such engagement should be recorded and recognised by the Company and by Ofwat as part of a portfolio of stakeholder engagement activities. Thames Water has revised its response to Ofwat accordingly.

The CCG is satisfied that the Company has consistently engaged with all relevant stakeholders, including regulators and the many groups which the Company consults regularly. The CCG has concluded that the accumulated evidence from such engagement activity supports the Company's revised Business Plan. Indeed, the CCG considers that Thames Water undertakes such engagement as part of its normal everyday activity, and therefore neither the Company nor the CCG felt it needed to be specifically commented upon.

4. Conclusion

The work of the CCG in the first half of 2014 has not in any sense been a repetition of that undertaken for the CCG's Report on the December 2013 Business Plan. It has involved a deconstruction and reassessment of the previous work to ensure that the Company's revised proposals and their supporting evidence showed much more clearly the line of sight ('golden thread') back to customers' preferences. The CCG considers that this fundamental review has given greater coherence to the outcomes from the extended work. The new exercises with consumers were necessarily limited in

³ Thames Water, GAR A Effective Stakeholder Engagement Process

scope and timescale by the need for Thames Water to deliver a revised Business Plan during June 2014. The CCG is satisfied that best practice was applied in specifying, commissioning and undertaking the work. The appropriate cross-sections of customers were questioned, in both hall meetings and wider consultations, with appropriate numbers of customers of the water-only companies for whom Thames Water provides sewerage services. This supported the conclusions that are built into the Plan.

As noted in section 3.2, Thames Water's research on customers' views on Outcome Delivery Incentives (ODIs) produced results that are not consistent with research results produced by the Consumer Council for Water (CCWater). Thames Water's research on ODIs showed how a narrow majority of customers accepted the Company's proposed package of rewards and penalties. Customers' opinions were mixed on the issue of rewards: customers did not as a whole reject the notion of rewards, though the survey findings suggested that they considered incentives should be weighted towards penalties. CCWater's research found that, uninstructed, customers intuitively opposed reward packages being added to their bill.

The CCG recognises that Thames Water acted properly in line with Ofwat guidance; as a result, the research tested a range of scenarios of bill impacts, some of which were not in line with the ODI ranges in Ofwat's guidance. The CCWater research, by contrast, was qualitative. The CCG suggest that this may account for the difference in customer responses between the two research exercises.

Whilst the CCG supports the Company in its decision to follow Ofwat guidance in framing the new round of customer research on ODIs, it cautions, that customers may be confused if they receive higher than expected bills as a result of the approach taken.

5. Annex CCG Meetings in 2014

6 February 2014	Customer Engagement Sub-Group
25 February	combined Customer Engagement and Finance Sub-Groups followed by main CCG
13 March	main CCG
28 March	main CCG
28 April	main CCG
12 May	Customer Engagement Sub-Group
29 May	main CCG
9 June	combined Customer Engagement and Finance Sub-Groups (open to main CCG members)
25 June	main CCG

In addition to the above, monthly meetings were held between the Thames Water team and CCG Chair and/or Vice Chair.