South Staffs Water

incorporating

CAMBRIDGE WATER COMPANY

Overview of Updated Business Plan for 2015-20

27th June 2014

Introduction

This overview document summaries the updates that South Staffs Water (incorporating Cambridge Water) has provided to Ofwat in the submission for 27th June 2014.

South Staffs Water is in the unique position of providing our customers with very low customer bills and excellent service to customers. We have the 2nd lowest household water bill and are 1st place on the SIM. This updated plan is fully endorsed by the Board and is founded on proposals that have very high levels of customer support, which we have tested in recent months. The Board has developed a plan which is challenging yet seeks to maintain this exceptional balance of high service and low bills. We are concerned therefore that this revised proposal as whole receives support at the Price Review.

The update to Ofwat follows their feedback on the December 2013 business plan and our continued dialogue with our South Staffs Customer Challenge Group (CCG) and Cambridge Local Water Forum. There are six fundamental issues for us in the June 2014 update:

- Outcomes
- Affordability/Acceptability (new research has been undertaken)
- Wholesale Totex
- Small Company Premium
- PR09 Legacy (two companies – South Staffs and Cambridge)
- Retail Cost Additions (debt claim and input price inflation)

We conclude with an update to customer bill projections for the period to 2020.

Risk Based Review and Feedback

The Risk Based Review undertaken by Ofwat led to the following assessment:

Outcomes – customer engagement	Outcomes – performance commitments	Wholesale totex assessment - evidence	Wholesale totex assessment - costs	Retail cost allocation	ACTS adjustments	Affordability	Board Assurance	AMP5 Legacy
B	C	B	C	A	C	C	B	D

We have since had a very productive period of engagement with Ofwat to clarify the required evidence and presentation of material. We have also continued to engage extensively with our Customer Challenge Group (CCG) and undertaken phase 2 customer research.

Headline Improvements to our Plan

Below is a high level summary of the improvements made to this business plan update:

- A second phase of customer acceptability research has been undertaken. Results found 87% of customers are supportive of our revised plan.

- Comprehensive cost benefit analysis (CBA) demonstrates that the Small Company Premium safeguards customer service and our relative efficiency position. We have valued the customer benefit of the SCP using willingness to pay data of South Staffs Water's higher service and efficiency - both of which are above the average £1.90 per customer cost (based on a 0.40% uplift to WACC).

- The benefit case for continuing with a SCP outlined above is supplemented by strong evidence that our customers support the continuation of the premium. In our research of 1,000 customers independently commissioned (by *ICS Consulting*) there was 90% acceptance of the Small Company Premium.

- Significant improvements have been made to our Outcome Delivery Incentive (ODI) package. We have ensured that stretching performance is in place and that the incentives reflect customer valuations of service (WtP). We have also ensured that the services our customers receive are protected and have defined an approach to ensure the full transparency of delivery to both customers and regulators.

- The PR09 legacy commentary is now comprehensive, and fully explains all of the financial adjustments forthcoming and confirms that all PR09 regulatory outputs have been achieved.

- Three wholesale totex representations / cost exclusion claims have been made that total £19m which is 4.6% of our wholesale totex.

- Substantially stronger ACTS claims are submitted for debt/deprivation and for retail indexation, addressing the challenges arising from the RBR.

It is also appropriate to note that our core strategy remains the same and hence a number of features of our original plan remain. These include:

- Our focus on keeping bill levels well below the national average (they are currently over 20 per cent below this) and very high service provision (we are 1st place on SIM) is retained as an over-arching strategy.

- The five outcomes we have put forward remain our focus – though the detail behind these has been enhanced.

- Overall expenditure (wholesale totex levels) are unchanged.

- We continue to focus on ensuring our retail cost allocation is best practise.

1. Outcomes (ODIs – Outcome Delivery Incentives)

In response to Ofwat's feedback on our initial plan, the following changes have been made to our ODI package in the June update:

- As a result of using customer willingness to pay, the reward level (P90) has increased from 0.6% of RORE to 1.4%. Penalties (P10) are now 1.4% compared to 1.5% in December's plan.

- We have reviewed the application of the incentives, these now will be applied linearly instead of in discrete bands as previously presented. In addition to this the incentives will be assessed annually, with the net reward or penalty applied at the end of the AMP.

- The water quality outcome, under the 'acceptability of water to customers' measure, now has a reward and penalty incentive (previously this was reputational only). This provides greater balance to the incentive package.

- We have added increased clarity to how the ODIs will be measured, assured through external audit/Board approval and reported to stakeholders and the wider customer audience.

- Previously, we focussed on the AMP6 (2015 to 2020) period only – there are now longer term aspirations set out.

- We have now explained how the selected performance commitment provides the best value for money (optimum CBA using customer valuations of service – WTP values) and are hence aligned to customer feedback.

- Many of the performance commitments are more stretching and the deadbands are narrower to make the chances of incentives (penalties/rewards) being triggered much higher. This protects customers from any under-performance. We have added clarity on our historic performance in each area which helps demonstrate that service to customers will not deteriorate. Our relative position compared to other water companies is also presented, which confirms that we are already a high performing company. Hence we consider the risk package is stretching but also fair.

- We have reviewed the reputational incentives. We have explained their purpose and their importance to customers / stakeholders, the key milestones and activities we intend to use to measure progress. We have explained why they are not appropriate as financial incentives.

We have actively engaged with our CCG to ensure our package reflects and protects the needs of our customers and stakeholders, including the quality regulators. In addition, we have gained external advice and assurance from *ICS Consulting*, who have advised on the approach taken to apply our WtP values in setting the penalties and rewards, setting PC's and deadbands and have provided a peer review.

Summary of Outcome Delivery Incentives (ODIs)

The following table shows our measures of success, associated performance commitments and commentary on why we have chosen a financial or reputational incentive.

Outcome	Measure of Success	Form of Incentive	Expected 2014/15 Performance	Performance Commitment by 2019/20	Why the Form of Incentive is Appropriate
1 Outcome Excellent water quality now and in the future	Mean zonal compliance (MZC)	£-	99.97% (above the industry average of 99.96%)	99.97%	• Our customers place a high priority on water quality, 97% of customers said that activities to maintain water quality are important. • Our performance commitment is above industry average performance. Our performance commitment allows for the natural variation with this measure. • As our MZC is so close to 100% we believe there is no significant customer benefit from increased performance so a reward is not appropriate. • This measure is therefore a penalty only incentive, based on willingness to pay data. It is measurable, independent from other existing measures and is fully supported by all stakeholders.
	Acceptability of water to customers	£+/-	1.83 nr/1000 (above industry average of 2.13)	1.80 nr/1000	• Again there is a high priority placed on water quality by our customers, (97%). • Our data shows that against the industry we have room to improve our performance which is currently above the industry average; therefore a reward for significant outperformance is appropriate. We have valued this measure using our customer WtP data. • This measure is a financial incentive, attracting both reward and penalty. It is measurable, independent from other existing measures and is fully supported by our customers.

Outcome	Measure of Success	Form of Incentive	Expected 2014/15 Performance	Performance Commitment by 2019/20	Why the Form of Incentive is Appropriate
2 Outcome Secure and reliable supplies now and in the future	Interruptions to supply	£+/-	10 minutes (Upper quartile performance)	10 minutes	• Our customers place a high priority on reliable supplies with 97% of customers saying that activities to maintain reliable supplies are important. • We are excellent performers in this measure, being in the upper quartile of the industry. • CBA has proven that we are currently at our optimum level of supply interruptions; therefore we propose to maintain our upper quartile position. • A penalty incentive based on willingness to pay data, will protect customers against significant deterioration • A reward incentive, based on willingness to pay, will ensure that we are incentivised to improve our high standard of performance and encourage us to look for further innovation to stretch performance in the future.
	Asset serviceability infrastructure	£-	Stable	Stable	• Serviceability assessment is comprised of several indicators which represent areas of performance that customer's value. • Maintaining stable serviceability has been a regulatory requirement for some time and we consider that a penalty incentive, based on willingness to pay data, is appropriate to protect customer interests. • We believe a reward is not appropriate as there is no driver to deliver improving serviceability.
	Asset serviceability non-infrastructure	£-	Stable	Stable	
3 Outcome An excellent customer experience to customers and the community	Service incentive mechanism (SIM)	£+/-	88 (Industry leading)	90	• SIM has been defined as a penalty and reward incentive by Ofwat. • Our PC stretches our already industry leading performance and shows our desire to further improve our position.
	Customer satisfaction from independent surveys	Rep	96% customer satisfaction	98% customer satisfaction	• Our additional customer surveys allow us to understand customer satisfaction and brand perception further. • To avoid double counting with our SIM measure, which already provides a financial reward or penalty; we have classified our additional surveys as a reputational measure.

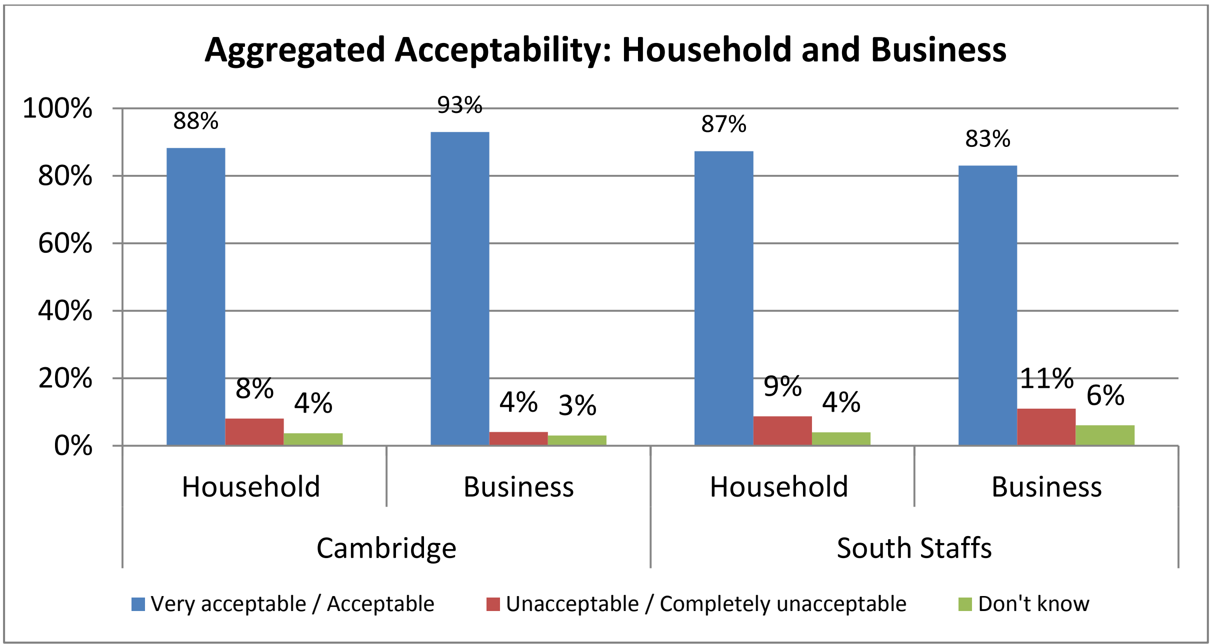
Outcome	Measure of Success	Form of Incentive	Expected 2014/15 Performance	Performance Commitment by 2019/20	Why the Form of Incentive is Appropriate
	Community activity and engagement with customers	Rep	300 employee days delivered within the community and related activities	400 employee days delivered within the community and related activities	• Our community engagement is a reputational measure as our customers value this activity, but are not willing to pay for step change in performance. • Our PC is based on getting every one of our employees involved in this activity.
4 Outcome Operations which are environmentally sustainable	Leakage (SST region)	£+/-	Actual of 70.5 Ml/d against a target of 74.0 Ml/d	70.5 Ml/d	• Our customers have told us that they value a reduction in leakage highly, with 97% saying it is either their top priority or a priority for them. • Our performance commitments are at or below our normal year SELL for each of the 5 years in line with our Water Resources Management Plan (WRMP). • As there have been regulatory targets for leakage for some time it is appropriate that these are further enhanced through the introduction of a penalty, based on willingness to pay data, to protect against underperformance. • Leakage is an area where it is possible to improve performance and there is customer support for doing so, therefore a reward incentive based on WtP values is appropriate to encourage us to innovate to stretch our performance in the future.
	Leakage (CAM region)	£+/-	Actual of 13.5 Ml/d against a target of 14.0 Ml/d	13.5 Ml/d	
	Water efficiency programme (household PCC)	Rep	PCC of 131.44 l/h/d	PCC of 128.31 l/h/d	• This is a reputational measure. It is important to our customers who want more advice and education on water efficiency, however they are not willing to pay for these improvements. • We will use our PCC to indicatively measure the success of our activity. Our activity will be far reaching, encouraging our communities to think differently about the water they use. • Our PC is based on a 2.5% reduction over the AMP, in line with already existing DEFRA targets.
	Biodiversity activity	Rep	66 ha of Company land managed	116 ha of Company land managed	• This is a reputational measure as while our customers feel strongly about the environment they are not willing to pay for significant environmental improvements. • We have planned activities for 12 sites, which will result in an additional 50ha of company land being managed.

Outcome	Measure of Success	Form of Incentive	Expected 2014/15 Performance	Performance Commitment by 2019/20	Why the Form of Incentive is Appropriate
	Carbon emissions from power consumption	Rep	Baseline of zero relative to AMP6 proposed reductions.	Additional 5,210 tCO_2e Saved	• This is a reputational measure as it is important to our customers. There is already a financial impact through the Carbon Reduction Commitment; therefore a financial incentive for this measure would be double counting. • Additionally, there are a number of externalities which affect our measurement of carbon emissions, driven by the controlling market and government policy changes.
5 Outcome Fair customer bills and fair investor returns	Independent customer surveys of value for money and affordability	Rep	87% acceptability	90% acceptability	• Our surveys will test and validate our customers' views on value for money and affordability. • To avoid double counting with our SIM measure, which already provides a financial incentive; we have classified this measure as reputational.
	Support for customers in debt	Rep	17,000 customers engaged with on debt	30,000 customers engaged with debt	• Supporting customers in debt forms part of our company ethos and demonstrates our commitment to helping families when they are in financial hardship. • This is reputational measure as our customers are not willing to pay for additional activity in this area. • We are keen to adopt a social tariff to facilitate our commitment to increase the number of customers we engage with on debt by 76%. We will continue to seek customers support on this prior to implementation.

2. *Affordability / Acceptability*

Based on differences in real/nominal bill projections in our 2013 survey and feedback from Ofwat that our acceptability research did not reflect our latest 2020 bill projection, we commissioned *ICS* to undertake further acceptability research.

In our latest survey we have asked the acceptability question projecting future bill levels in real terms, but also highlighting that inflation will apply to these values over the course of the next 5 years. We agreed this approach with Ofwat at a meeting on 9th April. Our CCG were also consulted and agreed to this revised approach. The results from the survey of 1,000 customers were an 87% acceptability rating, with similar high results for the lower socio economic grouping. The following chart shows the regional and household/business response breakdown consistent with the overall reating of 87%:



Our plan continues to include a proposed social package to support customers with affordability issues; to extend the Charitable Trust; and to deliver further environmental improvements schemes beyond the statutory requirements (the NEP). We are hopeful that Ofwat will support this package when they set their Determinations. The Company is also progressing research with customers to ascertain if there is support for a social tariff to be introduced, which the Company considers would be in the interests of all customers if it can reduce debt levels and reduce the number of customers in payment difficulty.

3. *Wholesale Totex*

The RBR review identified a wholesale totex initial threshold of £398m, compared to the £409m we required that was submitted in the December 2013 Business Plan. This is a £11m difference, equating to 3%. The Board are surprised and disappointed at this given our current totex levels are the third most efficient according to the *CEPA* analysis (6th based on Ofwat's upper quartile email) and our future AMP6 totex needs are the 2nd lowest in the sector (for the water service, expressed on a per property basis).

On reviewing the models we have made two representations on how we believe the models disadvantage us on electricity costs in spite of our position as one the most efficient companies in the sector for this area:

- A representation against pumping head variables excluded from the refined models, hence our unusual topography is not fully reflected.

- A representation against the time-trends used for predicting future power costs, which are higher in the future (as included in the December plan) than the model that took 2008-2013 levels as the basis

We have also submitted additional lower value cost exclusions that relate to:

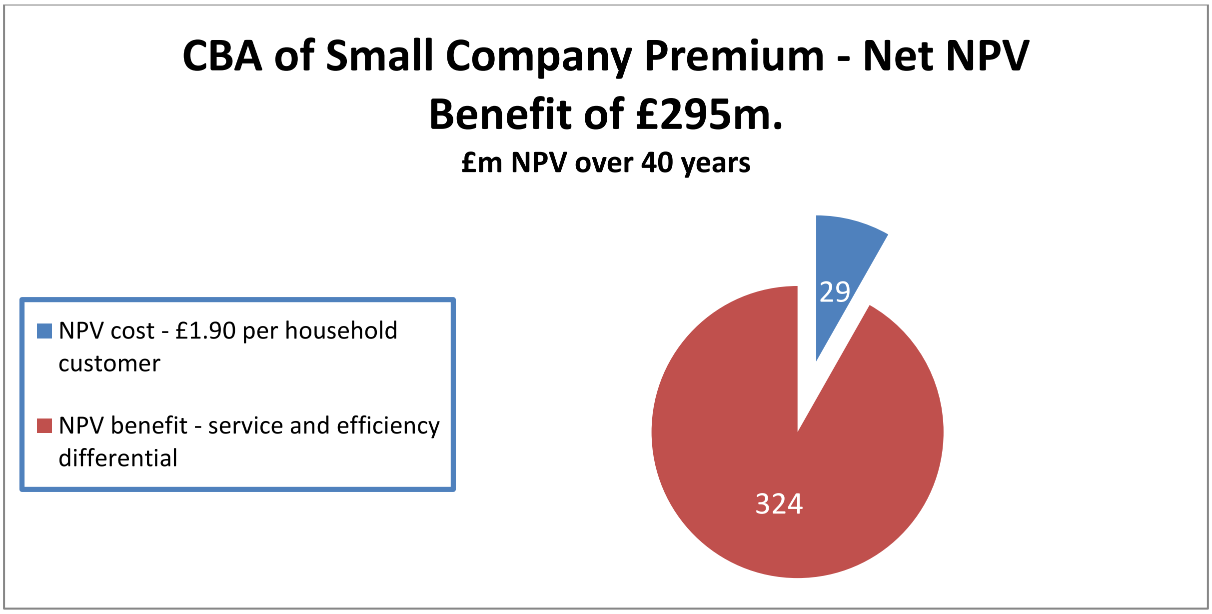
- Principle components of the uplift for safe-guarding customer supplies, hence expenditure on service reservoir, nitrate treatment plan replacement and associated works. This extra investment has been shown to be cost-beneficial and supported by customers.

- Traffic management permit costs

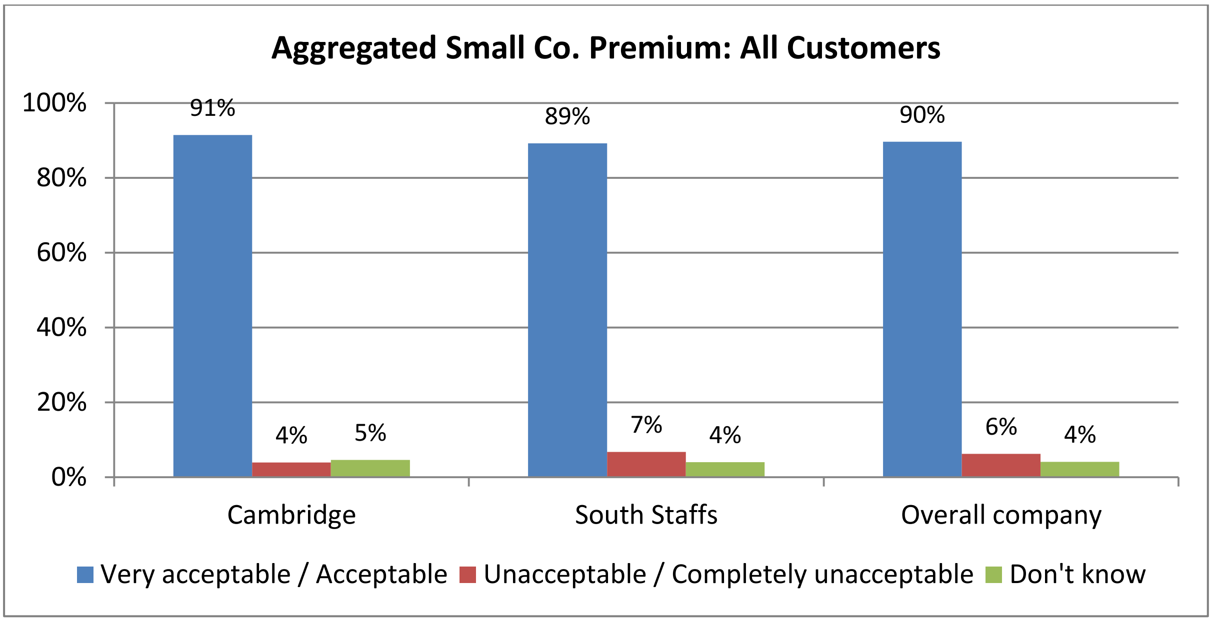
4. Small Company Premium

The Risk and Reward guidance from Ofwat did not include a Small Company Premium (SCP). We have produced a Company specific report to support our requirement for the SCP which supplements both of the *Oxera* reports on this subject for the six smaller WOCs. Our debt finance was raised at efficient levels that translate to a premium above 40 basis points, but the Board wish to constrain the premium to current levels and have tested this with customers who gave an overwhelming endorsement of this. The report submitted to Ofwat includes the following key points;

- Returns per customer for WASCs are higher than South Staffs even with SCP of <£2 per customer (due to our low relative RCV)
- CBA positive using WtP values when valuing the service and also the efficiency differential that our customers benefit from compared to both industry average levels and also the service offering of the WASCs. The net NPV benefit is £295m, which is a significant number for a Company of this size.
- Demonstration that the debt was secured efficiently given the constraints we face due to size and offsetting amounts are shown for the specific retail margin we will receive.
- Discussion on the consequences of the SCP being withdrawn.



We have also tested customer support for the continuation of the premium at current levels (0.40%), researching 1,000 of our customers. A question was asked if our customers were happy to continue paying c£1.90 (average household) for a local service. We utilised *ICS Consulting* to ensure that wording of the question was robust and did not cause any undue bias in our customers' response. 90% are content or very content with the continuation of the premium.



5. PR09 Legacy Adjustments

We made statements within our December Business Plan, approved by our Board, that all outputs had been achieved. Based on their initial feedback, it was apparent that Ofwat required more detail regarding the delivery of these outputs and explanations of the financial adjustments arising from the various regulatory true-ups, rather than high level statements. We have now submitted this to Ofwat early for the two companies that were set different Determinations at PR09 (Cambridge and South Staffs). External independent verification confirming delivery of the outputs from the last price review (PR09) has been provided.

6. Retail Cost (ACTS) Adjustments

We were pleased to see that Ofwat had assigned an A grade for our cost allocation, we were one of only two companies to receive this. Our main focus in retail is on the two ACTS (average cost to servce) adjustments:

1. Debt Claim: We have carried out further work on our deprivation claim for increased bad debt and collection costs. In response to Ofwat's requests for more evidence, we have:

    - Focused on demonstrating that our practices are industry leading (and better than other non-water industry approaches) and hence the claimed cost position is beyond management control

    - Assessed at a variety of different deprivation measures, now adopting multiple deprivation rather than income deprivation which reduces the value of the claim.

    - Future proofed the claim by adopting *PwC's* projection of how bad debt costs will change up to 2020.

2. Retail Indexation: We have provided evidence that:

    - We have already implemented an efficient operational model in our retail area. This level of efficiency has been benchmarked against efficient retail operations outside of the water sector.

    - We have already managed our staff reward levels down to an optimised point when benchmarked against regional averages for retail pay. Again the comparisons made are cross sector in nature and not against the water sector.

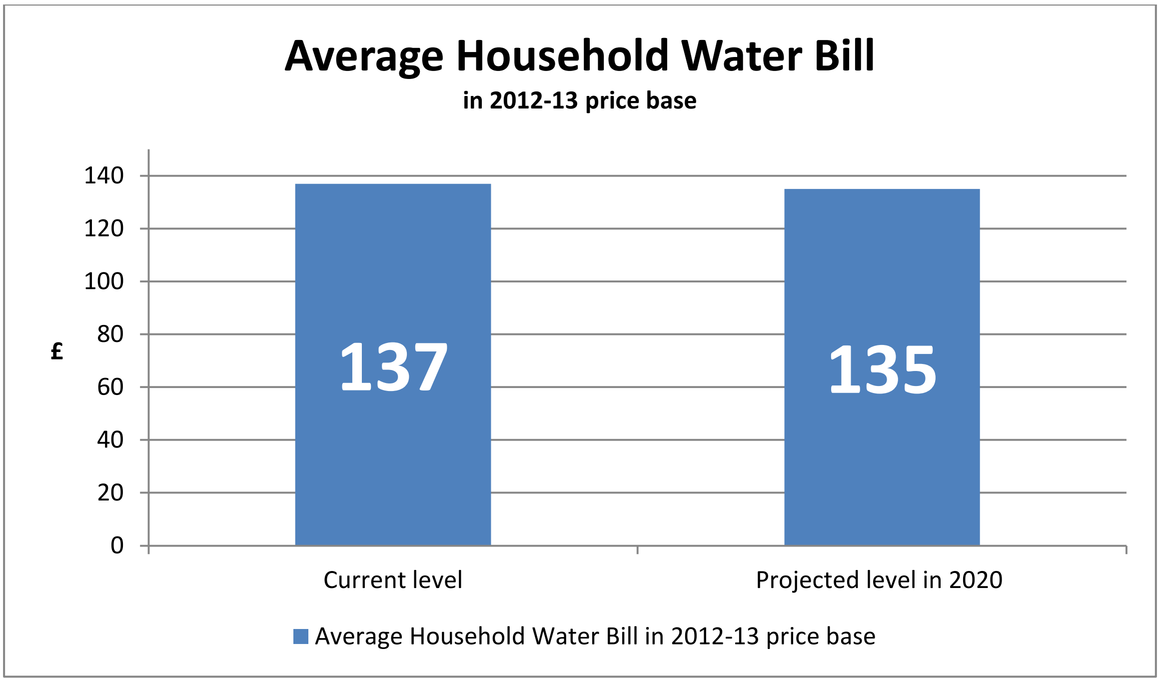
    - An excellent level of service is already provided to customers and therefore this has largely removed the inherent inefficiency associated with poor provision.

    - Focused on the specific inflationary pressures we will face in both our regions, using specific data sources and then a conservative projection for the later years

    - Provides an offsetting net position from the efficiency projections we consider to be feasible.

7. *Customer Bill Projections*

The Company has not adjusted pay-as-you-go rates or RCV run-off rates to secure change to bills in the AMP6 period. The bill projection expressed in 2012-13 price base is a small reduction from current levels, falling from £137 to £135 (based on the wholesale and retail components both expressed in 2012-13 price base). Indicative regional bills (in the South Staffs and Cambridge regions) would follow this trend, thus retaining the existing bill differential across our two regions.



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