Ms Sonia Brown

Ofwat

Centre City Tower
7 Hill Street
Birmingham
B5 4AY

14 March 2014

Dear Sonia,

The purpose of this letter is to provide Ofwat with the opinion of the Customer Challenge Group (CCG) on Affinity Water's response to the further guidance on risk and reward and subsequent specific challenges relating to their pre-qualification for enhanced status for PR14.

Process

In forming our opinion, we have considered all the customer research Affinity Water undertook in 2012 - 2013 as well as new research undertaken in March 2014 to test its proposed revised approach to applying financial incentives. We have also drawn on the recent research by CCWater which tested customers' views on the use of rewards and penalties.

We benefited from advice provided by the Drinking Water Inspectorate (DWI), the Environment Agency (EA) and Natural England (NE). A summary of their advice is provided in the penultimate section of this letter.

The CCG held a conference call / meeting on Thursday 13 March, where the company told us about the work that was underway to respond to Ofwat's further guidance, and we raised specific questions relating to the company's business plan. It was on the basis of this verbal briefing from the company that the Group agreed the contents of this letter.[1] The company's final response was still subject to Board approval at that time and therefore

[1] The meeting / conference call was attended by the following CCG members: Robin Dahlberg (Chair), John Fox, Karen Gibbs (CCW), David Hogarth (EA), Tim Hutchings, Hazel Smith and Damien Williams. In addition, the following CCG members submitted comments by email or telephone: Jacky Atkinson (DWI), Keith Cane, Kathy Hughes (WWF), Jill Thomas (CCW) and Mark Tomkins.

the CCG's opinion relates to the company's stated intentions. The tight deadline for the company's response to Ofwat means that the CCG will not have an opportunity to review the final submission before it is sent off on 17 March and therefore may be subject to change. The CCG will meet again on 19 March at which time we expect to have had the chance to consider the submission in full. If at that point we have any additional comments or concerns to raise we shall do so.

Proposed Changes to the Affinity Water Business Plan

Affinity Water advised us that to support their bid for enhanced status, they proposed to make some changes to the Business Plan they submitted to Ofwat in December 2013. We were assured that they would be adjusting some existing elements of the plan, and would deliberately avoid introducing new components.

The company told us the financial adjustments would mainly be to the cost of capital assumptions and to the Outcome Delivery Incentives (ODI) in order to bring them into line with Ofwat's recent guidance.

As was the case with our report to you last year, we do not believe we have the capability or capacity to comment on the financial aspects of the changes relating to the cost of capital or the small company premium, nor do we believe it falls within our remit. We therefore look to Ofwat to determine whether the company has met its requirements.

We have focused our efforts on reviewing the company's proposals for:

- the rewards and penalties associated with the ODIs
- uncertainty mechanisms: change protocol
- rolling-up the rewards and penalties until PR19 / bill acceptability
- the customer engagement strategy related to the Thames Tideway Tunnel bill impacts.

Rewards and penalties associated with the ODIs

The company told us that they intended to structure their rewards and penalties in such a way that the main emphasis was on leakage reductions, so that this would account for 90% of the expected total reward component. The remaining 10% required to achieve Ofwat's RORE guidance would be linked to reductions to major interruptions to supply (8-9%) and to delivering ahead of schedule the sustainability reductions the company agreed with the Environment Agency (1-2%). This was said to meet Ofwat's basic requirement that the ODIs remain inline with the company's willingness to pay research findings.

In both qualitative and quantitative research in 2012 - 2013, customers told the researchers that they did not wish to pay the company more for doing the job they were expected to do, but agreed the company should be penalised if it failed to discharge its duties or meet required standards.

Affinity Water conducted further research with domestic customers in March 2014 to explore attitudes to their proposed use of rewards and penalties that generated statistically significant results. These results tended to confirm the outcomes from the earlier research, as follows:

- About 72% of customers agreed or strongly agreed that linking bills to performance was a good idea; only about 4% of customers disagreed.

- However, about 88% of customers wanted certainty over the amount of their future bills.

- About 44% of customers thought companies should not be rewarded for exceeding customer expectations; a further 37% of customers neither agreed nor disagreed with this idea.

- Customers were provided with information showing how Affinity Water proposed to vary their water bills through changes to financing and incentives, with the outcome that their bills would always be lower than it was in 2015 in real terms (before inflation). About 60% of customers agreed or strongly agreed that the proposed changes were good; about 4% of customers said this was not a good idea. About 59% of customers thought the revised proposals were acceptable; only 6% of customers thought the proposal was unacceptable.

- However, only 21% of customers thought it was a good idea to incentivise performance when it meant higher bills; 45% of customers disagreed or strongly disagreed with incentivising performance if it meant higher bills.

- About 54% of customers preferred that their bills were certain between 2015 and 2020 (apart from inflation). Another 33% of customers neither agreed nor disagreed, and only 12% of customers said they did not want certainty.

- However, there was no consensus amongst customers on whether rewards and penalties should be rolled up and applied in the following five-year period.[2]

In its Business Plan, Affinity Water included both rewards and penalties for an ODI on leakage, and we commented critically in our CCG Report[3] as this seemed at odds with the results of their customer research.

In its guidance on Risk and Reward dated 27 January 2014, Ofwat said companies should amend their plans by adding more ambitious rewards and penalties.

The CCG recognises that it is entirely within Ofwat's power to require companies to follow its guidance in this area   However, as we noted in our report to Ofwat last year "…we wish to stress that customers are against paying the company more for doing the job they believed water companies are supposed to do."[4] We would extrapolate from all available research that customers want to see the commitments made in the company's business plan delivered and where possible exceeded but not if it drives additional increases in future bills.

If Affinity Water is required to modify its ODIs, the customer research would appear to support the company's decision to place the primary emphasis on leakage reduction. This is of greatest concern to customers.[5] Further, from the customers' perspective, leakage reduction and sustainability reductions are key to legitimising the introduction of compulsory metering, although customers would undoubtedly question whether it was right to reward the company for this.

We are, however, concerned that Affinity Water has tied such a large proportion of its penalties and rewards to the one outcome on leakage. We understand why the company has done this, but have concerns about the company placing "all its eggs in one basket." For this approach to be credible with customers, we believe it is essential that the company develop a performance monitoring system that is transparent, robust and reliable. The company must be able to demonstrate to any doubters that they have not manipulated the outcomes to improve their rewards or to reduce their penalties. We presume that Ofwat would continue to audit the company's reporting in this area.

We also raised a concern that such a reward structure might lead to the

[2] Summary of findings from the on-line panel questionnaire, 12 March 2014
[3] CCG Report to Ofwat, paragraphs 1.19 – 1.24
[4] CCG Report to Ofwat, paragraph 2.87
[5] CCG Report to Ofwat, paragraphs 2.43 – 2.48, 2.72, 3.95, 3.116, 3.121, 3.161, 3.168 – 3.175, 3.187 – 3.188, 4.35 – 4.46

company's attention and resources being focused on leakage to the detriment of other outcomes/commitments. In response to this challenge, we were assured that the all the outcomes were underpinned by performance measures and carried sufficient incentive (reputational or in some cases the risk of regulatory action) to ensure the company would meet all its targets or required standards.

We believe that the proposed changes to ODIs are reflective of the customer priorities established by the willingness to pay research. We also note that the company has chosen a reward package at the lower end of the range proposed by Ofwat, thereby minimising the potential impact on customers' bills. This is consistent with customers' views that the company should not be rewarded for doing the job it is supposed to do and their general unwillingness to see bills increase.

Uncertainty mechanisms: change protocols

At the 13 March 2014 meeting, Affinity Water also outlined Ofwat's concerns about the company using the change protocol to manage future uncertainties. The company explained how dropping the change protocol would change the risks to the business. They had identified a number of potential uncertainties when submitting their business plan although had not attempted to quantify these. Our colleague from the Environment Agency expressed particular concern about the company's ability to deal with any additional statutory commitments arising out of the River Basin Management Plan, and this would be exacerbated if the company could not request additional funding through the change protocol. At the time of our meeting, the Affinity Water Board had not yet decided how to respond to Ofwat on this point.

We considered how to assess customers' views on the change protocol issue using the available customer research. However, neither the 2012 – 2013 nor the March 2014 research specifically asked customers for their views on uncertainty mechanisms. We therefore simply repeat the observation that the research showed that customers preferred bill certainty over volatility and therefore look to Ofwat to ensure that the arrangements finally agreed deliver the stability customers are calling for.

We accept the company view that removing the change protocol would add risk to the company. In order to ensure that the company will be able to fulfil its obligation to deliver safe and reliable water supplies to customers, the regulators should assure themselves that the Plan is still viable in the absence of the change protocol.

Rolling-up the rewards and penalties until PR19 / bill acceptability

In the research undertaken in 2012 -2013 customers[6] placed great value on the certainty of future prices. As noted above, the most recent research shows that 88% of customers wanted certainty over their future bills.[7]

In our Report last year, we said we had a concern about the proposed application of the ODI incentives within AMP6.[8]

The most recent research presented customers with two options: applying rewards and penalties after two years; and carrying them forward to "the end of the five years." About 80% of customers chose the first option although the report notes that the example given only quoted a bill reduction.[9]

Affinity Water has attempted to address customers' calls for bill certainty between 2015 -2020 by rolling up the rewards and penalties until PR19.

Affinity Water has explained to us how the proposed changes to the penalties/rewards arrangements might impact on customers' bills. The figures mentioned at the meeting were provisional, as the Affinity Water Board had not yet approved the underlying changes.

We noted that in the March 2014 research, the company asked customers for their views on bill acceptability, after providing examples that showed that even if the company earned the maximum rewards possible their customers' bills in 2020 would be lower in real terms than the forecast bill in 2015 (before inflation).[10]

The researchers also asked the following question: Given that Ofwat require companies to make this change do you think the changes Affinity Water is proposing are good? About 60% of customers agreed or strongly agreed, so the researchers concluded that the responses suggest that a majority of customers agree or are neutral about these changes when they were told the bill would always be lower at the end of the period in real terms. Only

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[6] CCG Report to Ofwat, paragraphs 2.83, 3.199

[7] Summary of findings from the on-line panel questionnaire, 12 March 2014, question 4

[8] CCG Report to Ofwat, paragraph 1.24

[9] Summary of findings from the on-line panel questionnaire, 12 March 2014, question 11

[10] Summary of findings from the on-line panel questionnaire, 12 March 2014, section 3

4% of customers disagreed.[11]

In the CCG's opinion, customers will accept Affinity Water's proposed changes if the net result is that their bills still decline (before inflation). Further, rolling-up the aggregate rewards and penalties until 2020 provides bill certainty over the next five years, which is what customers have said they want.

The customer engagement strategy related to the Thames Tideway Tunnel bill impacts

In our report to Ofwat, we said that the CCG had challenged Affinity Water on how it would deal with the impact that the proposed increase in Thames Water's sewerage charges, related to the Thames Tideway Tunnel, had on the acceptability of their combined water and sewerage bills, as the scale of proposed price increase had significantly reduced the level of customer acceptability. We formed a view that the company was committed to devising an engagement programme, and noted that most of this work will necessarily be done after the preparation of the Business Plan.[12]

In their letter to Affinity Water following the pre-qualification decision, Ofwat required the company to address a number of actions by 11 April 2014. This includes a requirement to "…commit to a programme of engagement with your customers, in agreement with your Customer Challenge Group in order to explain the impacts of the Thames Tideway Tunnel on waste water bills."[13]

The company provided the CCG Chair with an early draft response to Ofwat on this issue, and we include below some of the key elements.

Affinity Water noted that whilst the bill impact from a major project, delivered by others, is not their responsibility, the company can give a strong commitment to support their customers. They want to ensure that their customers are provided with appropriate information and support to help them understand and manage the impacts on their bills.

The company also mentions that the current billing arrangements with Thames Water are under review and intend to maintain a constructive working relationship recognising that a change in commercial arrangements may necessitate some revisions.

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[11] Summary of findings from the on-line panel questionnaire, 12 March 2014, question 6
[12] CCG Report to Ofwat, paragraphs 1.26 – 1.27
[13] Ofwat letter to Affinity Water dated 10 March 2014, Appendix 2, Action 6

The CCG is also aware that in their Business Plan the company committed to retaining a CCG (or an equivalent body) to assist their future customer engagement programme.

As the CCG, we would be pleased to work with the company to help them develop and deliver an effective engagement strategy to address the Thames Tideway Tunnel bill impact. However, it is also important to have sufficient measures in place to deal with any affordability issues arising from this proposed bill increase. We remain confident that Affinity Water is committed to implementing an effective programme to assist its customers with these issues. We would also highlight the need for Affinity Water to work closely with Thames Water on both the engagement and support programmes to ensure consistency in their communications and support provided to customers.

We also note that CCWater has a separate role in reviewing companies' annual charges proposals and related communications, which provides an additional level of assurance.

Comments from regulators about Affinity Water's bid for enhanced status

As we did in our report to Ofwat dated 26 November 2013, this letter includes summaries of advice provided to us by the other regulators on Affinity Water's bid for enhanced status.

The Drinking Water Inspectorate (DWI) raised several points.[14] First, they explained that they were"… not aware of any significant matters in respect of Affinity Water and drinking water quality that would be material to the CCG taking a view on enhanced status…." However the Inspectorate wished to draw our attention to two matters:

- Given the recent flooding, the DWI expects the company to review its resilience to extreme events and to make sufficient provision for any additional work that might arise.

- The DWI also expects all companies "… to allow sufficient expenditure for maintaining and operating assets." Further, the DWI "… would expect the Company to provide assurance that its business plan makes full provision for meeting all statutory drinking water quality obligations, and that it will prevent any deterioration in quality an/or quantity requirements."

[14] Email from Jacky Atkinson to Robin Dahlberg dated 10 March 2014

The Environment Agency and Natural England provided the following comments:

> The Environment Agency and Natural England are not aware of any material changes to the business plan that would compromise the company's ability to meet its statutory environmental obligations. However the Environment Agency wished to draw our attention to the following matters. These comments also reflect the views of Natural England, in so far as they relate to the natural environment:
>
> > The Company's Board has previously provided assurance that its business plan will include all necessary measures to implement the National Environment Programme (NEP phase 4) and the Water Resources Management Plan. We expect the Board to fulfill this assurance.
> >
> > Your Risk and Reward Guidance (Jan 14) asked companies to review their change mechanisms. If Affinity Water removes its change mechanism to cater for unexpected schemes arising from the 2nd River Basin Management Plan (i.e. NEP phase 5) we would still expect any such schemes to be implemented by 2021. This is particularly relevant to Affinity Water as their allowance for NEP5 is £920K – which would be sufficient for investigations but should replacement schemes be needed, would most likely be insufficient.
> >
> > We agree with the DWI that the company needs to review the resilience of its infrastructure to extreme events and make provision for any additional work that might arise.[15]

Final Conclusions

In the CCG's opinion Affinity Water has tried to pick a reasonable course through the conflicting requirements of their customers and the regulators. They propose to increase the penalties and rewards packages to satisfy Ofwat. However, the company is only proposing the minimum amounts acceptable to Ofwat because they recognise that their customers want bill certainty and do not approve of rewarding the company for doing its job. Further, the changes proposed are grounded on willingness to pay research, and the most recent research that appears to show that customers will support (or at least not object to) the overall package of

[15] Email from David Hogarth to Robin Dahlberg dated 12 March 2014

incentives given that future bills will be lower in real terms (before inflation) than today even if the company earns the maximum rewards available.

I trust that this letter with our opinions on Affinity Water's bid for enhanced status meets Ofwat's requirements. I would be pleased to discuss this further if it would be of assistance.

Yours sincerely,

Robin Dahlberg

Robin Dahlberg
Chair, Affinity Water Customer Challenge Group

CC Georgina Mills