

# Bristol Water's

## Local Engagement Forum



Statement to the  
Competition and Markets Authority on  
Bristol Water's 2015-2020 Business Plan

April 2015

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## 1.0 Introduction

The independent Customer Challenge Group (CCG) for Bristol Water's Business Plan submission for Ofwat's 2014 price review is known as the Local Engagement Forum (LEF).

The LEF was established in January 2012 with a diverse membership including customer representative organisations, the statutory consumer, water and environmental regulators, local authorities, trade organisations, environment and countryside groups and specialist academic representation.

The purpose of this statement is to inform the Competition and Markets Authority (CMA) of the LEF's opinion of Bristol Water's 2015 – 2020 Business Plan and the basis of that opinion.

This statement is regarded by the LEF as a supplement to and should be read in conjunction with the reports it submitted to Ofwat in December 2013, June 2014 and October 2014. These reports contain the LEF's detailed views on the Company's proposals and are appended to this statement for reference (Appendices 2 to 4 inclusive).

The Drinking Water Inspectorate (DWI) has informed the LEF that it will be providing a separate submission to CMA on its role and remit and engagement in the PR14 process.

CCWater is also providing a response to the CMA.

## 2.0 The LEF and its engagement and challenge process

The LEF's key objectives have been to advise and challenge Bristol Water on its customer engagement methodologies for the Business Plan, on its interpretation of the results of this engagement and the reflection of customers' views in its strategy and its business plans. The LEF has also challenged the Company on the scope, justification, cost-effectiveness and affordability of its plans. The LEF's governance process is described in Appendix 1.

In undertaking its work over some three years, the LEF and its sub-committees have been fully aware of the need to robustly and independently challenge the Company and to be able to evidence its findings and opinions. The LEF maintained diaries of the challenges it has made throughout the process together with the resulting responses and outcomes. It included these diaries in its submissions to Ofwat.

The LEF was given adequate and appropriate access to Company information and personnel (including its external specialists) throughout the process. Bristol Water co-operated fully with information requests from the LEF and responded positively and constructively to its challenges. Numerous changes and amendments to Bristol

Water's plans resulted from the LEF's challenges particularly in the scope and approach to customer engagement and in the amount and form of assistance to customers who are struggling to afford their bills. These were important outcomes for customers which may not have come about without the activities of the LEF.

The LEF has met twice with the Company since Ofwat published its Final Determination (FD) At the 6 February 2015 meeting the Company informed the LEF of its decision to refer its case to the CMA. At the 31 March 2015 meeting the Company summarised its Statement of Case to the LEF.

### **3.0 LEF's opinion on key aspects of Bristol Water's Business Plan**

The LEF's opinions are based upon information provided to it by Bristol Water up to the end of March 2015. This has included the Company's Statement of Case (redacted) submitted to the CMA, its associated presentation to the LEF's at the meeting on 31 March 2015 and an Information Note prepared by the Company at the request of the LEF. This Information Note is given in Appendix 5 of this statement.

#### **3.1 Customer bills**

In its Statement of Case to the CMA, Bristol Water is proposing that average bills for its customers in 2019-20 will be around £11 (5.5%) less in real terms than in 2014-15.

The LEF was satisfied that the Company's proposed reduction in bills reflected an appropriate balance of the needs of customers and other stakeholders, was consistent with the Company's strategies and policies and that it represented good value for customers. The LEF was pleased to see that the Company challenged itself between its December 2013 and June 2014 submissions and accepted tighter margins and returns and greater capital expenditure efficiency in order to reduce bills rather than make cuts in the proposed level of investment or delivery of outcomes. This marked a specific win for Bristol Water customers, achieved through the LEF engagement process. The LEF challenged the proposed investment, requiring Bristol Water to justify the value for money of its proposals, often achieving reductions resulting in lower proposed bills.

The LEF notes that Ofwat's Final Determination results in significantly lower bills for customers than the Company has proposed. The LEF welcomes lower bills for customers. However, Bristol Water has informed the LEF that it cannot deliver its proposals for customers for the revenue Ofwat has determined and has illustrated the associated risks to the delivery of the individual outcomes. If the Company's case is correct then the LEF has concerns that its customers would not receive the levels of service and enhancements to their water supply in the period 2015 to 2020 on which they were consulted and 92% of them found to be acceptable.

The LEF acknowledges it has considered the Company's arguments and those put forward by Ofwat on the basis of limited information, notably about how the model used by Ofwat worked. Nevertheless, it is the LEF's view that customers will expect service levels to be at least maintained over the next five years, and would be concerned if they were to deteriorate. This was the outcome of research undertaken by Bristol Water, with the LEF's full support, which tested customers' views on service and price packages, in the lead up to submission of the Company's business plan.

The LEF, therefore, looks to the CMA to assess whether the models used during the price review were appropriate, and provide the company with the funding required to safeguard services to customers.

### **3.2 Customer engagement and willingness to pay**

The LEF, through its Customer Survey Sub-Committee (CSSC), were heavily involved in the design and implementation of the Company's customer engagement processes used to inform its Business Plan. The LEF welcomed this level of involvement which extended throughout the price setting process. The CSSC spent considerable time reviewing and challenging the details and results of the customer engagement process, thereby contributing to a rigorous and thorough research programme.

The extent of the CSSC's review and challenge of the customer engagement processes is described in detail in the LEF's report to Ofwat of December 2013 (see Appendix 2). A summary is presented in Figure 1 below.

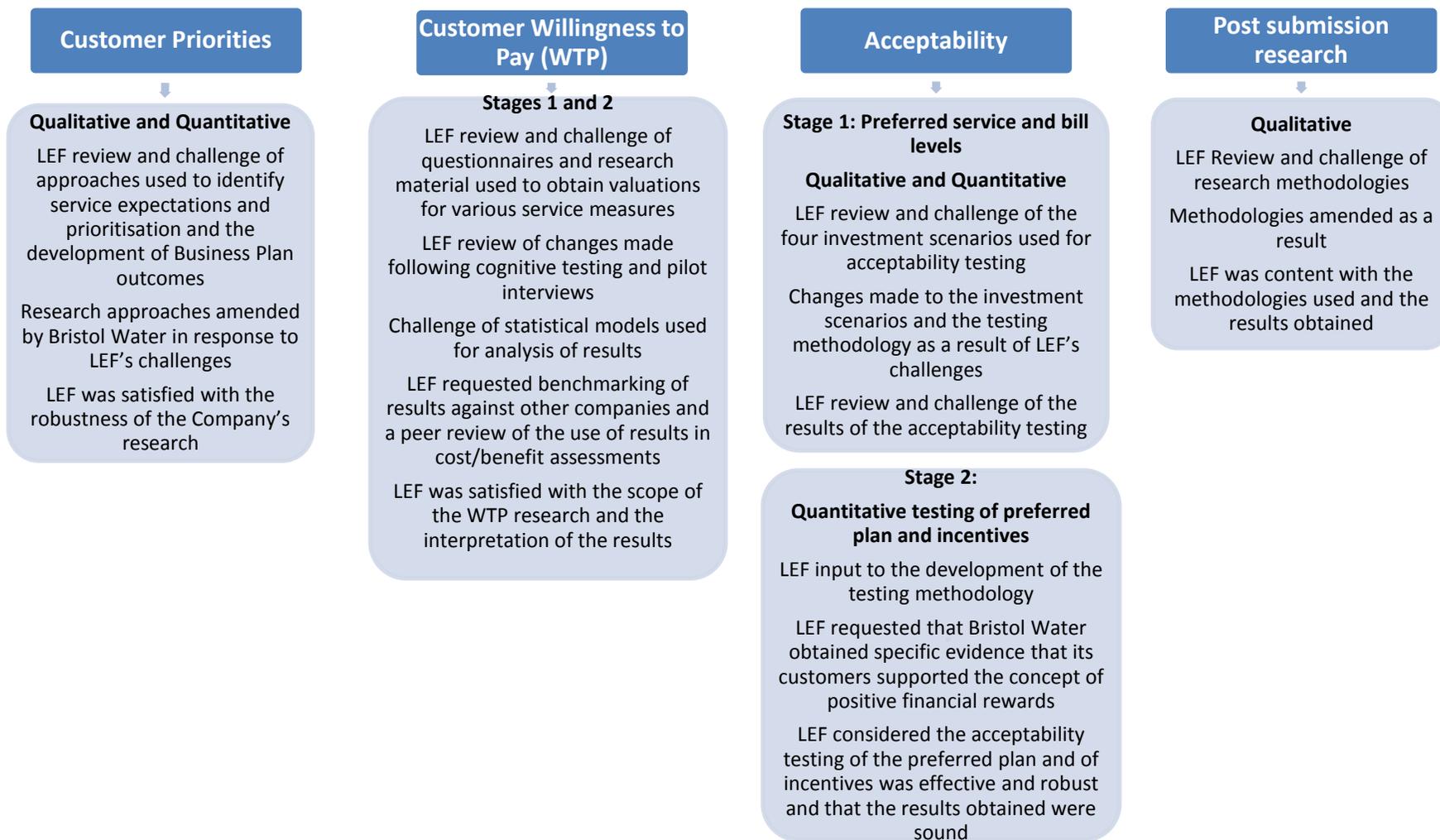


Figure 1 – The LEF review and challenge of the customer engagement process

Bristol Water has informed the LEF that Ofwat, in its initial submission to the CMA on 4 March 2015, is of the view that there were substantial weaknesses in the customer engagement used to support the proposed totex. It considers the engagement was 'superficial'. Ofwat's conclusions are not consistent with the LEF's experience of the Company's engagement process, which was good, or in Ofwat's Risk Based Review of March 2014. The LEF notes that in its Risk Based Review Ofwat assigned a B score from its tests on Bristol Water's customer engagement and willingness to pay (WTP) results, placing the Company along with seven others in the second highest tranche in the industry (there was only one company that achieved an A score).

Through its extensive review and challenge of the engagement processes the LEF considered the methodologies used by the Company and the results obtained to be robust. The LEF is of the view that the engagement was not superficial and it is therefore concerned that Ofwat's headline comments risk weakening the weighting of the extensive process that has been conducted, and thus also that of the underlying resultant detail underpinning the clear conclusions that were reached.

Ofwat issued revised guidance on Risks and Rewards in April 2014 requiring companies to include Performance Commitments in their future plans that provide opportunities to earn financial rewards for out-performance as well as suffer penalties for poor performance. Bristol Water did not include positive incentives in its December 2013 Business Plan because it had strong evidence that customers did not support them.

The Company undertook additional customer research into incentives and the methodology was reviewed and accepted by the LEF through its CSSC.

Bristol Water complied with Ofwat's guidance and included positive incentives in its June 2014 plan despite customers' confirming again, as a result of the additional research, that they were not generally in favour of them and did not want them funded through increases in bills. Customers were firmly of the view that water services should be of a uniform high standard, without incentives.

The LEF was disappointed that Ofwat required Bristol Water to disregard the views of its customers on the principle of how rewards are funded. Further opinion on the incentives the Company proposed are given in the LEF's reports to Ofwat of December 2013 and June 2014.

Notwithstanding the issues around incentives, the LEF was satisfied that the findings from the customer research and the willingness to pay studies were used appropriately in the design of the Company's aims and outcomes, in the development of the associated plans and the resulting impact on bills.

## **3.4 Outcomes and Performance Commitments**

### **3.4.1 Outcomes**

The LEF welcomed the opportunity to challenge the Company's proposed outcomes and to contribute to the thinking behind them. The LEF considers that the proposed outcomes reflect a sound understanding and reasonable balance of different customer and stakeholder views and priorities as evidenced by the Company's research. It believes the phasing, scope and scale of activities contained in the Plan are designed to deliver the outcomes in ways that are socially, economically and environmentally sustainable and to maximise acceptability to customers. It considers that Bristol Water gave adequate consideration to both the short and long term in its planning.

The LEF notes that Ofwat confirmed the Company's proposed outcomes in both the Draft and Final Determinations. It is the performance targets around those outcomes that the Company is disputing as a result of Ofwat setting the industry upper-quartile performance targets following its cross-company comparisons. Further comment on performance commitments, targets and incentives is given in Section 3.4.2 below.

### **3.4.2 Performance Commitments**

The Company originally proposed five performance commitments containing penalty-only incentives but increased these to eight (including five with financial rewards as well as penalties) in response to Ofwat's challenges and revised methodology.

The LEF supported the proposed performance commitments but throughout the process expressed its concerns over the adoption of rewards which customers were generally not in favour of paying for through increases in their bills. Specific comments on incentives, including the views of CCWater, the Environment Agency and Natural England, are given in the LEF's reports to Ofwat of December 2013 and June 2014.

The LEF notes that Bristol Water accepts all Ofwat's FD amendments to its proposed performance commitments with the exception of unplanned minutes lost, negative water quality contacts and mean zonal compliance. It appears to the LEF that Ofwat have imposed tighter targets in the Final Determination without the funding necessary to achieve them. Ofwat considers it has given Bristol Water enough funding to meet the targets.

For unplanned minutes lost and negative water quality contacts the Company wishes to revert to its original June 2014 targets which the LEF supported, with noted reservations from CCWater, because they aligned with the results of customer research.

For mean zonal compliance the Company is arguing that a target of 99. % is more appropriate than Ofwat's target of 100%). The LEF's views on the mean zonal compliance commitment remain as expressed to Ofwat in June 2014. It does not support the Company's proposed deadband on mean zonal compliance because of the potential negative impact on customers. However the LEF accepts the water quality standard hasn't been lowered and that Ofwat has imposed the 100% incentive across the industry with the exception of South West Water. Additionally the DWI notes the minimum statutory requirement is to achieve 100% compliance for mean zonal compliance, and it is not possible for the DWI to formally support a business case to achieve less than this.

### **3.5 Cost assessment**

The LEF expressed concerns to Ofwat in its report on the Draft Determination over the significant difference between the views of Ofwat and Company of the cost of the proposed investment in 2015-2020. These concerns remain following the Final Determination. While supportive of an efficiency challenge being made by Ofwat, it is difficult for the LEF to understand how the Company could deliver the proposed totex investment for significantly less than its estimates.

The LEF challenged the Company to illustrate the risks to the delivery of its proposed outcomes for customers if it were required to adopt the Final Determination totex allowances. As a result of how the Company plans to respond to the FD by constraining maintenance expenditure, not building the Cheddar Two Reservoir and reduced pump replacement and leakage reduction activity, the Company has informed the LEF that there are moderate risks in 2015-2020 to the delivery of the outcomes for 'sufficient supply', 'water quality', 'efficient use of resources' and 'satisfied customers' and a major risk to the reliability of water supply. In the longer term (to 2030) these risks become major for reliability and sufficiency of supply and 'satisfied customers' with an additional moderate risk to 'sustainable environmental impact'. As a result of recent and ongoing work, the LEF accepts the need for measures to reinforce supply resilience but has questions over the timing of these, particularly concerning Cheddar Two Reservoir.

The issues relating to wholesale costs between the Company and Ofwat appear to focus on differences on cost modeling methodology and efficiency assumptions. The LEF is not qualified to opine on this. The LEF was content with independent assurance provided for the Company's cost estimates and the asset planning methodologies employed and it supported the overall package of work and the associated bill impacts.

As mentioned above, the LEF is concerned that as a result of the Final Determination investment allowances, Bristol Water's customers will not receive the levels of service and enhancements to their water supply in the period 2015 to 2020 on which they were consulted extensively and found overwhelmingly acceptable.

### **3.6 Cost of Capital**

The LEF has taken an interest in the Company's assumptions on Cost of Capital including the incorporation of a Small Company Premium (SCP) as it has been keen to understand the potential detrimental impact on bills if the SCP was not allowed in the price determination.

The LEF notes the Company's updated assumptions on Cost of Capital in its Statement of Case to the CMA. It has continued to challenge the Company on its assumptions and has obtained an understanding of them. It is not the role of the LEF to take a formal view on the Cost of Capital. However, the LEF is concerned if Bristol Water has to remove any of the customer benefits from its Plan, all of which have been carefully negotiated, as a result of financeability factors.

### **3.7 Summary**

The LEF's remit has been to review and challenge Bristol Water's 2015-2020 Business Plan submissions to Ofwat in order to confirm that customers' best interests were being reflected and accommodated. Its work, including that of its sub-committees, has spanned more than two years and resulted in the LEF concluding that the final Plan included strategies and policies that strike an appropriate balance of the needs of customers and other stakeholders and represent good value for customers. The Company's customers overwhelmingly accepted the Plan.

The LEF is concerned at the significant gap between the Company's proposals and the Ofwat's Final Determination on them. As such the LEF welcomes the Company seeking the CMA review to ensure that customers receive the levels of service and enhancements to their water supply on which they were consulted and confirmed they found acceptable.