



*Putting customers at the heart
of the business*

**SOUTH EAST WATER
CUSTOMER CHALLENGE GROUP
REPORT TO OFWAT**

2 December 2013

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Note on sources:

Throughout this report, we have sought to make our observations and recommendations evidence-based. We draw mainly on three sets of documentation:

- 1) Minutes of Customer Challenge Group meetings – the notation we use is CCG1/2, where the first number is the number of the meeting and the second number is the number of the minute. Links to all our minutes can be found in Annex C
- 2) The Challenge Log – the notation we use is CL99 where the number is that of the particular challenge as listed chronologically in the Log. Access to the Challenge Log is via SEW PR14 micro site.
- 3) Pieces of customer research conducted by the Company – these are identified by name. Access to all the research is via the Engagement Appendix to the Business Plan on the secure section of the SEW PR14 micro site.

Note on approach:

In Information Notice 13/15, Ofwat confirmed its consistent approach throughout this Price Review that: “we would not be specifying the content or presentation of CCGs’ reports. We want to give each CCG the freedom to explain its findings in the most effective way.”

We welcome this flexibility. We have sought to produce a comprehensive and detailed assessment of South East Water’s Business Plan, while concentrating on the impact on the customer. We have focused especially on the Company’s customer engagement and how it has used the findings from that research to shape the Plan. We have endeavoured to be genuinely challenging while scrupulously fair, always supporting our views with evidence.

This is the independent report to Ofwat from the Customer Challenge Group (CCG) of South East Water (SEW) on the Company's Business Plan for 2015-2020.

Section A: Setting The Scene

A1: Nature And Operation Of The CCG

SEW advertised externally for the appointment of an independent Chair for the CCG and appointed Roger Darlington. He invited the four organisations that were proposed for CCG membership by Ofwat – the Environment Agency (EA), the Drinking Water Inspectorate (DWI), Natural England (NE) and the Consumer Council for Water (CCW) – to nominate a member to the Group. In addition, he appointed members to represent household customers, business customers, and local authorities and one with experience of customer research and engagement. The qualifications and expertise of the Chair and eight members are summarised in Annex A.

Except when the CCG had private sessions (which it did regularly), SEW has had three senior managers in attendance led by the Head of Assets & Economic Regulation (which latterly was a Board position).

Our terms of reference reflected the role given to the CCGs by Ofwat (see Annex B) and we operated totally transparently with publication of all minutes (see Annex C). We met 11 times, three times to consider drafts of the Company's Business Plan and drafts of this report. All the CCG challenges and the Company's responses to those challenges were recorded in a Challenge Log that is referenced often in this report.

We feel that overall the CCG process has worked well and we commend Ofwat for proposing this approach and South East Water for embracing it. However, we have encountered some problems – notably around the PR14 timetable – and we felt that it would be useful to capture some learnings from the process so far and make a number of recommendations for the future. These eight recommendations are set out in Annex D.

A2: Past And Present Of South East Water

The present SEW is the result of a merger in December 2007 involving the old South East Water and Mid Kent Water. It has 2.1 million customers, making it the second largest water only company in England & Wales (after Affinity with 3.5 million customers).

Across a whole range of key operational measures – which we have listed – SEW performs well for its customers. We provide graphs to show how the Company has delivered some £90-95M of investment year after year.

However, the CCG has drawn attention to the Company's disappointing record on complaints. Since the Company's creation, it has had a problem in this key area. Per 10,000 customers, two years ago it had the highest number of complaints in the sector and last year the second highest.

While the Company has instituted programmes to address the causes of complaints and achieved some real progress – all of which we reference – we have felt it right to highlight the issue both because of its centrality to the customer experience and because of a marked reluctance by the Company to acknowledge the matter publicly as fully and frankly as we would have wished.

We have mentioned SEW's gearing ratio which is relatively high and the Company's corporate structure which includes entities in Luxembourg and the Cayman Islands. We do this in the context of reputational risk to the Company.

Section B: The Overall Challenge Process

B1: Adequacy Of The Company's Customer Engagement

In this report, we have reviewed 13 pieces of customer research carried out by SEW during the lifetime of the CCG and expressed our view on each. Seven of those have fed directly into the Business Plan. The most important was the Willingness To Pay (WTP) research which found that SEW's customers are not willing to pay any more than they do now for service improvements.

The CCG has had a number of concerns about stated preference research that we have listed in our report. It should be noted that our reservations are not criticisms of SEW, since the current WTP methodology is standard throughout the industry and our concerns are relevant to the whole sector.

Indeed, far from criticising SEW for its WTP research, we commend the Company for engaging with us in the debate over weaknesses in stated preference methodology and for its willingness to take on board our suggestion of using a different method, menu driven customer valuation research, for triangulation which in fact broadly supported the conclusions that the Company had drawn from the WTP research.

We have concluded that:

- The Company has carried out an impressive range of research, largely using several market research companies with the most experience and highest reputation for this kind of work.
- The Company has consulted extensively with the CCG on most of these pieces of research and taken on board a substantial number of detailed observations from the CCG on methodology and materials.
- The research has deployed a range of methodologies and used a range of respondents and the CCG has been pleased at the consistency of the results and messages coming from this programme.
- We regard some of the research as innovative, namely the triangulation work to check the WTP research (which the CCG itself suggested) and the research on outcomes which attempted but failed to establish a basis for customer valuation of changes in service levels.

B2: How The Company's Customer Research Has Shaped The Business Plan

Ofwat has made clear: "We expect a clear, coherent and evidenced 'golden thread' to run through the whole business plan so it is clear how each element of the plan fits together." This was the CCG's view too.

Throughout all our discussions on different drafts of the Business Plan, the CCG constantly challenged the Company to show how each major element of the Business Plan is supported by appropriate customer engagement and the priorities and preferences identified by the customer research.

Our report lists the ways in which the Business Plan references all the relevant evidence and we have been pleased to see the 'golden thread' being clearly evidenced throughout the document.

B3: Meeting Statutory Obligations

In its Methodology Statement for PR14 as confirmed by Information Notice 13/20, Ofwat has asked that the three environmental and quality regulators – the Environment Agency (EA), the Drinking Water Inspectorate (DWI), and (in our case) Natural England (NE) – to present their views on company business plans for PR14 primarily through the report of the relevant CCG.

Each of these regulators has provided the CCG with a statement – set out in Annexes E, F & G respectively – and, on this basis, Ofwat should be assured that the three environmental and quality regulators are broadly supportive of the Company's Business Plan, as it relates to meeting the requirements of DEFRA's Statement of Obligations, and have no significant objections outstanding at the present time. It is, however, a matter for the Company to ensure that it has allocated sufficient expenditure and resources to meet its statutory obligations.

B4: Acceptability To Customers And Affordability By Customers

We have set out information on historic bill levels for SEW. We note that bill levels have fluctuated but are currently the highest since the Company was formed.

We have reviewed the current bill level for SEW. We note that Ofwat data for estimated average household bills for 2013/14 shows the Company as having the 7th highest bill out of 23 companies. Compared to an industry average (weighted) of £186, SEW's average bill of £201 is 8% above the average.

SEW commissioned acceptability research on its Business Plan proposals with a nil increase in bills in real terms – although the actual proposition in the final plan is for a 1% reduction in real terms.

This acceptability research found:

- 76% of household customers and 78% of business customers found the Business Plan somewhat or completely acceptable when asked an initial (uninformed) question.
- 86% of household customers (84% of low income households) and 79% of business customers found the overall Business Plan somewhat or completely acceptable, once informed with more details.

The CCG believes that this research provides clear endorsement for the pricing and service propositions in the Business Plan and notes that the acceptability levels were in excess of the threshold referenced in CCWater's research (70-75%).

The CCG welcomes SEW's intention to introduce a new social tariff in 2015/16. We note that some 30,000 customers might be eligible but that, taking into account the current level of subsidy that customers will support for the next five years, some 15,000 can be expected to be on the tariff by 2019/20.

Section C: Challenge To Component Parts Of The Company's Business Plan

C1: How The CCG Was Consulted On The Business Plan

SEW showed us five drafts of the retail plan for households, four drafts of the retail plan for businesses, five drafts of the wholesale plan, and one draft of the overall plan. There were three opportunities for CCG meetings to consider draft components of the Business Plan and two meetings when the CCG Chair and the CCG consultant met with the Company's regulatory team to discuss these drafts in more detail.

Although we saw a summary financials paper two months before the Ofwat deadline for submission, only at the last CCG meeting before the submission date did we have detailed information on prices and outcome delivery incentives and only two weeks before the deadline was the CCG shown a Business Plan comprehensively populated by most of the relevant financial, outcome and incentive statistics.

Essentially this was a consequence of the tight PR14 timetable and the common deadline for submission to Ofwat of the Business Plan and the CCG report.

The CCG challenge to SEW was a strong one and discussions on drafts of the Business Plan were – especially at Board level – robust. But we believe that the end result is a better plan: more stretching, better evidenced, and more consumer-focused.

C2: Comments On Overall Plan

Key to the whole Business Plan has been the shift to outcomes and the development of Outcome Delivery Incentives (ODIs).

We believe that SEW has selected around the right number of outcomes and more importantly chosen the right outcomes, that is the ones that matter most to its customers as evidenced by its research.

The CCG was sympathetic to SEW's aspirations early in the planning process to measure these outcomes wholly in terms of customer perceptions as this would clearly demonstrate

outcomes and not outputs. We were anxious, however, about whether it would be possible to develop in time proper measures for such perceptions and can understand why in the end the Company has chosen to use a mixture of actual service measures and perception measures.

The CCG notes that, from the point of view of customers, the proposed incentives regime would represent a maximum 'return' of around £2.45 per customer per year in the event of the failure to achieve all the targets and a maximum bill increase of £1.44 per customer per year in the event of beating all the targets. In the context of a bill of £199 in 2012/13 prices, this would be a maximum decrease in the bill of around 1.23% or a maximum increase in the bill of 0.73%. In practice, any decrease or increase might be smaller.

We do not know how customers would view such a regime as this has not been tested in detail with customers. However, the Company has assured us that the reward/penalty range is comparable to the current Service Incentive Mechanism (SIM) and that this has been shown to be effective in changing the Company's behaviour. So the CCG concludes that such an ODI package would benefit customers but not in a manner that they would directly notice in prices.

Each of the three components parts of the Business Plan refers to a new proposal for the creation of two Customer Panels – one for household customers and another for business customers. We very much welcome this proposal which will involve each Customer Panel reviewing on a quarterly basis performance against plans in the relevant customer base. We note that this new approach will be introduced in Spring 2014 for full implementation by April 2015.

C3: Comments On Retail Plan For Households

This plan is built around a CLEAR acronym:

- **C**lean water
- **L**ow leakage
- **E**ffective service
- **A**ffordable bills
- **R**eliable service

We have made a series of detailed comments on this plan, notably challenging the level of ambition around reduction in leakage and complaints.

C4: Comments On Retail Plan For Businesses

This plan is built around a CHOICE acronym:

- **C**lear prices
- **H**elp, advice and additional services
- **O**perational stability
- **I**nnovative customer contracts
- **C**lean water
- **E**ffective service

We have made a series of detailed comments on this plan, notably examining the preparation for impending competition in this market segment.

C5: Comments On Wholesale Plan

This plan is focused on eight customer outcomes, five compliance outcomes and three sustainability outcomes.

Again we have made a series of detailed comments on this plan, including a challenge on planned reductions in water consumption.

C6: Comments On Selected Appendices

SEW's Business Plan is supported by 28 detailed appendices and the Company has offered the CCG access to any of these that it wishes to see. Most fall outside the CCG's terms of reference and ability to assess – notably all the documents to do with costs – but others bear directly on those issues that are central to our report.

Therefore we have viewed and briefly commented upon the Appendices on Engagement, Communications, and Performance,

Section D: Recommendations And Conclusion

In the main body of this report, we have made a series of 13 recommendations to Ofwat that, for convenience, we have summarised at the end of our report

Over the last 20 months, the CCG and SEW have been on a joint journey. Neither party knew quite how this new arrangement would work. It has not always been an entirely comfortable process for either party but the discussions and debates have been professional and constructive.

The effective embedding of the CCG within the Company's business planning process has enabled a level of challenge that would not have been possible in the past.

In the first 15 months, the CCG met approximately every two months and the Chair was in approximately weekly contact with the Company, in addition to the discussions on individual pieces of research that took place through our Customer Engagement Sub-Group. In the last three months, the CCG has met monthly and the CCG Chair has been in daily contact with the Company, while CCG members have studied successive drafts of the Business Plan.

This level of involvement and engagement enables us with confidence to conclude that, as regards our area of competence, the SEW Business Plan should be commended to Ofwat.

Section A. Setting The Scene

A1: Nature And Operation Of The CCG

Background To Our Formation

In the field of economic regulation, there are broadly three institutional models for enabling a consistent and coherent consumer voice in any particular sector:

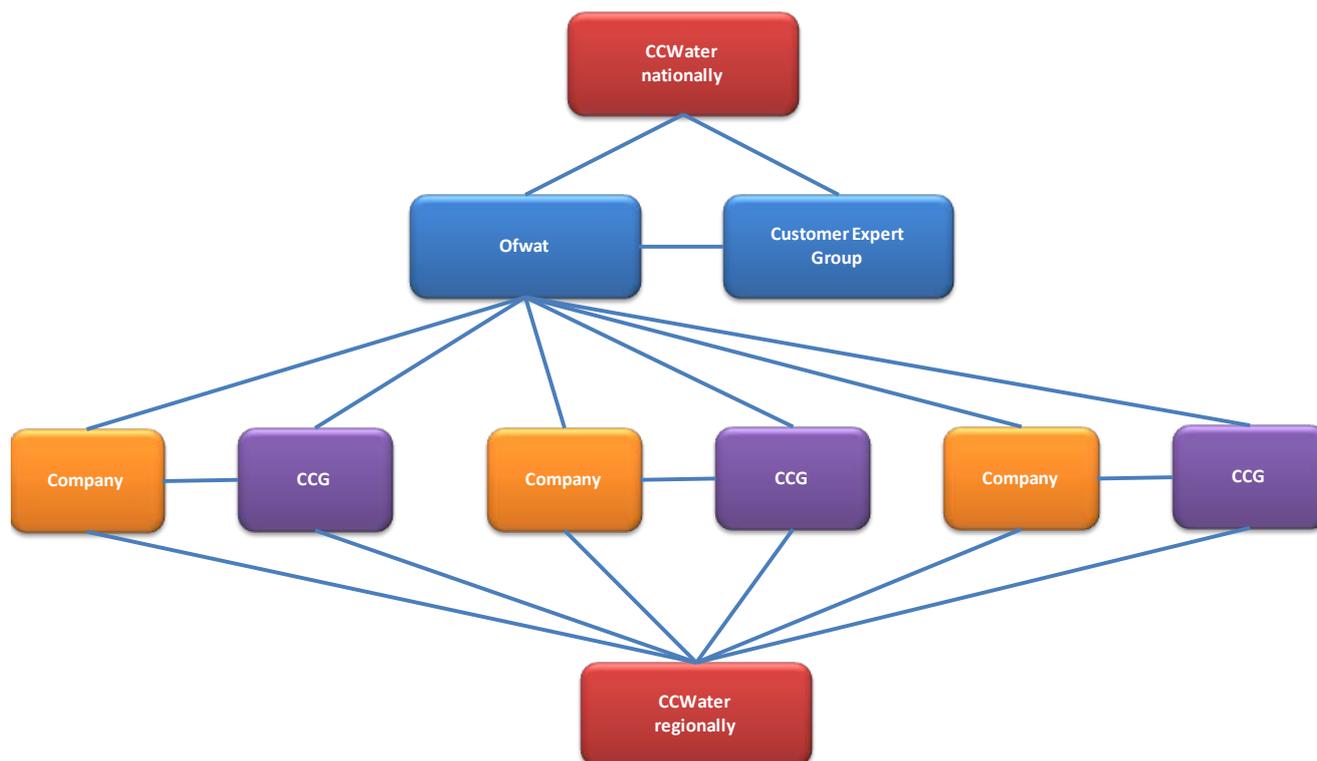
- a body inside the regulator – for instance, the Communications Consumer Panel in Ofcom and the Customer Expert Group in Ofwat
- a body outside the regulator – for instance, Consumer Futures (energy & posts), Passenger Focus (rail & buses), and the Consumer Council for Water (water & sewerage)
- a body alongside the regulated company – such as the Customer Challenge Groups in the water sector

In the lead up to the last Ofwat Price Review PR 09, the Consumer Council for Water (CCWater) encouraged each water company to set up regular meetings with the Environment Agency, the Drinking Water Inspectorate & Natural England (or Natural Wales) and CCWater, as the statutory customer representative, so that the water company's business plan proposals could be discussed and challenged as they were developed. These 'quadripartite' groups provided the opportunity to question and explore issues with the company while gaining an insight into the various drivers of investment and company strategy.

This 'quadripartite' approach was judged by all concerned to be a positive way of working and one that Ofwat has chosen to build on in requiring all water companies to establish a Customer Challenge Group (CCG) for the current Price Review PR14. The new CCGs have the important role of submitting to Ofwat a response to the business plan of their company. So far as we are aware, the CCG model is currently unique.

We commend Ofwat for proposing this approach and South East Water for embracing it.

Institutional Customer Voice In The Water Sector



Our Chair And Our Members

Ofwat made clear that they expected the Chairs of CCGs to be independent but left it to companies as to how they selected their CCG Chair. South East Water chose to have an open selection process conducted through Odgers Berndtson. Shortlisted candidates were interviewed both by Odgers and by a four-member panel of Company managers led by the Managing Director.

This process resulted in the appointment of Roger Darlington as CCG Chair and his brief biographical details will be found in Annex A.

It was agreed between SEW and the Chair that the appointment of the CCG members should be by the Chair, in consultation with the Company. He decided to strike a balance between having a membership large enough to represent the major interests but small enough to ensure full participation at meetings. This resulted in a membership of eight in addition to the Chair.

Four representatives came from the four organisations which constituted the 'quadripartite' structure used in PR09: Jim Barker from the Environment Agency, Elinor Cordinor from the Drinking Water Inspectorate, Louise Bardsley from Natural England, and Karen Gibbs from CCWater. The CCG recognised the pressure on the three regulators in supporting all the CCGs in England & Wales, so we accepted the use of substitutes and each organisation used this facility. Attendance was very good and the CCG very much appreciated the commitment of these four expert organisations to the work of the Group.

Four further representatives broadly covered the interests of household customers (Caroline Farquhar from the Tonbridge & Malling Citizens Advice Bureau), business customers (originally Ben Earl of B&Q and later John Archer of the National Farmers Union), and local authorities (Janet Hill from Swale Borough Council) plus a special knowledge of consumer research & engagement (consultant Kathryn Rathouse). Attendance was excellent and the Chair really valued the insights of his colleagues.

The qualifications and expertise of these eight members are considerable and are summarised in Annex A.

In most respects, the membership of our CCG is not untypical of that of other CCGs. However, we believe that we were rather different in having as a member someone who is expert in customer research and engagement. The CCG – and we believe - the Company found this incredibly useful, since the conduct and use of customer research was at the heart of our role and our deliberations.

As with other CCGs, managers from the Company are not members of the Group but attended most of the discussions. In our case, SEW was represented by David Hinton (Head of Assets & Economic Regulation which latterly was a Board position), Tanya Sephton (Regulatory Programme Manager), and Jane Gould (formerly Head of Communications and now a consultant working on PR14 communications strategy). Nicola Blake, Regulatory Assistant, took our minutes and circulated our papers.

The CCG was at all times impressed by the regulatory team's willingness to engage with the Group and to consider seriously all our challenges. The exchanges were robust but always evidence-based and the relationship was a thoroughly professional one. All the CCG challenges and the Company's responses to those challenges were recorded in a Challenge Log that will be referenced many times in this submission.

In the months leading up to our report for Ofwat, we decided to employ a consultant to provide us with specialist help on the submission. We considered the use of a reporter who would have a specialist, technical knowledge of the sector but decided on a different approach for two reasons.

Firstly, the Company itself decided to continue with the reporter process used in previous Price Reviews for its own internal governance and we wanted to do something that would be distinctive and different. Secondly, we wanted our report to have a powerful customer focus and therefore decided to employ an expert in customer experience.

We found Carole Pitkeathley through Odgers Berndtson and her brief biographical details will be found with those of CCG members in Annex A.

CCG Chair Roger Darlington wrote the report with support from all the CCG members and the CCG consultant Carole Pitkeathley.

How We Have Worked

The CCG started by determining its terms of reference for which it drew upon the Ofwat methodology papers for the PR14 process and guidance from CCWater. These terms of reference are set out in Annex B.

As originally envisaged by SEW before the CCG was created, the Group would have had three sub-groups: one for household customers, one for business customers, and one for the Water Resources Management Plan (WRMP). In the event, the first two groups were felt to be unnecessary, given the extensive customer research programme of the Company, while the third group was created in the form of the Environmental Focus Group chaired by the Asset Director for the Company.

The CCG thought it important to keep aware of the work of the Environmental Focus Group that it achieved through some common membership, regular reports, and two visits by the CCG Chair. This has ensured that our comments on the Company's Business Plan are consistent with our appreciation of the draft WRMP.

In the view of the CCG, the Environmental Focus Group process worked very well, ensuring early and comprehensive input by local stakeholders into the WRMP programme of work. **We commend the Company on this initiative.**

Once the CCG was created, we considered whether we should set up any sub-groups. We decided against this, partly because we wanted all members to be involved in all discussions and partly because we did not want to place an extra strain on the time commitment of members.

Although we did not set up any physical sub-groups, we did establish one virtual group of four members (including Kathryn Rathouse) to take a special interest in the customer research programme, to advise on draft materials, and to review draft reports. This work was undertaken through e-mail and telephone calls and, when required, face to face meetings with the Company.

The CCG was clear from the beginning that, although its members came from different backgrounds and through different organisations, we wanted a collegiate style of working which meant that – in the words of our terms of reference – “all members will contribute fully and candidly to all discussions and not simply represent an organisational position or limit themselves to an organisation's interest”. This, indeed, is how we operated.

Equally, the CCG was very clear from the start that it wished to operate with openness and transparency. Therefore our terms of reference and all our minutes were published on an appropriate part of the Company's web site [for links see Annex C], the Chair was in regular contact with “Utility Week” (including a personal profile in the edition of 18/5/12), and the Chair made several conference presentations (including one carried on our web pages).

Furthermore the Chair visited the SEW's Staff Council to explain the role of the CCG and the Company took a number of opportunities to mention in its publications the role of the

CCG (including the consultation on the draft Water Resources Management Plan and the Autumn 2013 edition of the e-newsletter “The Source”).

On one occasion, we welcomed a principal economist from the Environment Agency to a CCG meeting in an observer capacity as part of his professional development.

The CCG normally met about every two months and alternated its meetings between Snodland (HQ of SEW) and London (usually the offices of Water UK). In the three months running up to the submission of our report to Ofwat, we met monthly. In all, we had 11 meetings before submitting our report.

Outside of CCG meetings, the Chair and other CCG members had frequent meetings with the Company’s regulatory, metering and customer service teams and the Chair had regular meetings separately with the Company’s Managing Director Paul Butler and Chairman Gordon Maxwell. Furthermore the CCG Chair visited the Company’s Board on four occasions: two before the drafting of the Company’s Business Plan commenced and two during the process of drafting and approving the Plan.

A major objective of all these meetings was to ensure that there were ‘no surprises’ – so that the CCG would know exactly what would be in the Business Plan and the Company would know exactly what would be in the CCG report, in both cases to allow time and opportunity to discuss differences.

Throughout the whole PR14 process, the SEW CCG maintained contact with other CCGs, partly through some overlapping membership (the four ‘quadripartite’ members all sat on other CCGs) and partly through meetings of CCG Chairs. Obviously the four CCG Chairs drawn from CCWater met regularly through the CCWater Board and the other six CCG Chairs (including the one for SEW) found it very useful to have their own regular gatherings.

We all valued the convening by Ofwat of workshops for CCG Chairs and the SEW CCG was represented at all six (in all but one case, by the Chair himself).

While we feel that overall the CCG process has worked well, we have encountered some problems – notably around the timetable – and we felt that it would be useful to capture some learnings from the process so far and make a number of recommendations for the future. These recommendations are set out in Annex D.

A2: Past And Present Of South East Water

At several points in Ofwat’s final methodology statement for PR14, there is reference to the Company’s Business Plan containing a narrative. We felt that it would be useful for the CCG’s own report to follow such an approach. Our understanding of the term narrative is a summary of where the Company has come from, where it stands now, and how the Business Plan will take the Company and its customers forward over the next five years. The five year plan does, of course, need to be consistent with the Water Resources Management Plan which has a 25 year perspective.

Where The Company Fits In The Sector

At the time of the privatisation of the water sector in England & Wales in 1989, what we now call South East Water consisted of five different water only companies. Successive mergers in 1994, 1999 & 2007 led to the creation of the present Company. Clearly the latest and largest merger has special significance as it is still impacting on aspects of the Company's operations. That merger in December 2007 involved the old South East Water and Mid Kent Water.

The current SEW supplies drinking water to 2.1 million customers in Kent, Sussex, Surrey, Hampshire and Berkshire and, as such, it is the second largest water only company in England & Wales (after Affinity with 3.5 million customers).

SEW operates through two geographical regions which are not contiguous. In the Western Region, sewerage service is provided mainly by Thames with some from Southern. In the eastern region (the larger), sewerage service is provided mainly by Southern with some from Thames. In the case of those SEW customers who receive their sewerage service from Thames, there is one bill (provided by SEW); in the case of those SEW customers who receive their sewerage service from Southern, there are two bills.

Joint research between SEW and Southern found that 91% of customers are aware that their water and waste water services are provided by two separate companies, but between 1 in 4 and 1 in 3 customers is unable to identify correctly who supplies each service.

This complex pattern of services makes it difficult for customers in the region always to be sure who provides their water and sewerage services respectively and what those services cost respectively. This is a level of complexity that necessarily must impact on the nature and quality of customer research. It was a matter we raised with the Company in our discussions on their customer research.

Where The Company Stands Now

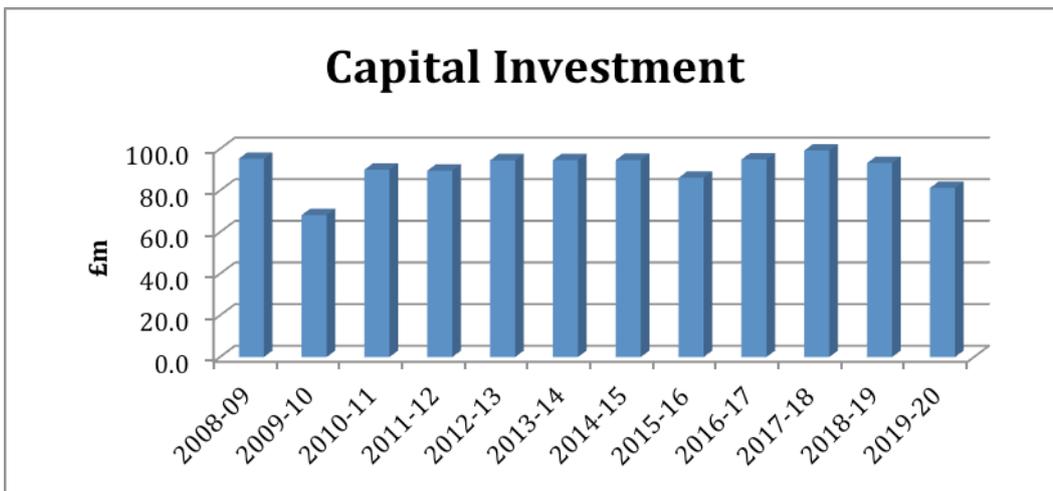
On a range of important regulatory measures, South East Water provides excellent service to its customers as evidenced by the following data (all figures for 2012/13):

- 99.96% compliance with water quality regulations
- only 62 properties regularly experiencing low pressure
- a better than target figure for supply interruptions of an average of 13 minutes per year per customer
- stable serviceability on both above ground and below ground assets
- a Security of Supply Index (SOSI) score of 100
- a better than target reported leakage level of 93 million litres per day (the 11th successive year that the target figure has been met)
- a better than target water savings figure of 1.5 million litres per day
- a better than target reduction in carbon emissions of 1.5% on the previous year
- only one category 3 pollution incident in the year

SEW has made good progress with its compulsory metering programme and is on course to complete installation of 174,000 meters in the current Price Review period and a further 175,000 meters in PR14. The Company has pointed out to us that this was a highly ambitious programme that has never been undertaken before (Southern Water is doing it in parallel and in one Asset Management Period). The programme has come with a number of tariffs and communication strategies designed to reduce customer issues and concerns, including step changes in bills via transitional tariffs and a social tariff for those who have difficulty as a result of being moved onto a meter.

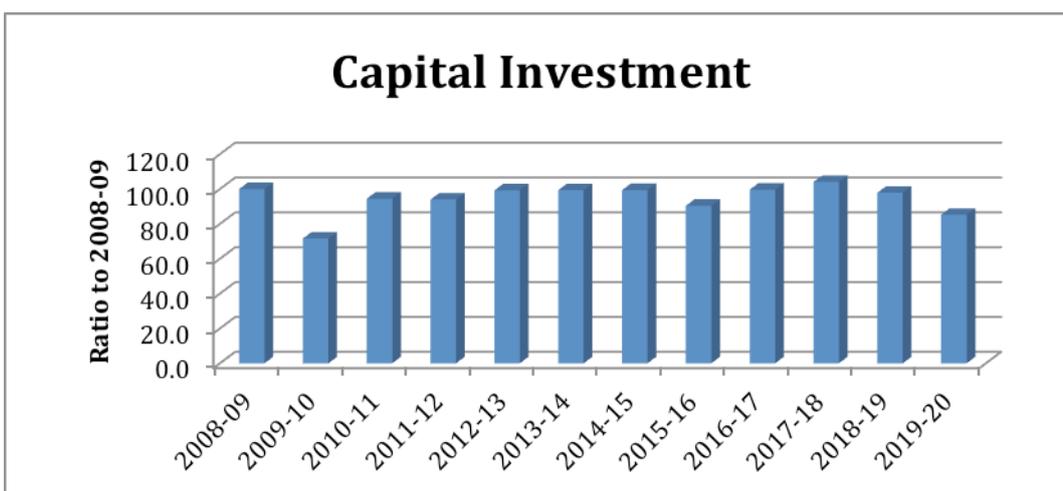
Fundamental to SEW's progress has been a sustained level of investment.

Since the current Company was created, the investment profile in cash terms (all figures in 2012/13 prices and all future years as estimates) has looked like this:



Source: SEW

Since the current Company was created, the investment profile as a ratio of the first year (2008/09 = 100 and all future years as estimates) has looked like this:



Source: SEW

It will be observed that, as has been typical in regulated industries, investment has dipped at the end or the beginning of Asset Management Plan (AMP) periods, but typically SEW has delivered some £90-95M of investment year after year.

Although historically SEW has been a well-performing company, it has not traditionally shown evidence of a wish to be best in class. Our understanding is that the Company adopts this position because it believes its customers are not prepared to pay for improvements in service. This apparent lack of ambition could be detrimental to customers in the longer term and is somewhat disappointing given that SEW is not the only company whose customers have little appetite for paying more.

We know that the Company agrees with this, but makes the regulatory point that it has not changed service because there is no willingness to pay and this in turn keeps bills down which is where customers want them to be. That said, there are ways of improving the customer experience without spending a lot of extra money.

In the course of commenting on drafts of the Business Plan, the CCG invited the Company to revisit and refresh its most fundamental aspiration which has previously been the one set out in the Strategic Direction Statement (SDS) for the PR09 process, namely that the Company's wish is: "To be recognised as the leading water supplier in the South East of England."

The CCG queried why SEW had chosen to be the leading company among only six out of 19 companies in the sector. The Company has given two explanations for this previous choice of aspiration. First, due to the performance of the SE companies historically, SEW would inevitably be close to industry benchmark levels if it achieved this. Second, it provides a regional context that reflects that SEW operates in similar operating conditions, such as water scarcity, growth in population, and relatively small percentage of commercial use.

In the current plans, however, the Company now declares its aspiration as follows: "We strive at all times to exceed our customers and stakeholders' expectations in every aspect of water supply". We are pleased to see this vision set out in the Executive Summary of each of the three component parts of the Business Plan for 2015-2020 as this will be of benefit not only to SEW customers but also to the wider population, especially if more companies strive for this type of outcome.

It is now clear that SEW aims to move away from a 'relative to others' type mission and vision statement to one measured against meeting stakeholder and customer expectations. Certainly, the CCG welcomes the Company's intention to use customer satisfaction as a key measure for performance in the Business Plan. This will mean that the target moves as customers' expectations change and therefore the approach will be a significant driver of continuous improvement

We appreciate that this approach has considerable merits, but it will be important to continue to use such sector-wide comparison data as will remain available (it seems that the new approach to incentives will reduce such data) – especially the SIM score.

When we have raised in discussions with SEW a performance measure in which it does not do so well, we have noted a tendency for the Company to challenge the validity or

fairness of that measure. Of course, any particular measure has its weaknesses and consistency and credibility both suggest that a balanced scorecard approach – involving both customer expectation and industry tables - is a desirable approach to be followed by both companies and the regulator.

Complaint Levels

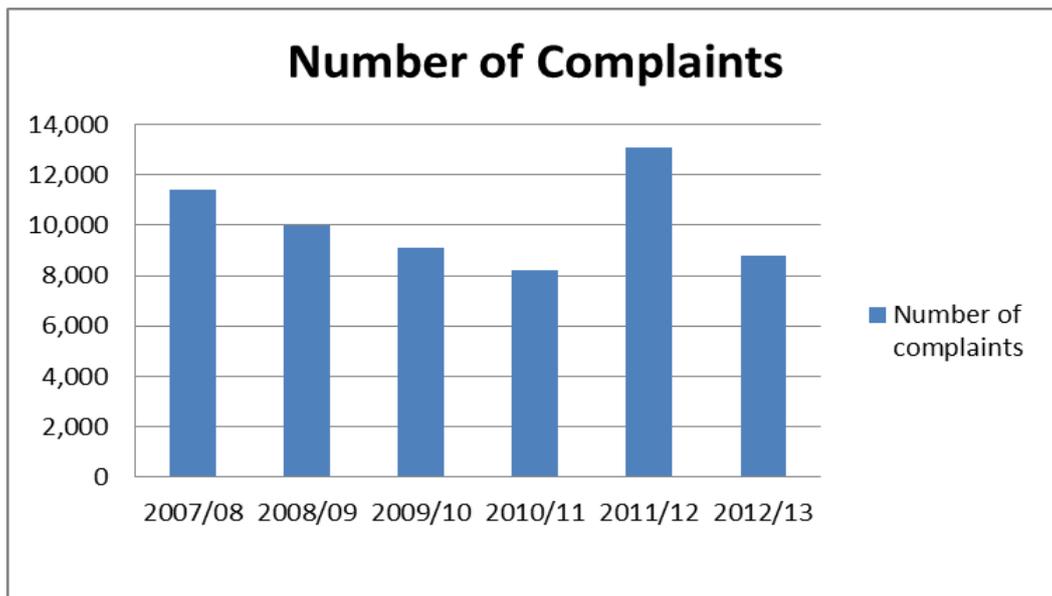
SEW's generally good performance makes it all the more disappointing that its complaints record has been poor. We have chosen to highlight the Company's complaints record in this report because:

- It is critical to customer perception of the service given by the Company.
- It has been a persistent issue over a number of years.
- It is necessary to appreciate that the Company has a mountain to climb to achieve industry standards of complaint handling.
- We would like the Company to embrace a new level of openness with its customers over aspects of service which fall short whenever it stalls or stumbles on that climb, especially in the context of the next Price Review period when the Company will be measured by a wider range of both performance and perception measures.
- It is particularly relevant to the Business Plan for the reason set out in the letter to CEOs from Ofwat's Chief Operating Office on 25 October 2013:

"We will be assessing companies' past performance when we review their business plans. Companies with a poor record of past performance will need to work harder to evidence that they are able to deliver the outcomes set out in their business plan."

Ever since the merger, SEW has had a problem with the level of complaints it receives. This is evident from this data showing the Company's total written complaint levels since its formation:

Year	Number of complaints
2007/08	11,440
2008/09	10,006
2009/10	9,102
2010/11	8,232
2011/12	13,095
2012/13	8,787

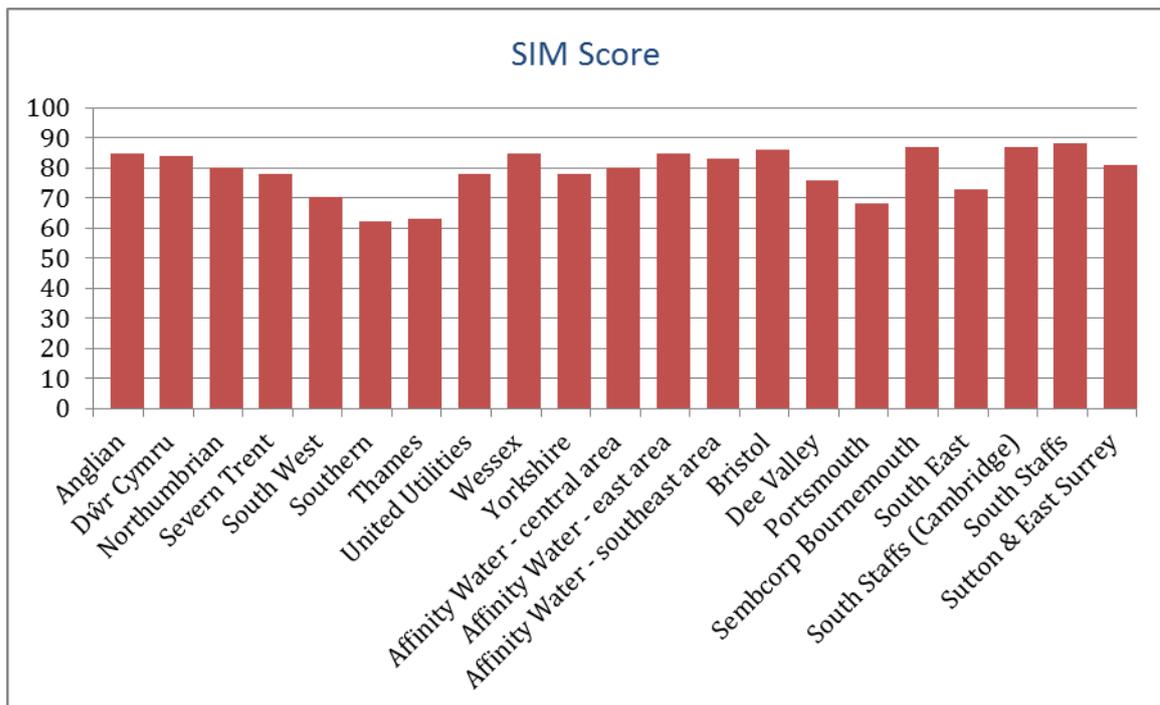


Source: SEW

This record reveals that the overall number of complaints to SEW is currently at much the level it was three years ago, whereas CCWater annual complaints reports show that, for the sector as a whole, complaints number have fallen for each of the past five years.

In Information Notice 13/11, Ofwat published each Company's average Service Incentive Mechanism (SIM) score for the two years 2011/12 and 2012/13. Out the 18 companies listed, SEW came second from the bottom (joint with Southern) with a SIM score of 64 – just one point above the worst performing Company (Thames) - compared to an industry average of 76 and a top score (by South Staffs Cambridge) of 86 (in all cases out of 100).

Ofwat's annual SIM survey for 2012/13 shows SEW's position relative to other companies in the sector has improved somewhat with the Company now holding a position of 4th from bottom, an improvement of two places from the previous year.



Source: Ofwat

The SIM measure uses a mixture of quantitative and qualitative components. CCWater looks specifically at the number and nature of complaints.

CCWater's annual report on written complaint handling in the sector for the year 2011/12 showed that:

- In terms of absolute number of complaints to CCW, SEW had a 59.1% increase in total complaints from 8,232 to 13,095, a percentage increase only exceeded by the much smaller number in the then Veolia Water East.
- In terms of the number of complaints per 10,000 connected properties, SEW had by far the worst record in the industry with a figure around three times that of the sector average (147.1 vs 53.2) which was a rise to over twice the level of the other companies, with the exception of United Utilities.

CCWater's annual report on written complaint handling in the sector for the year 2012/13 showed that:

- In terms of absolute number of complaints to CCW, SEW had a 32.9% decrease in total complaints from 13,095 to 8,787, an impressive and welcome percentage decrease.
- In terms of the number of complaints per 10,000 connected properties, SEW still had almost the worst record in the industry (only Southern was worse) with a figure around twice that of the sector average (98 vs 49).

Why have complaints been so high in recent years?

SEW has told us that, in early 2011, there was a migration of separate billing systems from the old South East Water and the old Mid Kent Water. While the actual migration went

well, the unfamiliarity of call centre staff with the new system during the main billing period in Spring 2011 led to higher than normal response times on all of the main contact channels.

While complaints numbers have fallen very significantly (by almost a third) from 2011/12 to 2012/13, the level of complaints to SEW is still twice the national average, the second highest in the entire sector, and the highest for any water only company.

The CCG has been asked to appreciate that SEW has the second largest metering programme in the country and the impact of the universal metering programme is bound to raise the Company's profile with customers and, by its compulsory nature, is likely to drive a degree of both contact and complaint. While low compared to the size of the overall programme, it is suggested that the levels still impact on the overall contact and complaint levels.

Even allowing for this, however, the metering programme cannot be deemed as the major factor in SEW's continuing high complaint levels. When it comes to contacts, metering only accounts for 5.1% of total contacts. When it comes to complaints, CCWater's complaints analysis for 2012/13 reveals that the Company does indeed have the highest level of complaints relating to metering, but it also has the second highest level for complaints relating to billing & charges and the second highest level for complaints relating to water supply – and both categories are larger than the metering category.

The CCG has observed that, not only does SEW have a disappointing record on complaints but, the Company has shown a reluctance to acknowledge this as fully and frankly as we would have hoped.

In the last two Annual Performance Reports as well as in the media releases prepared in response to the last two CCWater reports on complaints, the successive drafts of the Business Plan, and even in discussions with the Board, we have noted – and fed back to the Company – a defensiveness that falls somewhat short of the “open, honest and transparent” principles of “good, effective engagement” that the Business Plan Appendix on Engagement rightly endorses.

To give one example: In the Company's “Annual Performance Report” for 2012/13, on three occasions in the report, it is pronounced that customer complaints have fallen by over 30%. Although this is true, there was no acknowledgment that this was a fall from a record high, that complaint numbers are still higher than two years previously, and that SEW's complaint record (in terms of numbers per 10,000 connections) remains far above the industry average.

Poor performance against the SIM measure can carry a regulatory penalty and the CCG notes that SEW has proactively included a revenue reduction of 0.25% in the Business Plan in order to reflect this performance and produce an accurate plan.

More importantly we acknowledge the major efforts that have gone and are going into improving the Company's complaints record.

This includes the ‘Commit and Deliver’ training programme, the restructuring of the customer services team, the new bill design, the increasing number of contact methods

being developed, and the extra investment into Information Services. We expect that the move to customer satisfaction targets, designed to incentivise the correct behaviours and promote cultural change, will prove successful.

As regards the current financial year, we very much hope that the Company will achieve its aim of less than 6,500 complaints which would represent a 25% reduction on 2012/13 numbers and the best figure for five years. We are pleased to note that the half year data provided to us show that currently the Company is on track to achieve this target.

Financial Structure

As with many water companies, the ownership of SEW has evolved since the Company's creation in December 2007. The Company is now owned 50% by the unlisted Utilities Trust of Australia (UTA) which is managed by Hastings Fund Management Ltd, 25% by CDPQ (Caisse de dépôt et placement du Québec), and 25% by Desjardins which is a passive owner with CDPQ acting on its behalf. All the owners ultimately act on behalf of pension funds looking for stable returns on investments.

The CCG was keen to have a constructive dialogue with the owners of SEW to understand why they have invested in the Company and what they expect from their investment. Therefore we were pleased to be visited for such a discussion by Valeria Rosati (Hastings Fund Management) and Jean-Etienne Leroux (CPDQ) [CCG8/4]. The CCG was pleased to note the alignment of objectives and approach from the two current investors. We welcomed the assurance that both sets of investors have a long-term perspective to their investment and we noted the value they attach to the stability of the industry, the consistency of regulation, and the predictability of returns.

Following the meeting, a number of detailed questions were posed to the investors [CL168-174]. One of the issues we subsequently discussed in correspondence with the investors was the corporate structure of SEW, something we had raised at an earlier meeting of the CCG when we were visited by the Company's Finance Director Jo Stimpson [CCG5/7].

The CCG welcomed the clarification from these exchanges on the Company's ownership and financial structure but we were surprised at the seeming level of complexity involved. This may well reflect our lack of knowledge of such matters, but then customers generally will be no more knowledgeable on this subject. Given that all the assets and operations of SEW are in the south east corner of the UK and that its owners are based in Canada and Australia, it was surprising to us that the corporate structure involves companies registered in Luxembourg and the Cayman Islands.

The CCG has been assured that this structure is entirely legal, is compliant with HMRC rules, and indeed used by several other water companies in the UK. However, we feel that, especially in current circumstances, the Company runs a reputational risk in that this structure would be difficult for the Company's customers to understand and appreciate.

It is important that there is transparency of ownership and that the Company can demonstrate that it will be fair in sharing any benefits between investors and customers.

One of our early challenges was to ask SEW to be clear in explaining where customers' money goes.

The CCG has raised this matter in the context of the Business Plan because so much of what the plan seeks to achieve – such as acceptability of bills, a better understanding of leakage, reduced consumption of water, the need on occasions for usage restrictions – rests on the Company having high levels of legitimacy and trust in the eyes of its customers and so many of the outcome measures in PR14 will be based on customer perceptions of different aspects of the Company. In all the circumstances, we feel that the current financial arrangements run a risk – we put it no higher than that - of customer perceptions undermining that legitimacy and trust and possibly influencing those perception measures.

This is not simply the view of CCG members; it is the view of SEW's customers. In the Business Plan Appendix on Communications, it states: "Beyond the direct experience our customers have of dealing with South East Water, we also know from our research that there are a number of wider issues that can impact on customers' views and perceptions of us, and how satisfied they are with the services they receive." One of the examples given is: "Taxation status of water companies".

Another matter of interest to the CCG has been the gearing of SEW. In its final methodology statement for PR14, Ofwat states that its notional gearing assumption would be in the range 60-70%. We recognise that this is an assumption and not a target and that there is scope for higher gearing and reasons for it.

Gearing for SEW is currently at 78.7%. We are in no position to judge whether this is an appropriate level of gearing, but recognise that, at a time of low borrowing costs, there are advantages in such a gearing level. Our concern is whether a rise in interest rates would present funding difficulties for the Company, although ultimately the risk is one borne by the investors.

We note that, in its report on the UK water sector entitled "Stable Outlook For Sector But Individual Companies Will Face Challenges" (October 2013), Moody's notes that highly-leveraged companies are most at risk from a challenging PR14.

Ofwat's final methodology statement includes the proposal to establish a financial structure monitoring regime. We welcome this.

Section B. The Overall Challenge Process

B1: Adequacy Of Company's Customer Engagement

A major distinguishing feature of the PR14 process is an attempt by Ofwat to shift company thinking away from what the regulator expects in a business plan to what customers want from a business plan. Such an approach requires two things: first, a major programme of customer engagement to establish what customers think and want; second, the use of results from this engagement in the construction of a customer-focused business plan that is consistent with all the other complex demands on the company.

As set out in the CCG's terms of reference (see Annex B), a key role of the Group was to satisfy itself as to the adequacy of SEW's customer engagement research programme.

In fact, the Company drew up a Customer Engagement Plan even before the CCG was created because the extended, inter-related timetable of the PR 14 process required customer research to begin in early 2012. The original text of the Plan was dated 1 May 2012 but the first CCG meeting was not held until 12 June 2012.

The Plan was shown to two research companies – Accent and Ipsos MORI – for an independent critique and suggestions from those two organisations further developed the Plan. **The CCG believes that it was a sensible idea to seek out such external validation of the approach.**

With the appointment of the CCG Chair and the formation of the CCG itself, the draft Plan was then the subject of discussion at the second and third CCG meetings [CCG2/5 & CCG3/8] and further refinements were made before the Plan was finalised. In particular, it was agreed to categorise research more tightly as PR14-focused or routine and on-going. This was to reassure us that SEW would focus efforts on ensuring the robustness of the core research which would feed into the Business Plan.

SEW's Customer Engagement Plan envisaged a set of research projects, each with its own methodology and materials. The CCG decided that a sub-group of four members – including one who is a professional social research consultant – would work with the Company to comment in detail on methodology and materials as each project was designed and launched.

In the end, the Company carried out no less than 11 different pieces of customer engagement relevant to the production of the content of the Business Plan – but not all of these were actually used in the crafting of the Plan. The CCG engaged with the Company at a very detailed level on the various research components of the customer engagement programme and a full record of the CCG's comments and the Company's responses to them has been captured in the Challenge Log.

Seven pieces of research as part of the PR14 process were actually used for the Plan. We review them in chronological order

1. Initial qualitative work

This was designed before the formation of the CCG, but the results were presented both to the CCG Chair in a specific meeting and to the full CCG in a scheduled meeting [CCG2/6].

The research was conducted by The Marketing Works. Twelve groups of eight or nine customers were convened twice in six different locations. Like all qualitative research, the numbers involved were small and the sample purposively selected, so no meaningful quantification of opinion can be adduced from the outputs, but the research provided an indication of how the Company is generally perceived by its customers and helped to inform the later quantitative research.

The CCG believes that this piece of qualitative research was an appropriate and useful starting point for the Customer Engagement Plan but clearly could not be used in any quantitative context.

2. The Willingness To Pay main stage research

The Willingness To Pay (WTP) survey – perhaps better called a survey of customer preference for different service levels - is the single largest and most influential piece of research in the customer engagement process. Members of the CCG devoted considerable time to commenting in detail on the methodology and materials used for this research and offered a whole series of suggestions [CL12-47].

WTP-type research has many strengths but some weaknesses too.

WTP is a standard methodology across a range of industry sectors, notably utility operations. It has been used for many years by many government departments, sector regulators, and utility companies. Over time, several methods have been developed to measure a customer's willingness to pay to receive a better service or avoid receiving a worse one. These methods are often differentiated by whether they measure a customer's hypothetical or actual willingness to pay and whether they measure that willingness to pay in a direct or indirect manner. Each method relies, of course, on individual customers' perceptions of value and price as well as their own circumstances and the market and environment in which they operate. In short, it is not an exact science.

In the water sector, such research is now covered by detailed industry guidance issued by UK Water Industry Research (UKWIR). SEW has chosen to do its WTP research with Accent which is a market leader in this field, both nationally and internationally.

At the heart of WTP research is the stated preference (SP) methodology which seeks to put a relative value on specific attributes for which the customer is not directly or specifically charged.

At one CCG meeting [CCG3/5], the Group initiated an important debate with Rob Sheldon of Accent on some of the reservations which some members saw about SP methodology and later he helpfully provided a detailed written response to these concerns.

The CCG's main concerns around the WTP research are as follows:

- The descriptions of attributes relating to drinking water quality in the UKWIR manual are problematic because there is an absence of reference to health & safety issues in the manual. Our concern is that, by not having the issue reflected directly in the survey, one may reduce the value attached to water safety by customers.
- The stated preference (SP) work needs to be supported by revealed preference research. In a 2011 Ofwat report entitled “The Use Of Revealed Preference Customer Behaviour In Future Price Limits”, it was recommended that water companies collaboratively promote such research but, to the best of our knowledge, this has not been done.
- The survey offers only a restricted range of choice alternatives and therefore does not enable respondents to choose their ideal outcome. This weakens the SP valuation results. Instead of choosing between two service options, respondents could be allowed to add extra improvements to each attribute, at a cost, until they had found their ideal choice.
- Respondents are given choices over outcomes when many of the actions that the Company must take are, in fact, non-discretionary, notably the maintenance of certain quality standards. We were assured that the attributes included in the survey were all related to service levels over which the Company has some discretion and that respondents are told when their bill will need to change just to maintain current, non-discretionary service levels.

After the CCG discussion with Rob Sheldon, a follow-up meeting was held at Accent’s offices with representatives of the Company and the CCG and it was agreed that the most constructive means of dealing with these reservations was to conduct some further research using a different methodology to establish how robust are the findings of the main WTP research. This is a process known in the market research profession as ‘triangulation’.

It should be noted that the CCG reservations over stated preference research are not criticisms of SEW. The current WTP methodology is standard throughout the industry and our concerns are relevant to the whole industry.

Far from criticising SEW for its WTP research, **we commend the Company for engaging with us in the debate over weaknesses in stated preference methodology and its willingness to take on board our suggestion of using a different method, menu driven customer valuation research, for triangulation**

The outcome of SEW’s WTP research was the finding that essentially the Company’s customers had no significant willingness to fund service improvements through higher bills. In many ways, this is an unsurprising result since currently the UK is experiencing its worst recession in the lifetime of most of its citizens. Interestingly it is also consistent with previous Price Review surveys by the Company.

However, we have two observations.

First, it is unclear to us why the SEW WTP values were so low compared with the rest of the South East companies and the rest of the sector nationally. A comparison exercise carried out by Accent (“Comparative Review Of Willingness To Pay Results”, Final Report, October 2013) found that, of 15 companies involved, SEW had the second lowest WTP for both households and businesses and that SEW and the company with the even lower

WTP were somewhat out of the general range of WTP levels recorded (especially for businesses). We were expecting a total of 19 companies to cooperate with the Accent data share and note that four companies have not done so; naturally we wonder if this would have had any effect on the overall conclusions.

There could be many reasons for the spread of WTP findings by the 15 companies. There might have been different methodologies at work, although Accent's comparison study suggests that the methodologies used by different companies were more aligned than in the past. Different customer bases might have taken different views on the willingness to pay more for service improvements, although it seems odd that customers in the South East demonstrate less willingness to pay than other parts of the country when economic growth and living standards are usually more robust here than more deprived parts of the country.

Second, we feared that the low WTP results for SEW might drive a certain lack of ambition by SEW in its Business Plan. However, the Company has assured us that there is not a lack of ambition, but simply a recognition – evidenced by this research – of a lack of WTP by its customers for specified service improvements.

The CCG believes that, notwithstanding some reservations over the stated preference methodology used, the WTP main stage research has provided a sound basis for building the Business Plan on the assumption that SEW customers have no significant willingness to pay more for improvements in service. Furthermore the research has enabled the Company to prioritise areas for investment based on willing to pay data for specific service attributes.

3. The Willingness To Pay second stage research

In response to customers' strong feelings towards the level of leakage and to support the preferred options in the WRMP, this particular piece of research was intended to explore and quantify customers' views and priorities with respect to the types of measures the Company could undertake to manage the supply and demand balance. As with the main stage research on WTP, the work was carried out by Accent.

Again CCG members inputted a whole series of detailed comments [CL48-58].

This WTP survey looking at options was a welcome addition to the research as it not only tested customers' service priorities but it also asked them how they would like these to be delivered. It helped validate the acceptability of the options chosen within the WRMP.

However, we had some queries about the data analysis (raised in a meeting with SEW & Accent on 5/7/13) and suggested a peer reviewer looking at the report [CCG8/5]. This suggestion was accepted by Company but the review was completed too late for us to consider it.

The CCG believes that this was a valid and useful piece of research.

4. The triangulation research

SEW agreed to carry out this extra piece of work in response to CCG reservations about the limitations and potential bias of stated preference methodology in the main WTP research. As it was a CCG proposal, naturally we inputted many comments on the design of the research [CL72-83].

This research – again by Accent - asked about willingness to pay in a ‘transparent’ way so that customers understood what they were being asked (rather than WTP being calculated from questions which are indirectly about WTP). It can be described as menu driven customer valuation research. This piece of research allowed the Company to compare results using different methods, and so provide reassurance that the WTP assessment from the stated preference survey is sound.

The results were fairly consistent with the primary WTP results except in the case of (1) hosepipe bans, where the preference is for a deterioration – from 1 in 10 years to 1 in 5 years - rather than an improvement as would have been predicted from the primary WTP results, and (2) possibly pressure where there were almost the same levels of support for deterioration and maintenance.

The CCG welcomed the Company’s willingness to undertake this extra work at our suggestion. We were pleased to find that this triangulation research broadly confirmed the main stage WTP research that gave us more confidence in the earlier research.

5. Research of proposed social tariff

The CCG had no particular involvement in this project but the institution of the research was reported to us [CCG8/8].

The CCG was pleased that this research was carried out on this important issue to examine sources of support for vulnerable customers as an adjunct to research on bill impacts.

6. Joint research with Southern Water on bills

Although the CCG was not directly involved in commenting on this particular piece of research, one of our members (Kathryn Rathouse) had some engagement in her professional capacity. We welcomed this shared research with SW on separate/combined billing and we were impressed with the innovative questionnaire.

The CCG hopes that this research will encourage SEW and SW to explore joint billing of their respective services.

7. Acceptability research

The CCG made detailed comments on the research proposal [CL175-185]. CCWater issued to all water companies, copied to CCGs, its view on the nine high level principles

for such acceptability research and, in our view, the acceptability testing carried out for SEW met all these principles.

This acceptability research – conducted by Accent – found:

- 76% of household customers and 78% of business customers found the business plan somewhat or completely acceptable when asked an initial (uninformed) question.
- 86% of household customers (84% of low income households) and 79% of business customers found the overall business plan somewhat or completely acceptable, once informed with more details.

The CCG believes that this research was soundly conducted and provides clear endorsement for the pricing and service propositions in the Business Plan.

Four pieces of research as part of the PR14 process were not actually used in any substantive sense for the Plan. We mention them in chronological order:

1. Online Panels

Four qualitative online panels were held addressing brand awareness, WRMP options, customers' priorities, and speed of delivery versus affordability respectively.

These days, online research is widely used, but it has serious methodological challenges, not least that – even in the relatively prosperous South East – a significant proportion of homes (around 20% as confirmed by the latest annual tracker) are still not online and therefore online panels are never wholly representative of the customer profile.

The CCG's most serious reservation was around the very small sample size (16 participants in the general panel and 7 participants in the young people panel). We therefore cautioned against any weight being attributed to the results. We made other more detailed comments [CL35-71].

The Company assured us that decisions would not be based on this research and that the online panels are seen as a convenient way to test the temperature on some specific issues, such as brand awareness of water companies to decide whether to carry out further research on these issues.

The CCG believes that, due to the very small sample size, the online panels have limited use to help inform decisions about whether to carry out further research.

2. Demand management focus groups

Eleven water saving ideas were explored with 12 focus groups. The findings were presented to the Group [CCG4/6].

Our understanding is that, in the end, no decisions relevant to the Business Plan itself were made by SEW on the basis of this particular piece of research, but the Company used customers' preferences around demand management options in the preferred plan for its water efficiency strategy for the WRMP and also AMP6.

The CCG believes that the focus groups provided a useful basis for informing decisions, but customer preference is not necessarily linked to effectiveness so the information from this source needs to be considered alongside other information about the effectiveness of demand management options.

3. Water reuse focus groups

The CCG had no particular involvement in this project but the findings were reported to us when available [CCG5/6].

Although this research did not specifically influence the Business Plan, we understand that it was used to inform the WRMP and define what water reuse options to include in the WRMP (and AMP6 funding on investigations).

The CCG was pleased to note that SEW carried out research into this potentially controversial issue before including it in the WRMP.

4. Outcomes research

The CCG had many discussions with the Company on its proposed approach to measuring and incentivising outcomes [CCG5/5, CCG6/4, CCG7/6, CCG8/6, CCG11/4] and we inputted many comments into the relevant research [CL104-130, CL137-142, CL151-154]. We discussed two main issues. The second of these was our main concern.

Firstly, one point of discussion and debate was whether the perception measure should be satisfaction or some other measure. We recommended that a questionnaire design expert, Caroline Bryson, be consulted on the research. She recommended that SEW avoid asking about satisfaction because there are a number of well-established problems with this type of question. The suggestion was to ask about perceived quality (e.g. rating some of the issues on a scale from very good or very poor) rather than satisfaction.

When consulted again after cognitive interviews were carried out with two versions of the questionnaire (satisfaction and an alternative), Caroline Bryson found it difficult to make a recommendation due to the small number of interviews and problematic wording on the alternative version.

She did make the following conclusion: “Overall, the decision to use either approach is probably defensible, and which one to use depends on SEW’s information needs: whether it wants to try to pinpoint actual customer experience or whether it wants to capture customer perceptions of the services SEW provides.”

The Company decided to proceed with the measure of satisfaction as it was seeking a measure of perception to complement the other outcome measures related to performance.

Secondly, and of more concern, the Company wanted to attempt a valuation in changes in levels of satisfaction in order to enable the outcomes incentives to be directly related to the value customers place on a loss or gain in their overall level of satisfaction. The CCG recognised that this was a laudable objective, but repeatedly expressed the most serious doubts about whether customers can meaningfully answer the question that they were

being asked. For instance, if customers only have a vague sense of what it means to move from, say, a satisfaction rating of 4 to a satisfaction rating of 5, we doubted that they could make a very precise valuation (e.g. would you pay £2.50 more for it?).

The Company proceeded with the research. The cognitive interviews, the final research results, and indeed the novelty of such a valuation approach all pointed to potential problems of such a valuation. The CCG had already made very clear that it did not believe customers could understand this type of questioning and, in the course of the research design, it pointed to a number of serious methodological challenges and issues.

The Company, therefore, chose not to use the valuation results in creating the size and scale of the satisfaction outcome incentives. It has instead chosen to use the risk-based Return on Regulatory Equity (RORE) mechanism to provide upper and lower bands on the incentives.

It did, however, use the fact that, while the detailed numbers were not appropriate for use, the asymmetry of the valuation placed on satisfaction by customers – that is, customers did not place much value on improved satisfaction but did place considerable value on it decreasing - was reflected in the incentive design and indeed was entirely consistent with both the main stage WTP findings and the triangulation research.

The CCG acknowledges that SEW had the best of intentions in proceeding with this research and that, had they found some way of doing it in a methodologically robust way, it would have provided a valuation in changes in satisfaction that could have been used in the Outcomes Delivery Incentives package, but we are not surprised that the results were not useable and welcome the Company's recognition of this.

In addition to these 11 pieces of core research for the PR14 process, the Company continued with its non-PR14 programme of research that included its annual trackers and this engaged the CCG and provided background information.

A. The Annual Tracker Survey 2012

This is, of course, an ongoing exercise and not something specific to PR14, but it has provided some useful material for customer engagement around PR14. We made a number of comments and suggestions designed to improve the quality and take-up of the survey [CL91-100].

A major weakness in a postal survey of this kind is that often response rates are low. In the case of SEW, a typical participation rate has been a mere 2-3%. The CCG sub-group made a number of suggestions designed to boost the participation rate and we were pleased that the Company was responsive to these suggestions and that the final rate was a much higher one of 16%.

Related to the low response rate, there is also non-response bias i.e. the unrepresentative nature of participants compared to the Company's customer base as a whole. Older customers were much more highly represented in the completed surveys than would be expected if the participation rate was even across all segments of the customer base.

B. The Annual Tracker Survey 2013

As in the previous year's such survey, SEW was responsive to CCG suggestions on the tracker [CL143-150], including ideas for achieving another good participation rate in this survey, so cash prizes were on offer and there was a key reminder process. We were pleased to see that this year's participation rate was as high as last year's at around 16% - a very considerable improvement on such trackers prior to 2012.

As with previous such surveys, the highest percentage of respondents was aged over 60. Metered customers were disproportionately represented in the respondents. Only 2% of respondents were business customers.

To summarise the CCG's position on the customer engagement programme:

- **The Company has carried out an impressive range of research, largely using several market research companies with the most experience and highest reputation for this kind of work.**
- **The Company has consulted extensively with the CCG on most of these pieces of research and taken on board a substantial number of detailed observations from the CCG on methodology and materials.**
- **The research has deployed a range of methodologies and used a range of respondents and the CCG has been pleased at the consistency of the results and messages coming from this programme.**
- **We regard some of the research as innovative, namely the triangulation work to check the WTP research (which the CCG itself suggested) and the research on outcomes which attempted but failed to establish a basis for customer valuation of changes in service levels.**

On this basis we are able to make the following recommendation:

Recommendation 1:

Ofwat should be reassured that the Company has carried out an impressive range of customer research with the methodology and findings being the subject of detailed critique by the CCG.

B2: How Company's Customer Research Has Shaped The Business Plan

The Need For 'A Golden Thread'

As set out in the CCG's terms of reference (see Annex B), a key role of the Group was to check that the SEW's customer engagement research programme properly shaped the content of the Business Plan submitted to Ofwat. Conducting customer research is just the first step. The crucial next step is using that research in an intelligent way to inform the Business Plan in a manner that truly reflects customer priorities and wishes.

Of course, it cannot simply be the case that the views of customers coming out of the research are mechanically translated into Business Plan objectives, no matter how robust the research and no matter what the cost of the project. The CCG is acutely aware that a balance needs to be struck between the needs of customers and the Company's ability to

meet those needs, while bearing in mind the cost of doing so and of meeting other business requirements such as resilience needs and statutory obligations.

Customers are not always well-informed about their water company. For instance, in one piece of research (qualitative focus groups), some SEW customers insisted that they had suffered drought restrictions most years (whereas there have only been two occasions in the past decade) and, in another piece of research (the triangulation work), some customers ‘forgot’ that they had been subject to restrictions (even though this experience was less than a year ago).

Considerable judgment is required in according proper weight to the different elements of customer research and in translating the views of customers into viable operational and capital programmes.

Ofwat – most recently in the letter of 25 October 2013 to CEOs – has made clear: “We expect a clear, coherent and evidenced ‘golden thread’ to run through the whole business plan so it is clear how each element of the plan fits together.” This was the CCG’s view too.

The Evidence Of ‘A Golden Thread’

Throughout all our discussions on different drafts of the Business Plan, the CCG constantly challenged the Company to show how each major element of the Business Plan is supported by appropriate customer engagement and, where this is not the case, why it is not. Inevitably, complex trade-offs have to be made and, as far as possible, these need to be made explicit and supported by evidence that will include customer views.

As successive drafts of the component parts of the Business Plan have been presented to the CCG for review and comment, we have been pleased to see the ‘golden thread’ being better evidenced than originally, so that it is now clear as seen from the following points:

- In the retail plan for households, the chapter on each of the five outcomes making up the CLEAR acronym has opened with a section entitled “What customers said” which has quoted relevant comments from different pieces of research.
- In the retail plan for businesses, the chapter on each of the six outcomes making up the CHOICE acronym has opened with a section entitled “What customers said” which has quoted relevant comments from different pieces of research.
- In the wholesale plan, the chapter on each of the outcomes making up the CLEAR acronym has sections on how customers currently perceive the subject (drawing on the outcomes research) and what customers have told the Company about their requirements for the future (drawing on WTP and other research).
- In respect of all three component parts of the Business Plan, we have encouraged the Company in our detailed comments to support any reference to customer views or wishes with a reference to the relevant research finding.

- The Appendix on Engagement does not only summarise the findings of each piece of research but, in Section 6, details how each of 13 pieces of research has been used to inform the Business Plan.

Recommendation 2:

Ofwat should be assured that the Company has successfully demonstrated to us that it has evidenced each part of the Business Plan with reference to the relevant pieces of customer research.

Outcome Delivery Incentives

Historically SEW – like other water companies – has been hitting performance targets and yet not achieving the customer satisfaction scores that it would like and perhaps expect. This has been most clearly the case with leakage.

So, for the PR14 Business Plan, the Company has used its research to set satisfaction levels for different outcomes. This is an innovative approach and very different from the traditional approach in the water sector of measuring outputs in terms of physical attributes. The Company has then gone further in setting incentives around a satisfaction number that is particularly innovative.

This approach to outcome delivery incentives is not without risks but the CCG fully supports it and commends SEW for this innovative approach.

SEW had the option, of course, to move to measuring outcomes wholly by satisfaction, but this would have been a huge step to make from one Price Review to another. Our understanding is that the Board had reservations around such a single-step approach and instead opted for the combination of performance and satisfaction as a measure of achieving an outcome.

While the CCG had considerable sympathy with the aims of a fully satisfaction-based approach, we too judged that a staged approach – with a mix of performance and satisfaction measures - in PR14 was the most sensible approach.

We also believe that a combined approach might be needed in the future as customer views can be affected by the context (e.g. temporary use bans introduced by neighbouring companies could affect views held by SEW customers) and because there are certain objective measures that cannot entirely be replaced by assessment of customer views (e.g. objective measures related to water resources).

In many cases, the actual measures of performance are shared between the retailer and the wholesaler that will provide focus for both elements of the business. Furthermore there are incentives placed on these too, so that will drive performance.

The CCG welcomes the shared responsibility of performance between the retail and wholesale arms of the Company.

B3: Meeting Statutory Obligations

In its methodology statement for PR14 as confirmed by Information Notice 13/20, Ofwat has asked that the three environmental and quality regulators – the Environment Agency (EA), the Drinking Water Inspectorate (DWI), and (in SEW's case) Natural England (NE) – present their views on company business plans for PR14 primarily through the report of the relevant CCG.

Environment Agency

Environment Agency (EA) representatives have regularly attended the CCG and the EFG. The annexes to this report include the text of the relevant correspondence between the EA and SEW dated 1 and 19 November 2013. The comments in this correspondence were made following dialogue with the Company throughout the WRMP process including the Statement of Response and business planning process up to the date on the relevant correspondence.

These comments were made without having seen the complete and final proposed Business Plan. The EA expects to continue to work with the Company on some of the details of proposals. However, it does not anticipate any material changes in its overall response.

In the EA's view, from the information provided, it understands that the Company is planning to meet its statutory environmental requirements set out in DEFRA's Statement of Obligations and it welcomes the company's commitment to meeting them.

The statements from the Environment Agency are at Annex E.

Drinking Water Inspectorate

The Drinking Water Inspectorate (DWI) has a representative who has regularly attended the CCG. The annexes to this report include a copy of a letter dated 17 November 2013 received from the DWI.

The Company submitted four formal proposals for drinking water quality to the Inspectorate. The DWI has formally supported all of the Company's proposals and it will put legal instruments in place to make the proposals legally binding programmes of work.

It should be noted that these improvement schemes will make only a small contribution to enabling the Company to meet its legal obligations in respect of drinking water quality. These obligations are met overwhelmingly by the Company making sufficient provision for operational and maintenance requirements in its Business Plan, and by its use of those resources.

The statement from the Drinking Water Inspectorate is at Annex F.

Natural England

Natural England has a representative who has regularly attended the CCG and the EFG. The annexes to this report include a copy of a letter dated 21 November 2013 received from Natural England. The comments in the letter were made following correspondence and dialogue with the Company throughout the WRMP process including the Statement Of Response (SOR) and business planning process to date.

Natural England expects to continue to work with the company on its Habitats Regulations Assessment (HRA) up until the submission of the Business Plan and possibly until the submission of the final WRMP. However, it does not anticipate any material changes in its overall response.

Overall Natural England is broadly satisfied with the proposals for AMP6 as far as they relate to the Company's statutory responsibilities for landscape and biodiversity. With regards to protection of biodiversity and landscape, Natural England considers the proposals within the Business Plan and WRMP are a significant improvement upon the previous water resource plan and accompanying AMP5 business plan. Natural England has been particularly pleased with the stakeholder engagement through the EFG. It considers that some elements of the plan are particularly good and could be considered best practice including:

- The partnership approach proposed for catchment schemes investigations and delivery.
- The proposed cumulative landscape mitigation strategies for each Area of Outstanding Natural Beauty (AONB) and National Park.
- Proposals to integrate the extensive Strategic Environmental Assessment (SEA) monitoring programme into everyday business delivery.

There are some proposed schemes in the revised Water Resources Management Plan (rWRMP) where significant environmental impacts or/and uncertainties remain to be resolved. The Company is committed, both in their Business Plan and in their rWRMP to work to resolve these impacts/uncertainties by the end of AMP6.

The statement from Natural England is at Annex G.

On the basis of the statements from the three environmental and quality regulators, the CCG feels able to make the following recommendation:

Recommendation 3:

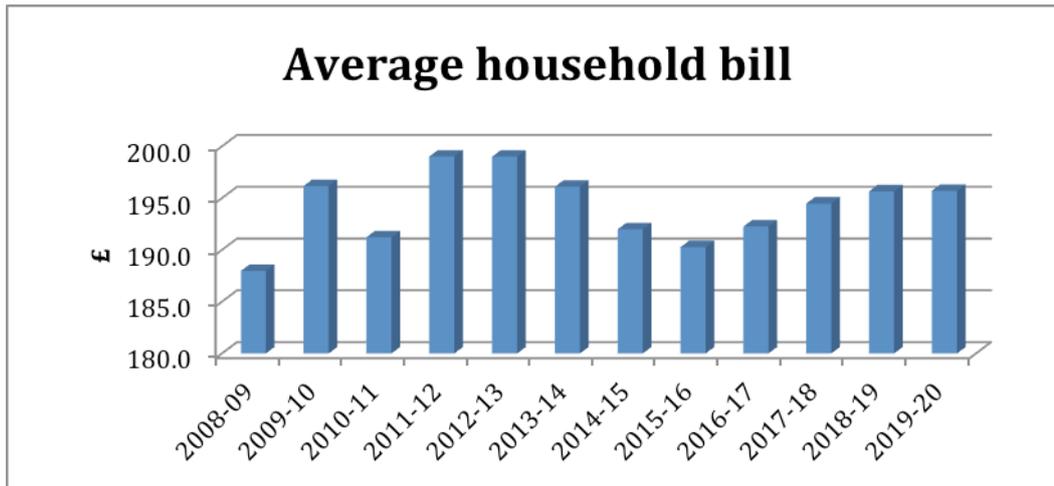
Ofwat should be assured that the three environmental and quality regulators are broadly supportive of the Company's Business Plan, as it relates to meeting the requirements of DEFRA's Statement of Obligations, and have no significant objections outstanding at the present time. It is, however, a matter for the Company

to ensure that it has allocated sufficient expenditure and resources to meet its statutory obligations.

B4: Acceptability To Customers And Affordability By customers

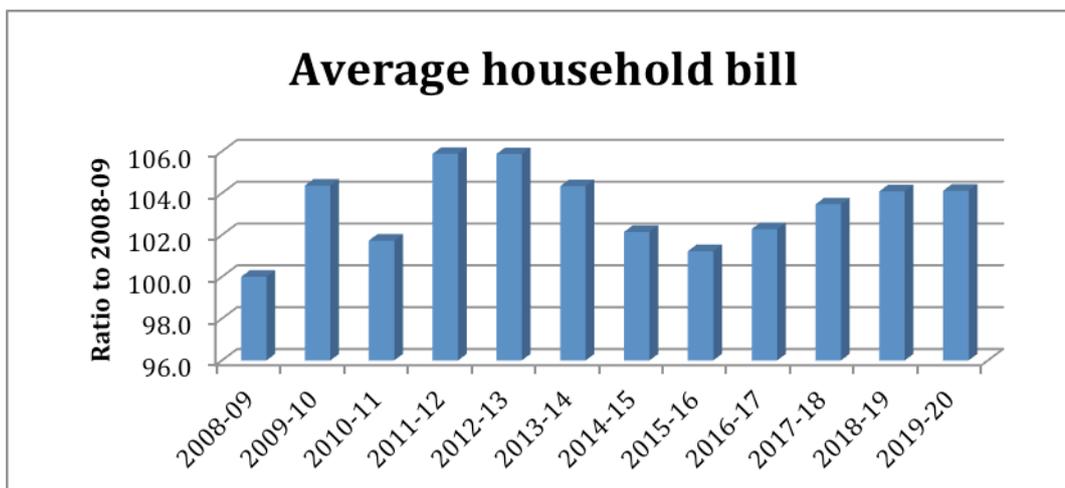
Historic Bill Levels

Since the current Company was created, the bill profile in real terms (all figures in 2012/13 prices and all future years as estimates) has looked like this:



Source: SEW

Since the current Company was created, the bill profile as a ratio of the first year (2008/09 = 100 and all future years as estimates) has looked like this:



Source: SEW

It must be noted that, in respect of both bar charts, 2008/09 is an atypical year since the merger of December 2007 required bills to be reduced by around £5 each as part of the remedy agreed with the Competition Commission.

As will be seen, discounting 2008/09, bill levels have fluctuated, are currently the highest they have been, but are scheduled to fall before rising again.

Current Bill Level

The logical starting point for considering acceptability and affordability of SEW bills over the period 2015-2020 is to look at the current bill level.

Currently the average SEW customer pays £201 a year. However, in practice the bill varies depending on whether the customer lives in the old South East Water area or the old Mid Kent Water area, depending on whether the customer is unmetered or metered, and depending on rateable value for unmetered customers and on usage volume for metered customers.

SEW has, however, been gradually reducing the regional differential via a staged tariff harmonisation exercise, both to reflect the true cost of providing water in these areas and to make charges less confusing to customers. **The CCG welcomes this.**

Staying with the average figure though, Ofwat data for estimated average household bills for 2013/14 shows SEW as having the 7th highest bill out of 23 companies. Compared to an industry average (weighted) of £186, SEW's average bill of £201 is 8% above the average.

Of course, there are many reasons why costs – and therefore prices – can vary from company to company including water source type, treatment costs, and environmental constraints. SEW operates in an area of serious water stress combined with a region of population growth.

The Company feels that a more appropriate comparison than the Ofwat data would be of the SEW bill with other water companies in the South East facing the same water scarcity issues: Anglian, Northumbrian-Essex & Suffolk, Southern, Sutton & East Surrey, Thames Veolia Central, and Veolia South East. SEW is the 4th highest out of the eight companies which are covered by this definition. £193 is the average for these eight companies compared to £186 for the industry as a whole.

There is clearly some validity in a bill comparison based on the grouping suggested by SEW, but we do observe a tendency for the Company to query the validity of any comparison in which it does not do well. Since all companies will have regional issues of one sort or another, then the CCG believes that it is not inappropriate to use the national average situation. Even if SEW fails to accept this, it is still has a higher average bill (£201 compared to £193) within its own preferred comparator group.

In the publication “Clear Water”, where SEW sets out its intended plans for 2015-2040, information is given on customer perception of bills. In the case of households, 70% feel the bill is about right, while 20% believe it is slightly too much and 9% feel it is far too much. In the case of businesses, 60% feel the bill is about right, while 22% believe it is

slightly too much and 16% feel it is far too much. This is why there is no willingness to pay, of course, because customers already feel they are paying enough and some will be aware that it is higher than many others pay.

The CCG believes that, on this basis, household perception of the SEW bill is quite encouraging. While business perception is not so supportive, such customers will soon have a choice of provider.

Acceptability To Customers

SEW consulted in June 2013 on “Clear Water” which set out the Company’s plans for the next 25 years. This document proposed outcomes as a way of measuring performance, and this was an important pre-cursor to the Business Plan and the view of what areas it would need to focus on. However, unlike some of the other companies in the sector (including all five other companies in the South East), SEW did not consult on a draft Business Plan for the next five years.

A factor in this course of action was that five years ago SEW did consult with its customers and the response rate was very low. However, response rates can be very low if the processes for reaching out to customers and stakeholders are inadequate. Other companies – such as Thames and Affinity - have been very proactive in eliciting responses and have achieved a high number of comments (although very low as a proportion of the number of documents issued).

Another – more decisive - factor in SEW’s decision not to consult on a draft Business Plan (DBP) was that the research programme itself was designed to catch priorities, service levels and willingness to pay amongst other things. The acceptability research at the end was the Company’s test of the package and so it did not consider the DBP would serve a useful purpose in engagement terms.

This approach was laid out in the Customer Engagement Plan in early 2012 and the CCG did not challenge the decision at that time. However, the CCG had only just been appointed at that point and most of us had no direct experience of a business plan process in a regulated sector. On reflection now and observing the experience of some other companies and CCGs, we feel that it might well have been advantageous for SEW to have consulted publicly on a draft Business Plan.

It may be that consultation on a draft Business Plan would not have elicited much useful extra insight from the customer base and that, as an engagement tool, it would have had limited impact. However, stakeholders may have found it particularly useful as a means of comparing SEW’s proposals with those of its neighbouring companies

Furthermore, production of a draft Business Plan would have acted as a discipline on the Company to form an overall view on its plan for 2015-2020 earlier than it has done and it would have given the CCG a framework in which to consider more meaningfully the draft components of the final Business Plan as they were produced and made available to us. As it was, in the words of one CCG member, assessing these different drafts has been “like doing a jigsaw puzzle without having the picture”.

Once SEW had an outline plan, it did, of course, conduct acceptability research on the implications of that plan for customer bills. As with all the customer research commissioned by the Company, the CCG made detailed comments [CL175-185].

This acceptability research – conducted by Accent – found:

- 76% of household customers and 78% of business customers found the Business Plan somewhat or completely acceptable when asked an initial (uninformed) question.
- 71% of household customers and 74% of business customers found the Business Plan bill impact (including sewerage company information) somewhat or completely acceptable.
- 86% of household customers (84% of low income households) and 79% of business customers found the overall Business Plan somewhat or completely acceptable, once informed with more details.
- 92% of household customers and 93% of business customers found the Business Plan clear or very clear.

CCWater commissioned SPA Future Thinking to do research on the appropriate level of acceptability. The acceptability threshold that most customers spontaneously cited was 70-75%. There was broad consistency across both domestic groups and business customers, with the majority of participants identifying this approximate 3:1 ratio as a reasonable proportion and a fair target for companies to achieve. The range of spontaneous views on an appropriate threshold across domestic customers was 51% to 75%. For business customers, the range was 60% to 95%.

The CCG is pleased that the levels of acceptability found by the research for SEW are so high and in excess of the threshold referenced in CCWater’s research.

The CCG notes the intention to finalise a Business Plan that would involve customer bills from 2015-2020 1% below the current average bill in real terms – below the scenario that has been the subject of acceptability testing. This is welcome in that it represents a significant scaling back of increases compared to 2010-2015 and we presume that, had this option been the subject of acceptability testing, it would have won even more support than the option that was in fact tested

However, it is broadly the approach being taken by virtually all the companies in the sector and only just meets the aspiration expressed by Ofwat’s Sonia Brown that water companies should be looking to deliver below inflation increases in the coming Price Review (“Telegraph” on 10/10/12 & presentation on 13/11/13).

As a CCG, we challenged SEW to see if it could deliver an even lower price increase. The Company has advised us that its sensitivity analysis around different pricing options has demonstrated that the option being put forward in the Plan is the optimum one. Furthermore we are well aware that the understandable wish of current customers to have the lowest possible bills has to be weighed against the need for future customers to have sufficient resilience in supply and proper protection for the environment.

Recommendation 4:

Ofwat should satisfy itself that SEW's price proposals for PR14 are not just consistent with the Company's Business Plan but competitive in relation to pricing proposals for the sector as a whole, taking proper account of genuine differences between different companies' local circumstances and demands and the need to ensure adequate resilience and environmental standards.

Besides the overall level of bills, we know from research that customers would prefer a smooth bill profile – that is, bills to be adjusted once to take account of the new price determination and then remain constant in cash terms over the Price Review period. The bill profile proposed by SEW for PR14 does not meet this preference. We have been advised by the Company that any further flattening of the bill profile would be constrained by financeability issues.

Recommendation 5:

Ofwat should consider whether it would be possible for SEW to achieve a flat bill profile for PR14 and still maintain financeability of the Business Plan.

Affordability By Customers

The general economic background to PR14 is that, in the last decade, incomes have increased by around 14% but combined water and sewerage bills have increased by around 40%.

Overall, the water sector in England & Wales has real problems of affordability and debt:

- Some 5.4 million households (23% of all households) spend more than 3% of net income on water & sewerage bills, while some 2.6 million households (11% of all) spend more than 5% on such bills.
- Of those households spending more than 3% of net income, 24% are single pensioners and 30% are working age people living alone, so the problem seems to be especially concentrated in single occupancy households.
- Of those households spending more than 5% of net income, 90% have an income of less than £160 a week or £8,300 a year, so the problem is clearly part of poverty as a whole.
- Nationally the total debt by customers of water companies is £1.64 billion.
- As a national average, the household bill for water & sewerage is £16 a year more than it should be because of non-payments of bills.

In the case of South East Water, on average 2% of customers do not pay their bills each year that compares favourably to an industry average of 5.9%. This might be due in part to the relative affluence of the Company's customer base compared to some other parts of the country. No doubt, it is also due in part to the active debt management activity of SEW as spelled out in Section 13.6.1 of the retail plan for households.

The CCG has been pleased to see the development of a new social tariff as part of the preparation of the Business Plan and has reviewed the research around this new tariff [CCG8/8].

Although the research showed that 80% of customers surveyed would support a social tariff, it highlighted that there is a challenge to address in any proposal in that there is a degree of mistrust among customers as to whether any social tariff funds could be used elsewhere in the business and not wholly for what it is intended. In response to this, the Company has proposed ring-fencing the social tariff fund so that it cannot be used for any other reason. SEW will also pay for the administrative costs of running the scheme. The scheme will be reviewed every year. **The CCG welcomes all this.**

The CCG also welcomes SEW's intention to introduce the new social tariff in 2015/16. We note that the relevant research found that nearly 80% of customers said that it was acceptable to reduce tariffs for certain customers and that a slightly lower proportion found it acceptable to introduce a social tariff if the income level for a single person household is set at £12,000 or lower.

The CCG observes that some 30,000 might be eligible for the new social tariff but that, taking into account the current level of subsidy that customers will support for the next five years, some 15,000 can be expected to be on the tariff by 2019/20.

In line with SEW's new outcomes approach, affordability of bills has become a more prominent feature of the Business Plan in this Price Review. This focus on affordability and value for money as a key outcome is welcomed by the CCG, especially given the current cost of living pressure on most retail customers.

The CCG particularly wished SEW to consider the needs of the most vulnerable of their customers, such as those on low incomes or with disabilities and health problems or those with communication difficulties.

At the request of the CCG, SEW provided two detailed papers for us on the Company's affordability strategy. Our CCG member from a local Citizens Advice Bureau spent considerable time with SEW's Head of Billing and Collections to ascertain the extent of help available and plans for the future. **At all times, the Company engaged positively in providing information about their operations and intentions.**

The CCG found that the help available for supporting those experiencing difficulty in paying bills or facing other problems had been developed over time in a piecemeal manner, reflecting both the history of the merged companies' operations and the changing approach to affordability in the sector.

There appeared to be no formal strategy for addressing the needs of these customers and no inclusion of the cost or structure of the support within the previous business planning process. No dedicated research had been carried out by SEW on this topic in the past with the result that it was not possible to ascertain whether the measures chosen by the Company were the most cost effective or most suitable to address the needs of these groups.

Despite this lack of formalisation of planning, the CCG did feel that SEW's Board and staff had a genuine desire to help those most in need and were committed to maintaining support for measures that they believed had provided valuable assistance for customers. The table at Section 13.7.2 in the Retail Household Plan gives a summary of the measures currently in place for its vulnerable customers or for those experiencing payment difficulty.

The CCG was gratified to see that the challenges made in the past months on this topic, as well as SEW's own revised consideration in this area, have resulted in the incorporation of support measures becoming part of the business planning process. In particular, the recent Willingness To Pay research undertaken to ascertain customers' willingness to support lower income customers has led to SEW's development of a social tariff with ring-fenced funding. The CCG is aware of the extensive work undertaken by the Billings and Collections team in consulting widely to formulate a sustainable and, hopefully, effective tariff framework.

SEW is now committed within its Business Plan to use customer research in the design of tariffs including Willingness To Pay research for support for the vulnerable or low income groups. Also the Company has stated that it wishes to raise the profile of the assistance that it offers to consumers via a structured engagement programme with stakeholder and community groups. **These moves are welcomed by the CCG.**

We have proposed to the Company that:

1. SEW should assess the effectiveness of the social tariff following introduction to ensure that it is reaching the targeted numbers speedily and to test whether the tariff has the correct level of financial support to provide meaningful assistance to customers struggling with their bills.
2. SEW should conduct further research into the cost effectiveness of the other forms of support offered by the Company to the vulnerable customer (e.g. the dedicated field advisors, the Helping Hand Scheme, and so on) to ascertain whether other options might be more suitable or cost effective. It was acknowledged by the CCG that there was little time prior to the Business Plan's issuance to commission such research given other research pressures.
3. The proposed SEW Customer Panel for household consumers should be involved with review of the effectiveness of the social tariff and reviews of the outcomes of the research into the effectiveness of other support measures as outlined in the previous recommendation.
4. The proposed SEW Customer Panel for household consumer should be involved in the design and evaluation of the engagement programme to ensure that customers are fully informed of help available and to ensure adequate uptake of the support on offer and that engagement and outreach is carried out with as many customer groups as possible.

Section C. Challenge To Component Parts Of The Company's Business Plan

C1: How The CCG Was Consulted On The Business Plan

CCG Review Of The Business Plan

The CCG doubts that Ofwat has fully appreciated the problems posed for both the companies and CCGs in consulting one another on their submissions to the regulator, especially given the reduced timetable for the process and the requirement for simultaneous delivery of these submissions.

As far as the Company is concerned, SEW has had to decide at what point and how often to consult the CCG on drafts of component parts of the Business Plan. The earlier it consulted us, the more we could influence the text, but the less developed the material on which we were invited to comment. The more often it consulted us, the more we could shape the document, but the more work there was in reading new lengthy drafts with a rapidly approaching deadline. It has to be remembered that four of our CCG members sit on other CCGs as well, so that they had multiple workloads at precisely the same time.

In the event, SEW showed us five drafts of the retail plan for households, four drafts of the retail plan for businesses, five drafts of the wholesale plan, and one draft of the overall plan. There were three opportunities for CCG meetings to consider draft components of the Business Plan and two meetings when the CCG Chair and the CCG consultant met with the Company's regulatory team to discuss these drafts in more detail.

Although we saw a summary financials paper two months before the Ofwat deadline for submission [CCG10/6], only at the last CCG meeting before the submission date did we have detailed information on prices and outcome delivery incentives [CCG11/4] and only two weeks before the deadline was the CCG shown a Business Plan text comprehensively populated by most of the relevant financial, outcome and incentive statistics.

We did not see any text of the overarching summary of the Business Plan until after our last CCG meeting and only two weeks before the submission date of both the BP and the CCG report, although the Company reassured us that the summary plan contains no extra information and simply summarises the three main plans.

We can understand that the bottom-up nature of construction of a Business Plan means that the summary is written after the three component parts. However, this method of production, combined with the PR14 timetable, meant that the CCG spent months reviewing the changing text of the three component plans but never had a proper opportunity to review the summary plan. While earlier sight of the summary plan probably would not have been material to any of our judgments on the adequacy of the Plan, it would have made the use of our time much more effective because we would have been concentrating from the start on the fundamentals of the plan instead of trying to complete the jigsaw without the picture on the box.

Of course, important blocks of the eventual Business Plan had come to the CCG in previous months, including the Water Resources Management Plan, quality information, cost of capital and the capital programme. However, these building blocks were not the plan itself and did not enable us to assess the plan as a whole at that stage. The actual figures – not least on prices and incentives – were critical to an overall appreciation of the plan. By the time we had to finalise the text of this report, the CCG had not seen a fully drafted text for any of the four component parts of the SEW Business Plan. That said, the plans we did see were very well developed so we do not believe that the text that we did not see would have been material to any of our judgments on the adequacy of the Plan.

The CCG challenge to SEW was a strong one and discussions on drafts of the Business Plan were – especially at Board level – robust. But we believe that the end result is a better plan: more stretching, better evidenced, and more consumer-focused. As the CCG worked through the successive drafts of the different parts of the Business Plan, the recurrent theme of so many of our observations was that, at so many points in the draft material, the links with the customer research and other customer data needed to be much more clearly made and demonstrated. As the drafting process evolved, these links were much better made and we were pleased that the Company took on board these comments.

CCG Consultation On Its Report

The guiding principle underlining the relationship between the CCG and SEW can be summarised as ‘no surprises’. We expected the Company to show us everything that would be in the Business Plan in time for us to challenge it and we in turn undertook to show the Company drafts of our report to Ofwat in time for them to express any views that we might wish to consider.

As regards SEW’s consideration of drafts of our CCG report, six drafts were shown to the Company’s regulatory team and senior management. The SEW Board itself had two opportunities to discuss drafts of the CCG report with the Group’s Chair – the first was five weeks before the Ofwat deadline and the second was four days before the deadline.

In recognition of the need to strengthen the dialogue with the Board on the evolution of the CCG’s report, it was agreed at the first Board discussion of the draft CCG report that the next draft would be discussed with the three independent directors before a final version was brought back to the Board in late November. The meeting between the CCG and the Non-Executive Directors proved particularly useful in clarifying the respective positions of the CCG and the Board.

It has to be said that, with the best will in the world, this complex choreography - of discussions around successive drafts of the company’s Business Plan and the CCG’s report to Ofwat - has proved very difficult because PR14 involved so many new elements, the timescales were so tight, and Board and CCG meetings had to be scheduled so closely together. Ultimately both the Company and the CCG were driven by a very tight regulatory timetable determined by Ofwat.

Board Assurance Process

The CCG has always been acutely aware that, however well the CCG process worked, we could only make a limited assessment of the Company's Business Plan. We have neither the time nor the relevant expertise to make a full assessment and, above all, it is not part of our terms of reference [see Annex B and Ofwat's documents on PR14 methodology] to assess the whole plan.

What we did do, however, was to request of the Company's Board information on the assurance processes that the Board itself would be using to satisfy itself that the material being submitted to the regulator amounted to "a high-quality business plan" as defined in the Ofwat final methodology document.

The CCG therefore received and discussed a paper on Board assurance of the Business Plan [CCG8/11].

Given the requirement for increased Board engagement compared to PR09 and the tight timetable for PR14, a revised assurance approach was implemented that included three additional PR14-specific Board meetings in June, July and September 2013 for the entire Board membership. The agenda for these additional PR14-dedicated Board meetings included the review of and agreement on each building block of the Business Plan. These meetings supplemented the two PR14 strategy meetings held in November 2011 and January 2013.

In line with the current agreed governance on regulatory compliance, the Board of SEW commissioned the Company's reporter, Strategic Management Consultants (SMC), to carry out assurance audits on the main Business Plan building blocks. SMC was asked to carry out the same level of assurance audit that is applied during the annual report process.

The reporter was booked for audits over two phases, July and October. As part of the Board governance, the reporter's audit reports were provided to the Board and the reporter also attended the Board meeting to present his findings. We understand that SMC carried out three weeks of audits that took approximately 60 man hours.

The CCG requested the attendance of the reporter at its final meeting before completing its report on the Business Plan and Bob Garrett of SMC attended our last meeting before we submitted this report to Ofwat [CCG11/7].

He gave us a presentation covering the primary support components of the Business Plan, capital expenditure, operating expenditure, the retail operation, financial issues, and other matters including efficiency targets and outcomes & incentives. We were assured that at no point was any significant problem or weakness identified by the SMC team.

On this basis, the CCG was satisfied with the assurance process adopted by the Board and the assurance given to us by the reporter that the Company's Business Plan was both high quality and independently audited.

Recommendation 6:

Ofwat should be assured that the Company has had the data and processes underpinning its Business Plan independently audited by an experienced and reputable company.

Recommendation 7:

Ofwat should be assured that the full Board of the Company has been fully involved in the production of the Business Plan and each Board member has signed up to the quality of the Plan.

C2: Comments On Overall Plan

Overview

This section of the SEW Business Plan is a summation of:

- the retail plan for households
- the retail plan for businesses
- the wholesale plan

We make detailed comments on the three component plans in Sections C3, C4 & C5 respectively. Here we make a number of important observations that apply to all three of these plans.

At every stage in discussing every part of the Business Plan:

- The CCG has urged the Company to make plain what has been called ‘the golden thread’ – how what is said is supported by the research that has constituted the customer engagement plan. We have encouraged the Company to be both customer-centric and data-centric throughout all parts of the plan.
- The CCG has encouraged the Company to make clear what it will be doing that is genuinely new – as opposed to statutory or regulatory requirements – and where what is new is simply new to SEW or particularly innovative in the sector.
- The CCG has pressed the Company to do all it can to raise the level of its ambition and not use evidence of a lack willingness by customers to pay more to produce a relatively unambitious plan. We sought to challenge the Company on the scale of its ambitions in critical areas such as complaints, leakage, consumption, prices, and incentives. A key part of the CCG challenge process was our encouragement to the Board to raise with the executive management the need to have the highest realistic aspiration in all the circumstances. **We felt that the Board was responsive to this challenge and the final targets are more stretching than might otherwise have been the case.**

In any regulated market with competition – and the water sector in England & Wales is scheduled to see the introduction of competition for non-household customers in 2017 – it is essential to have a clear separation of a provider’s retail and wholesale operations. Broadly speaking, there are three ways of achieving this:

- through financial separation as in the letters & packets business of Royal Mail
- through functional separation as with the creation of Openreach as part of BT
- through corporate separation as in parts of the energy sector

Currently the water sector is in the process of introducing separate price limits that, for the first time in a price review, requires separate business plans for a company's retail and wholesale activities. Which functions are allocated to retail and wholesale respectively cannot be a decision for the company but has to be determined by the regulator and, in the methodology for PR14, Ofwat has made clear its views.

Recommendation 8:

Ofwat should satisfy itself that the division between retail and wholesale activities in the SEW Business Plan accords with the PR14 methodology.

It is clearly essential that the costs of the service to households and non-households respectively are fairly allocated and that both allocations include an appropriate proportion of the wholesaler's costs. This is important both for fair treatment as between different categories of customer and for effective and fair competition when this is introduced. Since this is the first time that costs have been allocated in precisely this way in the water sector, one cannot assume that such allocations are straightforward and obvious.

In a market where some customers have a monopoly provider and some have a competitive choice, there is a danger that, where possible, costs will be loaded onto the monopoly part of the businesses. Clearly SEW's reporter has examined this and Ofwat will be aware of this danger.

Recommendation 9:

Ofwat should satisfy itself that the division of costs between retail household, retail non-household and wholesale activities in the SEW Business Plan are fair and in no sense anti-competitive.

Since water companies' business plans now have to have separate elements for the retail and wholesale activities of companies, the links between the two – and most especially clarification of delivery of outcomes – is vital. **We believe that SEW has shown clear and strong links of this kind in the three specific components of its Business Plan.**

Outcomes

In any sector built upon an asset-heavy network involving complex engineering, there has been a historic tendency to focus on outputs - 'hard', relatively objective measures of actual performance. A key feature of the PR14 methodology is a welcome shift from outputs to outcomes – 'soft', more subjective, but customer-determined measures.

One way of putting this might be to see outputs as what the company believes customers want and outcomes as what customers actually say about the service they receive.

In earlier drafts of the Business Plan, we were not sure that this distinction was explained sufficiently clearly for a non-regulatory audience, but this is now better done.

As part of the customer research underlying the draft Water Resource Management Plan (WRMP) process, SEW identified six customer outcomes which were set out in the document “Clear Water: Piecing Together The Bigger Picture 2015-2020” (June 2013). The CCG supported these outcomes and they appeared to be endorsed by the consultation process.

At an Ofwat workshop for CCG Chairs held on 9 July 2013, an exercise was run based on information from 14 companies that had at that point published their proposed outcomes for PR14. It was striking that:

- Some companies had very few outcomes (five - United Utilities) and some a lot (19 - Bristol).
- Some had long sentences (Welsh Water) and some single words (Wessex Water).
- Some outcomes were more top level and some a derivative of others.
- Some were more measurable than others.
- Some were more capable of incentives.

SEW refined and repackaged its proposed outcomes for the Business Plan expressing them in the form of the CLEAR acronym with five priorities (represented by the five letters of the acronym) leading to eight actual outcomes.

- **C**lean water
- **L**ow leakage
- **E**ffective service
- **A**ffordable bills
- **R**eliable service

We believe that SEW has selected around the right number of outcomes and more importantly chosen the right outcomes, that is the ones that matter most to its customers as evidenced by its research.

Recommendation 10:

Ofwat should be supportive of the outcomes chosen by SEW for its Business Plan, since these are clearly supported by customer research and, in the view of the CCG, address all the key issues of importance to customers.

Incentives

Clearly there is little point in committing to defined outcomes unless there is some kind of incentive mechanism to promote the fulfillment of these outcomes.

While customers will readily understand the notion of outcomes and indeed through research have played the key role in defining them, customers will find it harder to appreciate the process by which these outcomes are being incentivised.

There are two broad measures for an outcome. The first echoes the traditional approach of using a hard and fast key performance indicator. The second is the newer approach of using a measure of customer acceptability or satisfaction. SEW has chosen to use a combination of the two measures in respect of each outcome. Therefore a common thread through the retail plan for households, the retail plan for businesses, and the wholesale

plan is the combination of actual performance and customer satisfaction as twin measures of achieving an outcome.

The CCG was sympathetic to SEW's aspirations early in the planning process to measure these outcomes wholly in terms of customer perceptions as this would clearly demonstrate outcomes and not outputs. We were anxious, however, about whether it would be possible to develop in time proper measures for such perceptions and can understand why in the end the Company has chosen to use a mixture of actual service measures and perception measures.

The concept of combining actual measures (many with shared responsibility between the retailer and the wholesaler) and an on-going measure of customer satisfaction is a good one and does provide focus for both elements of the business.

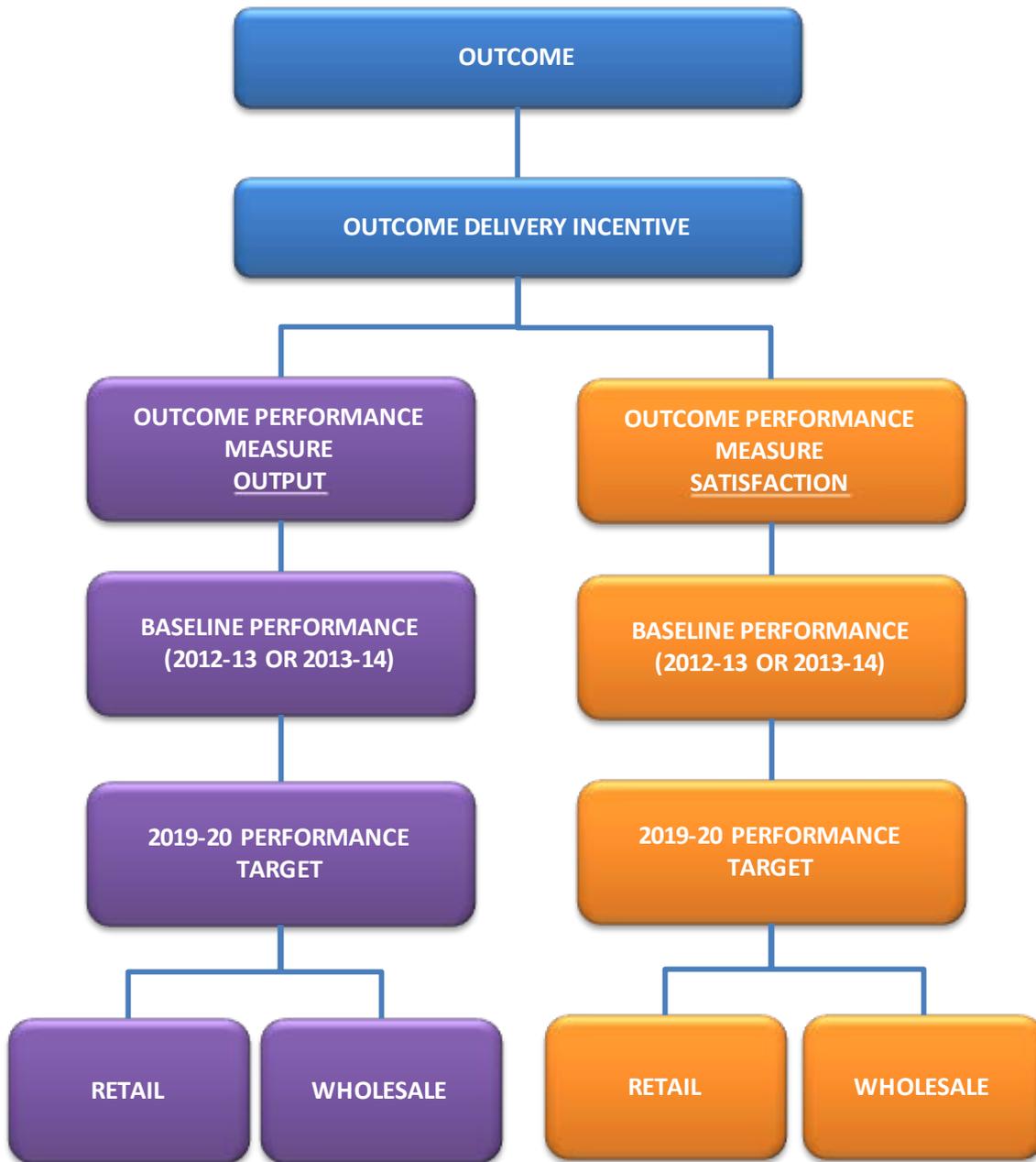
In the case of the output measure, for each outcome there has to be a baseline, which is essentially the current level of performance, and a target for the end of the 2015-2020 Price Review period that is determined by the Company. In the case of the satisfaction measure, for each outcome there has to be a baseline, which was determined by customers themselves through the outcomes research project, and again a target for the end of the 2015-2020 Price Review period that is determined by the Company. In fact, since there is no WTP for improved service levels, in the case of six out of the seven customer outcomes, the target for perception is the same as the current measure of perception.

Responsibility for achieving each target then has to be allocated between the retail business and the wholesale business in a manner that is transparent and convincing.

This approach carries risks for the Company, not least that the customer perception measure can be impacted by events or developments outside the remit and control of the Company. **We commend SEW for moving in this direction.**

This new approach is illustrated below:

Construction Of Outcome Delivery Incentives



Finally, the Company has to spell out in each case whether exceeding a target will result in a reward and whether failing a target will result in a penalty and, if so, what form or value that reward or penalty will represent. Ofwat proposed that, for each outcome, there should be a 'dead band' zone - a buffer within which incentives should not apply. In effect, movements in this zone would be regarded as 'noise'.

Originally SEW had hoped that its outcomes research could identify both how much customers valued a particular outcome and how much they would value an improvement in that particular outcome.

We cautioned strongly that, while customers could value a current level of service, they would find it exceptionally difficult to value an incremental change in that level of service. The research proved this was indeed the case and rightly the Company decided not to use the research as the basis for valuing a change in customer perception.

Originally SEW had thought that it could assign a value to a 1 point improvement and a 1 point deterioration in satisfaction. However, a five-point scale of satisfaction was used in the outcomes research and for household customers all but one outcome (predictably leakage) resulted in a score between 4.1 and 4.7. These findings both made a 1 point improvement statistically impossible and made any substantial improvement hard to justify in the context of no willingness to pay for service improvements. While business customers gave satisfaction scores consistently lower than those of household customers, since all but one score (again leakage) fell between 4.1 and 4.5, again a 1 point improvement is not possible.

Although the CCG welcomes the generally high satisfaction scores, we believe that any future research on customer satisfaction would be better if it deployed an even numbered scale (so no customer is tempted to go for a middle or neutral score) and a wider scale such as 10 points (so that distinctions in valuation are sharper).

Since the SEW-commissioned research could not give meaningful measures for customer valuation of changes in service, the Company made an assessment of the impact of experience in respect of pressure, interruptions, discoloration, and customer service. In the case of the other outcomes, experience was not relevant, since it is difficult for customers to say they have experienced leakage, all customers have experienced a recent hosepipe ban, and assessing taste and odour is very subjective.

To construct a total incentive around this approach to outcome delivery incentives (ODIs), SEW has used Return on Regulatory Equity (RORE) as a tool and analysis by Frontier Economics to develop that tool. This has resulted in an incentives package for the Business Plan from -£10.2M (which would represent -1%) to +£1.2M (which would represent +0.6%) a year. This represents an asymmetry between penalties and rewards but that reflects a similar asymmetry in the SIM measure.

The CCG notes that, from the point of view of customers, this incentives regime would represent a maximum 'return' of around £2.45 per customer per year in the event of the failure to achieve all the targets and a maximum bill increase of £1.44 per customer per year in the event of beating all the targets. In the context of a bill of £199 in 2012/13 prices, this would be a maximum decrease in the bill of around 1.23% or a maximum increase in the bill of 0.73%. In practice, any decrease or increase might be smaller.

We do not know how customers would view such a regime as this has not been tested in detail with customers and we are not sure that these levels of change would be noticeable by them. However, we have been assured by the Company that the reward/penalty range is comparable to the current SIM mechanism and that this has been shown to be effective in changing the Company's behaviour. So **the CCG concludes that such an ODI**

package would benefit customers but not in a manner that they would directly notice in their bills.

Of course, this ODI approach is new and experimental and we accept that measures might evolve during the PR14 period and that the incentive range might be wider in PR19. Implementation will require detailed attention from the proposed Customer Panels.

Meanwhile, since this ODI package is a new approach and involves certain assumptions and complicated calculations, Ofwat needs to be satisfied that it has been well-constructed and that it is likely to work.

Recommendation 11:

Ofwat should satisfy itself that the proposed Outcomes Delivery Incentives package is properly designed and likely to be effective in changing Company behaviours and delivering benefits for customers.

Identifying outcomes and setting outcome delivery incentives in a business plan is the essential start, but these Business Plan incentives have to be translated into management incentives that properly align with the Business Plan incentives and make them most likely to be achieved.

The CCG had some concerns about whether the teams that will be incentivised in certain areas are the same teams that are providing the data on which they will be measured. However, we have been assured that the Board governance processes around the production of the Business Plan and the setting of ODIs are such that the targets will be genuinely stretching.

The setting and application of management incentives based on the ODIs will require and involve a change in the current culture that may not be an easy process. This is not a matter for the CCG or Ofwat, but we trust that the proposed Customer Panels will be involved in this.

Overall plan document

This summary document is very clear and accessible and a skilful summary of the two retail plans and the wholesale plan. The CCG would have found much earlier sight of this document a considerable aid in focusing its time and attention in its overall assessment of the Business Plan.

We note the intention that the document will have opening contributions from the Chairman and the Managing Director but, at the point of finalising our report, only the second of these was available to us.

The MD's statement points out that "our prices will reduce" and the one part of the Executive Summary of the summary document that we have seen talks of the Company delivering "lower water bills". Of course, this is true in terms of real prices but most consumers think in cash terms and could be misled by talk of lower prices when overall prices will rise by almost the level of inflation over the period. In any event, a reduction of 1% in real terms over five years is not something that should be exaggerated.

Presentationally the Company needs to appreciate that, months after making statements on prices for 2015-2020, it will make an announcement on prices for 2014/15 and prices might rise in cost terms. We think that it would be fairer to represent SEW's plans for prices from 2015-2020 in terms such as: "We will ensure that our average bill rises by no more than inflation and even a little less."

The Executive Summary of the overall plan was not completed in time for it to be considered by the CCG.

Naturally we welcome the acknowledgement in Section 3 of the work of the CCG. We would like the plan to explain how the CCG report can be accessed by customers and stakeholders.

Section 3.2 on "Key challenges from the Customer Challenge Group and outstanding issues" was not completed in time for it to be considered by the CCG.

In Section 5, the part on customer service – a topic we have debated regularly with the Company – states that "... we continue to be viewed as a 'performance outlier' ". Besides the fact that an outlier can be exceptionally good or bad (and this is not explained), the language is 'management speech' and not customer-friendly.

Section 9 on incentives is excellent in setting out all the incentives in a clear tabular form.

Section 15.2 on affordability would have been of special interest to the CCG but no text was available at the time of completion of our report.

Section 18.2 talks of "a Customer Panel" but we thought that the Company was proposing two: one for household customers and one for business customers.

C3: Comments On Retail Plan For Households

Overview

As we have studied successive drafts of the retail plans, the main points made by the CCG have related to making the text more intelligible to the typical customer, making more use of contact and complaints data, and referencing more strongly the substantial customer engagement work conducted by the Company. **We have been pleased to see this section of the plan improve substantially in these respects.**

The text now makes strong references to the engagement and how it has shaped the plan and there is a clear thread running through which constantly refers back to the engagement. The activities that will be carried out are clearly and properly explained using simple graphics and text.

The Executive Summary of the retail plan for households was not completed in time for it to be considered by the CCG.

The CCG is pleased to see that, at the beginning of the retail plan for households, there is the personal endorsement of the plan by the Customer Services Director.

Following a strong challenge from the CCG for the Company to be more open about its poor complaints record, we acknowledge that the Customer Services Director specifically mentions the issue in his contribution. However, it is not really meaningful to state that performance has “not always been great”. Virtually no company could claim that its customer service has “always” been “great”. But we recognise and welcome that the Company has moved on this matter and that the Customer Services Director now apologises to customers for the past record. We hope that this sort of openness will be carried forward into the implementation of the Business Plan.

The retail plan for households is built around a CLEAR acronym. While some CCG members found this a little contrived, it is a presentationally neat way of structuring the plan.

Naturally we welcome the acknowledgement in Section 3 of the work of the CCG.

Section 3.2 on “Key challenges from the Customer Challenge Group and outstanding issues” was not completed in time for it to be considered by the CCG.

Throughout our discussions with SEW on various drafts of the plan, we have urged the Company to acknowledge the disappointing nature of its complaints record in recent years. In Section 4.3 on “Our customer service performance”, the Company has come some way towards this acknowledgment but, in our view, it is still using language that is more ‘management speak’ than a clear admission to customers that it got it badly wrong, it is sorry, and it is now putting it right. Talk of “a high number of complaints when compared to the rest of the water industry” and “we continue to be viewed as a ‘performance outlier’ ” is not the same as an up-front admission that two years ago the record was the worst in the sector and last year it was the second worst. Customers appreciate candour.

Section 4.4.4 commits SEW to providing a joint bill with Southern Water in respect of the latter’s sewerage service which would bring relevant SEW customers into the position of those SEW customers who receive their sewerage service from Thames. **Since the joint research between the two companies shows that a majority of SEW’s customers want joint billing, we very much support this.**

Section 4.5 suggests that competition for business customers will have some benefits for household customers, but the nature of those benefits and how they will flow through to household customers are not articulated.

In section 5.1, it is stated that the customer research programme has engaged with over 5,000 household customers and we suggested that it would be useful for there to be a table summarising the way that this number has been built up. The Company has acted on this suggestion and the table is now at Section 5.3. In fact, the number of household customers consulted was almost 6,000 so the Company is underselling itself a little here.

Section 5.2 has illustrations showing the core and non-core customer research. We feel that it would have been useful to reference contact data and complaints information in the non-core graphic or perhaps to create a third circle to emphasise how the Company is properly using all the relevant data that it has to hand from whatever source.

We are pleased that the Company has – in Section 5.6 – acted upon comments on an earlier draft of the plan by incorporating data from contacts made to the Company by its customers on a routine basis outside of proactive research. The text states that 55% of contacts are about bills. It would have been useful to have a breakdown of such a large percentage, although the top four categories are identified without actual percentages. In spite of the substantial metering programme, only 5% of contacts concern metering.

We would have liked to see the breakdown of the contacts information into different categories within each heading. This may include, for example, the number of billing contacts related to a lack of understanding as compared to the number where customers dispute the bill or are unable to pay. We would also be interested to know how the percentages in each category compare to similar complaint categories in other companies. Not only would this have given the CCG a stronger insight into why customers contact the Company, but it would also allow the Company to share with us the data analysis work it must have carried out in order to identify areas for improvement or investment.

In earlier drafts of the Business Plan, we were not sure that the distinction between outputs and outcomes was explained sufficiently clearly for a non-regulatory audience. Section 6.1 now does this. The ‘circles’ in Section 6.1 provide a clear picture and the ‘grid’ in Section 6.2 shows how the outcomes are broken down.

However, the Customer Panel will want to know about the surveys involved including: how many, how often, who will receive surveys, how robust the questions will be, and how relevant the questions are. The Panel will also want to consider whether there are any other engagement measures that ought to be included in this process such as complaints, enquiries, repeat complaints or enquiries, types of contact, and so on. Some regulatory measures are included in the balanced scorecard that is being developed, but now is the time to ensure that all relevant data is being captured and considered and the CCG wishes to seek assurance from SEW that this exercise has been carried out. The role of the proposed Customer Panel in the design and interpretation of these surveys will also be important.

In earlier drafts, there was talk of “a change of customers’ perception about our performance”. Throughout both this plan and the wholesale plan, there is a focus on changing customers’ perceptions through the new Communications Strategy. We cautioned that great care needed to be shown in how this aspiration is expressed. Customers will not want to feel that they are being manipulated into accepting poorer service than they are entitled to expect. The current text in Section 6.5 better reflects the Company’s intentions.

The material in Section 6.5.2 is particularly good in explaining why the Company wishes to value changes in satisfaction but frank in acknowledging the limitations of the relevant research and the position of the CCG on this.

The CLEAR Agenda

Following the CLEAR acronym:

- **C**lean water
- **L**ow leakage
- **E**ffective service
- **A**ffordable bills
- **R**eliable service

Sections 10-14 of the retail plan for households have a clear and consistent structure. In each case, the section looks at:

- what customers said
- what SEW will do
- where SEW is now
- where SEW wants to be and by when
- how SEW will work with its wholesaler to achieve the relevant outcome
- what SEW will do as a retailer to achieve this outcome
- how SEW will measure its performance

Clean water

Section 10.4 and others undertake that SEW will publish an annual performance report showing relevant indicators. It would have been useful if all these references had been summarised, so that we know exactly what will be the full range of indicators that will be covered in the annual performance report and how this will differ from past annual performance reports. In short, we want to know what will be new.

Low leakage

Customers certainly want much lower leakage. It was noticeable that, in the original qualitative research which was part of the Customer Engagement Plan, the provision of more information about the Company's operations produced a more informed group of customers who were more supportive of the Company's position - except in the case of leakage. When customers were given information on actual levels of leakage, concern increased rather than decreased, since the actual levels of leakage were often even greater than assumed levels.

In Section 13.3.2, SEW proposes a reduction in leakage from 93 million litres a day (Mld) in 2015 to 88 Mld by 2020 which would represent a reduction of 5.4% or just over 1% a year. We understand that, for the previous five years, the level of reduction was 3.7%, so a larger scale of reduction is planned for PR14. Given the strong concern about leakage levels expressed by customers, this is a welcome move.

The Company needs to be transparent about how it is going to measure leakage and maintain this method for the duration. There are a number of ways used in the industry and we would not want to see the Company accused of exploiting such differences to

achieve its water efficiency targets. From a customer point of view, a measure of so many litres per property per day would be most intelligible and this approach has been encouraged by the Environment Agency. The CCG is pleased to see SEW embracing this further measure in the plan.

The outcome of greater acceptance of leakage by customers will be achieved by a combination of reducing actual leakage and enabling customers to better understand the issues around leakage. The CCG would be interested in SEW's view on what is hoped to be the ratio of performance improvement to helping customers better understand the situation.

The assumption is that currently customers do not understand the issues surrounding leakage and so the Company will provide this information and customers' views will then change. The engagement information provided within this section indicates that customers lay the blame for leakage squarely at SEW's door and that they expect leakage improvement within a short timescale.

The activity of communicating the challenge for leakage is expected to improve acceptance but this was not the case with the focus groups so, unless improved performance accompanies this, communications will have a limited effect on changing consumers' views. The primary activity – which relates to the wholesaler - is to do something first.

Effective service

In Section 12.1, it is suggested that customers wanted the Company to offer a flexible range of contact methods over the next five to ten years. At a time when over 80% of UK homes are already connected to the Internet and social media and mobile devices are exhibiting explosive growth, a time scale of a decade for expanding customer channels would be markedly unambitious.

Section 12.3.2 sets out the Company's aspiration in relation to future Service Incentive Mechanism (SIM performance).

An earlier draft of this plan projected that the Company would achieve an average SIM score in relation to the industry during 2014/15 and that its SIM score would be above the industry average for the 2015-2020 period. The current draft is both more realistic in relation to the short term and more ambitious in relation to the medium term, suggesting that SEW will not reach the average SIM performance until 2015/16 but that "by the end of 2020, we will be among the top performers in the industry". We welcome this level of ambition but we wonder how SEW has reached its assumptions on industry average forecasts.

The Company must appreciate that the industry average will be a constantly rising target and that it will have to work really hard to keep up with rising standards in the sector, let alone become – as we would certainly wish – a top performer in the industry. It is not certain that clearer bills, call centre enhancements, a billing system upgrade, and web site enhancements will of themselves reduce complaints so substantially. A culture change is needed. The move to outcome satisfaction-based incentives should be the primary driver of culture change anticipated in the Business Plan. This is a deliberate decision by the

Company that benefits the customer via change in the way that it measures its own performance.

Throughout the drafting of our report, we have challenged the Company not just over the disappointing number of complaints that it has received since it was created, but also over its lack of transparency in communications with customers and other stakeholders in the past over the true performance levels around complaints. In Section 12.3.2, it is said of “the level of complaints” that: “We have been improving every year ...” This is self-evidently not the case as the bar chart in this section makes plain. But we welcome the clearly set out ambition in the bar chart that SEW will indeed improve its complaints level every year in PR14 and no doubt the Customer Panel will be monitoring this closely.

This section explains that each category of complaints is sponsored by a Board director. This is a positive step, but we would want to be reassured that the Company understands the customer journey as a whole and the total customer experience it delivers, so that it is managing each touch point, and not just its many processes, as part of that wider journey. This is very important; otherwise the different areas of responsibility will have limited success in the long term.

In Section 12.5.1, it is unclear what is meant by “smarter bills”. Billing systems might become more interactive (or smarter in the jargon), but we do not understand how bills themselves become smarter. This is ‘management speech’.

We note in Section 12.5.1 that an online billing option will be available for metered customers from Spring 2016. This is an advance on the Spring 2017 target set in earlier drafts and responds to a challenge from the CCG to move more quickly on this customer service. Of course, provision is one thing, but take-up is another, and we have not seen any targets for take-up of this option. We do, however, welcome the improved target date set by SEW.

In this regard, we would point out that the 2013 Annual Tracker survey showed that 80% of customers already say that they have access to the Internet and that 64% said that they would be ‘very likely’ to pay their bill online with another 21% stating that they would ‘possibly’ do this. SEW is way behind many other utility companies in this regard.

Section 12.5.2 promises investment to replace and upgrade both the infrastructure and associated software of the call centre platform. This is, of course welcome but, given that complaint handling has been a major problem for the Company in the past and that the worst experience of complaint handling was occasioned by an IT issue, we hope that this upgrade will be handled in a manner that genuinely improves service and does not cause a set-back in current progress.

In Section 12.5.2, the number of unique visits to the SEW web site is given as between 60,000-80,000. We query the significance of this figure. We would want to know how this relates to the size of the customer base and compares with other water companies. We would want to know how much it is rising and how many of these visits are to seek information or to conduct transactions or report issues. Meanwhile what we do know from the 2013 Annual Tracker is that 90% of respondents said that they had not visited the web site when they had experienced problems. Clearly, therefore, the Company has much more scope to make more effective use of the site.

The same section lists a number of web site improvements that are planned. Originally these were to be brought into effect by 2017 but now the plan is for them to be in place by Spring 2015. We welcome this faster timetable since we have repeatedly encouraged the Company to embrace new online technologies and techniques more quickly.

In Section 12.5.3, we welcome the commitment to a greater use of new technologies and social media for contacting customers and allowing them to contact the Company, but SEW is far behind many other companies – even some in the water sector – in using social media. Although we are told that (very recently), the Company went on Twitter and Facebook, there is still no reference to these information sources on the homepage of the Company's web site and no information on how many followers and friends respectively there are. Greater use of new online tools will require investment but will pay off both financially and reputationally.

Affordable bills

Transparency around bills is vital. Therefore we are pleased that the Company plans to show in Sections 13.3.3 & 13.3.4 the cost components of the average bill for unmetered and metered customers respectively. This information was not available to the CCG in time for it to be considered for this report.

In Sections 13.4 and 13.6.2, we are promised benchmarking exercises to compare the costs of other wholesalers and other retailers respectively. It would be useful to know more about how this would be done and what data sources would be used.

Section 13.5 is another instance of where it is important to make clear that the Company is planning to inform customers and not to manipulate them. This section describes the need for "engaging customers to take them beyond their water bill, so they consider their overall water supply service is value for money". The CCG believes that what the Company is trying to do is to educate and inform customers so that they have a greater awareness of what is involved in supplying water – but this could be clearer.

For customers that cannot pay, it is necessary for effective enforcement measures to be taken and the litigation activity set out in Section 13.6.1 shows that SEW is both active and effective in enforcing payment of bills. However, nothing specific is said about activity in the next Price Review period.

SEW's customers support its metering programme and we welcome the commitment in Section 13.6.4 to continuation and completion of the programme started early in the current Price Review period which should see around 90% of the Company's customers metered by 2020.

In Section 13.6.4, it is unclear what is meant by "smarter tariffs". Meters might be interactive (or smarter in the jargon), but we do not understand how tariffs themselves become smarter. This looks like another instance of 'management speech'.

Section 13.7.2 sets out a good range of the schemes on offer for SEW customers vulnerable to debt and the Company has provided helpful explanations of each one. The Customer Panel may wish to pursue with the Company opportunities for extending these schemes for the benefit of more customers.

We very much welcome – as set out in Section 13.8.3 - the creation of a social tariff for those household customers who have special difficulty in paying their bills. However, we queried if the intended reach (approximately 30,000) and the intended timescale (15,000 over the next five years) are as ambitious as they might be. The Company has explained that, taking into account the current level of subsidy that customers will support for the next five years, some 15,000 is the number that can in fact be on the tariff by 2019/20.

In Section 13.7.1, we are advised that around 8.5% of the Company's customers are "more likely to experience payment difficulties". This percentage equates to 70,634 using the Experian Mosaic data. Comparing 15,000 to 70,000 seems to leave a lot of customers unaddressed by a social tariff, although some will be assisted through other measures in use by the Company. The CCG would urge SEW to look closely at this data to ensure that genuine cases do not slip through the net.

Reliable supplies

Section 14.2 explains that 85% of customers assert that an interruption to supply of less than 6 hours is acceptable but the measure chosen for this is average minutes lost per property. We appreciate that the wholesaler maintains a variety of interruption data and the number of customers reporting repeat interruptions. Such data would provide the Customer Panel with more context and the opportunity to challenge performance in line with what customers said was important to them.

Section 14.3 includes a section on water efficiency.

According to the White Paper "Water For Life", average water consumption in England & Wales is currently 154 litres per person per day. In the case of SEW the consumption figure is 165 litres per person per day – the highest in England & Wales. We believe that more recent figures show that SEW is not actually the company with the highest per capita consumption (PCC) but it is one of the highest.

Of course, the reasons for water consumption vary with factors including household type and average income. Water use is often highest in relatively affluent areas where more homes have gardens and higher car ownership.

Given that SEW bills are relatively high and the region is water stressed, there are compelling reasons for endeavouring to reduce water consumption among the Company's customers. This is one of the reasons why the continuation and completion of the Company's ambitious metering programme is so important. We looked to the Business Plan to provide clear evidence of water efficiency activity and an appropriate reduction in per capita consumption (PCC). The CCG notes the comment from the EA in Annex E that it appears that SEW will, at the end of the Price Review period, still have one of the highest PCCs in the country.

In Section 14.5.1, the Company makes clear its intention to continue with its metering programme and we strongly support this. The Company could draw on its experience of metering to date to give confidence levels to the savings attributed to metering in its forward plans. The Company explains that it intends to use the opportunity of a metered customer base to explore further trials of tariff options. We welcome this - although we

suspect that customers will be very conservative about possible changes and that any changes will create winners and losers.

Performance Monitoring & Ongoing Challenge

Section 18.2 is a really useful table that sets out all the measures to be used against customer outcomes. Unfortunately it is not easy to read.

The work of the Customer Challenge Group has been all about the creation of a Business Plan for 2015-2020. It has no role in relation to monitoring implementation of the Plan once accepted by Ofwat. Clearly, if customers are to be at the heart of the Company's culture, there would be value in having an institutional voice for consumers in the implementation as well as the production of the Business Plan.

Therefore **we very much welcome the proposal** by SEW in Section 18.3 to create a Customer Panel to review on a quarterly basis performance against plans in the household customer base. We note that this new approach will be introduced in Spring 2014 for full implementation by April 2015.

We challenged the practicability or the usefulness of an earlier suggestion that a political representative serve on the Panel and we note that this proposition has been dropped. On the other hand, either in terms of membership or consultancy, the Panel would benefit enormously by having access to an expert in improving the customer experience.

It is unclear whether SEW envisages that the Chair of the Panel covering household customers will be the same or different from the Chair of the Panel covering business customers.

We note that the Chair(s) of the newly-created Customer Panels for household and business customers will attend meetings of a cross-Company Executive Team to undertake quarterly regular performance monitoring of Company activity. **This is an excellent idea.** The seniority of the management at that forum suggests that the Panel Chair(s) should have appropriate expertise and standing.

We would urge SEW to consider how the work of the current CCG might feed into the new Customer Panel(s) and how subsequently the work of the Customer Panel(s) might in turn feed into any future CCG-type body focussing on PR19.

C4: Comments On Retail Plan For Businesses

Introduction

Necessarily a major difference between the retail plans for households and businesses respectively is that, in the former case, the situation of monopoly will remain unchanged whereas, in the latter case, competition will be introduced from 2017. Some members of the CCG have experience of the introduction of competition in other former monopoly utility sectors such as gas, electricity, posts and telecommunications.

From this experience, we know that all former monopoly providers claim publicly to welcome competition when it is forced upon them by government and regulator, but often underestimate the extent of operational and culture change required to compete effectively. Also we are aware that competition takes time to develop and winners and losers in terms of customer numbers or market share are not quickly identified.

We are encouraged that, in this retail plan for businesses, SEW shows a real appreciation of the competitive challenge on the horizon and is planning for both losses and gains. In a public document such as the Business Plan, no company can be expected to give too much detail of its competitive strategy and its expected changes in customers served. However, the CCG is sure that the Company's Board will be focused on this, both as the Business Plan is finalised and as competition is introduced.

As a water only company, SEW does not have the size of some of the other market players and, since it has not entered the Scottish market, it has no current experience of competition. So it will have to work hard to ensure that its lost customers are no more than its gained customers.

Overview

This retail plan for businesses could have been much briefer than the retail plan for households with SEW arguing that the planned introduction of competition in the business market made it inappropriate to reveal too much of its thinking and planning. To its credit, the Company has done a lot more than it strictly needed to do and produced a retail plan for businesses broadly in line with that for households but, of course, holding back on information which might be useful to competitors,

This is the component of the Business Plan where the CCG has seen the most substantial development from one draft to the next. When the CCG originally saw a draft of the retail plan for businesses, it felt that the draft was simply a transposition of the retail plan for households with minimal changes in terminology. The retail plan for businesses is now a substantially different piece of thinking from what we originally saw and from the retail plan for households.

This is as it should be and **we commend the Company for developing a full plan that is specifically focused on the different needs and views of businesses.**

The plan has a very clear layout, a good explanation of where the business sits, and strong explanations of some of the challenges that face the business. There are clear links to the engagement and research throughout the whole of the plan. Also there is good evidence of the use of other information gathered by the business teams during their day-to-day dealings with customers.

However, the report might have benefitted from actual quotes from the research to strengthen it - it is not enough just to paraphrase the customer view. The household plan has lots of quotes and it not only brings that report to life but it also legitimises it for consumers.

The CCG is pleased to see that, at the beginning of the retail plan for businesses, there will be the personal endorsement of a Board member, although the text was not available to us at the time of completion of our report.

The Executive Summary of the retail plan for businesses was not completed in time for it to be considered by the CCG.

As compared with the CLEAR acronym for the retail plan for households, there is a CHOICE acronym for the retail plan for businesses:

- **C**lear prices
- **H**elp, advice and additional services
- **O**perational stability
- **I**nnovative customer contracts
- **C**lean water
- **E**ffective service

While some CCG members found this a little contrived, it is a presentationally neat way of structuring the plan. The acronym is currently used first in Section 2 but not spelled out until Section 6.4. It needs to be explained in brief form at the very beginning of the plan. It should also be mentioned in the Executive Summary when this is finalised.

We welcome the commitment in Section 5 that dedicated teams for household and business customers will be operating from as early as Autumn 2014.

Naturally we welcome the acknowledgement in Section 6 of the work of the CCG.

Section 6.1 on “Key challenges from the Customer Challenge Group and outstanding issues” was not completed in time for it to be considered by the CCG.

Section 7.2 provides a very useful disaggregation of business users. It states that 2% of business customers account for 44% of volume. Later, it is pointed out that managing service delivery to these customers is easier because they have good relationships through key account managers. Customers are defined by business sector, which indicates for example that agriculture/horticulture takes 14% of volume and hotels/catering 11%. Relative to other sectors, these are high total users but there is no indication of how they are engaged or how many of the 2% of high volume customers they include. We would like the Company to explain how it intends to engage with the larger numbers of smaller users whose total sector consumption is significant, and who would share common pressures and needs.

It is good to see in Section 7.3 that SEW has engaged the economic consultancy KPMG to analyse the competitive challenge and that the Company has identified the “switch risk” of different industry segments. This work should better equip it to face the coming competition.

We welcome the acknowledgement in Section 7.5 that the SEW complaint record is wanting, although the language used is perhaps not as forthright as the actual situation – described in Section A2 our report – would seem to require.

In section 9.1, it is stated that the customer research programme has engaged with 3,000 business customers and we suggested that it would be useful for there to be a table summarising the way that this number has been built up. The Company has acted on this suggestion and the table is now at Section 9.3.

The CHOICE Agenda

Section 9.4.1 mentions opportunities for cost reduction. This is important for many business sectors, including agriculture/horticulture, where market forces lead to low margins and therefore to cost sensitivity.

Section 9.4.2 and others mention help to trace and repair leaks in customer supply pipes. This is important to farmers and other customers with very long and often complex supply pipe networks, where undetected leaks can lead to very high bills for wasted water. This section refers to SEW's Loyalty Index research which the CCG has not seen but might well be an appropriate matter for consideration by the proposed Customer Panel. Meanwhile we welcome it, not only as a tool to help the Company understand how it may perform once the market opens, but also as another measure of customer satisfaction if it repeats this process on a regular basis.

Section 9.4.3 and others show a recognition of the importance of stability of supply to business sectors that depend on it which is different from household needs. It is useful that there is a cross-reference to drought plan/temporary use bans in this respect.

Section 10.2 provides a good explanation of an outcome as opposed to an output.

Following the CHOICE acronym, Sections 13-18 of the retail plan for businesses have a clear and consistent structure. In each case, the section looks at:

- what customers said
- the current position
- where SEW wants to be and by when
- how the retailer will work with the wholesaler to deliver the outcome
- what the retailer will do to achieve this outcome
- how performance will be measured

Clear prices

We welcome the commitment in Section 13.2 to developing understanding of customers' business operations that will be good for long-term relationships.

Section 13.2.4 promises a new benchmarking exercise to compare SEW's business retail costs against its household retail costs and those of the Company's competitors. The CCG would welcome further information on sources for this data, how it will be compared, and how it will be used within the Company and by the Customer Panel(s).

Help, advice and additional services

Section 14 has changed considerably since the last draft. The various outcome measures have now been replaced with a retention target.

This is admirable and is a stretch for the Company because in the last draft much was made of improving customer satisfaction around help and advice (given the previous poor showing both in the Tracker Surveys and during the engagement and research activities). Replacing these targets with a retention target is risky though because customers will stay or go for a variety of reasons – not least of all price which consumers have told SEW it could do better on (44% said it could be more competitive on prices). The help and advice given could be really good but, if the sums do not add up, then business customers may still vote with their feet.

In an earlier draft of Section 14.2.3, SEW set out the aim to help existing customers improve their water efficiency by 5% over the coming Price Review period, but we can no longer find this reference in the plan.

Operational stability

Section 15.2.2 explains that there will be a new performance measure to ensure that customers who are affected by repeat interruptions have their water supply service more closely monitored, but we query what is meant by “repeat” and what would be involved in such monitoring? On the face of it, this would seem like good business practice that would already be in place and not constitute a new measure.

We do not know if business customers have stated an acceptable length of time for supply interruptions. If so, then this ought to be reflected in the same way as in the challenge described for household customers in their plan.

Innovative customer contracts

Section 16.1.2 estimates that 45% of business customers will remain on the default tariff, 50% will move to a new tariff, and 5% will be new to SEW. We understand that these figures have been derived from the KPMG work on customer retention analysis, but it is unclear what estimate has been made of business customers who will leave SEW when they have the choice to do so.

In the case of new (and lost) customers, presumably more important than customer numbers here are the volumes of water and the scale of revenue involved. This may be information that cannot be revealed in a public plan but, in the absence of a further information, it looks as if SEW does not expect the advent of competition materially to affect its revenues and profits.

No doubt the proposed Customer Panel will keep these targets. Under review

Clean water

We welcome the recognition in Section 14.2.4.2 – underlined by the business customer feedback quoted in Section 14.1 – that taste and smell can be a particularly sensitive issue

for certain categories of business customer and the commitment of a technician visit if the problem cannot be resolved straight away.

Effective service

Section 18.2.1 sets out the intention of SEW to use the Research Industry Standard Loyalty Index to score customer loyalty. We support the use of the Loyalty Index as an additional way of considering how customers view the company. However, the Company is so far restricting this to its business customers in preparation for competition in supply. Using this methodology or something like Net Promoter for household customers would give a strong indication of satisfaction.

We welcome the ambition set out in Section 18.2.2 to reduce the number of complaints received from business customers and the challenging targets represented by the graph.

In Section 18.2.4.1, it is unclear what is meant by “smarter bills”. Billing systems might become more interactive (or smarter in the jargon), but we wonder how bills themselves become smarter. More ‘management speech’ here.

In Section 18.2.4, the number of unique visits to the SEW web site is given as between 60,000-80,000. Presumably this is a total figure and not specific to business customers. As we noted in the case of the retail plan for households, we would query the significance of this figure.

We would want to know how this relates to the size of the customer base and compares with other water companies. We would want to know how much it is rising and how many of these visits are to seek information or to conduct transactions or report issues.

Performance Monitoring & Ongoing Challenge

The work of the Customer Challenge Group has been all about the creation of a Business Plan for 2015-2020. It has no role in relation to monitoring implementation of the Plan once accepted by Ofwat. Clearly, if customers are to be at the heart of the Company’s culture, there would be value in having an institutional voice for consumers in the implementation as well as the production of the Business Plan.

Therefore we very much welcome the proposal by SEW in Section 22.3 to create a Customer Panel to review on a quarterly basis performance against plans in the business customer base. We note that this new approach will be introduced in Spring 2014 for full implementation by April 2015.

We doubt the practicability or the usefulness of having a political representative on the Panel. On the other hand, either in terms of membership or consultancy, the Panel would benefit enormously by having access to an expert in improving the customer experience.

It is unclear whether SEW envisages that the Chair of the Panel covering business customers will be the same or different from the Chair of the Panel covering household customers.

We note that the Chair(s) of the newly-created Customer Panels for business and household customers will attend meetings of a cross-Company Executive Team to

undertake quarterly regular performance monitoring of Company activity. **This is an excellent idea.** The seniority of the management at that forum suggests that the Panel Chair(s) should have appropriate expertise and standing.

As with the Customer Panel for household customers, we would urge SEW to consider how the work of the current CCG might feed into this new Customer Panel and how subsequently the work of this Customer Panel might in turn feed into any future CCG-type body focussing on PR19.

C5: Comments On Wholesale Plan

Overview

As we have studied successive drafts of the wholesale plan, the main points made by the CCG have related to making the text more intelligible to the typical customer, making more use of contact and complaints data, and referencing more strongly the substantial customer engagement work conducted by SEW. **We have been pleased to see this section of the plan improve substantially in these respects.**

We have urged the Company both to be innovative and to make that very clear in the plan. It is clear that the Company is trying hard to be innovative and to point that out, but some changes - while perhaps innovative for the water sector- are not really that new as regards the utility sector as a whole.

Overall this plan has strong links to the engagement plus good descriptions of the activities that will be carried out and what is expected to be achieved. There is good use of graphics to highlight references to the research.

The CLEAR acronym for household customers' priorities and the CHOICE acronym for business customers' priorities are so central to the wholesale plan that they should have been explained in the Executive Summary if this section is indeed to be a genuine summary as opposed to a simple introduction or scene-setter.

The CCG is pleased to see that; at the beginning of the wholesale plan, there will be the personal endorsement of the plan by a Board member, although the text was not available to us at the time of completion of our report.

Naturally we welcome the acknowledgement in Section 3 of the work of the CCG.

Section 3.1 on "Key challenges from the Customer Challenge Group and outstanding issues" was not completed in time for it to be considered by the CCG.

Section 5.1 provides a clear explanation of the anticipated imbalance between supply and demand, but a diagram might have helped to underline this vital point even more clearly. The last of the 'bubbles' even suggests that some supply areas will show a shortfall from as early as 2016. It might have been helpful to identify these locations and the reasons for the shortfall as well as providing assurance that the needs of these locations are addressed in the plan. No doubt the local media will pick up on this point once the plan is published.

Section 5.3 on financing of investment from 2015-2020 explains that SEW has included in its Business Plan a reduction in the rate of return from 5.3% to 4.45%, primarily as a result of lower borrowing costs in the coming Price Review period compared with the current one. Clearly this is a vitally important assumption but the CCG is in no position to comment upon it.

Recommendation 12:

Ofwat should satisfy itself that the rate of return assumed by SEW is, in all the circumstances, an appropriate one to use.

Section 6 provides a good early explanation of the previous investment, how this will impact future investment, and an update on activities since the last determination. The section tells a story and offers a clear picture of 'where we are now and how we got here', setting the scene for the next PR period – an all round improvement on previous versions.

Section 7.2 has illustrations showing the core and non-core customer research. We feel that it would have been right to reference contact data and complaints information in the non-core graphic or perhaps to create a third circle to emphasise how the Company is properly using all the relevant data that it has to hand from whatever source.

Section 8 is all about the linkages between outcomes, measures, and incentives. This is of considerable importance and the clear exposition of the linkages is an exceptionally useful feature of the plan.

The table of performance commitments in Section 8.3 and the 'wheels' showing linkages within each set of outcomes in Section 8.5 merit particular study because they communicate so much.

Section 8.6.1, which explains why SEW wishes to measure customer satisfaction, is one of the most important in the whole Business Plan. **The CCG believes that the Company is absolutely right to aim for customer satisfaction as the ultimate outcome for all customer-facing activities.** Perception is reality framed by history and the Company is wise to look at the bigger picture and recognise that so many things influence and affect the customer experience.

Section 9 on incentivisation of performance contains a table which is very detailed but very important.

Section 9.1, which explains how SEW will apply the incentives, is another critical section. Upper and lower limits are a sensible approach. We queried on a previous draft whether, if there are service failures, customers will have to wait unto the next Price Review to receive 'compensation'. In the later version, it is clarified that service guarantees will still ensure payments if guarantees are not met. This shows that the Company has listened to us and provided comfort that customers will not be waiting until 2020 to see some benefit.

Section 10 is one of many in the Business Plan that talks about a change of customers' perceptions and, on earlier drafts, the CCG warned about the language used here, so that there was no misunderstanding that the Company wanted to change the view of the customer rather than the service experience itself – which we know is not the case. The

language now used – improving customer knowledge, better informed views, understanding the challenges – is a real improvement and again shows that the Company has listened to the CCG as the drafts of the plan have evolved,

Outcomes

Sections 13-21 address in turn the eight customer outcomes, five compliance outcomes and three sustainability outcomes and examination of each outcome looks at:

- how SEW has arrived at this outcome
- how customers currently perceive this outcome
- what customers have told SEW about their requirements
- how SEW will deliver those requirements
- how SEW will measure its performance

This is a clear and consistent structure.

Section 14.2 points out that SEW has met its leakage target for 11 consecutive years and yet customers are still very dissatisfied with the current performance of 16%. The CCG suggested that it would be helpful to explain that those targets are generated through the calculation of the sustainable economic level of leakage (SELL) which is a measure set by the Environment Agency and audited by reporters as part of the WRMP process. Helpfully the text now does this.

In Section 14.4, as we mentioned in our comments on the retail plan, the Company needs to be transparent about how it is going to measure leakage and maintain this method for the duration since there are a number of ways used in the industry. From a customer point of view, a measure of so many litres per property per day would be most intelligible and this approach has been encouraged by the Environment Agency. The CCG is pleased to see SEW embracing this additional measure.

Section 15.2 sets out the SEW view on how customers perceive their experience in the context of an outcome about direct interaction with SEW. In Section A2, the CCG made clear how troubling it has found the complaints record of the Company over a period of years and this section does not properly acknowledge the scale of the problem the Company has faced and the number of customers who have been dissatisfied with the Company's service.

Section 15.4.1 is vital, since it deals with future achievement of the Service Improvement Mechanism (SIM) – a measure where historically SEW has done badly and which we examined in some detail in Section A2 of this report. In our comment on an earlier draft of this part of the plan, we challenged the level of the Company's ambition in relation to its future SIM achievement since it appeared to be aiming for the industry average, although we recognised that this would be a very significant improvement, given both that in past years SEW's SIM score has been well below the average and that the industry average is constantly improving.

The Company is now projecting that, by the end of 2020, it will be “among the top performers in the industry”. We welcome this increased level of ambition. No doubt the proposed Customer Panels will make tracking SIM achievement a priority in their work.

Section 15.4.2 deals with training for field technicians. This is a vital ingredient of any successful company and we feel that more could and should be said here about what sort of training would be involved and how its effectiveness would be monitored.

Section 17.2 addresses customer perceptions around reliability of their water supplies. The continuing trend is to use a customer minutes lost target of 13 minutes per household per year. However, customers said, resoundingly, that they did not believe any supply interruption should last more than 6 hours. Averaging it out over the whole customer base is one measure, but SEW ought to be heeding the engagement and at least looking at the number of supply interruptions that last longer than six hours. It should also consider repeat interruptions.

Section 17.3.1 sets out the intention of SEW to reduce per capita consumption (PPC) from 158.5 litres per day in 2014/15 to 141.3. There has been considerable correspondence and conversation between the EA and SEW on this projection, summarised in Annex E.

The original comment of the EA was: “You have one of the highest per capita consumption figures in the country and we would like to see you show greater ambition in reducing it.” Following the dialogue with the Company, the EA still concluded: “In your submitted statement of response it would appear that you will remain with one of the highest PPCs in the country. However, we welcome your commitment to positively influence your customer’s water use behaviour and achieve greater levels of PCC reduction.”

Section 20 is on protecting the environment. In earlier drafts the CCG was concerned that sustainability is a difficult area for which to create outcomes and that the one then described was not an outcome but an input. The sustainability outcomes are now much better articulated and do relate to outcomes rather than inputs or outputs. The CCG has been pleased to see this response to our challenge.

Investment

In Section 22.2, it is explained that the guiding principle for the targeting of investment is a focus on those vital assets that are at most risk of failing. This seems to be self-evidently sensible, but raises a couple of issues.

First, can one accurately predict the likelihood of failure of all assets or are there inherently unknowns that simply cannot be quantified? Second, while investment may well be targeted on assets with a high risk of failure, what proportion of investment should be deployed in this way and what proportion should be allocated to a systematic repair and replacement programme? SEW has a replacement rate for below ground assets of less than 0.31% in five years compared to an industry average of 0.44% in just one year.

In Section 22.2.2, we are advised that the optimum investment schemes selected by the computer model are subject to further scrutiny by technical and engineering expertise. We welcome this good business practice which will provide reassurance that SEW is sense-checking the model using ‘real’ people and their skills.

Section 22.3.1 explains that the cost of the centralised cost database will be spread over a number of years. This is a positive feature of the plan that the CCG welcomes as it provides a benefit to consumers.

Section 22.3.3 maps outcomes against investment decisions. **We regard this as a useful and important section of the plan that demonstrates a real shift in Company thinking from an asset-driven organisation to a much more customer-focused one.**

Section 23 sets out the cost of financing the Company's investment programme. Clearly a key factor here will be the cost of capital. This is not a matter for the CCG but it is so central to the determination of customer bills – it impacts around a quarter of the total bill - that we felt it important to have some appreciation of the subject.

Therefore we requested a paper from the Company and had a useful discussion at one of our meetings [CCG4/8] and we covered the subject again in a wider discussion of financial issues with the Finance Director Jo Stimpson [CCG5/7].

Although it is for Ofwat to determine the cost of capital, obviously the Company has had to make an assumption on this in order to prepare and cost its Business Plan. The CCG is not qualified to judge if that assumption is well-founded. What is clear though is that the cost of borrowing has fallen so much that the difference in the weighted cost of capital (WACC) for PR14 will be significantly different than that for PR09 – more so than for any previous successive price reviews.

Although the cost of capital has fallen as interest rates have remained at low levels, one cannot be sure that interest rates will stay so low through until 2020. This is particularly a problem for a highly geared company such as SEW, although ultimately the risk is borne by the shareholders.

We note that SEW is assuming a cost of capital of 4.45%. However, in her speech of 10 September 2013, Sonia Brown of Ofwat used for illustrative purpose an estimate of 4.1% based on the average projections made by analysts and added a range of plus/minus 0.5% to reflect the uncertainty with these projections. Then, in her speech of 13 November 2013, she insisted: "... when companies put forward their proposals for the cost of capital in their business; there is a real opportunity for this number to start with a 3".

Recommendation 13:

Ofwat should satisfy itself that the Company has used a realistic and well-founded assumption on the likely cost of capital in the calculation of the funding requirement for its Business Plan.

Performance Monitoring & Ongoing Challenge

The balanced scorecard in Section 28.2 is an appropriate approach and will be key to stakeholder assessment of how well the Business Plan is being implemented over the period 2015-2020.

As with the retail plans for households and businesses, we very much welcome the proposal by SEW in Section 28.3 to create Customer Panels for household and business customers respectively to review on a quarterly basis performance against plans.

Again we note that the Chair(s) of the newly-created Customer Panels will attend meetings of a cross-Company Executive Team to undertake quarterly regular performance monitoring of Company activity and reaffirm that we view this as an excellent idea.

Again we would urge SEW to consider how the work of the current CCG might feed into the new Customer Panels and how subsequently the work of the Customer Panels might in turn feed into any future CCG-type body focusing on PR19.

C6: Comments On Selected Appendices

SEW's Business Plan is supported by 28 detailed appendices and the Company has offered the CCG access to any of these that it wishes to see. Most fall outside the CCG's terms of reference and ability to assess – notably all the documents to do with costs – but others bear directly on those issues that are central to our report. Therefore we have viewed three of the appendices and have a number of brief comments to make on them.

APP.20 Appendix On Engagement

The Executive Summary comments: "We believe it is a unique opportunity to create closer links between the true value of water, the services we provide, and the cost to our customers and society." We presume that "it" refers to the customer engagement around the production of the Business Plan for 2015-2020. While this is an especially useful opportunity to make the links identified, it is surely not "unique" since there are many more, not least the CCG process itself, the proposed Customer Panels and all the activities described in the appendix on communications.

The CCG welcomes the acknowledgement of our work in the Executive Summary: "The group has been central in scrutinising not only how we have developed the engagement plan, the individual research methods, and the physical materials for our many conversations with customers, but how we have translated the results into this business plan."

Section 2 uses a mixture of tenses – present and future. We would suggest that all references to the PR14 engagement process should now use the past tense.

The CCG has found immensely useful Section 3 of the Appendix which summarises all the research carried out for the PR14 process. We are sure that Ofwat will find this a valuable source of information too. We suggested that the company that conducted each piece of research should be identified in the Appendix and this suggestion was accepted

In this section, the description of the first piece of research – qualitative research with household customers – refers to "naïve customer focus groups". The term "naïve" might be common in the market research sector but we would have preferred use of a term like "uninformed".

APP.21 Appendix On Communications

We have been pleased to note a move from a generally reactive communications approach to a much more proactive one. Indications of this include the growth in the number of press releases and the embracing of social media.

We welcome the statement in the summary that “We are committed to ... being innovative in our communications” but we would suggest that SEW still has some way to go to demonstrate this. The Company is now on Facebook and Twitter but many other companies have been using such social media for longer and more cleverly. Even today, the SEW web site does not have links on its homepage to its Facebook and Twitter accounts.

The move in 2015-2020 to outcome delivery incentives and measurement of customer perception around many of the outcomes will give the Company’s communications strategy a new and more important role. This is recognised in the Appendix when it states in Section 2: “Clearly effective communications and marketing has a crucial role in helping to achieve many of these outcomes.”

However, the CCG has warned repeatedly in discussions on drafts of the Business Plan that the role of communications is to better inform and empower customers and not to push them into accepting lower performance levels than they are entitled to expect because their perceptions have been manipulated to some extent. We know that the Company understands and accepts this but, in the future, all the materials and messages need to reflect this.

A good example of where this will need to be the case is in respect of what Section 3 calls “the leakage challenge”. The Appendix gives no information on how communications is planned to impact customer perceptions in this sensitive area.

APP.22 Appendix On Performance

In our discussions with SEW in the production of the Business Plan, we have repeatedly urged the Company to be candid about its poor complaints record in the current Price Review period. This Appendix is yet another example of how we think the words used by the Company do not reflect a frank acknowledgment of the disappointing experience that many customers have had to face.

The Executive Summary explains: “We recognised that at the start of the period our customer service performance was neither where it should be nor where our customers expected it to be.” This kind of ‘management speak’ – a performance not being “where it should be” – simply does not accord with a complaints record which has been the worst in the sector and last year was still the second worst in the industry.

We note that overall investment for 2010-2015 is actually greater than that approved by Ofwat in the last Final Determination (FD) – an overspend of £32M or 8%. We understand that this will result in an off-set against revenue but a subsequent increase in the Regulatory Capital Value (RCV). The profile of actual investment against that projected in the FD year on year is very different.

Section D. Recommendations And Conclusion

In the main body of this report, we have made **a series of 13 recommendations to Ofwat** which, for convenience, we summarise here:

Recommendation 1:

Ofwat should be assured that the Company has carried out an impressive range of customer research with the methodologies and findings being the subject of detailed critique by the CCG.

Recommendation 2:

Ofwat should be assured that the Company has successfully demonstrated to the CCG that it has evidenced each part of the Business Plan with reference to the relevant pieces of customer research.

Recommendation 3:

Ofwat should be assured that the three environmental and quality regulators are broadly supportive of the Company's Business Plan, as it relates to meeting the requirements of DEFRA's Statement of Obligations, and have no significant objections outstanding at the present time. It is, however, a matter for the Company to ensure that it has allocated sufficient expenditure and resources to meet its statutory obligations.

Recommendation 4:

Ofwat should satisfy itself that SEW's price proposals for PR14 are not just consistent with the Company's Business Plan but competitive in relation to pricing proposals for the sector as a whole, taking proper account of genuine differences between different companies' local circumstances and demands and the need to ensure adequate resilience and environmental standards.

Recommendation 5:

Ofwat should consider whether it would be possible for SEW to achieve a flat bill profile for PR14 and still maintain financeability of the Business Plan.

Recommendation 6:

Ofwat should be assured that the Company has had the data and processes underpinning its Business Plan independently audited by an experienced and reputable company.

Recommendation 7:

Ofwat should be assured that the full Board of the Company has been fully involved in the production of the Business Plan and each Board member has signed up to the quality of the Plan.

Recommendation 8:

Ofwat should satisfy itself that the division between retail and wholesale activities in the SEW Business Plan accords with the PR14 methodology.

Recommendation 9:

Ofwat should satisfy itself that the division of costs between retail household, retail non-household and wholesale activities in the SEW Business Plan are fair and in no sense anti-competitive.

Recommendation 10:

Ofwat should be supportive of the outcomes chosen by SEW for its Business Plan since these are clearly supported by customer research and, in the view of the CCG, address all the key issues of importance to customers.

Recommendation 11:

Ofwat should satisfy itself that the proposed Outcomes Delivery Incentives package is properly designed and likely to be effective in changing Company behaviours and delivering benefits for customers.

Recommendation 12:

Ofwat should satisfy itself that the rate of return assumed by SEW is, in all the circumstances, an appropriate one to use.

Recommendation 13:

Ofwat should satisfy itself that the Company has used a realistic and well-founded assumption on the likely cost of capital in the calculation of the funding requirement for its Business Plan.

Over the last 20 months, the Customer Challenge Group and South East Water have been on a joint journey. Neither party knew quite how this new arrangement would work. It has not always been an entirely comfortable process for either party but the discussions and debates have been professional and constructive.

Ofwat has rightly been looking for innovation in the PR14 process and one should not underestimate how innovative the CCG process itself - actually recommended by the regulator - has been.

To use the language of the Price Review, in a sense this CCG report and the Company's Business Plan are outputs. The 20-month interaction between us has, we believe, produced an outcome – a process of producing the plan and a plan itself that is much more focused on the customer and much better evidenced by reference to research of customer views than would have ever been the case in any previous Price Review.

This has been possible and achieved through the effective embedding of the CCG inside the Company that has enabled and encouraged a dialogue of a detail and frequency that would not have been possible in the past. In the first 15 months, the CCG met approximately every two months and the Chair was in approximately weekly contact with the Company in addition to the discussions on individual pieces of research that took place through our Customer Engagement Sub-Group. In the last three months, the CCG has met monthly and the CCG Chair has been in daily contact with the Company while CCG members have studied successive drafts of the Business Plan.

On this basis, we can say that the proposed Business Plan is consistent with the views of customers, but the CCG recognises the needs for further detailed challenge by Ofwat on those elements of the Business Plan unseen by the Group or beyond its competence. Furthermore we note that the ability of SEW to deliver against the objectives in the Plan is reliant on whether the Company has made sufficient provision in its financial calculations and the outcome of the Final Determination.

This level of involvement and engagement enables us with confidence to conclude that, as regards our area of competence, the SEW Business Plan should be commended to Ofwat.

Annex A - CCG Membership

Roger Darlington - Independent Chair of the Customer Challenge Group

Roger has wide-ranging chairing experience and currently chairs the DCMS Consumer Expert Group, the Consumer Futures Post Offices Advisory Group, and the Nominet Policy Stakeholder Committee.

He also has deep experience of speaking for consumers in regulated industries having served on the governing bodies of organisations such as Consumer Focus, Postwatch, the Communications Consumer Panel, and the Internet Watch Foundation.

Before becoming a portfolio worker in the consumer sector, Roger spent 24 years as a national official with the Communication Workers Union, spending the last seven years as Head of Research. Before becoming a union official, he served in Westminster and Whitehall. He has a First Class Honours degree in Management Sciences from the (then) University of Manchester Institute of Science and Technology.

Jim Barker - Environment Agency

Jim has worked for the Environment Agency since its creation in 1996 in various roles including incident response, inspection and regulation, and strategic planning. He is currently Water Planning Manager for the South East and, in this role, he is responsible for the Environment Agency's contribution to the Water Framework Directive, Water Resource Management Plans, and the 2014 business plan process.

Jim has a BSc Honours degree in Physics and Geography.

Jim is also a member of SEW's Environmental Focus Group and a member of three other CCGs.

Elinor Cordinor - Drinking Water Inspectorate

Elinor is a Principal Inspector with the Drinking Water Inspectorate (DWI) and oversees drinking water safety planning and risk assessments, the Price Review process, and regulatory programmes of work. She has also acted as the liaison inspector for Dwr Cymru, Dee Valley Water and United Utilities, with responsibility for maintaining an overview of water quality issues for the companies.

Elinor studied microbiology and biochemical engineering in London (UCL) before joining Severn Trent Water as a graduate trainee in 1990. She spent 15 years with the company in a variety of roles, predominantly related to drinking water quality, before joining the DWI in November 2005.

In 2010 Elinor was awarded an MBE for services to the Drinking Water Inspectorate, following the Inspectorate's investigations into the cryptosporidiosis outbreak in North West Wales in 2005/2006.

Elinor is a member of six other CCGs.

Louise Bardsley - Natural England

Louise is Natural England's Senior Adviser for the water sector in the South East of England. She is currently the lead on Natural England's engagement with the water companies in the region including Southern Water, Thames Water and South East Water.

Louise has worked for Natural England and its predecessor English Nature since 2001 in a variety of roles, though usually maintaining a link to the water environment. She represented Natural England's local team in the Asset Management Planning discussions for the 2000-2005 and 2005-2010 Price Reviews, as well as looking after a suite of wetland and heathland designated sites.

Previously, Louise has worked for the Wildlife Trusts as water policy officer and was a post-doctoral research fellow at the University of Sussex. Her PhD is in the terrestrial resource use by the common toad and she has a lifelong passion for amphibian conservation.

Louise is also a member of SEW's Environmental Focus Group and a member or support member of three other CCGs.

Karen Gibbs - Consumer Council for Water

Karen leads the Consumer Council for Water's Environmental Policy Team and is the Regional Manager for London and the South East. Areas of particular interest include water resources planning, demand management and water efficiency, metering and drought management.

Karen has worked in consumer representation within the water sector since 1993, originally at Ofwat, then at Water Voice, and latterly at CCWater.

Karen is also a member of SEW's Environmental Focus Group and a member of five other CCGs.

Caroline Farquhar - Tonbridge & Malling Citizens Advice Bureau

Caroline started work at the Tonbridge and Malling Citizens Advice Bureau (TMCAB) in 2006 as a volunteer adviser and later as a staff member. The TMCAB is one of over 380 individual charities across England and Wales that provides free, impartial and non-judgemental advice to the public on matters such as debt, benefits, housing, relationships, legal issues and employment. Citizens Advice Bureaux are also members of the national Citizens Advice organisation which is an independent charity in its own right.

Caroline is Projects Co-ordinator at the Tonbridge & Malling CAB and she is also the project lead of the Kent Consumer Empowerment Partnership and part of the strategic management team for a partnership of West Kent Bureaux.

Prior to joining the CAB, Caroline spent ten years in the investment banking industry in London, in internal audit and control functions, and as a Credit Officer. Caroline has a law degree and an MBA.

John Archer – National Farmers’ Union, South East Region

John is Regional Environment and Land Use Adviser with the National Farmers’ Union (NFU) in the South East. He has been with the NFU for over 16 years, following a career in the Royal Navy. His NFU work has included water quality and resources as well as planning, employment, public access, and a range of other regulatory matters.

He has represented the agriculture sector on the South East River Basin Planning Liaison Panel since its inception, and has been a member of numerous catchment project steering groups across the region, including Catchment Sensitive Farming, the Downs and Harbours Clean Water Partnership, and the River Avon Restoration Project Board.

John is also a member of SEW’s Environmental Focus Group.

Janet Hill - Swale Borough Council

Janet is Climate Change Officer at Swale and this council role sees her taking responsibility for all matters relating to climate change and embedding it within council policy. She regularly advises officers and members on government policy and is a key member of the Kent Climate Change Network.

Janet has previously worked for CPRE Kent and the Kentish Stour Countryside project. She also worked with VSO and Save the Children in Ethiopia, Kenya and Tanzania.

Before joining the SEW CCG, Janet was a member of the London & South East Committee of the Consumer Council for Water.

Kathryn Rathouse - social research consultant

Kathryn has a BA degree in Experimental Psychology from Oxford University and a Masters degree in Environmental Psychology from the University of Surrey. For seven years, she worked at BRE, before creating her own Company in 2006 to conduct social research.

She has carried out research projects on many aspects of the water sector for clients which have included DEFRA and water companies such as South East Water, Southern Water, United Utilities, and (the then) Veolia Water.

Carole Pitkeathley – consultant to the CCG

Carole is a customer experience professional who has spent almost 20 years working in the utilities sector on both regulatory and consumer issues. Initially working for the electricity regulator Offer, she held senior posts in Ofgem and then became a director of

the consumer advocacy body energywatch at its conception in 2000 where she stayed until its closure in 2008.

For the past five years, she has worked as an independent customer experience consultant helping companies improve the experience they give to their customers through specialist advice, coaching, training and facilitation. She has worked with companies such as Northern Gas Networks, Yorkshire Water, Enterprise, Skanska Utilities, Morrison Utility Services, and the Renewable Energy Association.

She has a Post Graduate Certificate in The Economic Management of Regulated Utilities from Warwick University.

Annex B – CCG Terms Of Reference

Background

Customer Challenge Groups have developed from the quadripartite groups and the Wales PR09 Forum following Ofwat's decision to establish local groups with a formal role at future price reviews.

Each local Group brings together organisations involved in the water sector in England and Wales to help ensure water industry decisions take account of consumers' views, particularly on issues which may impact on standards of service or the level of bills.

In performing this role, the Groups will recognise and take account of both the legal quality requirements faced by companies and the views of consumers. Consumer research and consultation mostly conducted by the water companies will be a key way for the local Group to understand consumers' views and will be used to make sure they are reflected in decisions.

Aims of the Customer Challenge Group

The main aims of the Group are to:

- engage key organisations in planning the strategic direction for water management by South East Water;
- facilitate open discussions on all aspects relating to the strategic management of water by South East Water in a regional context;
- engage in the water price setting process and report to Ofwat on South East Water's consumer engagement and business plan.

Roles of the Customer Challenge Group

The main roles of the Group are to:

1. lead to a better understanding by all interested parties of the main obligations, issues and priorities in the delivery of water policies by South East Water;
2. advise and challenge South East Water so it strives for best practice when planning its consumer engagement and research with its customers to gain an understanding of the main obligations, issues and priorities that need to be addressed;
3. advise and challenge South East Water to develop customer-supported, long-term strategic and business plans that will deliver the agreed outcomes which will include meeting statutory quality obligations, and outcomes based on customers' priorities and willingness to pay, as well as being a good deal for the customer;
4. provide a way to discuss and resolve conflicting priorities, through informed and transparent trade-offs, as they arise which will include an understanding of the costs and benefits of any proposals – increasing the consumers' influence in these negotiations. These actions should include advising and challenging South East Water and regulators to consider:

5. the opportunities for using innovative or sustainable means of delivering the required or desired outcomes;
 - the scope, justification and cost-effectiveness of the preferred delivery mechanism;
 - phasing delivery or outcomes to maximise the affordability and acceptability of the Company's overall business plan.
6. provide a report to Ofwat on South East Water's engagement process and the Company's strategic and business plan (see appendix for further details of likely content of this report);
7. discuss the longer term planning to meet aspirations for drinking water quality, environmental water quality, and customer service;
8. inform the policy and decision-making of South East Water on key issues that affect customers' water bills or services at price reviews and on important issues such as compulsory metering and social tariffs.

The Group will not address matters which are proper to Ofwat's Customer Expert Group such as sector-wide issues like cost of capital and provision for pensions.

The Group will not address matters which are proper to CCWater nationally or regionally such as the day-to-day operations of the Company or individual customer complaints.

The Chair

The Chair will be appointed and paid by the Company but will at all times act in an independent capacity.

The terms and conditions of the Chair's appointment will be the subject of a contract between him and the Company.

The Chair's role will be to facilitate the Group's discussions and make sure every Group member has a full and fair chance to:

- contribute to all the discussions and deliberations of the Group;
- challenge the Company on its customer engagement processes and its strategic and business plans;
- challenge the regulators as appropriate.

In between meetings of the Group, the Chair will be the principal link between the Group and the Company but will ensure that all Group members are kept informed and involved.

The Chair will have regular access to the Managing Director of the Company and the Chair of the Company's board.

The Chair will liaise with Chairs of other Customer Challenge Groups, especially in the south of England.

Membership

Members of the Group will be appointed by the Chair in consultation with the Company.

The Group should comprise of core members who have a key interest and statutory remit in the water sector:

- Consumer Council for Water
- Environment Agency
- Drinking Water Inspectorate
- Natural England

Other members will be appointed to bring to the Group particular knowledge of:

- residential customers
- business customers
- local authorities/communities
- customer engagement

Membership of the Group may be supplemented from time to time if required.

Three members of the Company will normally be in attendance at Group meetings and discussions but will withdraw whenever the Group needs to deliberate without Company representatives.

Other Company staff may attend the Group for particular agenda items where they have relevant responsibility or knowledge.

Organisations other than the Company - such as Ofwat - may attend meetings by invitation where this would facilitate the deliberations of the Group.

Frequency and Location of meetings

It is envisaged that meetings will be no less than four and no more than seven a year, but meetings will be convened when a need arises to discuss important policy and developments and the periodicity of those meetings during the three-year price determination cycle of the regulator will be shaped by the needs of that stage of the cycle.

During price reviews, there will be key stages when the group will need to meet. The key meetings are likely to be:

- to give input as the Company develops its consumer engagement and research plans;
- to assess and make suggestions on consultation materials, research questionnaires and supporting other material;
- to review the findings of the consultation and research;
- to challenge the scale, scope and delivery of obligations and to challenge the overall business plan, where necessary;

- to agree a report to Ofwat on how the Company has interpreted customers' views in its business plan, whether the plan represents a good deal for customers, and whether it meets statutory quality requirements.

The location of meetings will normally alternate between one of the Company's facilities and suitable premises in central London.

Governance

The Company will provide secretariat and administrative support and costs.

The Chair should ensure the Company can be challenged effectively to give proportionate assurance to Ofwat on the Company's engagement process and strategic plan.

Whenever the Company makes information available to the Group in confidence, such confidentiality will be fully respected.

Any member who sits on another Customer Challenge Group will ensure that information sensitive to one Company is not made available to another Company.

If a member believes that an agenda item might represent a conflict of interest for him or her, this should be raised with the Chair in advance of the meeting who will advise whether the member should absent herself or herself for that item.

Members will normally meet their own expenses but, where appropriate, the Company will meet reasonable travel expenses.

The Group's work programme and approach will be agreed with its members.

All agenda papers will normally be circulated at least one week in advance.

Draft minutes will normally be circulated to members within one week of the meeting and cleared electronically within a further week, following which they will be placed on the relevant section of the Company's web site (with redactions if this is really necessary).

Style and conduct of meetings

It is expected that Group discussions will be robust and challenging but always conducted with civility and respect. The aim will always be to reach a consensus position, but this will not prevent an organisation represented by a member from making direct representations to the Company or regulators.

While members of the Group will usually represent a broad stakeholder interest, it is expected that all members will contribute fully and candidly to all discussions and not simply represent an organisational position or limit themselves to an organisation's interest.

Appendix

Ofwat, in its Illustrative Terms of Reference for the Customer Challenge Groups, states that the Groups must produce a report for the regulator that comments on:

a) The Company's engagement process

- the effectiveness of, or any concerns with, the Company's engagement with its various customers and with the local Customer Challenge Group (taking account of the characteristics of good engagement set out in chapter three of Ofwat's policy statement on customer engagement, and any further advice Ofwat provides to the Group); and
- whether the level of engagement and assurance is proportionate to the materiality of the Company's business plan proposals.

b) The Company's strategy and business plan

- whether the plan delivers the required legal outcomes;
- whether the Company has actively considered the opportunities for more innovative and sustainable approaches to delivering the required or desired outcomes;
- whether the Company's longer-term strategy and business plan is an appropriate response to customers' views;
- whether the Company's business plan strikes a reasonable balance between the views of different customers and stakeholders, highlighting any areas where particular segments of current or future customers are likely to have outstanding concerns;
- whether the Company has explored the range of cost-effective solutions and phased delivery of its various outcomes to maximise acceptability to customers; and
- whether the Company's overall final business plan appears likely to be acceptable to a majority of customers, highlighting any areas of concern.

Annex C – CCG Minutes

CCG meeting No 1 - 14 June 2012:

http://www.southeastwater.co.uk/media/114577/CCG_14June2012minutes_web.pdf

CCG meeting No 2 - 20 July 2012:

http://www.southeastwater.co.uk/media/142921/CCG_200712_Final_Minutes2.pdf

CCG meeting No 3 - 27 September 2012:

http://www.southeastwater.co.uk/media/3556/CCG_270912_Minutes_%20Final.pdf

CCG meeting No 4 - 27 November 2012:

http://www.southeastwater.co.uk/media/3603/271112_CCG_Minutes.pdf

CCG meeting No 5 - 17 January 2013:

http://www.southeastwater.co.uk/media/142905/CCG_17_january_2013_minutes.pdf

CCG meeting No 6 - 25 February 2013:

http://www.southeastwater.co.uk/media/4006/CCG_250213_Minutes_Final.pdf

CCG meeting No 7 - 24 April 2013:

http://www.southeastwater.co.uk/media/163622/SEW_CCG_240413_Minutes_Final.pdf

CCG meeting No 8 - 23 July 2013:

http://www.southeastwater.co.uk/media/4426/CCG_Final_230713_Minutes.pdf

CCG meeting No 9 – 12 September 2013:

http://www.southeastwater.co.uk/media/177832/CCG_minutes_120913.pdf

CCG meeting No 10 – 18 October 2013:

http://www.southeastwater.co.uk/media/180724/CCG_181013_Final_Minutes.pdf

CCG meeting No 11 – 12 November 2013:

http://www.southeastwater.co.uk/media/182767/CCG_121113_Final_Minutes.pdf

Annex D – Future Price Reviews And The CCG Model

The Customer Challenge Group model used in Price Review 14 was new. We commend Ofwat for proposing this approach and the water companies for embracing it. The regulator and especially the companies have committed significant resources to making the approach work and we believe that it has been a success that is likely to be continued in some form into future price reviews and that it will be of interest to regulators and companies in other sectors.

But there are learnings to be drawn from the experience of the last couple of years and we would like to capture and record these while current CCG members are still around and while we have the opportunity of a document of record.

The CCG process has shaped the CCG product in terms of the report to Ofwat. The proposals which we set out in this annex follow from our experience as documented in Sections A & B of the report.

We would make the following recommendations in relation to **the wider Price Review process**:

We have set out some of our reservations about the WTP methodology and contrasted the stated preference approach as compared to the revealed preference approach. Furthermore we have felt that there were times when customers were asked in research to comment on issues that they really could not meaningfully comment on e.g. pace of change (in the online panels), effectiveness of water resource options (in the WRMP focus groups), and WTP linked to changes in satisfaction (in the outcomes research).

Recommendation i:

Before the commencement of the PR19 process, Ofwat should instigate an open and wide-ranging review of the current Willingness To Pay methodology in the sector with a view to mitigating the weaknesses in the stated preference approach and the promotion of more use of other complementary approaches. It would also be helpful to consider what it is and is not appropriate to ask customers to comment on.

We have noted that Accent did the Willingness To Pay research for no less than 14 water companies in the current Price Review. In the Appendix on Engagement, SEW sets out that 10 out of 13 pieces of customer research were conducted by Accent.

Recommendation ii:

Ofwat and Water UK should consider how best to promote diversity and choice in the companies chosen by water companies for their research and most especially WTP research.

We would make the following recommendations in relation to **the wider Customer Challenge Group process**:

We have highlighted the novelty of the CCG model that has not previously been used in the water sector and has no direct analogue in other sectors.

Recommendation iii:

At an appropriate time, Ofwat should commission and then publish an independent review of the experience and efficacy of the Customer Challenge Group model in its different formats with a view to informing subsequent Price Reviews in the sector and stimulating debate in other sectors.

We have pointed out that, as the work of the CCG developed in this new model for the sector, it became apparent that the time commitment of CCG members was significant.

Recommendation iv:

If a version of the CCG model is to be used in the future, companies should consider paying those members for whom the CCG work is not part of their employment either a modest monthly retainer and/or an attendance allowance or alternatively make a donation to the organisation releasing the individual from other work.

In most respects, the membership of our CCG is not untypical of that of other CCGs. However, we believe that we are rather different in having as a member someone who is expert in customer research and engagement.

Recommendation v:

If a version of the CCG model is to be used in the future, Groups should either consider appointing a member with a special expertise in consumer engagement and/or employ a consultant with such expertise.

SEW drew up a Customer Engagement Plan even before the CCG was created because the extended, inter-related timetable of the PR14 process required customer research to begin in early 2012.

Recommendation vi:

If a version of the CCG model is to be used in the future, all Groups should be set up early enough to have a dialogue with their company before any drafting of the Customer Engagement Plan for that Price Review.

We valued the convening by Ofwat of workshops for CCG Chairs. However, we would all have appreciated more notice of such workshops and more stability among the regulator's staff interfacing with CCGs.

Recommendation vii:

If a version of the CCG model is to be used in the future, Ofwat should ensure more advanced scheduling of workshops for CCG Chairs and more consistent personnel support for the CCG process.

We have highlighted that, with the best will in the world, the complex choreography of consultation between the Company and the CCG on the Business Plan and CCG report respectively has proved very difficult because the timescales were so tight and Board and CCG meetings had to be scheduled so closely together.

Recommendation viii:

If a version of the CCG model is to be used in the future, Ofwat should ensure that more time is allowed for a considered dialogue between all companies and their CCGs over the draft text of the proposed Business Plan with a fresh look at the case for permitting a short interval of time between submission of the Business Plan and submission of the CCG report to the regulator.

Annex E – Statements By The Environment Agency

There are two statements from the EA, the second following clarification from the Company as a result of the first.

Introduction

The final price review methodology confirms that Ofwat expect the Environment Agency to highlight in the Customer Challenge Group report whether your business plan will meet your statutory obligations (section 4.2.1 Setting Price Controls for 2015-2020, Ofwat, July 2013). As part of our engagement with your Customer Challenge Group, we have been working with you to be assured that your business plan is in accordance with these requirements.

The following report summarises our views of the evidence provided. These views are based on a high-level review of the processes as described in the letter explaining our expectations sent to you in August 2013.

Overview

We have had good ongoing dialogue with the company during development of the business plan. We note that the willingness to pay surveys carried out by the company appear to show that customers are satisfied with the current level of service and are not willing to pay for improved levels of service. This has driven the company's 'business as usual' approach to AMP6.

Overall, we are reasonably comfortable with your proposals for AMP6 as far as we know them, but there are some areas where we would like to see some improvement.

We welcome:

We are pleased to note that you have included two environmental outcomes for your business plan: 'We are compliant with environmental obligations' and 'We will reduce our impact on the environment'.

We are pleased to note that you have included the National Environment Programme (NEP) requirements in your plan and have made an allowance for uncertainty arising from Water Framework Directive schemes.

We are pleased to note that the changes proposed for inclusion in the revised Water Resource Management Plan (WRMP) forecast are consistent with those included in the business plan forecast.

We do not support:

We believe that some of your performance measures and commitments on environmental obligations are inappropriate. The performance commitment should be zero breaches of environmental permits, not zero prosecutions for breaches.

We have some reservations on performance measures based on customer acceptability determined from annual surveys.

We need to see:

We are pleased to note that you plan to continue your catchment management work to protect water quality. We would like to see this approach rolled out further where appropriate.

You have one of the highest per capita consumption figures in the country and we would like to see you show greater ambition in reducing it.

We have made more specific comment on the following areas:

These are our observations on the replies you have made to the questions posed in response to the expectations letter.

1. Delivery of statutory and environmental requirements

We welcome your assurance that your company will meet its environmental obligations. We also expect to see written confirmation from your board that you will deliver all your environmental obligations. This should include proposals for any transitional investment programme. In order for us to be able to provide appropriate assurance to Ofwat and Defra it would be helpful to receive your confirmation as soon as possible

2. Measures identified within the National Environment Programme (NEP)

We are encouraged by your agreement to include all of the measures set out in the NEP within your final business plan. We believe that the programme will allow you to deliver what is best for both the environment and your customers.

3. Provision for the outcome of second cycle river basin management plans and delivery of Water Framework Directive (WFD) obligations.

We are pleased that you have made provision within your business plan for achieving outcomes from the second cycle river basin management plan.

4. Evidence of options and proposals for reducing the impact of a company's abstractions from the most seriously affected sites

We are pleased to see that you are putting forward options and proposals within your business plan to reduce the impact of your abstraction from the most seriously affected sites. We note that you have:

- included the confirmed and/or likely sustainability changes set out in NEP phase three in the water resources supply-demand component of your business plan.
- made an allowance for currently unknown sustainability changes in your business plan.
- assessed whether planned increases in abstraction may cause deterioration in WFD water body status.

- considered which abstractions would fall within Ofwat's Abstraction Incentive Mechanism.
5. Alignment of the Water Resource Management Plan (WRMP) options and business plans

Defra expects that the Water Resources Management Plan (WRMP) will form the water resources supply-demand balance component of the business plan. We welcome your assurance that the main water resources supply-demand components of your business plan will be consistent with your WRMP statement of response.

6. Reservoir safety

We note your intentions to maintain reservoir safety although you have provided limited information on the programme of work. This is an important duty given the potential high impact your reservoirs pose to public safety. Your continued maintenance and capital investment is essential for public safety.

You have not referenced the recent changes in reservoir legislation. Please confirm how you will implement these changes during the next AMP.

Defra set out its expectation in the Statement of Obligations that companies will prepare reservoir plans. We would expect you to continue to develop and maintain on-site plans. You do not refer to incident planning and working with partners to reduce impacts to downstream communities, should an incident occur. We encourage you to co-operate with relevant authorities and partners on the development and maintenance of site plans and on incident planning.

7. Mitigation measures adopted to manage future risks

You have provided some evidence that you plan to take appropriate measures to manage risks from natural hazards and climate change. However, we would like to see more details about your approach to flood risk and resilience, and how you have used relevant guidance from Ofwat and others. It should be clearer as to how the risks revealed by your analysis are addressed in your business plan.

We note that 12% of your properties are supplied from a single source and that you are addressing this in a system reliability context largely by dualling mains. We would like reassurances that should any of your sources fail (for example due to groundwater contamination), this would not result in you seeking environmentally damaging abstractions to make up for the loss.

8. Environmental outcomes

We are generally satisfied with the outcomes included in your business plan as they accurately reflect the important role that your company plays in protecting the environment. However, we believe that some of your performance measures and commitments on environmental obligations are inappropriate. The performance commitment should be zero breaches of environmental permits, not zero prosecutions for breaches.

8.1 Delivery and incentives

We note your view that there is no customer support for paying for service improvements so you believe that incentives are inappropriate. We also note that you will measure success through customer satisfaction surveys. Your plan is not particularly ambitious but you state that this is supported by willingness to pay surveys. Balancing the results of quantitative research on customer preferences with your own incremental costs is essential to ensure sufficient ambition. Strong incentives should, wherever possible, financially reward or penalise delivery of environmental outcomes in line with customer preferences

9. Pollution incidents and compliance

We acknowledge your commitment to continue to improve operational performance and to achieve 100 per cent compliance for all licences and permits, which is in-line with legal obligations and our expectations. We also strongly support your objective of zero pollution incidents.

10. Change mechanism

At previous price reviews, Ofwat has used the change protocol for managing in-period changes to the risks and costs. This time you are being asked to put forward proposals for dealing with such changes. It is imperative that new statutory requirements, for example schemes arising from the 2nd River Basin Management Plan can be delivered whilst maintaining levels of ambition around customer priorities. We would like to see a clear process for dealing with predictable but, nonetheless uncertain new commitment you could face during AMP6.

To be assured that important “discretionary” outcomes are not prejudiced by additional legislative requirements, we believe you do require an explicit change mechanism for dealing with such changes. We acknowledge your assurance that you are developing one.

Concluding Remarks And Recommendations

Overall, we are broadly comfortable with the contents of your business plan and from the information received, you appear to have included your environmental requirements. However, we have the following recommendations for improvement we would like you to consider:

- We are disappointed that there is a lack of ambition in your plan, e.g. to firmly drive down per capita consumption (PCC) in AMP6, although we note that your customers are not prepared to pay for service level improvements.
- We recommend you amend your performance measures relating to environmental outcomes to say zero breaches of abstraction licences and permits, rather than zero prosecutions for breaches of licences and permits.
- We would like further information on the flood risk and resilience work that you have carried out. We look forward to working closely with you over the next few weeks to

finalise your business plan. Our aim is to help you produce a plan that delivers its statutory obligations and facilitates the continuing achievement of better environmental performance.

Sarah Powell 1 November 2013

**Update following further communication with the Company
19 November 2013**

Following receipt of our evaluation report on 1 November 2013, we have been involved in further discussions with you regarding our recommendations in the report. This note provides an update to our response based on those discussions.

The following table summarises the company's response to Environment Agency recommendations. Based on the further information provided to us, we now also make the following additional observations:

Environment Agency recommendation/statement	Company response (11/11/13)	Environment Agency comment (19/11/13)
The performance commitment should be zero breaches of environmental permits, not zero prosecutions for breaches.	We fully accept this point and agree that the performance commitment should be zero breaches of environmental permits.	We are pleased that you have accepted this point and have amended your outcomes scorecard.
We are pleased to note you plan to continue your catchment management work to protect water quality. We would like to see this approach rolled out further where appropriate.	In our business plan we have fully incorporated the NEP provided to us by the Environment Agency. On this basis we have included: 6 surface water catchment management schemes on the rivers Ouse, Cuckmere, Wallers Haven, Thames, Eastern Rother and Medway; 8 catchment management investigation schemes on groundwater catchments covering our abstractions at Hartlake, Pembury Springs, Tonbridge, Boxalls Lane, Woodgarston, College Avenue, Borough Green and Beenhams Heath.	Thank you for confirmation that you have included these NEP requirements.
You have one of the highest per capita consumption figures in the country and we would like to see you show greater ambition in reducing it.	In the Environment Agency's representation on our draft WRMP14 you included a very helpful set of box plot charts (in Appendix 3a) that compares our per capita consumption figures with the industry and with other south east water companies. We believe these plots confirm our pcc forecast to be well position overall. Appendix 3a confirms that our final pcc forecast, whilst at the higher end of the range, does sit within the pack of industry level final pcc forecast values. We are pleased with this position overall	In your submitted statement of response it would appear that you will remain with one of the highest pcc's in the country. However, we welcome your commitment to positively influence your customer's water use behaviour and achieve greater levels of pcc reduction.

	<p>given we are operating in one of the driest and more affluent areas of the UK where we might expect pcc values to sit nearer the higher end of the range rather than at the lowest end.</p> <p>Appendix 3a also confirms that our final pcc forecast is at the lowest end of pcc forecasts for all south east water companies, this in our view reflects a strong level of ambition in the region, as supported by our water efficiency strategy.</p> <p>To avoid any future confusion or doubt, whilst comparisons across the industry are very helpful, we will continue to work harder in the next few years and ahead of our next WRMP in 2019 to positively influence our customer's water use behaviour and achieve greater levels of pcc reduction where these can be supported.</p>	
<p>We note your intentions to maintain reservoir safety although you have provided limited information on the programme of work. This is an important duty given the high potential impact your reservoirs pose to public safety. Your continued maintenance and capital investment is essential for public safety.</p> <p>You have not referenced the recent changes in reservoir legislation. Please confirm how you will implement these changes during the next AMP.</p>	<p>We have established reservoir safety plans (include incident plans) in place for all 8 of our sites that come under reservoir safety requirements. All these plans meet with the recent changes in reservoir legislation. We will provide further information with our plan.</p>	<p>Thank you for the additional information. This is noted.</p>
<p>We note that 12% of your properties are supplied from a single source and that you are addressing this in system reliability context largely by dualling mains. We would like assurances that should any of your sources fall (for example due to groundwater contamination), this would not result in you seeking environmentally damaging</p>	<p>The risk of loss of sources due to contamination has been accounted for in our target headroom assumptions, so we can offer the assurances you seek. In the event of a contamination incident there would be a range of measures we could take to eliminate the potential for environmentally damaging abstractions to make</p>	<p>Thank you for the additional information. This is noted.</p>

<p>abstractions to make up for the loss.</p>	<p>up the loss.</p>	
<p>We would like to see more details about your approach to flood risk and resilience, and how you have used relevant guidance from Ofwat and others. It should be clearer as to how the risks revealed by your analysis are addressed in your business plan.</p>	<p>History: In 2009 we undertook a Flood Risk Assessment for all sources of flooding on all assets across our supply area. The results of the assessment showed we needed to invest in protection works to ensure 135,936 customers benefit from a reduction in the risk of flooding. By refinement and optimisation of the Flood Risk programme we are able to report that over 322,000 customers are now at reduced-risk from flooding.</p> <p>The Environment Agency updates us regularly on the risk poses to our assets the latest position is that we have 93 separate assets at 55 different sites that are potentially at risk of flooding, which in turn could impact on both the quality and reliability of the water we provide to the retailer and their customers, and so will need to invest in mitigation measures such as raising electrical equipment, installing flood-proof doors, and improved drainage to reduce this risk. Cost £2.7m, all included in the plan.</p> <p>We also have included this outcome in our plan for number of sites at risk from flooding:</p> <p>We will invest in our assets to protect the service for the future: Water infrastructure assets performance assessment - stable Water non-infrastructure assets performance assessment - stable Number of sites at risk of flooding – Zero by 2019-20</p>	<p>Thank you for the additional information.</p>
<p>The performance commitment should be zero breaches of environmental permits, not zero prosecutions for breaches.</p>	<p>As stated earlier in this letter, we fully accept this point and agree that the performance commitment should be zero breaches of environmental permits.</p>	<p>We are pleased that you have accepted this point and have amended your outcomes scorecard.</p>
<p>We are disappointed that there is a lack of ambition in your plan, e.g. to</p>	<p>Given that our starting position for pcc is higher than many parts of</p>	<p>Noted</p>

<p>firmly drive down per capita consumption (pcc) in AMP6, although we note your customers are not prepared to pay for service level improvements.</p>	<p>the UK, we believe that our plan does include a firm, and sustainable long term per capita consumption reduction which is ambitious during AMP6, and indeed beyond this point too. We have assumed the pcc reductions are achieved within the service level of improvements accepted by our customers'.</p>	
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Based on the further information provided to us, we make the following concluding observations:

The company have provided additional information as requested in our Business Plan evaluation report.

1. Introduction

- 1.1 The Drinking Water Inspectorate (DWI) is the independent regulator of drinking water quality in England and Wales. We protect public health and maintain confidence in public water supplies by ensuring water companies supply safe clean drinking water that is wholesome, and that they meet all related statutory requirements. Where standards or other requirements are not met, we have statutory powers to require water supply arrangements to be improved.
- 1.2 We publish information about drinking water quality and provide technical advice to the Secretary of State for the Environment, Food & Rural Affairs, and to Welsh Ministers.
- 1.3 For PR14, water companies are expected to ensure that their business plans make provision to meet all their statutory obligations, including the need for public water supplies to be safe, clean and wholesome, and that provision is made for a sustainable level of asset maintenance to maintain public confidence in drinking water quality. Ministers summarised these requirements in Defra's Statement of Obligations¹, and in their further guidance on PR14 matters to Ofwat. In addition, the Inspectorate set out in **DWI Information Letter 01/2013 – The 2014 Periodic review of Prices – Guidance for water companies**, published on 1st February 2013 supplementary guidance to companies on the regulatory framework for drinking water quality, statutory requirements, the Inspectorate's role in the Price Review process and our requirements for companies seeking technical support. The Inspectorate also published separate PR14 guidance on a range of specific issues. All of the Inspectorate's published PR14 guidance is available on the DWI website.
- 1.4 It is worth noting the particular emphasis that Ministers placed in their Guidance on the resilience of supply systems, and that the Inspectorate placed on existing duties to manage the introduction of new sources and to plan supply arrangements to protect consumers and ensure no deterioration in the quality of their supplies.
- 1.5 The Inspectorate has a position on all of the water companies' customer challenge groups in England and Wales. The Inspectorate's representative on South East Water's Customer Challenge Group has supported the process by acting as an independent member with the overall remit of ensuring that the Company business plan proposals reflect the views of consumers and place drinking water quality at the forefront of such plans.

2. Formal Drinking Water Proposals Requiring DWI Technical Support

- 2.1 As with previous periodic reviews, water companies seeking technical support from the Inspectorate must demonstrate the need for each proposal. The case for justification must be accompanied by evidence of the company's options appraisal

¹ <http://www.defra.gov.uk/publications/files/pb13829-statement-obligations.pdf>

process to identify the most robust, sustainable and cost-effective solution, with evidence that the preferred solution will adequately address the risk and deliver the required outcome within an appropriate timescale.

2.2 South East Water submitted 4 formal proposals for drinking water quality to the Inspectorate, listed in the table below:

PR14 DWI Ref.	Scheme Name	Quality Parameter(s)	Scheme Type	Preferred Option	DWI Final Decision
SEW51	Arlington, Barcombe, Bewl, Bray, Hazards Green WTW	Metaldehyde	Catchment management	Catchment actions various	Undertaking
SEW52	Kingston	Turbidity	Treatment	Microfiltration	Regulation 28 Notice
SEW53	Stockbury	Microbiological parameters	Treatment	Microfiltration	Regulation 28 Notice
SEW54	Waterworks road	Microbiological parameters	Treatment	Microfiltration	Regulation 28 Notice

2.3 The Company submitted its proposals to the Inspectorate by the published deadline of 31st July 2013. Some further follow up information was requested from the Company and responses received as required. The Inspectorate met with the Company before the proposals were submitted and the Company also presented its proposals for drinking water quality to the Customer Challenge Group. Therefore we were broadly aware of the Company's plans for drinking water quality and we are generally supportive of the Company's approach.

2.4 The Inspectorate has formally supported all of the Company's proposals and we will put legal instruments in place to make the proposals legally binding programmes of work. Our final decision letters were sent to the Company on 21 October 2013.

2.5 The three proposals which relate to microbiological parameters involve the installation of additional treatment due to a deterioration in the raw water bacteriological quality at the sites in question. The remaining proposal includes a number of catchment activities to address the risk of contravention of the pesticide standard, in this case metaldehyde, in water supplied from the works. The proposal also covers two separate bulk imports from Southern Water and Affinity Water respectively.

2.6 It should be noted that these improvement schemes will make only a small contribution to enabling the Company to meet its legal obligations in respect of drinking water quality. These obligations are met overwhelmingly by the Company making sufficient provision for operational and maintenance requirements in its business plan, and by its use of those resources. These are matters for the Company to determine and deliver. For its part, the Inspectorate will continue to keep under

review, and report on, the performance of the Company in meeting its legal obligations. Statutory powers are available to secure or facilitate compliance, if necessary.

2.7 The summary of improvement schemes above reflects the position at the time of writing this note. Further discussions are needed with the Company to finalise details. We will advise you of any material changes.

2.8 This note will be copied to Neil Hudson of South East Water, and any queries arising should be directed to Elinor Cordiner, Principal Inspector, Drinking Water Inspectorate via dwipricingreview@defra.gsi.gov.uk



Milo Purcell
Deputy Chief Inspector (Regulations)

Drinking Water Inspectorate
Area 7e, 9 Millbank
c/o Nobel House
17 Smith Square
London SW1P 3JR

17 November 2013

Annex G – Statement By Natural England

Date: 21 November 2013
Our ref: case 6112 Y
Your ref: SEWCCG

*Customer Services
Hornbeam House Crewe
Business Park
ElectraWay, Crewe
Cheshire CW1 6GJ*

T 0300 060 3900

Dear Roger

South East Water's Business Plan 2015-2020

Water Industry Act 1991 as amended by the Water Act 2003, Wildlife and Countryside Act 1981 (as amended), Conservation of Habitats and Species Regulations 2010 (as amended) National Parks and Access to the countryside Act 1949 (as amended) and Countryside and Rights of Way Act (2000)

Natural England is a non-departmental public body. Our statutory purpose is to ensure that the natural environment is conserved, enhanced, and managed for the benefit of present and future generations, thereby contributing to sustainable development. More information on our role in advice to the water sector can be found in Annex 2 to this letter. In our statutory role Ofwat expects Natural England to highlight in the Customer Challenge Group (CCG) report whether South East Water's business plan will contribute to delivery of the company's statutory obligations² with regards to the natural environment. Natural England has engaged with the company directly and through the CCG to be assured that the company's business plan is in accordance with these requirements in so far as they pertain to landscape and biodiversity.

Annex 1 provides our views of the business plan and evidence provided to date. In summary Natural England is broadly satisfied with the proposals for the business plan as far as they relate to South East Water's statutory responsibilities regarding landscape and biodiversity including designated sites. A summary of the main water company duties with regards landscape and biodiversity is provided in Annex 3. Should you have any queries on this letter then please contact me at Louise.bardsley@naturalengland.org.uk or 07717 427736.

A copy of this letter goes to Lee Dance and Emma Goddard at South East Water and Paul Nason at the Environment Agency.

We would be happy to comment further should the need arise but if in the meantime you have any queries please do not hesitate to contact us.

Yours sincerely

Dr Louise Bardsley Senior Adviser CC: Lee Dance, Emma Goddard – South East Water; Paul Nason – Environment Agency.

¹ Other pieces of legislation are also relevant to water company responsibilities to landscape and biodiversity only a selection are referred to here.

² Section 4.2.1 Setting Price Controls for 2015-2020, Ofwat, July 2013).



Annex 1 Natural England's Response 1: Water Resources Management Planning

Natural England has provided detailed comments on the draft water resource management plan (dWRMP) (24 July 2013) and on the statement of response (SoR) and revised WRMP (21 November 2013). Those comments are not repeated here although they remain relevant.

In summary Natural England has advised:

- The preferred option programme is compatible with and has been influenced by the statutory environmental assessments (Strategic Environmental Assessment (SEA) and Habitats Regulations Assessment (HRA)).
- Natural England welcomes the confirmation that biodiversity enhancements and mitigation of impacts on designated sites are included within the cost of schemes.
- We welcome the inclusion of investigations to resolve uncertainties and clarify mitigation proposals for the most potentially impactful schemes in Asset Management Planning round 6 (AMP6).
- We welcome the inclusion of the sustainability reductions to protect Greywell Fen Site of Special Scientific Interest (SSSI) in the rWRMP though we note the abstraction will not be closed until AMP7 (2020-2025).

The relevant rWRMP proposals in so far as they relate to landscape and biodiversity including relevant investigations, assessment, mitigation and enhancements are included in the business plan.

2. Biodiversity and Designated Sites

Natural England welcomes the commitment in the business plan to deliver the Environment Agency's National Environment Programme (NEP) which includes measures to deliver objectives of the Water Framework Directive (WFD). In particular Natural England welcomes the scheme to deliver enhancement of the habitats within South East Water's ownership which are linked to the South Downs Way Nature Improvement Area (NIA). This will make a significant contribution to the water company's biodiversity duties.

South East Water owns 30 SSSIs including one National Nature Reserve. Natural England welcomes the explicit reference to this nationally important landholding within the business plan. Natural England also welcomes the explicit reference to funding for maintenance and restoration of favourable condition on South East Water's SSSIs in this AMP period, which is in line with the government's biodiversity targets. This will also contribute to restoration/maintenance of favourable conservation status for those European protected species and Natura 2000 sites which overlap with these SSSIs.

Natural England is satisfied that the proposals in the 2015-2020 business plan will contribute to delivery of the company's biodiversity duties.

3. Landscape

The company has the potential to significantly positively and negatively influence protected landscapes in the operation of its land holding and in the development of new preferred options in particular. The options with the largest landscape impacts are not for delivery within the 2015-2020 business plan. South East Water has had regard to landscape in its assessment of new and upgraded assets in the business plan (and in the rWRMP). Natural England is particularly pleased with the commitment to undertake protected landscape mitigation strategies and considers this industry leading.

Annex 2 Role Of Natural England In Advice To The Water Sector

Natural England was established under the Natural Environment and Rural Communities Act 2006 (NERC Act). It is a non-departmental public body. Our statutory purpose is to ensure that the natural environment is conserved, enhanced, and managed for the benefit of present and future generations, thereby contributing to sustainable development.

Natural England has responsibility for ensuring that landowners and public bodies deliver objectives for European protected sites (Natura 2000 sites), Ramsar Sites (internationally important wetland sites) and the requirements for achieving and managing favourable or recovering condition for Sites of Special Scientific Interest (SSSI). Of particular note to water companies are the objectives introduced through the Water Framework Directive for Natura 2000 protected areas, to achieve compliance with the standards and objectives (conservation objectives) of the water dependent features of those sites by December 2015 (Article 4.2 WFD).

Natural England is also charged with helping to deliver the Government's Biodiversity 2020 strategy. This strategy set out a bold ambition to "halt overall biodiversity loss, support healthy well- functioning ecosystems and establish coherent ecological networks, with more and better places for nature for the benefit of wildlife and people". In support of this, our response therefore provides advice on how the plan can embrace a ecosystem approach and can support the conservation of biodiversity at a landscape scale. Delivery of objectives towards Biodiversity 2020 outcomes is complementary to and in addition to the statutory duties toward biodiversity under the NERC Act (2006).

Natural England continues to aim to work with the water sector to ensure that requirements for the protection and enhancement of the natural environment are met and that there is adequate opportunity for the development of more sustainable solutions. Protection and enhancement of the natural environment including biodiversity depend critically on delivering improved, integrated and sustainable land and water management.

Annex 3 Key Water Company Duties With Regards Landscape And Biodiversity

The following is a summary of some of water company key duties with regards to landscape and biodiversity. This is not comprehensive and is to illustrate the key areas on which Natural England has engaged with the water company.

1. European Sites and Species

Regulation 9 of the Conservation of Habitats and Species Regulations 2010 (as amended)

requires every competent authority, in the exercise of any of its functions, to have regard to the requirements of the Habitats Directive. Regulation 9A(8) places a duty on a competent authority in exercising any function, to use all reasonable endeavours to avoid any pollution or deterioration of habitats of wild birds. In addition, regulation 61 places obligations on competent authorities in respect of plans or projects likely to have a significant effect on a protected site.

Water Companies have a statutory duty to prepare WRMPs and so they are the Competent Authority for Habitats Regulations Assessment (HRA) of the WRMP. A HRA should assess the potential for a plan or project to have an adverse effect on the integrity of Special Areas of Conservation (SACs) or Special Protection Areas (SPAs). In England, as a matter of policy, sites listed or proposed under the “Ramsar Convention on Wetlands of International Importance” receive the same level of protection as SACs and SPAs. The business plan, as a financial plan is exempt from an HRA. However the options and actions within the plan must be compliant with the general duty to have regard to the purposes of the Directive.

2. Sites of Special Scientific Interest (SSSIs)

Section 28G of the Wildlife and Countryside Act 1981, as inserted by section 75 of and Schedule 9 to the Countryside and Rights of Way Act 2000, places a duty on public authorities, including water companies, to take reasonable steps consistent with the proper exercise of their functions to further the conservation and enhancement of SSSIs. These duties are mirrored in the general recreational and environmental duties placed on relevant undertakers in the Water Industry Act (1991) as amended.

Section 3.11.1 of the Statement of Obligations (SOO)³ states “where activities are being carried out by undertakers outside the boundaries of SSSIs but which have an impact on the special interest features of that SSSI, they will also need to review that activity and, where appropriate, cease or modify that activity in order to fulfil their S28G(2) duty”. Section 3.11.5 of the SOO states “...Statutory undertakers, in their business plans, will need to include those actions deemed necessary both to remedy adverse impacts on, and to maintain and enhance the condition of, SSSIs in 2015 –2020 and beyond”.

3. Protected Landscapes

Relevant Authorities (including water companies as a Statutory Undertaker) are to have regard to the purposes of National Parks (Section 11A (2) of the 1949 Act) and the similar duties towards Areas Outstanding Natural Beauty (AONBs) (Section 85 of the Countryside and Rights of Way Act 2000) and the Broads (Section 17A of the Norfolk and Suffolk Broads Act 1988). Duties to further the natural beauty and rural amenity are also included within the general recreational and environmental duties placed on relevant undertakers in the Water Industry Act (1991) (as amended).

4. Biodiversity

Under Section 40 of the Natural Environment and Rural Communities Act 2006 every public authority, including water companies, must in the exercise of its functions have regard so far as is consistent with the proper exercise of those functions to the purpose of conserving biodiversity. Conserving biodiversity in this context includes restoring or enhancing a population or habitat.

Section 4.2.6 of the SOO states “Undertakers will need to take account of the duty under Section 40 of the 2006 Act with respect to existing and proposed abstractions. Defra has published guidance for public authorities entitled Guidance for Public Authorities on Implementing the Biodiversity Duty.”

³ Statement of Obligations -Information for Water and Sewerage Undertakers and Regulators on Statutory Environmental and Drinking Water Provisions Applicable to the Water Sector in England - Defra 2012