

Jonson Cox
Chairman
The Water Services Regulation Authority (Ofwat)
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

1 April 2019

Dear Jonson,

I attach a summary of our response to Ofwat's Initial Assessment (IAP) of our Business Plan. In this response, we explain the process that the Board of Dŵr Cymru has followed in considering and responding to the various questions and actions raised by the IAP. The paper also includes an updated Board Assurance statement for our revised Business Plan.

It was encouraging that Ofwat supported and welcomed many aspects of our Business Plan, for example its ambitious targets to drive down our base costs and our sector leading approach to supporting our customers in vulnerable circumstances. There is therefore a lot that we agree on, in pursuit of the best possible outcome for our customers. Although we consider that our Business Plan was already based on comprehensive evidence and analysis, with extensive customer involvement, we have carefully considered the new information in the IAP, including Ofwat's areas of challenge for us, to further review our plans and to make changes where we can see that this improves the overall outcome for our customers.


However, as a Board, we have also taken stock of the challenges raised in the IAP, in particular relating to some £450 million (roughly 40%) of our capital enhancement programme – which lies at the heart of your “cost efficiency” challenge for us. This is a major concern for us, as the Board is convinced that our enhancement programme is the right thing to do, given it was developed from the very clear preference expressed by our customers (in our unique Welsh Water 2050 Consultation) that we should invest at a level necessary to protect the quality and resilience of service against both present and future challenges, whilst keeping bills at a level that they find affordable. This is borne out by the very strong support from customers for our Plan, with 92% finding it acceptable and 95% saying that it is affordable.

Not only are we sure of customers' support for our Plan, but also the substantial majority of the expenditure which has been questioned at the IAP stage is not discretionary for us. Rather, we will be required to carry it out to meet clear and specific legal and regulatory requirements, as applied by the DWI, NRW and EA in the specific case of Dŵr Cymru. In these circumstances, a divergence in view of anything like this magnitude between what we will need to invest to meet our legal obligations and what we will be funded for would pose a severe challenge for our company in terms of deliverability and financeability, and would make it potentially very difficult for us to meet the wider expectations of our customers. As we explain in our

response, we strongly believe that Ofwat's assessment of our expenditure plans and performance targets must reflect company specific factors and circumstances.

Given this context, it is clearly of the utmost importance to us that we are able to satisfy the questions and challenges raised in the IAP, so that the Draft Determination itself does not contain such a major divergence of view between ourselves and Ofwat. The uncertainty created by such a situation would be concerning for our customers, colleagues and other key stakeholders. To that end, the detailed nature of the questions raised in the IAP is helpful and we have aimed to provide comprehensive responses, further evidence and analysis to address the points raised. We are committed to working with Ofwat with the aim of arriving at an outcome that enables us to implement an ambitious and innovative Business Plan that has improved customer outcomes at its core. We are therefore, more than ready to provide any further information required or to take part in further dialogue with your team in advance of the Draft Determination, with a view to resolving these issues at as early a stage as possible.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Alastair Lyons', with a horizontal line drawn underneath it.

Alastair Lyons

Chairman, Dŵr Cymru Cyf.

Summary of the Response of the Board of Dŵr Cymru Cyf. to Ofwat’s Initial Assessment (IAP) of our Business Plan for Customers

Our Business Plan for Customers

As a Board, we spent over two years in the development of a detailed Business Plan which we consider to be ambitious and innovative in its pursuit of improved customer outcomes. This plan reflects our *Corporate Purpose*:

To provide high quality and better value drinking water and environmental services, so as to enhance the well-being of our customers and the communities we serve, both now and for generations to come.

Our Plan was driven by an unprecedented degree of customer involvement and participation, with a key feature of our approach being that we looked forward across multiple AMP periods, informed by our Welsh Water 2050 vision, which was strongly endorsed by customers and other stakeholders. Welsh Water 2050 sets out a long-term plan to meet the needs of present and future generations of customers by:

- responding to the changes to our operating environment, in particular growing challenges caused by climate change
- addressing over the long-term the challenges to resilience and performance posed by an ageing infrastructure
- substantially improving our cost efficiency and productivity through innovation, new technology and improvements to our processes and assets
- ensuring that bills remain affordable for all our customers, protecting those in vulnerable circumstances

Our Business Plan for the first five year period covered by Welsh Water 2050 seeks to strike the optimal balance between bills, investment and service, and between the interests of customers today and future generations, reflecting the clear preference of our customers to consider both. We recognise that it will not be affordable to bring all of our infrastructure estate up to the desired standard, even within a plan that extends out to 2050. We have, therefore, placed great emphasis on deploying innovative, predictive analytics so as to target our investment to have the greatest positive impact on service and resilience at the most efficient cost. Where service improvement is tied closely to investment, the improvement in service towards an ideal state has had to be paced at a rate which customers can afford and has had to be prioritised to reflect the preferences of our customers in their particular circumstances.

Our Business Plan also reflects the unique political and policy context in Wales, as set out in the Welsh Government’s “Strategic Priorities and Objectives Statement to Ofwat” and more broadly in the Well-being of Future Generations (Wales) Act 2016. Our AMP7 business plan is designed to be a significant but affordable first step towards delivering the long-term vision for our customers and the environment as set out in our Welsh Water 2050 document, which is closely aligned to the Government’s long-term well-being goals for Wales. The Plan also reflects the views and requirements of other key stakeholders, including regulators, customer and environmental bodies, with detailed involvement throughout by the Customer Challenge Group (CCG).

As a Board, we are strongly of the view that the Plan we published in September 2018 is in the best overall interests of our customers in the round and, of course, our unique ownership model means that we do not have to balance that with the interest of shareholders. We were pleased to note that the IAP gave a very strong rating for the process that the Board had undertaken in developing and assuring that Business Plan (referring to our submission as “not only high-quality, but also ambitious and innovative”). Since we

published the Plan, the feedback that we have received from customer groups and other stakeholders has generally been extremely positive and supportive.

Our Approach to Ofwat's Initial Assessment of Plans (IAP)

It is in our culture to be open to challenge and to be willing to change our thinking in light of new information or best practice. That transparent and collaborative culture drove the detailed development of our plans by our Board, management and external stakeholders working together to create the best possible outcome for our customers. This was recognised by Ofwat in the scoring of our Assurance Process. We have, therefore, welcomed Ofwat's challenges of our plan contained within the IAP and have considered the merits of each challenge to reassess what we initially put forward. The comprehensive documentation in the IAP for the sector as a whole has enabled us to review other companies' approaches, to adopt aspects of best practice in some cases, and to test the ambition and appropriateness of our own Plan in that light. We have carefully considered the detailed questions and challenges to our Plan contained in the IAP. In this submission, we set out how we have either changed our Plan in light of new information or sought to provide additional evidence to address the points you have raised. We have set out a summary of our responses to the six key areas of concern raised in the IAP in an attached Annex.

In many cases, the challenge from Ofwat reflects a review across the sector of specific common issues, highlighting differences between one company's proposed outcomes and the approaches of other companies. In many such cases, we believe that the questions raised in our case by such cross-sector benchmarking can be answered by reference to the specific characteristics of our company's operating area, our customers' declared preferences, or the distinctive public policy context in Wales. Whilst benchmarking is a well-used and legitimate approach to informing questions of a company's Plan, the performance targets and funding required for each company must ultimately reflect its own particular operating environment.

Some of the actions requested by Ofwat, primarily concerned with Outcome Delivery Incentives (ODIs), require us to seek further evidence of the views of our customers. Working closely with the CCG, we have commissioned further independent customer research to investigate these issues. The CCG was very clear in its view that this research needed to be conducted to the same high standards as the original customer research, which shaped so much of our original Plan, and we agree with this view. For that reason, it was not possible within the limited time to 1 April to conduct the customer research, consider its findings with the CCG, and then revert to the Board to approve any resulting changes to our Plan. We have alerted Ofwat officials to our intentions and have committed to provide the resulting update to our Plan to Ofwat as soon as practicable. The research is already well underway, so we confidently expect that the results will be available later this month.

Main Areas of Change to our Plan

The action tracker spreadsheet sets out in the prescribed format our response to all of the actions and questions raised in the IAP. We have made changes to our Plan where we consider that this is the appropriate response to a challenge raised by Ofwat, or where there is new information (from benchmarking information in the IAP or from our own experience since September 2018) which we believe points to scope to improve on our plan for customers. All material changes have been discussed with the CCG and approved by the Board.

In summary, the most significant changes to our plan are:

- Pollution incidents MOS – a tougher 2025 target reflects the new baseline set by improved performance last year (although achieving our proposed target is contingent on us being able to carry through our

proposed investment plans) – achieving above upper quartile performance on the basis of the more detailed benchmarking approach set out in our response

- Internal sewer flooding MOS – a tougher 2025 target reflects a better understanding of the impact of changes to reporting required by the industry data consistency project (although again contingent on investment funding)
- Per capita consumption (PCC) MOS – an increased targeted reduction in PCC due to new information in the IAP and initial results from our pilot of our Project Cartref to reduce domestic water use
- Customers on priority services register MOS – we have adopted the Ofwat proposed methodology and definition, accepting the resulting new target
- “Customer protection” delivery measures – we have proposed additional ODIs for the delivery of key enhancement projects (reservoir safety programme, Cwm Taf WTW and water distribution ‘zonal studies’) to ensure that customers do not pay for any improvements that are not delivered
- Output Delivery Incentives (ODIs) – a revised approach to setting ODI rates, using the new cross sector information and revised approach set out in the IAP. Our determination of specific ODIs will also need to reflect the results of the further customer engagement work once this is available
- Enhancement investment – we have provided a series of detailed new investment cases providing further supporting information and justification, reflecting helpful feedback and challenge in the IAP
- Retail cost plan – reassessed in light of cost component information published in the IAP, resulting in a lower cost plan for household retail services, whilst continuing to reflect the service expectations and cost to serve characteristics of our customers
- We have updated our Bid Assessment Framework to incorporate the additional protections for bidders suggested by Ofwat
- Leadership, transparency and governance – we have expanded on our commitments to be fully transparent to our customers in terms of key Board policies, including executive remuneration and dividend policy
- We have changed the target credit rating for the notional company to Baa1/BBB+ in response to a challenge from Ofwat, bringing our position into line with that for almost all of the other water and sewerage companies.

Areas where the Board has concluded that no change to the Plan is appropriate

There are other important areas where the Board has reconsidered our Plan in light of challenge in the IAP but decided that our existing Plan remains appropriate in our particular circumstances, so that any change would not be in the best interests of our customers. Again, in each case, the issue has been discussed with the CCG.

In summary, material issues where, after further consideration, our plan remains unchanged are:

- Loughor Estuary – we have written to you separately on the context for this multi-AMP investment scheme. Here an innovative approach was required over an extended time period to very significantly reduce the cost to customers of the necessary remedial work and to avoid the imposition of large scale infraction fines on the Welsh Government, which would have resulted had early progress towards compliance with the ECJ ruling not been demonstrated
- Setting Upper Quartile performance targets – we have made material changes to our proposed performance targets in the light of new information. However, in those cases where allowance needs to be made for different operating circumstances, differing levels of confidence in companies’ forecasts (for example demonstrated by very low penalty rates or large deadbands), differing levels of past or future

funding, or where there are data consistency issues, we believe that a uniform target applied across all companies is not appropriate.

- Funding for service improvements – whilst some ongoing improvement in service is achievable within the botex budgets based on historical upper quartile expenditure levels, we are concerned that Ofwat’s approach is inappropriate. Enhancement funding will be required to achieve substantial change, for example in the case of leakage where we will need to employ additional and innovative new investment methods, such as Project Cartref, to deliver the desired reduction (existing methods having arrived at the point of diminishing returns from investment in our case)
- Cost efficiency targets (retail) – we are concerned that the use by Ofwat of companies’ forecast cost efficiency, a departure from previous practice and from the approach used for wholesale, is not sufficiently robust and results in a cost allowance which is insufficient to deliver the service preferences of our customers, given their cost to serve characteristics
- Cost efficiency targets (wholesale) – recent total factor productivity trends in the UK cast serious doubt on the achievability of the 1.5% frontier improvement (relative to CPIH) assumed in the IAP
- Cost of capital (WACC) and RCV run-off rate – we have re-evaluated the WACC in our plan in the light of market evidence and continue to find it to be acceptable, albeit stretching in terms of the impact on financial ratios for both the notional and actual company. We note Ofwat’s statement that you intend to review the WACC for the sector in July and would urge that you take full account of the potential impact of any further reduction in WACC on the credit rating outlook for the sector, which is already negative. In the event of any further change to WACC, we would need to consider whether a consequent change was needed to our RCV run-off ratio, within the range of values supported by the underlying asset lives in the business, in order to preserve financeability and a strong investment grade rating, which is ultimately in the best interests of customers as it optimises long-term borrowing costs.

Board Assurance of our revised Business Plan

The Board provided a comprehensive assurance statement for our September 2018 Business Plan, which was given the highest category rating in the IAP.

The Board has considered the IAP at three meetings since 31 January and has had the benefit of further input and challenge from the CCG, with the CCG Chair participating in our final Board meeting to approve our response. All material changes to the Plan have been considered and approved by the Board, taking account of the views of the CCG.

In its September 2018 Assurance Statement, the Board provided assurance that the proposed Plan was financeable for the period to 2030, based on the assumptions made for the regulatory determination post 2025 in particular. None of the changes proposed to the Business Plan have a material impact on the forecast financial projections of the regulated business and so that Board assurance of financeability remains valid.

On this basis, the Board is able to reiterate its Statement of Assurance for the proposed Business Plan. Although not an Ofwat requirement for Dŵr Cymru, a new assurance statement to this effect is attached to this letter, signed by our chairman on behalf of the Board.

Conclusion

The Board has overseen all stages of this review process, which we believe has resulted in a revised Plan which is strengthened in some specific areas and which continues to provide the optimal, long-term balance for our customers, reflecting their clearly expressed views and preferences.

We welcome the opportunity created by the IAP to provide further information and evidence in support of our Business Plan. Whilst the issues raised in our case in the IAP are very significant in quantum, particularly in respect of our enhancement programme, our hope and expectation is that we can resolve as many as possible of the actions and challenges raised by Ofwat in advance of the Draft Determination. This would significantly reduce the scope of divergence and would enable us to focus our efforts on continuing to prepare to deliver what will be very challenging targets for service improvement and cost reduction, for the benefit of our customers.

To this end, we are very ready to provide further information as required, or to meet with Ofwat to discuss any remaining issues of ambiguity or concern, at any stage during its review process in advance of the Draft Determination.

Annex: Summary of Ofwat's IAP feedback and Welsh Water's response

Ofwat's concerns with Welsh Water's plan	IAP score	Welsh Water's response
Delivering outcomes for customers: A number of common performance commitments are not sufficiently stretching, including most performance commitments. It also goes against its customer preferences on some performance commitments where it proposes outperformance payments.	C	We have tightened our targets on 4 of the common performance commitments; pollution incidents, internal sewer flooding, per capita consumption and priority service register. We have taken into account the additional information provided in the IAP and changed our underperformance and outperformance payment rates for 6 performance commitments and are currently undertaking further customer research on payment rates for 9 performance commitments. This research follows the 'best practice' approach of companies identified by Ofwat in its IAP.
Risk and return: It does not fully justify its choice of target credit ratings, or provide sufficient evidence to support its proposed Regulatory Capital Value (RCV) run off rates or its proposed uncertainty mechanism for business rates.	C	We have changed our target credit ratings for the notional company based on information presented in the IAP, provided further evidence to support our proposed RCV run off rates and removed our proposed uncertainty mechanism for business rates.
Securing long-term resilience: Its analysis of future trends impacting the business is high level and there is limited evidence of a risk assessment that quantifies risk exposure. Its financial stress test also do not detail impacts on key financial ratios.	C	We have provided further evidence demonstrating the link between the high level risks identified in our Welsh Water 2050 document and our proposed AMP7 investment schemes to start addressing those risks, including further evidence explaining why we have prioritised our proposed investment schemes over other options.
Controls, markets and innovation: It presents limited evidence of third party collaboration on water resources trading or bioresource development and does not justify its decision to reject two direct procurement for customers (DPC) schemes.	C	We have provided evidence demonstrating our involvement with other water companies on potential further water exports to address projected water resource deficits in those regions; we highlight how we have taken into account potential opportunities arising from a developing market for Bioresources, and we have provided more detailed evidence and analysis supporting our decision not to progress two DPC schemes.
Accounting for past delivery: it forecasts it will overspend cost allowances for 2015-20. The company provides insufficient evidence it has learnt lessons and identified improvement measures to address current cost performance.	C	We have invested more in service and resilience improvements during 2015-2020 than originally envisaged in our AMP6 plan, in order to bring forward improved service and resilience outcomes for customers. This followed extensive customer research which showed that this was the preferred priority for our customers. We incurred this expenditure in the full knowledge that it would be subject to the cost sharing mechanism and as a consequence, roughly 50% would be borne by the company.
Securing cost efficiency: we have substantial concerns around Dŵr Cymru's cost efficiency, as its company level costs are around 22% above our view of efficient costs.	D	<p>The main IAP challenge concerns enhancement expenditure, where Ofwat has queried some £450 million of our proposed capital investment programme. This is the major concern for us. Over 70% of the queried amount relates to investment which is not discretionary e.g. drinking water quality and environmental obligations set by our regulators. We have provided further information to demonstrate the legal obligations that we face during 2020-2025 and to address other challenges raised in the IAP, on a scheme by scheme basis.</p> <p>Ofwat have assessed the efficiency of our wholesale running costs (Botex) as above average and in particular, our water wholesale Botex as above upper quartile efficiency. However, our household retail expenditure plan has been assessed as bottom quartile. We have made some changes to household retail expenditure plan and we have also raised concerns on the robustness of the household retail cost modelling approach.</p>

Board Assurance Statement

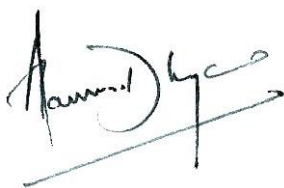
The Board has thoroughly reviewed Ofwat's Initial Assessment of Welsh Water's business plan and the preliminary conclusions reached by Ofwat, and has reflected on these in considering the response to the Initial Assessment. The Board has approved the changes made to Welsh Water's PR19 Business Plan in response to Ofwat's IAP feedback.

This approval process has taken place with reference to a 'change log' that captures all material changes to the Business Plan submitted in September 2018. The Board confirms that these changes do not weaken any of the Board's previous assurances concerning the September 2018 Business Plan, including the plan's ambition, deliverability, affordability, acceptability and financeability. The Plan remains fundamentally responsive to our customers' views, and designed to deliver long-term resilience and improved outcomes for customers and the environment.

The Board has received assurances from the Executive that the Business Plan tables have been subject to rigorous internal review in line with the processes employed to prepare the original set of (September 2018) Business Plan tables, and is satisfied that the data provided has been subject to appropriate assurance.

The Board has engaged with the CCG Chair on the changes to the plan, to ensure that any changes (or lack thereof) remain consistent with customer views and preferences.

In the Board's September 2018 Assurance Statement, it provided its assurance that the proposed plan was financeable. Having reviewed the changes to the Business Plan, we can confirm that none of the changes proposed impact on the financeability of the revised plan.

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Alastair Lyons
Chairman

On behalf of the Board of Dŵr Cymru Cyfyngedig (Welsh Water)
28 March 2019