



# Ofwat: Draft 2015-20 price control determination for Thames Water

## 1. Introduction

1.1 The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and sewerage consumers in England and Wales. CCWater has four regional committees in England and a committee for Wales. We welcome the opportunity to respond to Ofwat's 2015-20 draft price control determination for Thames Water (TMS).

## 2. Summary

2.1 In general, the draft determination is an improved package of price and service commitments to customers compared to the company's business plan.

2.2 Our market research shows that 72% of 'uninformed' customers found the draft determination's impact on bills acceptable. However, only 41% of customers who received more detail about the bill profile and inflation found the package acceptable.

2.3 While customers seem content with a general statement about inflation being added to bills, their views change markedly when this is presented in monetary terms. When customers receive their bills for 2015-16, and subsequently, they will note an increase in charges above the rate at which their household incomes are rising. This presents a challenge to companies and the regulatory regime in explaining and justifying bill increases. We therefore believe there is more Ofwat could do to improve the package further.

2.4 Across all companies, we would like to see a reduction in the 3.85% Weighted Average Cost of Capital (WACC), which we believe could be at a point estimate of 3.5% within a range of 3.00% to 3.75% based on analysis CCWater has commissioned. We welcome Ofwat's indication that the WACC may be reviewed for final determinations.

2.5 We are also concerned that the financial implications of Outcome Delivery Incentives (ODIs) carry a reputational risk to both companies and the regulatory regime. Customers may react negatively in the future if, in addition to Retail Price Index (RPI) increases added to their bills:

- they have to pay rewards for services and outcomes that many would expect a company to deliver as a matter of course;
- the level of performance that achieves a reward is not reflective of above industry average; and/or
- the reward reflects a level of performance other companies have achieved but where customers of other companies are not being asked to pay a reward.

2.6 Based on customer research we and some companies have carried out, many customers oppose the principle of paying rewards for service outperformance<sup>1</sup>.

2.7 We have further concerns about the draft determination for TMS that we would also like Ofwat to address in final determinations:

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<sup>1</sup> Outcome Delivery Incentives in the Water Industry - the Customer View (CCWater, March 2014)  
<http://www.ccwater.org.uk/wp-content/uploads/2014/03/Outcome-and-Delivery-Incentives-Report-FINAL.pdf>

- The potentially significant bill impact and value for money to customers from the Thames Tideway Tunnel (TTT) project. Ofwat is yet to set a separate price control for the TTT, and we expect this to ensure costs are efficient and minimised for 2015-20, and that the value of this investment is clear to customers.
- The risk of allowing additional retail costs for the delivery of a new customer billing system for which funding was allowed in 2010-15. We also wish to see adequate protection in place to prevent non-delivery or delays in giving customers the benefits of this new system.

2.8 CCWater is broadly supportive of Ofwat's draft determinations in terms of

- the interventions Ofwat has made to ensure TMS' service performance commitments reflect above industry average.
- the challenge to TMS' wholesale costs, to ensure they are comparatively efficient. Ofwat needs to ensure its model is fit for purpose to also achieve this at final determination.

### 3. Customer acceptability

3.1 CCWater commissioned market research to measure customer acceptability of the draft determination<sup>2</sup>. From a representative sample of 500 customers we found that

- 72% of 'uninformed' customers surveyed found the draft determination acceptable, when given basic general information about what will happen to TMS bills over 2015-20.
- However, only 41% of 'uninformed' customers surveyed found the draft determination acceptable when they were presented with more detailed figures showing how the average TMS bill will increase over 2015-20, taking into account the forecast of RPI inflation published by Ofwat.
- 50% of 'informed' customers found the package acceptable, after being presented with more detailed information about service levels that will be delivered, reflecting the investment the draft determination allows for.

3.2 While a majority of uninformed customers found the proposed prices acceptable when only receiving basic information, this reduced significantly (by 31 percentage points) when more information about how the average bill will change over 2015-20 was received. When more information about the service improvements to be delivered was provided, this only increased acceptability to 50%.

3.3 The significant reduction in acceptability when customers saw more detailed figures including forecast RPI shows how customers may respond when they see charges above the rate at which their household incomes are rising. This presents a challenge to companies and the regulatory regime in explaining and justifying bill increases. This response to the draft determination highlights areas where we believe there is more Ofwat could do to improve the package further.

3.4 As the bill profile presented to customers included the estimated cost of the Thames Tideway Tunnel (TTT), this indicates that in order to help improve

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<sup>2</sup> DJS research report for CCWater on customer acceptability of the 2014 Draft Determinations will be published in October 2014.

customer acceptability Ofwat and TMS should look to minimise the cost and bill impact of the TTT and ensure that communication to customers clearly shows the benefits customers will receive from all investments to be delivered.

- 3.5 While a specific price control for the TTT will not be set until final determinations, we expect Ofwat to use evidence of customers' views as a primary consideration in ensuring that the price control for this project is shown to reflect efficient costs and value for money if customers are to face a significant increase in bills as a result.

#### **4. Affordability and price profile**

- 4.1 In our research, of the customers who found the package unacceptable, 49% said that it was because they consider the current and/or future bill impacts (when inflation is taken into account) to be too expensive. This shows how important it is for TMS to offer suitable support for those who genuinely struggle to pay.
- 4.2 TMS has developed an extensive affordability strategy which includes a social tariff which was launched earlier this year. A number of water only companies (WoCs) bill on behalf of TMS and we are conscious that there are now a number of different social tariffs available with differing levels of bill reduction and using different qualifying criteria. This adds a level of complexity which makes it more difficult for customers to understand what is being offered and harder for them to apply for help.
- 4.3 We will therefore be pressing the company to review its approach at the end of the current financial year. We also wish to see TMS working closely with the WoCs to share experience in order to share and adopt best practice with a view to improving alignment between the social tariff schemes, and importantly their promotion and application processes.
- 4.4 TMS is the only company proposing above inflation bill increases in 2015-20, so bill levels and profiling are therefore key issues. Given that customer evidence usually supports smooth bill profiles, even with the addition of a large scale lengthy project as the TTT and its implications for cost recovery, Ofwat should set a smooth bill profile to give customers some stability.
- 4.5 While the PAYG ratio can be used to set the bill profile, the PAYG ratio should not be used by companies to buffer themselves against a tight cost of capital at the expense of customers now or in the future. Ofwat must also ensure that any revenue brought forward for the TTT is suitably ring-fenced in order to ensure transparency in the TTT funding arrangements.

#### **5. Outcomes - Performance Commitments and Outcome Delivery Incentives**

- 5.1 Our research<sup>3</sup> shows that customers do not support the principle of applying financial rewards to drive service improvements. We note that Ofwat's aggregate 'cap and collar' for the ODI financial reward/penalty model to +/- 2% on regulatory return on equity sets a boundary for the extent to which ODIs could drive future

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<sup>3</sup> Outcome Delivery Incentives in the Water Industry (SPA Research for CCWater, March 2014)  
<http://www.ccwater.org.uk/wp-content/uploads/2014/03/Outcome-and-Delivery-Incentives-Report-FINAL.pdf>

bills. However, there remains a risk of a negative customer reaction in the future if bill increases are driven by incentive rewards as well as inflation; even if bills do not increase in real terms.

- 5.2 Customers may also react negatively if the service performance achieved to secure the reward(s) does not clearly show an 'above average' change in service that is valued by customers, with a performance that compares favourably with the rest of the industry.
- 5.3 If, despite the absence of customer support, Ofwat decides that financial rewards should be part of the ODI package within final determinations, then it must ensure that companies are set targets that require the achievement of sector-leading performance.
- 5.4 In addition, the revised performance targets and penalties set by Ofwat must not lead to:
  - a reduction in the targets for delivering other customer priorities; or
  - companies diverting resources from services and outcomes that customers value highly into avoiding the more stringent penalties that Ofwat has set for some ODIs.
- 5.5 In relation to specific ODIs we would like to raise the following issues:
  - **Sewer flooding:** there is a significant difference between the draft determination and TMS' plan on the required target performance for this measure. This appears to have been caused by different approaches in modelling sewer flooding data. We are aware that this issue is subject to further dialogue between the company and Ofwat. This must lead to the final determination showing performance commitments against this measure that fully reflect the level of priority customers placed on addressing sewer flooding risks. This will give customers an assurance that value for money is being delivered, with TMS incentivised to achieve a level of performance that compares well to the rest of the industry.
  - **Supply interruptions:** Ofwat has increased the performance commitment (from 0.13 hours lost per property served per year down to 0.11 hours lost per property served per year by 2017-18) to achieve upper quartile performance. While we support Ofwat taking an 'industry upper standard' to drive better performance, we are concerned that this might drive the company to deliver short-term responses which are not in customers' interests in the long term. For example, an acceleration of the mains replacement programme without collection of the information required to target investment in the most cost-beneficial way, and/or short-term operational expenditure solutions to meet the tighter performance target for 2015-20, that does not represent the best solution on a whole-life cost basis. We want Ofwat and TMS to demonstrate that sufficient checks are in place to avoid these potential consequences.
- 5.6 We agree with Ofwat's requirement to take 5 years' and not 4 years' performance to calculate the reward/penalty applied.
- 5.7 We are also concerned about a potential lack of transparency inherent in the application of some rewards and penalties to the Regulatory Capital Value. While this will spread the impact on bills, customers need to know both the bill effect and the extent of the period to which it relates.

## Service Incentive Mechanism (SIM)

- 5.8 We consider that Ofwat should continue to apply SIM to the wholesale business to ensure that the company's monopoly wholesale business is incentivised to resolve problems quickly and effectively for customers and all retailers. This will be particularly important when competition goes live. In our research of small and medium enterprises<sup>4</sup> one of their key concerns was assurance that there would be no deterioration in the resolution of operational problems. In work we commissioned looking at problems in other sectors<sup>5</sup> where competition has been introduced alongside monopoly networks, the problem of misalignment of incentives has been highlighted. We do not want to see a similar problem in water.

## **6. Financeability**

- 6.1 We note that Ofwat, '*will consider whether there are changes in capital markets to regulatory determinations which would impact on our estimate of the cost of capital.*' This has been prompted by the Competition Commission determination for Northern Ireland electricity and Ofgem's draft determination for UK electricity distribution.
- 6.2 As explained in our responses to the earlier draft determinations, based on independent analysis we commissioned from Economic Consulting Associates (ECA)<sup>6</sup>, there is scope to reduce the Vanilla WACC from 3.85% (retail and wholesale) to within a range of 3.00% to 3.75%, with a point estimate of 3.5%. We consider that this is an appropriate balance between keeping prices for customers as low as possible while ensuring business plans are financeable.
- 6.3 We welcome Ofwat's indication that the WACC may be revised and would like to see Ofwat use this opportunity to set the WACC in line with our analysis to deliver further benefit to customers. In particular, we consider that there should be further consideration given to how systemic risk in the sector is assessed. Ofwat's assumption of the equity beta at 0.8 is significantly above ECA's range of 0.5 to 0.6.

## **7. Wholesale costs**

### **7.1 Thames Tideway Tunnel**

Ofwat's draft determination confirms its on-going challenge to the costs associated with the TTT scheme identifying a gap of over £330million between the company's modelling its own cost assessment of over £330million. We look to Ofwat to continue to challenge these costs as this has a potential significant impact on all TMS' sewerage customers' bills. Ofwat needs to ensure its model is fit for purpose to also achieve this.

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<sup>4</sup> Uncharted Waters: Non-household customers' expectations of competition in the water industry (2014) <http://www.ccwater.org.uk/wp-content/uploads/2014/06/Uncharted-Waters-Non-household-customers-expectations-for-competition-in-the-water-industry1.pdf>

<sup>5</sup> Lessons learned: a cross sectoral study of issues that have been detrimental or a risk to customers through the introduction of market reform (a PwC report for CCWater, to be published October 2014)

<sup>6</sup> ECA's reports for CCWater can be found here - <http://www.ccwater.org.uk/waterissues/pr14/futurepricesettingccwatersviews/>

- 7.2 There is still a lack of clarity around the TTT price control and interface with the Infrastructure provider (IP). We are looking to Ofwat to ensure the costs passed onto TMS' sewerage customers are kept to a minimum.
- 7.3 With this in mind, we welcome Ofwat's addition of performance commitments relating to TTT, with one reputational penalty linked to TMS' engagement with its sewerage customers to aid their understanding of TTT. We expect CCWater to be consulted on the proposed communications strategy and materials for customers. We also expect to be kept informed of and see arrangements in place between TMS and the WoCs that bill on their behalf to ensure messaging and information provided is clear and consistent. We would also wish to see clarity around the procedures for dealing with customer enquiries and complaints as these may relate to IP activity as well as TMS charging and policy issues.
- 7.4 We also support the inclusion of a performance commitment with penalties for project delays as a means of incentivising prompt delivery of TTT to further protect customers' interests.
- 7.5 We understand an Alliance Agreement between TMS and its contractors/ delivery partners will provide for co-operation and co-ordination of efforts to deliver the project. We do not know if such an agreement would provide sufficient incentive on TMS to secure prompt project delivery, and appropriate penalties for delayed/non-delivery. We look to Ofwat to determine the extent to which (if at all) such an Agreement can operate as an effective alternative to a dedicated performance commitment and associated penalties in the final determination.

## **8. Retail costs**

- 8.1 TMS' plan included the cost of replacing its customer billing system. Ofwat has highlighted concerns with the evidence provided in support of the proposed costs and because TMS was funded for a new billing system in 2010-15 but did not deliver this improvement. Ofwat has challenged TMS to provide further evidence to support the billing system investments as well as proposals for how to protect customers in the event that the investment does not deliver as envisaged.
- 8.2 We accept that there is a need for the investment supported by an assessment of the risks of continuing to use old systems and the benefits of improving customer service. However, it is extremely important that customers do not pay for something that has already been funded. We expect to see this investment subject to tight financial controls so that the money is invested where it's intended. We consider it appropriate to shortfall the company if it has not invested monies allocated to this in previous price controls. We expect to see Ofwat provide assurance in the final determination that the billing system will be delivered in the most cost beneficial way.
- 8.3 The replacement of a customer billing system for a large company can be beset with a variety of problems, so it is important that the project is well managed and customers are protected from delays and cost overruns. We support the added protection against failing to deliver this improvement through SIM and an ODI which Ofwat has strengthened. We would like Ofwat to advise if its other regulatory powers to intervene or apply sanctions could apply here if TMS either fails to deliver the new system, or errors occur in its delivery that detrimentally affect customers.
- 8.4 There is a gap between the draft determination and company plan in relation to the average cost to serve (ACTS). We are aware that TMS has commissioned



further analysis of the particular challenges associated with serving London, and dealing with a significantly higher proportion of short term customers living in rented accommodation. We have not seen the report on this work but would expect Ofwat to consider any new and compelling evidence.

## **9. Managing uncertainties**

- 9.1 TMS did not propose any uncertainty mechanisms in addition to those expected under the regulatory framework for 2015-20. We support this position.
- 9.2 Ofwat has set the sharing rate for business rates to 75% customer and 25% company, as it has for all companies receiving draft determinations at the end of August. We believe Ofwat could go further by offsetting increases in business rates with increases in RPI that go beyond the Treasury assumptions used in price setting.

## **10. Non-household retail revenue control**

- 10.1 TMS has been set non-household retail revenue for 2015-20, incorporating an aggregate 2.5% net margin. The company will need to develop a package of non-household default tariffs based on this revenue allowance.
- 10.2 The company has shared with us its research proposals for engaging with non-household customers on the issues of default tariffs, and preferences for non-household price controls in 2015-20. This seems a sensible approach given the nature of this topic, and we will work closely with TMS and its Customer Challenge Group in this on-going work.
- 10.3 All companies must ensure that their default tariff structure does not lead to disproportionate or sudden tariff increases for any groups of non-household customers. There is a risk of a negative reaction from non-household customers if they see a bill increase due to a change in the design of the tariff, or apparently as a result of competition. If this were to happen before 2017 it could look like a pre-emptive move by companies to gain ahead of the threat of competition. We expect Ofwat and the company to ensure this scenario is avoided.

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