Ofwat: Draft 2015-20 price control determination for Affinity Water
1. Introduction

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

2. Summary

2.1 The company’s business plan for 2015-2020 focuses on addressing a number of significant challenges in relation to balancing supply and demand and reducing the environmental impact of its operations. Key to the company’s strategy is their Water Saving Programme which will move household customers in their Central area onto meters over the next eight years. The metering programme is coupled with water saving promotion and assistance, and importantly a comprehensive approach to help customers with affordability issues. The performance commitments underpin this strategy and the outcomes that derive from the company’s extensive engagement programme.

2.2 CCWater is broadly supportive of Ofwat’s draft determination as the range of outcome/service commitments should lead to improvements for customers in a price package that will see a real-term reduction in the average water bill. Bills will move from £165 in 2015-16 to £155 in 2019-20 (before inflation).

2.3 However, we urge some caution based on the large difference in acceptability levels between AFW customers when asked about the water only service and when taking into consideration their sewerage bills.

2.4 The company’s ‘enhanced’ status means that Ofwat has accepted many of the company’s draft business plan commitments, costs and prices. These were subject to input and challenge from the Customer Challenge Group (CCG) on which CCWater had two members who were active participants. The company has also been able to demonstrate that its outcomes, service commitments and prices are reflective of evidence of customers’ views.

2.6 CCWater is generally supportive of Ofwat’s determination in relation to:

- The real terms price reduction for AFW customers over the five year period.
- The package of outcomes and measures the company will deliver, that reflect evidence of customers’ priorities and preferences.
- The company’s focus on the supply/demand challenges it faces in setting its outcomes and performance commitments.

2.7 However, within the detail of the draft determination, CCWater does have some concerns that we would like Ofwat to address in its final determinations. These are:

- The 3.85% Weighted Average Cost of Capital, which we believe could be lower, based on analysis CCWater has commissioned.
- The risk of a negative customer reaction in the future to paying rewards for services and outcomes customers may expect the company to deliver as a matter of course. Customers may react negatively if an area of performance where they may have to pay a reward is not reflective of
  - a level of performance that is not a significant improvement above industry average; or
reflects a level of performance other companies have achieved or exceeded, where customers of that company are not being asked to pay for a reward.

This represents a risk to both the company and to the regulatory regime given the lack of transparency in what the ‘enhanced’ status means financially to the company.

Customer research by CCWater and some water companies has shown that many customers are not fully supportive of the principle of paying rewards for service outperformance.

3. Customer acceptability

3.1 The research undertaken by AFW prior to the submission of its business plan found that 87% of its customers believed that the company’s plan for its water only business was acceptable. We are content with this and believe that the adjustments made by Ofwat in its draft determination will not have impacted negatively on this figure.

3.2 However, there was a significant drop to just 52% acceptability amongst AFW’s customers once the associated sewerage charges were factored in.

3.3 It is important to take account of customers’ views of the company overall and to consider how Ofwat’s price determinations may improve customer perceptions in the years ahead. CCWater’s tracking survey for 2013\(^1\) shows that AFW has a declining number of customers who consider their water charges to be offering value for money. Fewer customers also believe that their charges are fair or affordable. The commitment to improve the water service at a price package that offers below inflation prices should see improvements in these measures of satisfaction in the five years ahead.

3.4 AFW rightly acknowledges that the increase in sewerage charges (over which it has no control) will potentially have an impact on customers’ views, as is demonstrated by its own research. Since the company currently sends out joint bills on behalf of two of the three sewerage companies operating in its area it is quite probable that any negative reaction to an increase in sewerage prices will be directed at AFW rather than the sewerage provider.

3.5 We look to AFW to work closely with its associated sewerage companies, in particular Thames Water, to explain the investment plans that are driving the uplift in sewerage charges, and to ensure that customers are able to access any affordability packages that are put in place to assist those struggling with bills.

3.6 Ofwat must also consider the impact of the plans of sewerage companies on their associated water only companies when making its draft determinations.

4. Price profile and affordability

4.1 We welcome the £10 reduction in average bill level (before inflation) between 2015 and 2020. Ofwat states that AFW has chosen to smooth the profile of its bills through an adjustment to its PAYG ratio. However it is not clear from the information published what

period customers will be expected to be paying for the proportion of investment that has been added to the RCV.

4.2 The CCWater Annual Tracking Survey for 2013/14 reported a reduction in the number of customers who considered their water services to represent value for money in AFW’s Central and Southeast operating areas\(^2\). Delivering an earlier reduction in bills for these customers may help to address customers concerns as at present the real terms reduction does not start to impact bills until 2017/18.

4.3 For customers in the Central area what they pay over the 2015-2020 period will largely be determined by whether they are on a meter already or are switched over to a meter under the company’s Water Saving Programme. In the latter case their bills will stay on the present charging arrangement for the first two years after installation of the meter unless the customer opts to go onto the metered charges earlier - usually if their metered bill is lower.

4.4 For households with high water use the two year delay in switching provides an opportunity to reduce water use in order to reduce future metered bills and, where appropriate, to seek additional financial help through one of the support measures offered by the company. This approach will directly impact the company’s revenue stream within the period and depending on the ratio of people paying less and those paying more on metered charges, could have implications for the adjustment needing to be made under the Revenue Correction Mechanism (RCM) at PR19.

4.5 We therefore look to Ofwat to determine/confirm that the company’s forecasts for revenue are based on suitable, robust data and experience is drawn from neighbouring water companies with similar large scale compulsory metering programmes when it comes to its final determination. We would not want to see significant price adjustments being stored up for the next price review.

5. Outcomes

5.1 The Outcomes that have been financially incentivised directly relate to the delivery of the company’s water management strategy and satisfying customers overriding priority for a safe, reliable and resilient water supply.

5.2 The company has chosen to weight financial incentives so that there are more penalties for missing stated targets than rewards for exceeding them. The targets themselves are challenging. Performance will be monitored and reported on an annual basis and the overall balance of financial reward and penalty reflected at PR19.

5.3 However, based on customer research undertaken by CCWater and some water companies, we have concerns with the principle of applying financial rewards and penalties to drive service improvements, and the potential negative customer reaction this could lead to. There is also a risk of a negative customer reaction if they are asked in the future to pay for a reward to the company in return for

- levels of service that other companies have also delivered, but without the customers of that company having to pay a reward for it; or

- a level of service that is not a significant improvement, reflective of a ‘higher than industry average’ performance.

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\(^2\) CCWater Annual Tracking Survey 2013 - How is my company doing?
5.4 We understand that the company wishes to add any resulting reward/upward price adjustment to its RCV in AMP7. As it is now proposed to treat several elements of the company’s financial settlement in this way we would wish the final determination to clarify/quantify the potential benefits of this approach (difference in impact on customers’ bills) in the short and longer term.

5.5 **Leakage:**

5.5.1 AFW is targeting a 14% reduction in its leakage levels by 2020 and applying a financial reward and penalty. The company’s leakage performance compares well with the industry average, but this is an area where customers are eager for water companies to focus activities, and particularly so when they are undertaking compulsory metering. Repairs to supply pipes, as part of the metering programme, should help to deliver this performance commitment. It also provides the platform for raising customer awareness of the water resource issues in that area and the company’s strategy for dealing with these. We hope to help the company in this regard.

5.6 **Unplanned interruptions to supply over 12hrs:**

5.6.1 AFW aims to maintain its current performance in this area at 320 properties affected each year. We question whether a reward that applies for performance at between 0 - 135 properties is a suitable way of applying a financial incentive. While it would represent an improvement on current performance this could still see AFW rewarded for leaving over 100 properties without water for an extended period of time.

5.7 **Asset Health Index:**

5.7.1 AFW proposes to introduce an additional Asset Health Index after this was identified as a customer priority. CCWater looks forward to working with the company in the development of this Index through our continuing involvement in the reformatted CCG and our normal liaison activities which will be continuing as well as the CCG. We agree with the stated aims of reporting on company performance in a transparent manner and will be working with the company to ensure that this is delivered in a way that is meaningful and easily understood by customers.

5.8 **Value for Money Survey**

5.8.1 CCWater also welcomes AFW’s invitation to work with the company on the development of a customer survey to help determine their view of the value for money provided by the company. We look forward to inputting into the development of this measure and will be able to draw on our experience and specialist research skills in this respect.

6. **Wholesale costs**

6.1 AFW’s wholesale cost assessment of £1049m is inside Ofwat’s assessment of acceptable costs of £1095m.

6.2 As part of the Risk based Review Ofwat highlighted the large increase in lead pipe replacement activity proposed for AMP6. Although this is an expensive element of the wholesale plan the company has adopted a targeted approach that will focus on those supplies serving potentially vulnerable customers. This approach has the support of the Drinking Water Inspectorate and of customer research that highlights water quality as a key consumer priority.
7. **Retail costs**

7.1 We note that AFW is forecasting a negative SIM impact for the period. This is on the assumption that the challenges associated with the roll-out of metering and the impact of the Thames Tideway on wastewater bills will influence customers’ views of the company. It may also adversely affect the levels of debt managed by the company.

7.2 We would like to see Ofwat, for final determinations, use the SIM range to its full and adjust price limits by more than -0.5, used in previous reviews, for those companies who have consistently performed relatively poorly. Moreover, the final determinations must demonstrate that individual company’s SIM targets are stretching and will lead to a level of performance that compares favourably to industry best.

7.3 The company’s proposed communication strategy will need to address these issues and support must be given to customers who may struggle to afford their bills, either as a consequence of moving to a meter or due to an increase in wastewater charges.

7.4 The company is committed to working with Thames Water on their messaging around the Thames Tideway Tunnel project and its associated bill impacts and also on making applications for assistance through their respective social tariffs as straightforward/seamless as possible where AFW is billing on their behalf.

7.5 CCWater will also be working closely with AFW as it develops its metering programme implementation strategy and associated communications with customers in order to ensure that the experience of earlier programmes and identified good practice is shared and adopted by AFW.

8. **Financeability**

8.1 We are reassured that Ofwat’s own financeability modelling places AFW in an even stronger situation than the company’s own assessment.

8.2 As part of the awarding of ‘enhanced’ status, Ofwat has also applied a ‘do no harm’ principle to ensure AFW are not any worse of for being ‘enhanced’ and for receiving an earlier draft determination.

8.3 However, Ofwat has an opportunity to reconsider the cost of capital on the basis of the regulator’s own analysis and market analysis available from other parties. Ofwat’s 3.85% Vanilla WACC is in the higher end of Ofwat’s 3.6% to 3.9% range, indicating that there may be scope to lower the current point figure.

8.4 This is reinforced by an analysis of the cost of capital for CCWater by Economic Consulting Associates (ECA). They suggest that a Vanilla WACC with a point estimate of 3.5% for a range of 3.0% to 3.75% would be an appropriate balance between keeping prices for customers as low as possible while ensuring business plans are financeable.

8.5 The component parts of ECA’s assessment of the Vanilla WACC differ from Ofwat’s view in a number of instances. While the two parties’ cost of debt assumptions are similar, this is not true about the cost of equity. In particularly, ECA’s analysis suggests that Ofwat may have overstated systemic risk in the sector in the equity beta, with Ofwat’s assumption of 0.8 significantly above ECA’s range of 0.5 to 0.6.

8.7 We would like Ofwat to give further consideration to ECA’s assessment of how the cost of capital, particularly the equity beta, should reflect more fully market expectations. This could have the effect of reducing AFW’s average bill further by up to £4.
8.8 We also question the potential customer impact of using PAYG and the RCV mechanism to deliver short term bill reductions and to what extent this increases the total amount recovered from customers. It would be helpful if Ofwat was able to provide some comparative information in the Final Determination so that customers can be assured that this is in their best interests overall.

9. **Risk reward**

9.1 We understand the regulatory rationale for financial incentives, but research by several companies and CCWater\(^3\) shows that there is a significant risk that customers may react negatively to:

- Paying rewards in the future for company outperformance.
- Targets that appear to not be sufficiently challenging, or where a reward is proposed at a level where the company will not be at or near the industry best.

9.2 The outcome incentive package AFW is proposing to apply to eight of its performance targets runs the risk of a longer term consequence (and potential negative customer reaction) where a lower price in the short term then leads to price rises in the future if the company outperforms its targets, particularly if this is not transparent.

9.3 AFW’s own research also showed only 43% of customers support the idea of financial rewards for outperformance. They rejected the idea of incentivising performance where this would mean higher bills.

10. **Managing uncertainties**

10.1 AFW has chosen to withdraw its proposals for change mechanisms relating to statutory obligations (Water Framework Directive), adoption of customer supply pipes, the costs of the Open Water programme and obligations under major infrastructure schemes (HS2).

10.2 CCWater is not in favour of companies seeking to mitigate their exposure to risk by excluding items from their programme and seeking to pass the costs onto customers at a later date. We are therefore supportive of the removal of these mechanisms.

11. **Other issues**

**Affinity Water’s vision**

11.1 AFW’s vision is to be viewed as the leading community-focused water company. We welcome the commitment for the company to be accountable to the communities it serves.

11.2 However we wish to understand more about how the company will look to measure delivery of this vision and to ensure that it delivers on its promise to be transparent about its performance by regularly publishing information on its website.

**Lack of transparency in the Draft Determination**

\(^3\) CCWater - Outcome and Delivery Incentives in the Water Industry
11.3 The draft determination document lacks information that would show more clearly how Ofwat’s decision making has led to extra value for customers, in terms of prices and in the service commitments proposed by the company.

11.4 We would have liked to have seen

- a comparison between the draft determination price proposals compared to the company’s business plan, to show more clearly the value to customers of Ofwat’s cost challenge to the company.
- a clearer demonstration of how Ofwat has worked to ensure that AFW’s service commitments are driving the company to achieve levels of service that compare favourably to ‘industry best’ through the use of comparators (where available).
- clarity around how the various commitments and the incentives applied to them will help drive the company to deliver service quality to a level that places AFW in the upper tier of industry performers.
- how AFW is being driven to deliver tangible improvements in comparison with the rest of the industry.

11.3 We would like Ofwat to consider such a presentation of price and service commitments in the remaining draft and final determination reports.

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