



# **Ofwat: Draft 2020-25 price control determination for Anglian Water**

**CCWATER RESPONSE**

**AUGUST 2019**

## Introduction

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 2020-2025 draft price control determination for Anglian Water. This response also contains our views on the impact on Hartlepool Water customers.

## Section A - Executive Summary

### Customer Acceptability

2. CCWater has commissioned research to measure the customer acceptability of the Draft Determination package of prices and service improvements. It is vital that customers find the outcome of the price review acceptable, to improve perceptions of fairness and value for money, and to help improve the legitimacy of the industry in customers' eyes.
3. Of 500 Anglian customers who were surveyed, 87% found the package to be either 'acceptable' or 'very acceptable' on an 'uninformed' basis (when customers were presented with very basic information about the bill profile). This reduced slightly to 86% on an 'informed' basis, when customers also considered key service improvements in the package.
4. Given this high level of acceptability for the price and service levels, it is important that Ofwat and Anglian Water ensure that the Final Determination continues to deliver a package that allows customers' priorities to be delivered at a price that they accept.
5. Customer acceptability dropped to 77% when customers were presented with the potential impact of Outcome Delivery Incentives. This shows that there remains a risk that a significant number of customers do not support the potential impact of ODI outperformance payments on bills once this is fully realised.

## What we support

6. We support the following proposals in the Draft Determination for Anglian Water:

- The reduction in the Weighted Average Cost of Capital to 2.19%<sup>1</sup>, which is within the recommended range of a CCWater commissioned independent study of water company financing, market evidence and financing assumptions made in other regulated sectors. While this is within the range recommended by our consultants, it is at the top end. We therefore welcome Ofwat's comments that current market evidence suggests the cost of capital may be even lower when Ofwat comes to Final Determinations of price controls.
- Ofwat's request to the company to produce an action plan to implement a systems-based approach to resilience. This should underpin the company's operations and future plans. Anglian's customers favoured a balance between bill reductions and service improvement, with no delay in investment in resilience. It is important that the action plan demonstrates this.
- The range of Performance Commitments, which we believe are stretching, reflect customer priorities and were based on robust customer evidence.
- The increase in number of customers receiving affordability and vulnerability support through the allowances made in the Draft Determination for Anglian. We also support Anglian's commitment to assessing the quality of assistance provided. While this is welcome, we believe companies still need to do more because across the industry, there will still be more than one million customers who are in need of assistance but not receiving it, even after the improvements companies are making.

## What we have concerns with

7. We have concerns with the following:

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<sup>1</sup> Real (RPI) appointee level

- The profile of average bills across each of the five years of the price control, which sees a sharp fall in bills followed by subsequent increase. We know that customers value bill stability and would like to see Ofwat's Final Determination deliver a smoother bill profile.
- We welcome Ofwat's efficiency challenge to Anglian; companies can opt to appeal the Final Determination with the Competition and Markets Authority (CMA), customers do not have the option to appeal if their expectations are not met or if aspects of the price determination is unacceptable to them. We do not want customer supported Performance Commitments, service improvements or investment removed or reduced because of this challenge. We therefore expect Ofwat to reassure us that their models have validity and if Anglian have doubts that they can deliver this plan then they should appeal the decision with the CMA.
- The potential bill impact of Outcome Delivery Incentive (ODI) outperformance payments. While we recognise that Ofwat has reduced the scope of rewards and applied protections to limit excessive rewards, there remains a number of customers who do not support ODIs.
- The risk that more potentially lucrative ODI incentive rates for outperformance payments could mean that the company may be incentivised to pursue some ODIs at the expense of other customer supported service improvements.
- The number of 'amber' rated schemes in Anglian's statutory environment programme. This indicates that more evidence is needed to confirm the need for these schemes. While many customers support environmental improvements, it is important that this is based on robust evidence.

## Section B - Our detailed comments

### Customer acceptability

8. It is vital that customers find the outcome of the price review acceptable, to help improve perceptions of fairness and value for money, and to help improve the legitimacy of the industry in customers' eyes. CCWater commissioned DJS Research to carry out interviews with a representative sample of 500 customers from each water and sewerage company to test the acceptability of Ofwat's Draft Determinations.
9. Our Draft Determination research found that 87% of Anglian customers surveyed think that the Draft Determination proposals are either "acceptable" or "very acceptable"<sup>2</sup> on an 'uninformed' basis. This reduced slightly to 86% on an 'informed' basis, when more details about the proposed service improvements were presented.
10. Given this high level of acceptability for the price and service levels, it is important that Ofwat and Anglian Water ensure that the Final Determination continues to deliver a package that allows customers priorities to be delivered at a price that they accept.
11. Customer acceptability reduced to 77% when customers were presented with the potential impact of ODIs on their bills over the period. This shows that there remains a risk that a significant number of customers do not support the potential impact of ODI outperformance payments on bills once this is fully realised.
12. We give a higher weight to uninformed acceptability scores than informed because this is a better reflection of how the vast majority of customers will receive information about a price determination. The average customer does not receive very much information about the price review outcome.

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<sup>2</sup> Top line findings from DJS Research 23 August 2019

13. These top-line findings give an indication of customers' feelings about the Draft Determination. The full report, which will explore the reasons behind these answers in more detail, will be published on our website. This will help Ofwat to understand the reasons why customers found the Draft Determination acceptable or unacceptable: <https://www.ccwater.org.uk/research/category/price-reviews/>

## Bill profile and cost efficiency

### Bill profile

14. The Draft Determination would see bills reduced by 3% after inflation<sup>3</sup> over the period 2020-25. The figure Ofwat published (a 12% reduction) does not include inflation and the impact of ODIs, so we expect the company and Ofwat to make this clear to customers when explaining bill impacts at Final Determination and beyond.
15. We note that Ofwat's proposed bill profile is for a reduction at the start of the period. Given the impact of inflation, this would produce a sharp fall in bills followed by subsequent increase. 86% of customers surveyed in our acceptability testing research found the proposed bill profile acceptable. However, we know that customers value bill stability and that low income customers, in particular, can find it difficult to manage bill increases. For these reasons, we believe Ofwat's Final Determination should deliver a smoother bill profile.

### Cost efficiency

16. We welcome Ofwat's challenge to all companies on efficiency. Companies can opt to appeal the Final Determination with the Competition and Markets Authority; customers do not have the option to appeal if their expectations are not met or if aspects of the price determination is unacceptable to them.

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<sup>3</sup> Based on an assumption of 2%pa CPI-H

17. At Draft Determination there is a substantial difference between the resources sought by the company to deliver its proposed business plan and those allowed by Ofwat. We therefore want reassurance from Ofwat that the basis of their models are sound.
18. Meeting the required efficiency savings (of £1.2bn) is likely to be a challenge for the company. We note that, at this stage, Ofwat has indicated that it has not yet assessed additional evidence submitted by the company after the deadline for responding to the Initial Assessment of Plans (IAPs), which, when evaluated, may alter this situation.
19. We are not in a position to make a judgement on the difference in views on costs and deliverability; we therefore look to Ofwat for assurance that customers' long-term interests are being adequately protected. We would also seek assurance that its monitoring regime will give early warning if companies do start taking short or long-term operational risks.
20. We would not want to see Ofwat's challenge to Anglian putting in jeopardy the delivery of any well evidenced Performance Commitments, service improvements and/or investment that customer's value. Such commitments to customers should not be removed or deferred just to reduce overall costs. If Anglian have doubts that they can deliver these commitments then they should go to the CMA.

#### Weighted Average Cost of Capital (WACC)

21. An independent study commissioned by CCWater<sup>4</sup> has recommended a range for the WACC of between 1.7% to 2.3%<sup>5</sup>, based on an analysis of water company financing, market evidence and financing assumptions in other regulated sectors. We note that for the 'slow track' and 'significant scrutiny' Draft Determinations Ofwat has used a WACC of 2.19%. While this is within the range recommended by our consultants, it is at the top end. We therefore welcome Ofwat's comments that

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<sup>4</sup> Economic Consulting Associates (ECA) recommendations for the Cost of Capital 2020-25 (April 2019) – this is an updated recommendation for the cost of capital, following on from an ECA recommendation originally published in December 2017. The April 2019 update takes into account new evidence that has emerged in 2018 and 2019: <https://www.ccwater.org.uk/research/update-to-eca-recommendations-for-the-cost-of-capital-2020-2025/>

<sup>5</sup> Real (RPI) appointee level

current market evidence suggests the cost of capital may be even lower when Ofwat comes to Final Determinations of price controls.

#### 'Pay as you go' ratio (PAYG)

22. The PAYG ratio should reflect the balance of short and long term cost recovery relative to the companies' balance of operational activity and longer term capital investment. We note that Ofwat has reduced Anglian's PAYG slightly from 46.9% to 46.4% - this leads to a reduced revenue collection in 2020-25 that contributes to the lower bill profile.
23. When costs are reallocated from one category to another (e.g. from 'base' to 'enhancement'), this can have a knock on effect on the PAYG ratio as capital costs are typically recovered in the longer term. Ofwat should be clear in the Final Determination where changes in the cost assessments have led to a revised PAYG and that the ratio strikes the appropriate balance of cost recovery from current and future customers.

#### **Safe, reliable services: maintenance and long-term investment**

24. In Anglian Water's business plan research, customers favoured a balance between bill reduction and service improvement. In particular, they did not want to delay investment in resilience. However, given Ofwat's challenges to the company in the Draft Determination to provide better evidence, we cannot be sure that Anglian has identified and will address all of the risks.
25. In Ofwat's initial assessment of business plans (IAP) and the Draft Determination, Anglian is asked to provide an action plan by 22<sup>nd</sup> August to *'develop and implement a systems based approach to resilience in the round and ensure that the company can demonstrate in the future an integrated resilience framework that underpins the company's operations and future plans, showing a line of sight between risks to resilience, planned mitigations, package of outcomes and corporate governance framework'*.
26. We support this action and look forward to seeing the company's response to this challenge and working with them as they develop this framework.

27. We would like to see how the company's Performance Commitments and investment allowed for in the Final Determination will address current and future resilience risks as a result of this action plan. We would also like to hear from Ofwat about the interventions it would propose to make if Anglian Water's action plan is viewed as sub-standard.
28. Resilience can be affected by factors that may be uncertain or unforeseen now but may affect the company's ability to deliver its services reliably and securely in the future. Therefore, we wish to see companies showing flexibility to adapt to changes to current and future risks, and demonstrating to their customers and stakeholders that they have done so.

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

#### Performance Commitments (PCs)

29. Overall, we consider Anglian's PCs are stretching, reflect customer priorities and were developed based on extensive evidence of customers' views collected during the development of the Business Plan.

#### Outcome Delivery Incentives (ODIs)

30. Whilst 77% of Anglian customers supported the principle of using ODIs in the company's business plan research, not all customers wanted to pay for better service and not all supported the package, which was presented showing the potential bill impact of ODIs. Our research on the acceptability of the Draft Determination package shows that customer acceptability drops by 9% when customers are asked to consider the potential bill impact of ODIs.
31. We recognise that the potential customer reaction to ODIs is mitigated to a degree in Ofwat's Draft Determination, where a number of interventions have been made to the use of deadbands, caps and collars, and to incentive rates, compared to the business plan. The result is a shift in the balance between potential rewards and penalties, with a greater emphasis on penalties (which now have a potential impact of up to circa £30.5m, compared to the potential rewards of £13.6m).
32. We also welcome the overall cap on the ODI package, with a sharing mechanism if this is breached. The mechanism varies the proportion of the share in order to

incentivise high quality plans, although it is too early to form a view on the impact that this will have on company behaviour.

33. We have always been concerned about the potential for substantial rewards to lead to bill volatility and higher bills, so we broadly welcome the effect of Ofwat's interventions. However, given the results of our acceptability testing research and Anglian customers' limited support for the potential impact of rewards, there remains a risk that a significant number of customers do not support the potential impact of ODI outperformance payments on bills.
34. Several of the changes in financial incentive rates that Ofwat has proposed in its Draft Determination are the result of an attempt to create more consistency across the industry. We welcome Ofwat's interventions to incentive rates to more strongly prevent poor performance and incentivise more stretching improvements.
35. However, we have a concern with the incentive rate for the Performance Commitment for reducing internal sewer flooding. Anglian's 2019-20 target performance (of 1.7 incidents per 10,000 connections) sees the company among the leading 'performers' in the sector for this PC, so the level of stretch required to reach Ofwat's 2024-25 target of 1.34 incidents per 10,000 connections is less stretching than several other companies. In this context, we question why the ODI outperformance rate for this PC accounts for around 80% of the overall reward package available.
36. It is important that the availability of potentially more lucrative ODI outperformance rewards does not encourage any companies to pursue targets for some PCs at the expense of others, which may be equally important or valued by customers.

#### Customer Experience Measure (C-MeX)

37. We welcome the clarity on the details of the shadow reporting of C-MeX which will inform its final design, and will monitor how this progresses. However, we remain concerned that there may be insufficient weighting given to complaints performance in this Draft Determination. This could lead to Anglian not facing sufficient pressure to improve their complaint handling performance. They may

also be able to achieve a financial reward even where their complaint performance is static or declining.

## Affordability & Vulnerability

### Affordability

38. Our [Water Matters research](#) (2018) found that 81% of Anglian Water customers and 79% of Hartlepool Water customers considered their charges to be affordable. Anglian Water's own research indicates that the number of customers with affordability problems corresponds to approximately 20% of the customer base, although the proportion of Hartlepool Water's customers with affordability issues is higher than for the area as a whole.
39. We are therefore pleased that Anglian has put forward an ambitious plan to help address affordability. In particular, the company proposes to actively promote all affordability assistance under one brand and to undertake 300,000 ExtraCare affordability assessments each year. Overall, it plans to increase the capacity of its affordability support so that it can assist 475,000 customers per year. In our research, 77% of customers surveyed said that the proposed bill profile in the Draft Determination is affordable, which shows that the proposed bill decrease will help make bills more manageable for many customers.
40. We also welcome Anglian's bespoke affordability PC, which includes an annual review by CCWater to ensure that it reflects outcomes for customers. We look forward to working with the company on this.
41. While this is positive progress which we support, we believe companies still need to do more because across the industry, there will still be more than one million customers who are in need of assistance but not receiving it, even after the improvements companies are making.
42. We are disappointed that Anglian has no plans to directly contribute to fund the social tariff so that it can help even more customers who are struggling and will continue to press the company to agree to do this. We will monitor company financial performance closely and highlight this as an option to share benefits with customers where the company outperforms its financial targets.

## Vulnerability

43. We note the inclusion of the new common PC to measure Priority Service Registers (PSRs). However, a target to increase numbers on PSRs can drive the wrong behaviours by focussing on numbers rather than the quality of assistance. We want to ensure that help is meaningful and satisfactory for consumers.
44. We support companies going further than focusing solely on PSRs to ensure that all consumers receive the support they may need when in vulnerable circumstances (for example, in cases of transient or temporary vulnerability such as during a water supply interruption). In this context, we support Anglian Water's proposal to use an independent panel to assess the quality of the support it offers, as the company has recognised that a single quantitative measure of the PSR register does not adequately measure the quality of its support for consumers in vulnerable circumstances.
45. Ofwat's Draft Determination now includes a bespoke PC to measure the achievement and maintenance of the BSI standard for inclusive service provision, which Anglian added to its business plan in response to the IAP. The company concluded that there is a significant overlap between the qualitative panel commitment it originally proposed and the achievement of the BSI Standard, which by definition includes third party assurance. Given that the revised bespoke PC should assess quality of service provide with third party scrutiny and assurance, we agree with this change. As part of the assessment of the quality of support provided, we feel that consumers receiving the support and/or their representatives are in the best position to advise if the help is meaningful and there should be more focus on establishing and measuring this.
46. It is important that consumers receive support when they need it and that they are satisfied with the assistance provided. To support the PCs already in the Draft Determination, we support Anglian Water (raising awareness of the support available so that consumers know what help they can access.

47. We expect retailers and wholesalers to collaborate to identify any non-household consumers who need additional support. We will be monitoring what help consumers are signing up for. We will also liaise with companies to understand which consumers who would benefit from being on the PSR may be missing out.
48. Following the IAP, we challenged Ofwat's proposed vulnerability PC requiring companies to contact 90% of consumers on the PSR every two years. We felt more clarity was needed on what "contact" meant e.g. does it involve interaction from both parties such as consumer and the company? In the Draft Determination, Ofwat has provided reporting guidance on what "contact" means and has also split the data checking PC into two parts:
- a. % of customers attempted to contact to check data = 90%
  - b. % of customers actually contacted to check data = 50%

We support this as a sensible move.

### Other key company specific issues

#### Water Industry National Environment Programme (WINEP)

49. Anglian's statutory environment programme is one of the largest drivers of costs in its business plan and in Ofwat's Draft Determination. We note that many of the 'amber' schemes in Anglian's WINEP programme have been included in this Draft Determination, which is a different approach to that taken for some of 'Fast Track' companies' Draft Determinations, where many of these were excluded.
50. 'Amber' schemes indicate that there is a lack of evidence to fully justify the investment or operational activity needed. While we accept that such evidence may emerge before Final Determinations, customers should not pay for something that may not be necessary. The Final Determination should demonstrate that the schemes allowed for will deliver statutory requirements, provide value for customers and are based on robust evidence of environmental damage or risk caused by the company's activities.

## Population Growth

51. We note that a significant proportion of the challenge Ofwat has applied to Anglian's Business Plan relates to a difference between Ofwat and Anglian's estimate for the level of population growth from 2020. As population growth is a significant factor in Anglian's costs, and Anglian's business plan research shows that customers supported investment to meet the demand of future population growth, we want reassurance from Ofwat that a consistently applied, robust forecast is used in the Final Determination.

## **Other general issues**

### Innovation

52. We understand that Ofwat is considering an additional revenue adjustment for the Final Determinations, to allow companies' additional costs to invest in further innovation. We consider it essential that the industry should constantly be looking for new and better ways to think and operate. We welcome companies finding innovative ways to effectively and efficiently address the challenges facing the sector and its customers, including climate change, aging assets, a growing population, and changing customer expectations.

53. Companies may develop innovative methods of delivering services that have a tangible positive impact on customers; for example, in areas such as service quality, affordability and vulnerability.

54. However, we question why additional revenue (that customers will pay for) is needed to encourage greater innovation. This is especially the case if companies are also challenged to be more efficient. A Draft Determination that places greater commitments on companies to improve service delivery, protect the environment, and improve the resilience of their assets and operations should encourage innovative solutions without the need for a special revenue adjustment.

55. More collaborative working between the appointed companies to identify and share good practice would also help achieve this aim.

## Developer Services Experience (D-MeX)

56. While we have welcomed the introduction of new measures designed to improve developer experience with companies, we have some questions about how this will operate:

- We note that the quantitative D-MeX score is based on a survey of transactions and that the water companies are in the process of operating a shadow year. At the end of the shadow year, will Ofwat review whether these metrics have incentivised good behaviour, as planned? If so, how will it ensure that companies are incentivised to perform as well as possible and not just 'sufficiently' well in order to meet the minimum requirement?
- The qualitative score is given by developer customers surveyed in the customer satisfaction survey. How does the mechanism reflect the experience of self-lay operators and new appointees in this market?
- According to the outcomes PC appendix for each company, each company's score will be calculated by multiplying the incentive rate with the annual developer services revenue. It seems to us, therefore, that if a company has higher charges, it could achieve higher rewards. Conversely, if a company collects less revenue because there is a more competitive market in its supply area, then it could be penalised. How does this mechanism ensure that the right behaviour is incentivised?

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