



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

## 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 Bristol Water customers who were surveyed, 91%<sup>1</sup> 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). 92% of customers found the package 'acceptable' or 'very acceptable' on an informed basis (when customers also consider 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 Bristol Water ensure that the Final Determination continues to deliver a package that allows customers' priorities to be delivered at a price they accept.
5. Customer acceptability dropped to 82% when customers were presented with the potential impact of Outcome Delivery Incentives. This shows that there remains a risk that a number of customers do not support the potential impact of ODI outperformance payments on bills once this is fully realised.

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<sup>1</sup> Top line findings only from 23 August 2019

## What we support

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

- The reduction in bills over the 2020-25 period (7% after inflation<sup>2</sup>) and the proposed bill profile, which reflects evidence of Bristol customers' preference.
- The reduction in the Weighted Average Cost of Capital to 2.19%<sup>3</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. Any allowance for a small company premium for Bristol Water at Final Determination stage should be based on compelling evidence that the additional cost is outweighed by the value of the benefits to be delivered to customers.
- The 'notified item' which allows Bristol to reopen the price control in 2020-25 if currently uncertain costs emerge that are associated with abstraction from the Sharpness and Gloucester canal. Given the uncertainty, we agree with this approach so customers are not paying for company expenditure that may not be required for some time, if at all.
- The range of Performance Commitments, which we believe are stretching, reflect customer priorities and are based on robust customer evidence.
- The Performance Commitments and investment in future resilience that should see a reduction in the risk of supply interruptions. Bristol Water has seen some operational events in recent years which illustrate the importance of improving the long term resilience of its network, which is supported by customers.

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

<sup>3</sup> Real (RPI) appointee level

- The increase in number of customers receiving affordability and vulnerability support through the allowances made in the Draft Determination for Bristol. We also support Bristol's commitment to assess the quality of vulnerability 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:

- We welcome Ofwat's efficiency challenge to Bristol; 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 are 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 Bristol have doubts that they can deliver this plan then they should appeal the decision with the CMA.
- There is a risk that customers may not see any benefits from Ofwat's default cost of capital outperformance sharing mechanism. Ofwat has rejected Bristol's proposal for a premium, along with the associated benefit sharing mechanism the company proposed. Under Ofwat's outperformance sharing mechanism, customers may not see any benefits as the company does not propose to increase its gearing level to above 70%. We would like to see a greater commitment to share any benefits of financial outperformance with customers.
- Ofwat's reduction in Bristol's proposed commitment to improve resilience to supply interruptions in population centres of greater than 10,000 in relation to the delivery of the Glastonbury to Street scheme. Ofwat's intervention will mean the scheme will benefit only a localised population,

rather than the larger number, more widely spread, originally planned. We ask Ofwat to review this at Final Determination.

- 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 ODI penalty rates for some Performance Commitments are stronger for areas of service that are lower customer priorities in the company's business plan research (e.g. reducing mains bursts). While we support companies being incentivised to avoid failure, there is a risk that the company may be incentivised to focus on some more potentially punitive ODIs at the expense of other customer supported service improvements.
- The complaints measure within the Customer Experience Performance Commitment (C-MeX), which should be strengthened to help ensure that Bristol is incentivised to continue improving its complaint handling performance.

## Section B - Our detailed comments

### Customer acceptability

8. 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. CCWater commissioned DJS Research to carry out interviews with a representative sample of 500 customers from each water company to test the acceptability of Ofwat's Draft Determinations.
9. Our Draft Determination research found that:

- 91% of Bristol Water customers found the Draft Determination proposals either “acceptable” or “very acceptable”<sup>4</sup> on an uninformed basis.
  - 92% of Bristol Water customers found the package “acceptable” or “very acceptable” on an informed basis, when a summary of key service improvements was presented to them.
10. Given this high level of acceptability, it is important that Ofwat and companies 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 82% when they were presented with the potential impact of ODIs on their bills over the period. This shows that there remains a risk that some 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 react to a price determination. The average customer does not receive very much information about the price review outcome.
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 reduce by 7%<sup>5</sup> after inflation (15.5% in real terms) over the period 2020-25, compared to the 6% real terms decrease proposed by the company in its Business Plan. This would see customers receive a bill reduction of around £27 in 2020-21, with bills increasing by inflation only for the

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<sup>4</sup> Top line findings from DJS Research 23 August 2019

<sup>5</sup> Based on a forecast assumption of 2%pa CPI-H

remainder of the five-year period. The fall in bills comes because of Ofwat's reduced cost of capital estimate, increased efficiency savings, reduced cost allowances - particularly on resilience, and Ofwat's rejection of Bristol's claim for the small company premium - to offset potentially higher borrowing costs.

15. Ofwat's figures do not include inflation or 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. We remain concerned about the impact that inflation and ODI payments could have on the bills actually paid in future.
16. The research conducted by Bristol Water in developing its business plan found customer support for a bill profile that ensured stability of charges over the period of the plan. The Draft Determination broadly reflects this customer expectation as it follows a similar bill profile to that proposed by Bristol, with a large reduction in year one followed by level bills through to 2025. In our acceptability testing research, 90% of customers surveyed found the bill profile 'acceptable' or 'very acceptable'

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

17. An independent study commissioned by CCWater<sup>6</sup> has recommended a range for the WACC between 1.7% to 2.3%<sup>7</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 current market evidence suggests the cost of capital may be even lower when Ofwat comes to final determinations of price limits.
18. We note that Ofwat has rejected the company's proposals for the inclusion of a small company premium based on an assessment against three areas: level of

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<sup>6</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>7</sup> Real (RPI appointee level)

uplift, customer benefits and customer support. We would urge Ofwat to only include an uplift to the WACC at final determination should the company's evidence be compelling. We would also ask that where companies do not deliver their commitments to customers and it is clear that customers have not been compensated for the increased cost of the small company premium, Ofwat should consider clawing back the small company premium.

19. We note Ofwat's intervention to require Bristol to adopt its default cost of capital outperformance sharing mechanism. Bristol's proposed benefit sharing mechanism was dependent on it being given a small company premium for the WACC, which Ofwat rejected. While we welcome the opportunity for customers to share in the benefit of any outperformance on cost of capital, we note the company does not propose to increase its gearing level to above 70%. This means that the mechanism may not deliver any benefit sharing to customers. We would like to see a greater commitment to share any benefits of financial outperformance with customers.

#### Cost efficiency

20. We welcome Ofwat's challenge to all companies on efficiency. 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.
21. 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.
22. Meeting the required efficiency savings (of £70m), whilst also not being awarded cost adjustment claims, is likely to be a challenge for the company.
23. 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.

24. We would not want to see Ofwat's challenge to Bristol 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 Bristol have doubts that they can deliver these commitments then they should go to the CMA.

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

25. 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 increased PAYG slightly from 72.71% to 74.17% - slightly more revenue to be collected in 2020-25 from customers' bills to reflect greater proportion of short term operating costs in totex allowance.

#### Future uncertainty

26. We note that the Draft Determination includes a 'notified item' which allows Bristol to reopen the price control in 2020-25 if currently uncertain costs emerge associated with abstraction from the Sharpness and Gloucester canal. Given the uncertainty, we agree with this approach as, including this in the price determination may mean customers are paying for company expenditure that may not be required for some time, if at all.

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

27. Overall, we are reasonably satisfied that Bristol Water's resilience strategy appears to address the priority resilience issues for current and future customers. Bristol Water has seen some operational events in recent years, which illustrate the importance of improving the long term resilience of its network, which is reflected by the proposals in the company's Business Plan.

28. However, we have some concerns with the following:

- Ofwat has increased Bristol's target for reducing mains bursts (increasing mains repairs). Alongside this, Bristol has a stretching improvement in its supply interruption performance where it has performed poorly in recent years. There

is a danger that these two commitments could conflict and that the setting of ODI underperformance rates could incentivise the wrong behaviour in delivery.

- Ofwat has intervened to change a number of resilience-based commitments. It has narrowed Bristol's proposed commitment to improving resilience to supply interruptions in population centres of greater than 10,000 in relation to the delivery of the Glastonbury to Street scheme. While this delivery is important, it will benefit only a localised population rather than the larger number, more widely spread, originally planned. We are concerned that customers who will not now benefit from the original proposal will be disappointed as Bristol Water customers viewed future resilience as a priority in the company's business plan research. We ask Ofwat to review this at Final Determination.

29. 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

30. Overall, we consider Bristol Water's Performance Commitments as set out in the Draft Determination to be stretching, broadly reflective of customer priorities and developed based on extensive evidence of customers' views collected during the development of the Business Plan. The PC package was also developed in response to the Initial Assessment of Plans (IAP) and challenge through the Bristol Water Challenge Panel (BWCP), its PR19 Customer Challenge Group (CCG).

31. However, we have a concern with Ofwat's intervention to increase the target in reduction in mains bursts. This area of service was not identified as a customer priority in Bristol's research in preparing the business plan. We would be disappointed if this increased target had a negative impact on the company's delivery in other areas, such as reducing supply interruptions, which are a higher priority for customers.

32. Ofwat has also increased on the company ambition for reducing Per Capita Consumption (PCC) - from 5% to 6.3%. We agree with this intervention as encouraging consumers to value water is vital and that in using it wisely, PCC can be reduced. We recognise that this will give Bristol a greater challenge in educating customers to reduce their usage, especially given the real terms reduction in its cost over the period.

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

33. 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. We remain concerned that there may be insufficient weighting given to a company's complaints performance so that companies may not face 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.

34. We highlighted concerns about Bristol Water's complaints performance in our Complaints Report in September 2018. While we have been reassured by the action plan the company put in place and have seen improvement, we note Ofwat's cautious approach to evidence of Bristol's improvement ahead of its Final Determination, and would like to see Bristol receive a target in its C-MeX Performance Commitment that helps to drive further improvement.

#### Outcome Delivery Incentives (ODIs)

35. The ODIs mechanism has the potential to increase bill volatility - through the impact of outperformance or underperformance payments - and drive company behaviours. Research by Bristol showed that while customers understood the mechanism and were generally supportive of the idea behind it, they favoured a package of small incentives rather than any that resulted in large outperformance or underperformance payments. Customers considered underperformance payments counter-productive and would rather the company addressed the underperformance than were financially penalised for it.

36. Our research on the acceptability of the Draft Determination package also shows that customer acceptability drops by 10% when customers were asked to consider the potential bill impact of ODIs.
37. 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 £3.9m, compared to the potential rewards of £0.3m).
38. We also welcome the further protections for customers introduced by Ofwat and Bristol:
- 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.
  - The company's proposal to limit bill changes due to ODIs to £4 in any year to help manage bill volatility.
39. 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 Bristol customers' limited support for the potential impact of rewards, there remains a risk that a number of customers do not support the potential impact of ODI outperformance payments on bills.

## **Affordability & Vulnerability**

### Affordability

40. Our most recent [Water Matters research](#) found that 81% of Bristol Water customers considered their current charges to be affordable. The Draft Determination sets a greater reduction in bills to that proposed by Bristol Water in its Business Plan. Our acceptability testing research shows that 85% of Bristol customers surveyed consider the 2020-25 bill profile to be affordable, so if the Final Determination

reflects the same bill profile, the Draft Determination will potentially increase the level of affordability for customers.

41. We welcomed the company's business plan commitment to ensure none of its customers are in water poverty and would encourage the company to meet this even though Ofwat has removed this bespoke Performance Commitment in the Draft Determination.

42. In addition, we support the Draft Determination requirements for Bristol Water to:

- Increase the number of customers that receive support through social tariffs and WaterSure from around 17,000 in 2019-20 to 25,000 by 2024-25;
- Seek support from its customers to meet its ambitions on delivering social tariffs, as the company will need to increase its cross-subsidy from the current £1.75 to £2.12 before 2024-25.
- Continue to provide direct funding to debt advice partners who assist its customers;
- Undertake data mapping to better understand risks to customers in vulnerable circumstances and provide a more tailored service.
- Improve customer views of value for money; and
- Maintain high satisfaction among customers receiving vulnerability assistance.

43. However, we believe companies still need to do more to resolve the affordability problem. Across the industry, there will still be more than 1 million customers who are in need of assistance who will not be receiving it, even after the improvements companies are making.

#### Vulnerability

44. We are pleased that Ofwat has introduced a common PC in this area, something CCWater called for in our response to the PR19 methodology. However, Ofwat's common PC based on increasing the number of customers on companies' Priority Services Registers (PSR) could drive a focus on

numbers rather than the quality of assurance provided. We want to ensure that help is meaningful and satisfactory for customers.

45. Therefore, we are pleased that the Draft Determination includes Bristol's commitment to measure the satisfaction of customers on the PSR. We also feel that customers receiving the support (and/or their representatives) are in the best position to advise on whether the help is meaningful and there should be more focus on establishing and measuring this.
46. However, we feel that there should be more focus on identifying and delivering support to customers in transient vulnerability circumstances. It is important that customers receive support when they need it and that they are satisfied with the assistance provided. Raising general awareness, particularly within the advice sector, of the support available is crucial so that customers know what help is available for them to 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.

#### **Other key company specific issues**

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

48. We note the £4.5m allowed to deliver the company's obligations under WINEP for schemes designated as 'green'. We accept that 'green' status statutory schemes are based on robust evidence of the company's environmental impacts and/or risks. It is important that customers see tangible improvements to the environment from the delivery of this programme. We expect any schemes included in the programme at Final Determination to be cost effective and based on robust evidence of the company's environmental impacts.

## Population Growth

49. We note the differing sources of evidence of population growth forecasts used by Ofwat and companies. As this can be a significant driver of both costs and revenue, Ofwat needs to ensure that its Final Determination allowance reflects the most robust forecast.

## Other general issues

### Innovation

50. We understand that Ofwat is considering an additional revenue adjustment for the Final Determinations, to allow companies' additional costs to invest in further innovation. CCWater considers 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.

51. 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.

52. 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.

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

## Developer Services Experience (D-MeX)

54. While CCWater has 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 Performance Commitment 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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