Ofwat: Draft 2020-25 price control determination for South Staffs Water, incorporating Cambridge 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 South Staffs Water (SST). This response also contains our views on Cambridge Water (CAM). Collectively, in this response, we refer to the company as SSC.

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 SSC customers who were surveyed, 92%[1] of SST customers and 93% of CAM customers found the package to be either 'acceptable' or 'very acceptable' on an uninformed basis. 93% of SST customers and 90% of CAM customers found the package 'acceptable' or 'very acceptable', on an informed basis, once more detail of the service proposals were presented. Given this high level of acceptability for the price and service levels, 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.

4. Customer acceptability dropped to 88% for CAM customers and 76% for SST customers when customers were presented with the potential impact of Outcome Delivery Incentives (ODIs). This shows that there remains a risk that a significant number of customers (particularly in South Staffordshire) do not support the potential impact of ODI outperformance payments on bills once this is fully realised. The company found that only 27% of customers surveyed supported the use of these incentives in its business plan research.

[1] Top line findings only from 23 August 2019

What we support

5. We support the following proposals in the Draft Determination for SSC:

   - The reduction in the Weighted Average Cost of Capital to 2.19%[2], 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.

   - The range of Performance Commitments, which we believe are stretching, reflect customer priorities and are based on robust customer evidence.

   - SSC's resilience strategy, which appears to address the priority resilience issues for current and future customers, reflecting evidence from the freeze /thaw event and hot/dry weather in summer 2018. This includes improvements to two water treatment works (Hampton Loade and Seedy Mill) in the South Staffordshire region.

   - We support the inclusion of the two water treatment works in the Compliance Risk Index (CRI) for water quality, but would prefer that any penalties are not applied until after the improvements are completed.

   - SSC's commitment to increasing financial support for customers who are struggling to pay by 31,000 in 2019-20 to 40,000 by 2024-25. While this is welcome, all companies will 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.

   - SSC's research to test customers' appetite to contribute to its social tariff 'Assure' beyond the £3 current contribution; and to support customers who need additional financial support due to a sudden change in circumstances.

What we have concerns with

6. We have concerns with the following:

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[2] Real (RPI) appointee level

- The bill profile set out in the Draft Determination. SSC customers preferred slightly higher bills at the start of the 2020-25 period and then a ‘flat’ bill profile to 2025, with less of a rise from 2026 for a smoother long-term bill. As the customer research by the company has been acknowledged by Ofwat as being of good quality, we would like Ofwat to review the current bill profile to reflect customers’ long term preference in the Final Determination.

- Any risks to the delivery of customer-supported Performance Commitments, service improvements or investment as a result of Ofwat’s cost efficiency challenge. While it is important to customers that SSC delivers its service efficiently, customer-supported commitments should not be reduced or deferred to meet this challenge. We expect Ofwat to ensure that its cost assessment is valid and allows customer commitments to be delivered.

- SSC’s potential application for an additional allowance in the Weighted Average Cost of Capital. Any allowance for a small company premium for SSC 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 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 inconsistency in sources of population growth forecasts in the business plan, the Water Resource Management Plan and the Draft Determination. It is important that a consistently-applied, robust forecast is used in the Final Determination.

- While we welcome the new common Performance Commitment to measure the number of customers on the company’s Priority Services Register, we would like SSC go further and measure the customer awareness of available assistance and the satisfaction of those who receive it. We want to ensure that help is meaningful for customers and would like to see companies go further than focusing solely on PSRs to ensure that all customers receive the support they need when in vulnerable circumstances (for example, in cases of transient or temporary vulnerability).

- The uncertainty implied by the exclusion of 'amber' schemes in the Water Industry National Environment Programme (WINEP) for SSC from this Draft Determination. While this means customers will not pay initially for something that may not be necessary, should these schemes go ahead this will impact customers' bills in 2025-30. The programme should be based on robust evidence of environmental impacts of the company's activities and deliver value for money to customers.

Section B - Our detailed comments

Customer acceptability

7. 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.

8. Our Draft Determination research found that:
   - 92% of SST customers and 93% of CAM customers found the Draft Determination proposals either "acceptable" or "very acceptable"[3] on an uninformed basis.

   - 93% of SST customs and 90% of CAM customers found the package "acceptable" or "very acceptable" on an informed basis, when a summary of key service improvements was presented to customers.

9. Given this high level of acceptability for the price and service levels, 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.

10. Customer acceptability reduced to 88% for CAM customers and 76% for SST customers when they were presented with the potential impact of ODIs on their bills over the period. This shows that, particularly for SST customers, there remains a risk that a significant number

[3] Top line findings from DJS Research 23 August 2019

of customers do not support the potential impact of ODI outperformance payments on bills once this is fully realised.

11. 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.

12. 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

13. The Draft Determination would see bills reduced by 8% after inflation[4] over the period 2020-25. The figure Ofwat published (a 17% 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.

14. The Draft Determination would see bills reduce by £14 in 2020, and then remain flat for the remainder of the period at £132 (after inflation is taken into account). Our acceptability testing research found that 91% of both SST and CAM customers found the year-on-year profile of average bills over 2020-25 to be 'acceptable' or 'very acceptable'.

15. However, we would like Ofwat to reconsider the bill profile as SSC customers showed a different preference in the company's research, which gave customers bill profile options in a longer term context. In SSC's research, customers considered 2020-25 bills in the context of what may happen at 2026 and beyond. Customers preferred a smoother bill profile in 2020-25 if this means lower bill rises in 2026 onwards.

[4] Based on an assumption of 2%pa CPI-H

16. The research conducted by SSC in developing its business plan found significant customer support for a bill profile that ensured stability of charges over the period of the plan. The company planned to absorb inflation, at an anticipated level of 2%pa, and keep customers' bills flat across the five-year period from 2020. SSC research following Ofwat's Initial Assessment of Plans (IAP) showed 80% of customers preferred the flat bill option (83% SST and 74% CAM) from 2020-25, compared to a bill that fell and steadily increased. This support was echoed by business customers.

17. In that same research, when looking at a 10-year period, customers were asked to consider three bill profiles:

- Option 1: the company could recover the costs more quickly so current customers would see a small increase in bills in 2020 then flat bills to 2025, with less of a rise from 2026 for smoother long-term bills.

- Option 2: the company could recover the costs more slowly, meaning current customers would see a small decrease in bills in 2020 then flat bills to 2025, but then bills would rise more steeply from 2026. This option had the biggest bill increase in 2026.

- Option 3: the company could recover the costs at a natural rate, meaning current customers would see flat bills with no increase between 2020-2025, but then bills would rise more steeply from 2026. This option had a slightly lower bill increase in 2026 than option 2.

18. The research showed that customers preferred Option 1: slightly higher bills at the start of the period between 2020-25 then flat to 2025, with less of a rise from 2026 for a smoother long-term bill. They least preferred Option 3, where bills dropped by the largest amount between 2020-25 followed by a greater increase in the next five years.

19. Customers surveyed by the company also showed scepticism about an initial drop in bills at the start of the five-year period. When asked their views on a variation in bills from one year to the next, the highest annual movement in bills that customers considered acceptable was £3.

20. Ofwat has viewed the research carried out by the company after the IAP as satisfactory, and the company's customer engagement strategy overall as 'B' (a high quality plan with evidence that overall is sufficient and convincing). In the light of the quality of customer engagement and the evidenced customer support for a flat bill, we are disappointed that Ofwat has not listened to what customers want in setting bill levels. We urge Ofwat to reconsider this.

Cost efficiency

21. 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.

22. The required efficiency savings (of £69m) are likely to be a challenge for the company. While it is important for customers that companies deliver services efficiently, we would not want to see Ofwat's challenge to companies putting in jeopardy the delivery of any well evidenced Performance Commitments, service improvements and/or investment that customers value. Such commitments to customers should not be removed or deferred just to reduce overall costs. Therefore, Ofwat should ensure that its approach to assessing required totex is valid and ensures there is an efficient delivery of services and improvements that customers have supported.

23. While it is the company's responsibility to ensure that its commitments to customers are delivered, it would not be in customers' interests for companies to defer or reduce maintenance or any commitments to customers in response to the regulatory cost efficiency challenge.

Weighted Average Cost of Capital (WACC)

24. An independent study commissioned by CCWater[5] has recommended a range for the WACC of between 1.7% to 2.3%[6], based on an analysis of water company financing, market evidence and financing assumptions in other regulated sectors.

[5] 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/

[6] Real (RPI) appointee level

25. 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 in December 2019.

26. We are aware that SSC is considering making a case to Ofwat for a small company premium. In order to help make a successful case, the company is conducting customer engagement to measure support for the proposed adjustment. Even if the research evidence provides the necessary customer support, if a premium is to be allowed, it is important that there is also compelling evidence to justify it, including assurance that the value of what the company will deliver to customers over 2020-25 at least matches the value of any additional premium. This should be measured as part of Ofwat’s assessment in three areas: level of uplift, customer benefits and customer support.

27. We would also ask that if a premium is allowed, and SSC does not deliver its commitments to customers, Ofwat should consider clawing back the small company premium.

<u>‘Pay as you go’ ratio (PAYG)</u>

28. 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.

29. We note that Ofwat reduced the PAYG ratio for SSC from 61.3% to 57.5%. SSC asked for a higher ratio for financeability purposes and to support its preferred bill profile. Ofwat’s Draft Determination says there is a lack of evidence to support the company’s preference. As the company may revisit this issue in its response to Ofwat, 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, taking into account evidence of customers’ preferred bill profile as explained in paragraphs 14 to 19.

Safe, reliable services: maintenance and long-term investment

30. In general, we are satisfied that SSC’s resilience strategy appears to address the priority resilience issues for current and future customers. Following the freeze / thaw event and

hot/dry weather in summer 2018, the company reviewed its resilience plans involving the work of consultants and co-creation with customers, which we welcome.

31. Ofwat has allowed £63m for increased resilience and improvement in water quality customer contacts at the company's two water treatment works in the South Staffs region, Hampton Loade and Seedy Mill, which we welcome. Investment by the company at the treatment works was supported by 77% of informed customers in qualitative research, and the company has included a Performance Commitment around the delivery of the scheme, which will return money to customers in the event of delays. This is particularly important given the criticism directed at SSC in the recent Drinking Water Inspectorate (DWI) report about water quality at Hampton Loade and Seedy Mill.

32. We note in its plan SSC proposed to exclude from the Compliance Risk Index (CRI) water quality target the resilience works at Hampton Loade and Seedy Mill during the period of investment. However, Ofwat has not agreed with this approach. We support Ofwat's Draft Determination that this be included in the CRI, but how this is applied, in terms of penalties, needs further consideration. This could be achieved in three ways:

- Exclude elements under direction from CRI calculations;
- Amend CRI when used to set the level of regulatory incentive; or
- Determine not to implement penalties until work on investment schemes is completed.

33. We believe the third option to be preferable and would like Ofwat to consider this prior to Final Determinations. It is important that penalties are not applied for the two treatment works under CRI as otherwise the company will be penalised twice until the upgrades are completed (by an ODI penalty and under the CRI mechanism). We question whether this is correct when the company is taking action to improve both water treatment works and has a Performance Commitment to help ensure the improvements are completed on time (2023 for Hampton Loade, 2024 for Seedy Mill).

34. We would like to see SSC deliver the required improvements to benefit customers on time, and consider that to help achieve this, penalties should only be applied if the company fails to fully achieve the improvements by the deadlines. The company has also made a promise to pay customers for any delays to the upgrades as part of its ODI package, which we support as additional protection for customers.

35. 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)

36. Generally, we consider SSC's Performance Commitments are stretching, reflect customer priorities, and were developed based on extensive evidence of customers' views collected during the development of the Business Plan. Upon explaining the PCs to its customers in business plan research, over three quarters of the customers surveyed by SSC found all of the company's promises (PCs) acceptable.

37. The Draft Determination has seen Ofwat set more challenging targets around reducing the average amount of water each customer uses per day (138 litres per day (l/d) to 135 l/d in 2025 for CAM), and changes to the under and outperformance levels for supply interruptions and burst mains. We support these changes to strengthen the customer supported PCs.

Outcome Delivery Incentives (ODIs)

38. SSC's business plan research revealed that only 27% of its customers supported the principle of using ODIs. Our research on the acceptability of the Draft Determination package shows that customer acceptability drops by 15% for SST customers when they were asked to consider the potential bill impact of ODIs. However, for CAM customers, 88% found the potential ODI bill impact to be acceptable. This shows that for SST customers, there remains a risk that a significant number of customers do not support the potential impact of ODI outperformance payments on bills.

39. 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 £1.8m, compared to the potential rewards of £1.13m).

40. 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.
- Ofwat's removal of arbitrary grading of ODI rates which the company had accommodated in its business plan. 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.

41. Following Ofwat's initial assessment of business plans (IAP), SSC carried out research to explore customers' views on new and amended PCs and how stretching they are. This revealed that reducing leakage and keeping bills affordable are consistent top priorities. We therefore welcome Ofwat rebalancing ODI rewards and penalties relating to the leakage ODI in both regions.

42. We note that for the PC for water mains repairs, SSC's target for 2019-20 will see the company among the top 'performers' in the sector (at 120 repairs per 1,000km), with a target to remain at this level through to 2024-25. The ODI applied to this PC could see the company attain a potential reward of circa £19,000. While this is a small portion of the potential reward in the ODI package as a whole, we question why the company should be offered a reward for static performance, albeit in the upper quartile.

43. It is also important that the availability of potentially more lucrative ODI outperformance rewards do not encourage any companies to pursue targets for some PCs at the expense of others, which may be equally important or valued by customers.

<u>Customer Experience Measure (C-MeX)</u>

44. 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.

45. However, we remain concerned that there may be insufficient weighting given to the complaints performance in this Draft Determination. This could lead to SSC not having sufficient pressure to improve its complaint handling performance. It may also be able to achieve a financial reward even where its complaint performance is static or declining.

Affordability & Vulnerability

Affordability

46. Our Water Matters research (2018) found that 79% of CAM customers and 79% of SST customers found their charges affordable, which is higher than the average percentage across England and Wales at 74%. This may reflect that the company's current water bills in both regions are some of the lowest of all water only companies in England. In terms of proposed bill levels for 2020-25 in the Draft Determination, 77% of CAM customers and 82% of SST customers thought the bill profile is affordable.

47. This leaves a number of customers who consider that they either struggling to pay now or may do so in the future. Therefore, we support the company's commitment in its plan to increase the number of customers receiving financial support by 31,000 in 2019-20 to 40,000 by 2024-25.

48. We also welcome the research that is currently underway by SSC to test customer appetite to contribute to its social tariff 'Assure' beyond the £3 current contribution, and get views on the adoption of a two-tiered scheme of 'Assure' to support customers with a sudden change in circumstances that are in urgent need of additional financial support over a short period.

49. SSC has also carried out extensive engagement both during its 'hard to reach' customer engagement and in its social tariff research to ensure that Performance Commitments are shaped around customers' wants and needs.

50. 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.

Vulnerability

51. SSC has committed to Ofwat's strengthened PCs around adding more customers to the Priority Services Register (PSR).

52. While we welcome the new common PC to measure the PSR, we are concerned that a PC target to increase numbers on priority services can drive the wrong behaviours. We want to ensure that help is meaningful for customers and would like to see companies go further than focusing solely on PSRs to ensure that all customers receive the support they need when in vulnerable circumstances (for example, in cases of transient or temporary vulnerability such as during a water supply interruption).

53. We also feel that those customers 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.

54. We expect retailers and wholesalers to collaborate to identify any non-household consumers who need additional support. We will monitor what help consumers are signing up for and will also liaise with companies to understand which consumers who would benefit from being on the PSR may be missing out.

55. Following the IAPs, we challenged Ofwat's proposed vulnerability PC requiring companies to contact 90% of customers 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 customer and the company? In the DDs, Ofwat has provided reporting guidance on what "contact" means and has also split the data checking PC into two parts:

- % of customers attempted to contact to check data = 90%
- % of customers actually contacted to check data = 50%

We support this as a sensible move.

Other key company issues

Water Industry National Environment Programme (WINEP)

56. CCWater is concerned that the 'amber' schemes in the Water Industry National Environment Programme (WINEP) for SSC have not been included in this Draft Determination, which is a different approach compared with two 'Fast Track' companies.

57. We understand that this means customers will not pay initially for something that may not be necessary. However, if they all go ahead as the Environment Agency (EA) expects, this will impact customers' bills in 2025-30. Whilst we are assured by the company that this will have a minimal impact on customers' bills, we continue to urge Ofwat and the EA to

ensure that schemes that are included in the programme are based on robust evidence of water company environmental impacts and demonstrate value for money for customers.

Population Growth

58. The company's business plan proposed including a requirement to meet the needs of a growing population, particularly in the Cambridge region, which was informed by Local Authority (LA) forecasts and were in line with the company's Water Resource Management Plan. In the Draft Determination, Ofwat has used ONS estimates of population growth. This has resulted in a reduction of 20,000 in the number of new connections forecast in the company's region, which raises a number of concerns:

- Use of different growth projections in two separate public regulatory documents;
- The SSC Customer Challenge Group had already expressed concern about the projected growth in CAM and the impact on water resources based on LA projections; and
- The risk of SSC not delivering adequate enhancement to the public water supply.

Other general issues

Innovation

59. 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. 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.

60. 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.

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

Developer Services Experience (D-MeX)

62. 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?

63. 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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