



Ofwat: Draft 2020-25 price control determination for Thames 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 Thames Water.

Section A - Executive Summary

Customer Acceptability

2. 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's research into the acceptability of the Draft Determination (DD) found that 86% of Thames Water customers surveyed thought the proposals were acceptable (uninformed acceptability based on bill change from 2020 - 2025), indicating a high level of acceptability from customers. Further details on our research can be found below.

What we support

3. We are supportive of the following aspects of the DD:
 - The reduction in the Weighted Average Cost of Capital to 2.19%¹, 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.
 - We welcome Ofwat's efficiency challenge to Thames. While 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.

¹ Real (RPI) appointee level

- However, we do not want customer-supported Performance Commitments (PCs), service improvements or investment removed or reduced because of this challenge. We therefore expect Ofwat to reassure us that its models have validity and if Thames Water has doubts that it can deliver this plan then it should appeal the decision with the CMA.
- That Ofwat has challenged Thames Water to go further to help those customers who are most in need.

What we have concerns with

4. We are concerned about the following issues:
 - The lack of weighting given to complaint performance within the customer experience measure (C-MeX) which could see companies achieving rewards for static or declining performance.
 - The potential impact of Outcome Delivery Incentives (ODIs) on bills, particularly where there is not strong customer support for the principle.
 - The deliverability of Thames Water’s package of Performance Commitments given the company’s current performance.

Section B - Our detailed comments

Customer acceptability

5. 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. Our DD research found that a high proportion of Thames Water’s customers think that the DD proposals are acceptable. 86%² of uninformed customers and 86% of informed customers said the plan was either “acceptable” or “very acceptable.”

² Unweighted topline figures as of 23 August 2019. Figures may change slightly in the final report.

6. 74% of customers found the potential impact of ODIs on their bills over the period to be acceptable. While the majority of customers found the package acceptable, this still shows that over a quarter of customers do not. This is also a 12% decrease to the levels of acceptability achieved by the “base” plan. This highlights the potential for there to be a customer backlash against the impact of ODI outperformance payments on bills once this is fully realised.
7. We give a higher weight to uninformed acceptability scores than informed because this is a better reflection of how the majority of customers will react to a price determination. The average customer does not receive very much information about the price review outcome.
8. These top-line findings give an indication of customers’ feelings about the DD. 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 DD acceptable or unacceptable:
<https://www.ccwater.org.uk/research/category/price-reviews/>

Bill profile and cost efficiency

Bill profile

9. The DD would see bills reduced by 1% after inflation³ over the period 2020-25. Ofwat’s reported figure (a 10% 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 (FD) and beyond. The research conducted by Thames Water in developing its business plan found customer support for a bill profile that ensured stability of charges over the period of the plan. We know that customers value bill stability, so we believe Ofwat’s Final Determination should consider a smoother bill profile when forecast inflation is added in rather than the one currently proposed.

³ Based on an assumption of 2%pa CPI-H

10. In particular, the real increase between 2020-21 and 2021-22 under the DD at 2.7% is higher than the comparable increase of 1.9% from the company's April resubmission. However, we note that there is a modest re-profiling of bills and that Ofwat has reflected underperformance on leakage and security of supply which lowers bills in 2020-21 and 2021-22.

Weighted Average Cost of Capital (WACC):

11. The cost of capital has a large impact on customer bills. An independent study commissioned by CCWater⁴ has recommended a range for the WACC of between 1.7% to 2.3%⁵, based on an analysis of water company financing, market evidence and financing assumptions in other regulated sectors.
12. We note that for the slow track and significant scrutiny DDs, 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 its final determinations of price controls.

Cost efficiency challenges, categorisations and benefits sharing

13. 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 are unacceptable to them.
14. There is much in Thames Water's DD that is good news for customers including: more stretching performance targets, lower bills, and stronger penalties for poor performance. However, there is a significant gap between Ofwat's revenue allowance and Thames Water's business plan proposal (largely driven by Ofwat's efficiency challenge and the cost of capital).

⁴ 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/>

⁵ Real (RPI) WACC appointee level

15. 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 also seek assurance that its monitoring regime will give early warning if companies do start taking short or long-term operational risks.
16. Through our involvement in the company's Customer Challenge Group (CCG), we are aware that Thames Water does not believe that the DD, as it stands, is deliverable and has therefore proposed, by way of compromise, an alternative lower cost plan for Ofwat to consider. This alternative plan does not appear to deliver some key performance and investment commitments made to customers and stakeholders during the engagement on the business plan. It has also not been tested with customers.
17. The company identified in its resubmitted business plan in April 2019, the view that, *"additional performance stretch, together with reduced budgets, can only increase delivery risk on our operation"*. We are therefore concerned that the company's response to the DD has been to scale back its ambition by proposing the alternative plan that removes or reduces customer-supported schemes that are designed to help deliver the longer term resilience of water and wastewater services.
18. We would not want to see Ofwat's challenge to Thames Water 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. If Thames Water has doubts that it can deliver these commitments then it should go to the CMA.
19. We agree with Ofwat that Thames Water's proposed gearing benefit share mechanism did not provide as much protection as Ofwat's default mechanism. We therefore welcome the inclusion of the default mechanism in the DD.

20. We note that following its Initial Assessment of Plans (IAPs), Ofwat was considering for 'significant scrutiny' companies:
- i. Modified cost-sharing rates whereby the company would keep only 25% of cost outperformance and bear 75% of cost underperformance.
 - ii. Potentially capping ODIs on bespoke PC outperformance.
21. We welcome the clarity that Ofwat has provided in the DD that sets out the steps the company needs to take before Ofwat is able to conclude that a reduced cost sharing rate should not apply.

'Pay as you go' ratio (PAYG)

22. We note that Ofwat has slightly increased the PAYG ratio for Thames from 40.9% to 42.2%, increasing short term revenue to improve the financeability of the determination. Any benefit to the company from financeability adjustments should also help ensure commitments to customers are delivered, and not have an implication that revenue may need to increase (at customers' expense) at future price controls.
23. However, Ofwat should be clear in the FD that the PAYG ratio strikes the appropriate balance of cost recovery from current and future customers.

Safe, reliable services: maintenance and long-term investment

24. It is disappointing given the company's performance that Thames Water has not demonstrated that it has a good understanding of the condition of its assets and to be able to demonstrate how specific investments mitigate quantified levels of risk.
25. We recognise that maintaining assets can be a combination of reactive and proactive activity and the challenge for Thames Water is to develop a robust mains replacement programme focussing on the most vulnerable parts of the network within the context of the price controls set by Ofwat. We urge Ofwat in its FD to only include expenditure where there is a clear line of sight between the investment and outcome.

26. 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.

Strategic Regional Water Resource Solutions

27. We are supportive of initiatives to improve the security of water resources, including water supply transfers, as long as they deliver best overall value for customers and are cost effective. We agree that water companies should work together on strategic solutions in the context of the National Water Resources planning framework.
28. In this context, we welcome Ofwat's decision to fund the exploration of strategic regional water resource solutions, including the River Severn to River Thames transfer and the strategic Abingdon reservoir.
29. More needs to be done to clarify how water transfer schemes will be funded, remunerated and how such arrangements will be regulated in a way that benefits all customers and avoids introducing any cross-subsidy between customer bases.
30. Customers from 'exporting' regions should not be expected to bear any undue costs associated with the planning or implementation arrangements required to facilitate a future transfer of water from their region to others. However, we are reassured that there will be a mechanism that allows money allocated to this work to be returned to customers if a scheme does not proceed.

Outcomes - Performance Commitments and Outcome Delivery Incentives

Performance Commitments (PCs)

31. While we welcome more stretching PCs, we have concerns about the deliverability of some of them in view of the company's current performance. In particular, a 25% reduction in leakage from 2019-20 levels. Whilst this would take Thames Water to the upper quartile leakage performance, is a significant stretch that Ofwat acknowledges is the most ambitious in the sector.

32. While we - and the company's customers - wish to see a step change in the company's leakage performance, given the company has not been able to hit its more modest targets in the current 2015-20 price control period, the proposed more stretching target seems unlikely to be achieved without a materially different approach. We know that the company will be arguing that they cannot deliver a 25% reduction without more funding so has included the 20% reduction in its lower cost plan.
33. It is important that the company gives leakage high priority and is able to make the improvements that are necessary. As such, we welcome Ofwat's call for Thames Water to provide an action plan with its DD response, which will hopefully set out how it plans to achieve the leakage target. Whatever leakage reduction target is finally agreed, Ofwat needs to be certain it is deliverable and Thames Water must ensure it is delivered.
34. We note and welcome Ofwat's more stretching PCs for Per Capita Consumption, water supply interruptions, internal sewer flooding and blockages. However, we do have concerns about the deliverability of the package in view of the company's current performance and the impact on customers if the company fails.
35. For example, we note that Ofwat has imposed a more stretching PC for unplanned outages at water treatment works. In view of the company's current performance, (Ofwat notes that it is both worse than the median level and worse than all other companies), Ofwat has allowed Thames £77m in in the price control to achieve this more stretching performance. In the event of underperformance, we would like to understand how this additional funding will be treated given that it appears to exceed any penalty for underperformance.

Customer Experience Measure (C-MeX)

36. 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. As Thames Water has had issues with poor performance on complaints in the past, we remain concerned that there may be insufficient weighting given to complaints performance in this DD. This could lead to Thames Water not facing sufficient pressure to improve its complaint handling performance.

Mains Repairs/Bursts PC

37. We note that in its DD, Ofwat is now consistently using the common PC description of Mains Repairs, rather than Bursts. During business plan preparation, we accepted that the more proactive approach needed to meet the welcome target for leakage reduction would be likely to lead to an increased number of repairs being required.
38. However, a leakage reduction strategy should include other activities such as mains relining and replacement, as well as repairing bursts. We would like to see any initial 'spike' in the mains repairs PC target to reduce over time as the network becomes more stable and as the company, in the longer term, undertakes other activities to achieve its leakage target.
39. The DD proposes that both reactive and proactive mains repairs are monitored but that the PC and ODI are for the combined value. Ofwat needs to ensure that companies are not disincentivised to find leaks on mains proactively if a company is at or close to its PC target due to the number of customer-reported bursts/repairs.

Outcome Delivery Incentives (ODIs)

40. Thames Water's deliberative research on the principle of using financial incentive outperformance payments showed a lack of support from customers. In our customer acceptability research, support for Thames Water's overall Business Plan also decreased when ODIs were introduced. This reveals that the use of ODIs has a risk of a negative customer reaction if customers do not support the use of these financial incentives, and outperformance payments lead to bill increases.
41. We note that Ofwat has strengthened incentives for Thames Water to achieve its PCs by increasing the ODI penalty rate to -3.27% from -1.61% (while also reducing the rewards from +0.87% to +0.53%). While this reduces the scope of outperformance rewards, we believe that the evidence Thames Water has collected shows that customers have concerns about the principle of companies receiving financial rewards for delivering services and about the impact this may have on bills.

42. We remain concerned that the ODI mechanism enables bill levels to be significantly higher than those set out in Ofwat's FD. We are pleased there is to be an overall cap on the ODI package with a sharing mechanism if this is breached.
43. However, we have a concern with the incentive for the Performance Commitment for sewer collapses. Thames Water's 2019-20 target is the same as the 2024-25 target of four sewer collapses per 1000km of sewer. Only two other companies have rewards for this PC but only one other is rewarded for static performance. Whilst this only accounts for just over 3% of the overall common ODIs, we do not think it is appropriate for the company to be rewarded with no stretch even if their performance is already good.
44. 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.

Uncertainty mechanisms:

45. Thames Water indicated in its April business plan resubmission that customers "*supported the use of incentives to deal with uncertainties around planning for the future*". We note that Ofwat has not allowed Thames Water's proposed uncertainty mechanisms covering the first phase of the North East London resilience scheme and some small elements of the Water Industry National Environment Programme (WINEP). We agree that it is appropriate for companies to carry these business risks.

Affordability & Vulnerability

Affordability

46. While we are happy to see progress being made to support customers who are struggling to pay we believe companies still need to do more to deliver the step-change in this area that is needed. Across the industry, there will still be more than 1 million customers who are in need of assistance but not receiving it, even after the improvements companies are making.

47. Our [Water Matters research](#) (2018) found that 71% of Thames Water customers found their charges affordable. However, in our acceptability research only 65% of customers thought their charges were affordable. In this regard we note that Thames Water customers support a cross-subsidy of £11 per customer, but the company only plans to spend £5.50. We agree with Ofwat that Thames Water needs to go further to help those of its customers who are most in need.
48. The DD will see Thames Water increase its social tariff take-up to 200,000 customers by 2025 (driven by a bespoke PC). However, while we are happy to see progress being made to support customers who are struggling to pay, we believe Thames Water still needs to do more to deliver a solution to their affordability problem. 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 that companies are making.

Vulnerability

49. CCWater believes that in order to get a good picture of how a company is performing in providing services for customers in vulnerable circumstances they must measure awareness of the help that is available and satisfaction with the service being provided. We are pleased that Ofwat has introduced a common PC to track progress with Priority Services Registers (PSRs), something CCWater called for in our response to the PR19 methodology. However, we believe that there is the potential for a target that focusses solely on numbers to drive the wrong behaviours.
50. We would like to see Thames Water go further 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). It is important that customers receive support when they need it and that they are satisfied with the assistance provided. To support this, it is crucial that companies raise awareness of the support available so that customers know what help they can access.
51. While we welcome the new common PC to measure the number of customers on the Priority Services Register (PSR), we are concerned that a PC target to increase numbers on priority services can drive a focus on numbers rather than the quality of assistance provided. We want to ensure that help is meaningful for customers.

52. We 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). This particular issue came out of the Freeze/Thaw event.
53. We also feel that those 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. To support this, we would like to see a measure of customer satisfaction with services in the FD, as proposed by some other companies.
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.
55. We will also liaise with companies to understand which consumers who would benefit from being on the PSR may be missing out.
56. Following the IAP, 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.
57. However, we know that Thames Water, having consulted with other utility providers, feels that the 50% actual contact rate is unlikely to be achievable. We therefore seek clarification on what advice Ofwat has sought on this matter.

Other key company specific issue

Thames Tideway Tunnel (TTT)

58. Although the TTT is subject to a separate price control, we welcome both Ofwat and the company's efforts to be transparent about the associated costs and how these impact on Thames Water's wastewater bills.

Smart metering programme

59. We note that the while draft price controls reflect the inclusion of a further 600,000 smart meters (relative to the company's revised plan of c.700,000), the allowance in price limits is less than the company proposed. This is in view of Ofwat's efficiency challenge and rejection of some of the company's cost adjustment claims. We also note that its common PC on Per Capita Consumption has been tightened to reflect the metering programme. Thames Water also has bespoke PCs on replacement and installation of smart meters in London.
60. We support the challenge made by Ofwat on efficiency. CCWater does not wish to see the company cutting back or cutting corners on this programme especially in areas such as helping customers through the transition process. Through the CCG, Thames Water has assured us that its metering programme is unchanged under both the DD and the 'lower cost' plan it has proposed in response.

Water Industry National Environment Programme (WINEP)

61. The company's commitments under WINEP has been largely supported by Ofwat with some efficiencies sought. Customers value the environment and are largely supportive of Thames Water's strategy.

Population Growth

62. We note that there are differing sources of evidence of population growth forecasts used in DDs, Water Resource Management Plans and companies' business plans. As this can be a significant driver of both costs and revenue, Ofwat needs to ensure that its FD allowance reflects the most valid forecasts, and ideally be consistent with those used in other water industry planning processes.

Other General Issues

Developer Services Experience (D-MeX)

63. While we welcomed the introduction of new measures designed to improve developer experience with Thames Water, we have some questions about how this will operate:
64. 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?
65. 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?
66. According to the Outcomes and PCs 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 Thames Water has higher charges, it could achieve higher rewards. Conversely, if Thames Water 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?

Innovation

67. We understand that Ofwat is considering an additional revenue adjustment for the FDs, to allow Thames Water additional costs to drive further innovation.
68. We consider it essential that the industry should be looking for new and better ways to think and operate on a continuous basis. We welcome Thames Water finding innovative ways to effectively and efficiently address the challenges facing the sector and its consumers, including climate change; aging assets; a growing population; and changing consumer expectations.

69. Thames Water should also deliver innovative methods of delivering services that have a tangible positive impact on consumers; for example, in areas such as service quality, affordability and vulnerability.
70. However, we question why additional revenue (that customers will pay for) is needed to encourage greater innovation. This is especially the case if Thames Water is also challenged to be more efficient. A DD 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.
71. More collaborative working between the appointed companies to identify and share good practice would also help achieve this aim.

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