



Ofwat: Draft 2020-25 price control determination for Wessex 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 Wessex 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 Wessex Water customers who were surveyed, 91%¹ found the package to be either 'acceptable' or 'very acceptable' on an uninformed basis. 87% of Wessex customers found the package 'acceptable' or 'very acceptable' on an 'informed' basis, once more detail of the service proposals was presented. Given this high level of acceptability for the price and service levels, it is important that Ofwat and Wessex Water ensure that the Final Determination continues to deliver a package that allows customers' priorities to be delivered at a price that they accept.
4. However, customer acceptability drops to 77% when customers were presented with the potential impact of Outcome Delivery Incentives. This shows that there remains a risk that a number of Wessex Water customers do not support the potential impact of ODI outperformance payments on bills once this is fully realised.

What we support

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

¹ Top line findings only from 23 August 2019

- The proposed average bill decrease of 6% after inflation², along with a ‘smoother’ bill profile, which the majority of customers support. Given the comparatively high charges of Wessex Water, our research shows the majority of customers surveyed found this reduction to be acceptable.
- The reduction in the Weighted Average Cost of Capital to 2.19%³, 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 application of Ofwat’s gearing outperformance sharing mechanism, which should help mitigate against bill volatility and directly benefit customers.
- Ofwat’s efficiency challenge to Wessex Water. 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 its models have validity and if Wessex Water has doubts that it can deliver this plan, then it should appeal the decision with the CMA.
- The range of Performance Commitments, which we believe are stretching, reflect customer priorities and are based on robust customer evidence.
- Ofwat’s interventions to increase Performance Commitment targets in some resilience-related areas of service; notably a substantial increase in mains repairs (from 1.25 to 12%) and a 28% improvement in respect to sewer collapses.

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

³ Real (RPI) appointee level

- Wessex Water’s commitment to increase the number of customers receiving financial support from 43,000 in 2019-20 to 86,000 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.

What we have concerns with

6. We have concerns with the following:

- 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 ODI ‘enhanced’ incentive reward available for Wessex Water’s targeted performance for internal sewer flooding. The level of ‘stretch’ in performance is the lowest in the sector, so we question whether the potential high reward for this measure can be justified, even though this is an area of service customers view as a priority.
- It is important that the availability of potentially more lucrative ODI outperformance rewards or the risk of substantial underperformance penalties 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. All companies must demonstrate delivery of exceptional performance in areas of service customers value .
- The potential for Wessex Water customers to bear any costs associated with planning or implementing arrangements to enable the future potential transfer of water from the region to others. While we support the consideration of water transfers as part of a wider water resource strategy, 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.

- While we support the inclusion of a new measure on Priority Service Registers for consumers in vulnerable circumstances, we would like to see Wessex Water (and other companies) do more to measure the consumer awareness and satisfaction of assistance for vulnerable consumers, and ensure that all customers receive the support they need when in vulnerable circumstances (for example, in cases of transient or temporary vulnerability).

Section B - Our detailed comments

Customer acceptability

7. It is vital that customers find the outcome of the price review acceptable, to improve their 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.
8. Our Draft Determination research found that 91% of Wessex Water customers surveyed think that the Draft Determination proposals are either "acceptable" or "very acceptable"⁴ on 'uninformed' basis. This reduces slightly to 87% on an 'informed' basis (when customers are presented with key service improvements proposed in the Draft Determination).
9. Given this high level of acceptability for the price and service levels, it is important that Ofwat and Wessex Water ensure that the Final Determination continues to deliver a package that allows customers' priorities to be delivered at a price that they accept.

⁴ Top line findings from DJS Research 23 August 2019

10. 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.
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 reduce by 6% after inflation⁵ over the period 2020-25 (this is compared to the 5.9% real term decrease proposed by the company). The reduction in the average bill in real terms in 2020/21 is from £417 to £390 with bills remaining flat until 2024/25. The additional fall in bills comes as a result of Ofwat's reduced cost of capital estimate, increased efficiency savings, and reduced cost allowances - particularly on leakage, supply interruptions and reducing pollution incidents.
14. This figure does not include the impact of inflation or ODIs, and 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 customers actually pay in future.

⁵ Based on an assumption of 2%pa CPI-H

15. The Draft Determination follows a smoother bill profile to that proposed by Wessex Water, which would have seen a graduated increase to £430 in 2024-25. Our acceptability testing research shows that, when presented with the year-on-year average bill profile for 2020-25, 89% of customers surveyed found the profile 'acceptable' or 'very acceptable'.

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.
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 note that Ofwat has not allowed enhancement costs for commitments related to reducing leakage, and to reducing pollution incidents and water supply interruptions that the company must deliver at no additional cost to customers.
18. Meeting the required efficiency savings (of £237m) is likely to be a challenge for the company. We therefore want reassurance from Ofwat that the basis of its models are sound.
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 Wessex Water putting in jeopardy the delivery of any well-evidenced Performance Commitments, service improvements and/or investment that customers value. If Wessex Water has doubts that it can deliver these commitments then it should go to the CMA.

Weighted Average Cost of Capital

21. An independent study commissioned by CCWater⁶ has recommended a range for the WACC between 1.7% to 2.3%⁷, 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.

Outperformance sharing mechanism

22. Wessex Water proposed a sharing mechanism, which will invest 20% of net ODI payments in community projects and would cap any in-period outperformance payments to 2% of regulated equity. In its Draft Determination, Ofwat has intervened to require the company to also adopt its gearing outperformance sharing mechanism. However, we understand the company expects gearing to remain below 70% through the review period.
23. While we support Ofwat's intervention in that it could help mitigate against bill volatility and more directly benefit customers if gearing does increase, we would be disappointed if it reduced the company's commitment to investing in its wider community.

'Pay as you go' ratio (PAYG)

24. 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 47.3% to 47.5% - slightly more revenue to be collected in 2020-25 from customers' bills to reflect greater proportion of short term operating costs in totex allowance.

⁶ 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/>

⁷ Real (RPI) appointee level

Safe, reliable services: maintenance and long-term investment

25. Overall, we are reasonably satisfied that Wessex Water's resilience strategy appears to address the priority resilience issues for current and future customers. The Draft Determination has accepted many of the company's commitments related to resilience and increased targets in some; notably a substantial increase in mains repairs (from 1.25 to 12%) and a 28% improvement in respect to sewer collapses, both of which will be extremely stretching for the company. While we welcome the additional stretch, we note that an increased target to reduce mains repairs is counter intuitive when linked to a commitment to reduce leakage - which requires mains repair.
26. Although we support the changes to PC targets, we cannot be sure that Wessex Water has identified and highlighted all of the resilience risks. 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.

Water Transfer

27. We are supportive of initiatives to improve the security of water resources and would like to see more water supply transfers to help make this happen. We agree that water companies should work together on strategic solutions in the context of the National Water Resources planning framework.
28. We note Ofwat's additional allowance of £1.3m for Wessex Water to evaluate potential strategic regional water resource solutions in partnership with others, which could include a transfer to Southern Water.
29. However, 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. While the allowance in the Draft Determinations is to cover the initial assessment of possible solutions, Ofwat needs to provide more information on how this will benefit customers of both 'exporting' and 'importing' companies. We do not consider it appropriate that customers of Wessex Water should be

expected to bear any costs associated with planning or implementing arrangements to enable the future potential transfer of water from the region to others.

Outcomes - Performance Commitments and Outcome Delivery Incentives

Performance Commitments (PCs)

30. Overall we consider the PCs set out in Ofwat's Draft Determination for Wessex Water to be stretching, aligned with customer priorities and reflective of the evidence of customers' views established through the extensive engagement Wessex Water carried out during the development of its Business Plan.
31. We agree with the Draft Determination's acceptance of the company's proposed 15% leakage reduction PC target and the disallowance of enhancement expenditure as the company is not proposing to move beyond the industry's forecast upper quartile range and the associated revision to the associated ODI.

Outcome Delivery Incentives (ODIs)

32. Wessex Water's customer research evidence showed that customers have concerns about the principle of companies receiving financial rewards for delivering services, and the impact this might have on bills.
33. Our research on the acceptability of the Draft Determination package shows that customer acceptability drops by 14% for Wessex Water customers when they were asked to consider the potential bill impact of ODIs. 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.
34. 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 £26.6m, compared to the potential rewards of £24.5m).
35. In its Business Plan, the company proposed that any underperformance or outperformance above 2% return on regulatory equity (RoRE) is deferred until 2025

and added to the Regulatory Capital Value. We support Ofwat's intervention to set its standard sharing mechanism instead, where 50% of outperformance payments that exceed 3% of RoRE in any year are shared with customers through bill reductions in the following year. We believe this will give customers some additional protection against paying for any excessive outperformance payments.

36. We note that Wessex Water has a potential ODI 'enhanced' reward of £22.2m if the company exceeds its targeted performance for the common PC on internal sewer flooding. However, the level of 'stretch' in performance required to meet the 2024-25 target of 1.34 incidents per 10,000 sewer connections is the lowest in the sector due to Wessex Water's comparatively good performance at the 2019-20 starting point (1.6). We question whether this 'enhanced' incentive rate can be justified for the level of 'stretch' that has been targeted, even though this is an area of service customers view as a priority.
37. It is important that the availability of potentially more lucrative ODI outperformance rewards, or the risk of substantial underperformance penalties, 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. All companies must demonstrate delivery of exceptional performance in areas of service customers value.

Customer Experience Measure (C-MeX)

38. 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 the complaints performance in this Draft Determination. This could lead to Wessex Water not facing 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

39. Our [Water Matters research](#) (2018) found that 77% of Wessex Water customers considered their charges to be affordable. In our acceptability testing research, 76% of Wessex customers surveyed considered the profile of bills over 2020-25 affordable.
40. As this indicates that there are just under a quarter of customers who may struggle to pay, we welcome the package of commitments in the Draft Determination to help address affordability in its area, noting that comparatively, Wessex Water has amongst the highest charges in the industry. We support the Draft Determination commitments to:
- Increase the number of customers that receive support through social tariffs and WaterSure from around 43,000 in 2019-20 to 86,000 by 2024-25;
 - Introduce a free energy switching service to enable its customers to save money on energy bills;
 - Undertake 40,000 Homecheck water efficiency visits to help customers reduce their water use and their bill;
 - Continue to work with and fund third party debt advice partners;
 - Continue to support projects that improve financial capability to benefit a diverse group of customers.
 - Improve customer views of value for money;
 - Take 2,300 successful referrals per year from advice agencies for its affordability assistance schemes;
 - Maintain its British Standards Institution (BSI) standard for accessible services and its Customer Service Excellence Award; and
 - Increase the discounts given per 10,000 customers through its social tariff from £55,040 in 2019-20 to £87,029 by 2024-25.

This reflects the company's continuing commitment as an industry leader in this area, and the importance customers attach to these services.

41. 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 but not receiving it, even after the improvements companies are making.

Vulnerability

42. 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. While we welcome the new common PC to measure the number of customers on Priority Services Registers, we are concerned that a PC target to increase this number can drive a focus on numbers rather than the quality of assistance provided. We want to ensure that help is meaningful for customers.
43. We would like to see companies go further than focusing solely on PSRs to ensure that all customers 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). 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.
44. 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. We will also liaise with companies to understand which consumers who would benefit from being on the PSR may be missing out.
45. We also feel that 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. To support this, a measure of customer satisfaction with services provided would be of benefit.

Other key company specific issues

Water Industry National Environment Programme (WINEP)

46. We note the £372m allowed for delivering the company's obligations under WINEP, although this is substantially lower than the cost allowance sought by the company to deliver its statutory obligations. We would not want this lower cost allowance to put at risk the delivery of these obligations or more widely the company's other commitments and service improvements which customer engagement through development of the Business Plan showed customers support.

Meters

47. We welcome the £10m allowance for increasing meter penetration by installing 40,000 meters, as this can have additional benefits in encouraging customers to value water and consider its use more carefully.

Population Growth

48. 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 forecasts.

Other general issues

Innovation

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

50. 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.
51. 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.
52. More collaborative working between the appointed companies to identify and share good practice would also help achieve this aim.

Developer Services Experience (D-MeX)

53. 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?

Contact:

Michael Barnes

Policy Manager

Consumer Council for Water

Michael.Barnes@ccwater.org.uk

07824416654