

CYNGOR DEFNYDDWYR



CONSUMER COUNCIL FOR



CCWater Response to Ofwat's Draft Determination on Thames Water's application for an Interim Determination of K in 2014/15

CCWater's response to Ofwat's draft determination on Thames Water's application for an Interim Determination of K (IDoK) in 2014/15

1. Introduction

1.1 The Consumer Council for Water (CCWater) is the statutory body established to represent water consumers throughout England and Wales. We welcome the opportunity to respond to Ofwat's draft determination on Thames Water's IDoK application which we do as the statutory independent representative of Thames Water's customers but also as a member of the company's Customer Challenge Group, established by the company to provide rigorous challenge to its business plan proposals for the next industry wide review of prices in 2014 (PR14).

2. Summary

2.1 We welcome the strong challenge Ofwat has given to Thames Water's IDoK application. We, too, have challenged the legitimacy of this application given the scale of proposed price increase and the proximity of PR14. We believe it has been right to question the claimed costs and supporting evidence provided by the company, as well as the extent to which the company's position is a reflection of management action or inaction, or deficiencies in company policy, planning or delivery/processes.

2.2 In the case of bad debt for example, we believe that the company was aware of the growing problem at PR09 and should have instigated an appropriate debt management strategy and upgraded their systems much earlier on.

2.3 We also think it is important to take account of the financial benefits the company has enjoyed during the period which have resulted in significant gains for the company and its shareholders. A study commissioned by CcWater suggests that in the two years 2010-12 Thames Water gained £50.4 million from the lower cost of new debt than Ofwat had assumed in 2009, and £60.3 million from the unanticipated high level of inflation (RPI). This illustrates that the company's financial performance and the gains it achieved should have offset the unforeseen costs set out in the IDoK submission. Although a separate process, Ofwat's consideration of an application of the substantial favourable effects clause does therefore seem a reasonable course of action.

2.4 We fully support the regulator's initial conclusion that on the basis of the information shared to date a further price increase should not be applied next year (2014/15). While we accept that there is now an opportunity for Thames Water to submit further evidence in support of its application, we would urge the company to reconsider its position in light of the challenges posed by Ofwat and in order to demonstrate that it is considerate of the implications a significant price increase would potentially have for its customers at this time.

2.5 It should also seriously consider the reputational issues arising from a significant price increase next year and how this will impact on customer and stakeholder perceptions of the company.

3. Background

3.1 As Thames Water itself acknowledges, the continuing economic downturn is placing a very large proportion of its customers under immense financial pressure. The combination of inflationary and agreed price increases during 2010- 2015 have weighed heavily at a time when salaries and benefits have been capped or reduced in real terms. CCWater's own customer research suggests that 1 in 8 customers now consider their water and sewerage bills to be unaffordable. A further unexpected and substantial price increase next year will not be welcomed by any of its customers and could cause many more to struggle with their bills.

3.2 Our tracking research shows that customers' view of the value for money they currently get from Thames Water is just above the average for the industry; given it currently has a comparatively low combined water and sewerage bill this is what you would expect. A significant bill increase next year, followed by further proposed increases during 2015 - 2020 (largely driven by the Thames Tideway Tunnel) is likely to change customers' perceptions.

3.3 The decision by Thames Water to submit its IDoK application at such a late stage in the current AMP cycle is disappointing in a number of ways.

3.4 For customers, it seeks to increase average bills next year by an additional 8% above RPI and the 1.4% increase agreed at the last price review. Any price increase for an essential household service is unwelcome at this time, but on the scale proposed would result in serious financial hardship for some which, in turn, could add to the company's level of bad debt.

3.5 The timing has also had a significant impact on the company's business planning and associated customer research and wider engagement in the lead up to PR14. At a time when the company has been stating its intention to place customers at the heart of its plans for the future, its decision to squeeze out as much as it can from the current price settlement ahead of the next price review appears quite calculated.

3.6 Many of the cost pressures that Thames Water wants to pass on to customers next year have been managed or absorbed by the other water and sewerage companies.

3.7 This late submission has also impacted on the water only companies that bill for sewerage services on behalf of Thames Water. Firstly, it potentially leaves them with the task of explaining and responding to complaints about a substantial bill increase next year. It has also made their own business planning and customer engagement activities difficult given the uncertainty

about sewerage bill levels in 2014/15 and beyond (exacerbated by the additional uncertainty around the Thames Tideway Tunnel Scheme).

4. Specific Elements of the Application and Draft Determination

a) Tideway land acquisitions

4.1 While we are reassured that Ofwat is keeping a close eye on the costs associated with the Thames Tideway Tunnel scheme, there has in fact been a general lack of transparency over these costs and their impact on current and future customers' bills. We are pleased that the regulator has made a slight downward adjustment but would ideally want more of this information in the public domain as Thames Water's customers have not had any opportunity to influence this proposed scheme although they are expected to pay for it.

b) Land sales

4.2 As this is an offsetting component of the IDoK application, we are pleased that Ofwat has identified additional benefits beyond that initially declared by the company.

c) Bad debt

4.3 Bad debt is a problem facing all water companies and one that companies must address efficiently and effectively in order to minimise the associated debt and management costs that are recovered from paying customers.

4.4 We support Ofwat's challenge/assertion that while the company has provided evidence that it has incorporated all elements of Ofwat's debt recovery principles in its procedures, there is no assessment available on the practical application of these principles, the effectiveness of processes adopted or the rigour that the company has been applying to its debt recovery activities. The cross industry comparisons do not suggest that Thames Water has adopted "best practice" in all areas.

4.5 We are aware of delays in introducing new systems, and are therefore of the view that the company should have focussed more attention on this area, earlier on in the AMP period. A more effective debt management strategy may have helped to offset the growing bad debt problem.

4.6 Thames Water have made a case for a bad debt adjustment around the effect of the economic downturn and growing levels of deprivation in its area of operation. However, these effects will have been felt by all the water companies operating in the region but they have chosen to absorb/manage these costs.

4.7 The modelling initially submitted in support of this claim appears to have had fundamental and significant flaws which Ofwat has identified and on

that basis has significantly reduced the bad debt costs attributed to these factors.

- 4.8 From the customer perspective, it is important that water companies do have efficient and cost effective debt recovery procedures in place in order to minimise the bad debt costs passed on to customers. An IDoK claim for bad debt cannot be seen to reward a company for inactivity or poor performance in this area.
- 4.9 We think it is essential that Thames Water is judged in relation to its neighbouring companies' performance as in many cases there are joint billing arrangements and geographical and demographic overlaps. With this in mind, we would suggest that while any further modelling submitted by Thames Water may address earlier deficiencies, the actual debt management performance across the South East in comparison to Thames Water's may be a more revealing and more certain basis of assessing this claim.
- 4.10 Ofwat has stated in its guidance for the next price review that where water companies consider that their levels of bad debt are impacted by higher levels of deprivation (associated with higher unemployment, income or health) than the average company they will need to provide very strong evidence if they wish to apply for an adjustment to their household retail tariff. The guidance makes clear that a high bar will be set and companies will, in particular, need to demonstrate that the differences in bad debt costs are a result of factors that are outside of their control rather than as a result of inefficient management practices. Indeed it goes on to say that companies' will also need to demonstrate that they are already managing their bad debt costs in ways that are consistent with best practice across both other utilities and within the wider economy. We would therefore urge Ofwat to apply the same rigorous test to this element of the IDoK application.

d) Environment Agency charges

- 4.11 These should be possible to verify and on that basis we accept the conclusion drawn by Ofwat that these costs are allowed.

e) Private sewers

- 4.12 We agree with Ofwat that the claim for additional costs arising from the transfer of private sewers into company ownership in 2011 is less than convincing. On the evidence submitted it is difficult to see a sufficiently big increase in actual expenditure that is directly attributable to the transfer. Other sewerage companies have absorbed any additional costs arising from the transfer.
- 4.13 We also understand the costs Thames Water is incurring are less than initially anticipated and therefore assumed for budgeting purposes. Given

that the transfer of responsibility is still a fairly new development it seems most appropriate to wait for the price review when Ofwat can reach an industry wide conclusion on this matter.

f) Sewer flooding

4.14 Thames Water has included an under-spend on sewer flooding within its application although we understand it has delivered all the outputs agreed at PR09. Ofwat has reported that the sum involved is more than that suggested by the company. This is in part due to differences in view over what can now be reasonably delivered in 2014/15. Ofwat's view has been influenced by an examination of the company's past performance in this area and comparison with other sewerage undertakers' performance.

4.15 While customers continue to identify sewer flooding alleviation as a top priority and support expenditure on sewer flooding alleviation schemes they would wish to have assurance that this expenditure represented value for money. Given that Thames Water has underspent in this area, and previously delivered a lower level of outputs than proposed for the closing stages of this AMP, we support Ofwat's proposal to temper the company's ambitions and reduce the required outputs for 2014/15. The difference in expenditure will be returned to customers. We understand that this will allow the delivery of priority schemes like Counters Creek which was previously assessed under the Change Protocol. We believe that PR14 is the appropriate route for determining the sewer flooding programme going forward.

g) Deephams Wastewater Treatment Works

4.16 There appears to be a disagreement between Thames Water and Ofwat, and with the Environment Agency, over the delivery and completion of the Deephams scheme. While this is largely a matter relating to the re-profiling of expenditure following redesign as a result of planning issues, we look to Ofwat to ensure that customers do not end up paying more than they should reasonably be expected to now or in the future, and that any underspend in AMP5 is returned to customers.

h) Serviceability

4.17 The maintenance of sewerage infrastructure is a crucial component of a sewerage undertaker's investment activity. Funding is provided to ensure assets are appropriately maintained and a stable level of serviceability achieved. Under performance in this area should not be tolerated. We therefore support Ofwat's view that the identified underspend should be returned to customers.

5. Conclusions

- 5.1 We do not believe that Thames Water has made a compelling case for a further price adjustment in 2014/15.
- 5.2 The particular issue of bad debt and associated costs is not unique to Thames Water. We believe that the company could have taken more decisive action earlier on in the AMP period to mitigate against the rising bad debt levels it has been experiencing.
- 5.3 We believe that the company should be absorbing the costs associated with the transfer of private sewers until an industry wide provision can be agreed at PR14.
- 5.4 The areas that Ofwat has identified as being subject to significant under-spend clearly warrant a return to customers.
- 5.5 In our view the company has chosen to present a very one sided argument in only identifying limited gains during the period. We are sure that customers would want to see the company sharing any financial gain as well as pain with them given Thames Water's profitability, and unexpected financial gains due to the lower than forecast costs of borrowing and higher than expected RPI in recent years.
- 5.6 With all these factors in mind, we continue to oppose Thames Water's application and urge the company to reconsider its position.
- 5.7 Mindful that Ofwat may well receive further submissions from Thames Water, and the risk that movement on an issue, such as bad debt, could cause the materiality threshold to be reached, we urge Ofwat to continue with its robust challenge of this application given that the timetable for the IDoK may not provide CCWater or other stakeholders the opportunity of further comment before the final determination is announced.

For more information please contact:

Karen Gibbs
Senior Policy Manager
Consumer Council for Water
E-mail: karen.gibbs@ccwater.org.uk