



# **Ofwat: Draft 2020-25 price control determination for Affinity 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 Affinity 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 found that 88% of Affinity Water customers surveyed found the proposals 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 Draft Determination:
  - The reduction in the Weighted Average Cost of Capital to 2.19%<sup>1</sup>, which is within the recommended range of a CCWater commissioned independent study of water company financing, market evidence and financing assumptions made in other regulated sectors. While this is within the range recommended by our consultants, it is at the top end. We therefore welcome Ofwat's comments that current market evidence suggests the cost of capital may be even lower when Ofwat comes to Final Determinations of price controls.
  - Ofwat's acceptance of stretching targets for Water Supply Interruptions and IT service interruptions.

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<sup>1</sup> Real (RPI) appointee level

- Funding to evaluate strategic water resource solutions.

### 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 while having static or declining complaints performance.
  - The potential impact of Outcome Delivery Incentives (ODIs) on bills, particularly where there is not strong customer support for the principle.
  - The risk that investment schemes that are important to customers are deferred or removed in order to reduce costs.

## 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 Draft Determination research found that a high proportion of Affinity Water customers think that the Draft Determination proposals are acceptable. 88<sup>2</sup>% of uninformed customers and 87% of informed customers said the plan was either "acceptable" or "very acceptable." Given this high level of acceptability for the price and service levels, it is important that Ofwat and Affinity Water ensure that the Final Determination continues to deliver a package that allows customers' priorities to be delivered at a price that they accept.
6. 81% of customers found the potential impact of ODIs on their water bills over the period to be acceptable. While this remains a high level of acceptability, it is a lower level of acceptability achieved by the "base" plan. This highlights the potential for there to be a negative customer reaction against the impact of ODI outperformance payments on bills once this is fully realised.

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

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 their bills following 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 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

9. The Draft Determination would see average bills reduced by 4%<sup>3</sup> after inflation over the period 2020-25, with a very significant reduction in the average bill in 2020/21. When announcing its Final Determinations and future bill impacts, we expect Ofwat and the company to make clear to customers that the bill reductions mentioned are not the complete picture and that they need also to explain the impact of inflation and ODIs as these will determine what customers actually pay.
10. The research conducted by Affinity in developing its revised business plan found uninformed customer acceptability of its updated plan was 79%, with support for a bill profile that ensured stability of charges over the period of the plan and through to 2030.
11. We know that customers value bill stability and that low income customers, in particular, can find it difficult to manage bill fluctuations. For these reasons, we believe Ofwat's Final Determination should continue to deliver a smooth bill profile. We do accept, however, that the company is likely to have some significant investment requirements in AMP8 that may place upward pressure on water bills. We therefore look to the regulator to consider how best to secure a stable bill profile over the longer term.

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

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<sup>3</sup> Based on an assumption of 2%pa CPI-H

12. An independent study commissioned by CCWater<sup>4</sup> has recommended a range for the WACC of between 1.7% to 2.3%<sup>5</sup>, based on an analysis of water company financing, market evidence and financing assumptions in other regulated sectors.
13. 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.

#### Cost efficiency challenges and categorisations

14. It is important for customers that Ofwat makes sure that companies deliver service improvements efficiently. While the 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 the price determination 'package' is unacceptable to them.
15. However, the efficiency challenge to companies should not put 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, and we would not want this to lead to customer supported schemes such as leakage improvements and planned investment to improve the environment no longer going ahead.
16. Ofwat should ensure that its approach to assessing required totex is valid and will result in an efficient delivery of services and improvements. It is the company's' responsibility to ensure that their commitments to customers are delivered. It would not be in customers' interests for companies to defer or reduce their commitments to customers, in response to the regulatory cost efficiency challenge.

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<sup>4</sup> Economic Consulting Associates (ECA) recommendations for the Cost of Capital 2020-25 (April 2019) – this is an updated recommendation for the cost of capital, following on from an ECA recommendation originally published in December 2017. The April 2019 update takes into account new evidence that has emerged in 2018 and 2019: <https://www.ccwater.org.uk/research/update-to-eca-recommendations-for-the-cost-of-capital-2020-2025/>

<sup>5</sup> Real (RPI) appointee level

### Population Growth

17. 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 up to date forecasts.

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

18. 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.
19. When costs are reallocated from one category to another (e.g. from 'base' to 'enhancement'), this can have a knock-on effect on the PAYG ratio as capital costs are typically recovered in the longer term. Ofwat should be clear in Affinity Water's Final Determination where changes in the cost assessments have led to a revised PAYG and confirm that the ratio strikes the appropriate balance of cost recovery from current and future customers.

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

20. 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 and to current and future risks, and demonstrating to their customers and stakeholders that they have done so.
21. In Ofwat's IAP and the Draft Determination, Affinity Water was asked to provide an action plan by 22<sup>nd</sup> August to '*develop and implement a systems based approach to resilience in the round and ensure that the company can demonstrate in the future an integrated resilience framework that underpins the company's operations and future plans, showing a line of sight between risks to resilience, planned mitigations, package of outcomes and corporate governance framework*'.

22. We support this action and look forward to seeing the company's response to this challenge and working with them as they develop this framework. We would like to see how the company's Performance Commitments and investment allowed for in the Final Determination will address current and future resilience risks as a result of this action plan. We would also like to hear from Ofwat about the interventions it would make if Affinity's action plan is viewed as sub-standard.
23. We are pleased to see that Ofwat has accepted stretching targets for reducing water supply interruptions (-50%) and reducing the impact of IT service interruptions (-29%) as these have been areas where the company's past performance has not been good.

### Strategic regional water resource solutions

24. Ofwat is allowing an additional £83 million for the company to evaluate potential strategic regional water resource solutions, in partnership with others, including a Grand Union Canal transfer and the strategic Abingdon reservoir. We welcome this development. Affinity Water has particularly challenging water resources management issues that need to be addressed. Alternative new resources are clearly required to secure the long-term resilience of water supplies.
25. We are supportive of initiatives to improve the security of water resources, including water supply transfers, as long as they provide best value for customers and are delivered cost effectively. We agree that water companies should work together on strategic solutions in the context of the National Water Resources Planning Framework. However, more needs to be done to clarify how water transfer schemes will be funded and remunerated, and how such arrangements will be regulated in a way that benefits all customers.

### Outcomes - Performance Commitments and Outcome Delivery Incentives

26. Overall, we consider that Affinity Water's PCs are now stretching and reflect customer priorities. Ofwat has intervened in several areas but accepted the company's own proposed targets for per capita consumption (PCC) and water supply interruptions. On leakage, the company had offered a higher reduction target of 23% by 2024/25 with enhancement costs.

27. However, Ofwat has proposed a 20% target without the enhancement funding. The company has recently missed its leakage targets, although it remains one of the better performers in relation to leakage levels, and we therefore expect a further 20% reduction will be challenging for the company. As a company that is compulsorily metering its customers in order to help reduce demand, it is even more important to demonstrate a real commitment to bringing leakage down.

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

28. We welcome the clarity on the details of the shadow reporting of the C-MeX (which will inform its final design) and will monitor how this progresses. We remain concerned that there may be insufficient weighting given to a company's complaints performance so that companies may not have sufficient pressure to improve their complaint handling performance. They may also be able to achieve a financial reward even when their complaint performance is static or declining.

#### Mains Bursts

29. In its Draft Determination, we note that Ofwat is now consistently using the common Performance Commitment (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 likely lead to the need for an increased number of repairs. 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 reduce over time as the network becomes more stable and the company, in the longer term, undertakes other activities to achieve its leakage target.
30. The Draft Determination 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 and repairs.

#### Outcome Delivery Incentives (ODIs):

31. 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. Therefore, companies must have demonstrated clear customer support for both the principle and the range of ODI payments before they are included in price determinations. However, we believe that evidence collected by the company's research revealed that Affinity Water's customers have concerns about the principle of companies receiving financial rewards for delivering services, and the impact this may have on bills, with only 39% of customers supporting the principle of ODIs.
32. Similarly, our research to test customer acceptability of the Draft Determination reduced from 88% to 81% (77% for the potential impact of sewerage ODIs) once customers were shown more details about the potential bill impact of these incentives. While this reflects the top-line research results (the full analysis will follow), it may indicate that fewer customers accept the ODI package when they see how this may affect their bills.
33. We therefore welcome the steps taken by Ofwat to moderate the potential bill impacts that might result from ODI outperformance and that there will be an overall cap on the ODI package with a sharing mechanism if this is breached.

### **Affordability & Vulnerability**

#### Affordability:

34. We are happy to see progress being made to support customers who are struggling to pay but we believe companies still need to do more to resolve the 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 companies are making.
35. Our [Water Matters research](#) (2018) found that 69% - 71% of Affinity Water customers found their charges affordable (71% Affinity South East, 70% Affinity East, 69% Affinity Central; combined water and sewerage bill) CCWater's research into Affinity Water's Draft Determination found that 66% of customers thought current charges were affordable but that this increased to 77% when they were shown the effect the Draft Determination proposals would have on their bills. This indicates that there

will still be a significant proportion of customers who will struggle to afford their bills and require additional support.

### Vulnerability:

36. 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 the wrong behaviours. We want to ensure that help is meaningful for customers.
37. We would like to see companies go further than focusing solely on PSRs to ensure that all consumers receive whatever 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 consumers receive support when they need it and that they are satisfied with the assistance provided. It is crucial that companies raise awareness of the support available so that consumers know what help they can access.
38. We also feel that those consumers 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, a measure of consumer satisfaction with services provided would be of benefit. We therefore welcome Affinity Water's plan to have two reputational PCs that test whether consumers in vulnerable circumstances are satisfied with the services provided and whether they felt it was easy to do business with the company.
39. 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 liaise with companies to understand which consumers, who would benefit from being on the PSR, may be missing out.
40. Following the Initial Assessment of Plans (IAPs), we challenged Ofwat's proposed vulnerability PC requiring companies to contact 90% of consumers 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 consumer and the company? In the Draft Determinations, 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.

### General comments:

#### Innovation

41. We understand that Ofwat is considering an additional revenue adjustment for the Final Determinations, to allow Affinity Water additional funds to drive further innovation.
42. 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 Affinity 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.
43. Affinity Water should also develop innovative methods of delivering services that have a tangible positive impact on consumers; for example, in areas such as service quality, affordability and vulnerability.
44. However, we question why additional revenue (that customers will pay for) is needed to encourage greater innovation. This is especially the case if Affinity 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.
45. More collaborative working between the appointed companies to identify and share good practice would also help achieve this aim.

#### Developer Services Experience (D-MeX)

46. While we welcomed the introduction of new measures designed to improve developer experience with companies, we have some questions about how this will operate:
47. 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?

48. 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?
  
49. 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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