

CONSUMER COUNCIL FOR



CYNGOR DEFNYDDWYR



# Ofwat: Draft 2020-25 price control determination for Dŵr Cymru

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 a committee for Wales and four regional committees in England. We welcome the opportunity to respond to Ofwat's 2020-2025 draft price control determination for Dŵr Cymru.

## 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. Our research into the acceptability of Ofwat's Draft Determination<sup>1</sup> found that 91% of Dŵr Cymru's 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 are detailed below.
3. Dŵr Cymru did not undertake acceptability research for Ofwat's Draft Determinations. However, the company's draft business plan acceptability research conducted in September 2018 indicated high acceptability of a higher bill profile at 80% (uninformed response). Customers supported company proposals (for bills, service levels and resilience) but were not consulted on whether this could be done at a lower or more efficient cost. We note, however, that acceptability for the Draft Determination in our research is significantly higher, by 10%.

### What we support

4. We are supportive of the following aspects of Ofwat's Draft Determination for Dŵr Cymru:
  - Ofwat's more challenging upper quartile targets in the Draft Determination, which are in line with customers' views, particularly in relation to water supply resilience, water consumption (per capita consumption) and sewer flooding.
  - The voluntary profit-sharing mechanism introduced by the company and supported by the regulator, which is something that we challenged for during PR14 and again during the PR19 process.

- Ofwat’s position on flooding and environmental priorities, particularly its support of a long-term perspective with projects spanning across price cycles (e.g. remote monitoring of Combined Sewer Overflows).
- The reduction in the Weighted Average Cost of Capital to 2.19%<sup>2</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.

### What we have concerns with

5. We have concerns about the following aspects of Ofwat’s Draft Determination for Dŵr Cymru:
  - The potential perception that Ofwat’s cost efficiency challenge might jeopardise proposals for additional investment which were supported by Dŵr Cymru’s customers. Whilst we are not in a position to comment on Ofwat’s cost efficiency challenge, we consider it to be important that the regulator recognises the high levels of customer support for the company’s original proposals and plan. Ofwat should consider whether its final settlement might jeopardise any additional investment that customers had indicated that they would be willing to pay more for in the company’s earlier acceptability research.
  - The resilience of services and particularly the water supply, which is a key priority for customers in Dŵr Cymru’s area. We are pleased to see the need for projects such as Cwm Taf/Merthyr Water Treatment Works connectivity and water supply resilience recognised in Ofwat’s Draft Determination, but the fact that the cost of this project is not included provides uncertainty for customers. We are aware of Welsh Government’s (WG’s) concerns about the use of Direct Procurement in the context of its Strategic Policy Statement (SPS) for Ofwat; however from a customer perspective we expect Ofwat’s approach on

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<sup>1</sup> Top line findings from 23 August 2019

<sup>2</sup> Real (RPI) appointee level

procurement to ensure that there are no hidden costs which will be added to customer bills following its Final Determination (i.e. through an Interim Determination) and that the benefits to customers from key resilience projects are not delayed by a complicated procurement process.

## Section B - Our detailed comments

### Customer acceptability

6. 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 Dŵr Cymru's customers think that the Draft Determination proposals are acceptable. 91%<sup>3</sup> of uninformed customers and 89% of informed customers said the plan was either "acceptable" or "very acceptable." Given this high level of acceptability for price and service levels, it is important that Ofwat and companies ensure that the Final Determination continues to deliver a package that allows customers priorities to be delivered at a price that they accept.
7. 79% of Dŵr Cymru's customers found the potential impact of Outcome Delivery Incentives (ODIs) on their bills over the period to be acceptable. While this remains a high level of acceptability, it is nevertheless a pronounced decrease to the levels of acceptability before the potential impact of ODIs is factored in.
8. We support Dŵr Cymru's approach to sharing with customers any outperformance rewards achieved through its ODIs. It is important that customers are involved in the decisions about how money is returned via bills and/or where any additional investment in service is proposed.
9. 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 receives very little information about the price review outcome.

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<sup>3</sup> Unweighted topline figures as of 23 August 2019. Figures may change slightly in the final report.

10. These top-line findings from our research 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

11. Ofwat's Draft Determination means that average customer bills could reduce by 5% after inflation<sup>4</sup> over the period 2020-25. This decrease does not take into account the likely impact of ODIs. We therefore expect the company and Ofwat to make the impacts of both inflation and ODIs clear to customers when explaining bill impacts at Final Determination and beyond.
12. We are pleased to note that Ofwat's Draft Determination has limited the ODI impact on charges to £6pa. This seems more in line with the customer feedback in Dŵr Cymru's April 2019 research, in which only 55% customers supported the wider range of rewards and penalties proposed by the company.
13. The additional bill reduction in Ofwat's Draft Determination seems to be mainly attributable to the reduced cost of capital, which we support even though it is at the higher end of our recommendation, and Ofwat's efficiency challenge to the company. We think it is important, however, that aspects of the company's business plan which were supported by its customers, for example its resilience and affordability targets, are not at risk of being sacrificed in order to deliver these lower bills, particularly where there is evidence of customer support for additional investment.

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<sup>4</sup> Based on a forecast assumption of 2%pa CPI-H

14. We know that customers value bill stability and that low income customers, in particular, can find it difficult to manage bill fluctuations. Dŵr Cymru's bill profile research (2017) indicated customer support for a bill profile which ensured stability of charges over the period of the plan (60% support). The company's most recent research (April 2019) about future bills also demonstrates resistance to a fluctuating bill profile in the longer term (between 2025 and 2030). Whilst we believe that this specific bill profile research provides evidence that Ofwat's Final Determination should deliver a smooth bill profile, after inflation, rather than the one currently proposed which suggests a steep bill reduction at the beginning of the period (-12%) followed by an estimated incremental inflationary increase of 2%<sup>5</sup> each year over the five-year cycle. This does not result in a stable profile in line with the preferences of the company's customers.

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

15. The cost of capital has a large impact on customer bills. An independent study commissioned by CCWater<sup>6</sup> has recommended a range for the WACC of between 1.7% to 2.3%<sup>7</sup>, based on an analysis of water company financing, market evidence and financing assumptions in other regulated sectors.
16. 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

17. 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.

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<sup>5</sup> Based on a forecast assumption of 2%pa CPI-H

<sup>6</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>7</sup> Real (RPI) appointee level

18. The efficiency challenge to companies should not therefore 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 works such as leakage reductions, resilience projects, affordability assistance schemes and improvements to wastewater services no longer going ahead.
19. Ofwat should therefore ensure that its approach to assessing required Totex is valid and will result in an efficient delivery of services and improvements. It is the companies' responsibility to ensure that their commitments to customers are delivered; and it would clearly not be in customers' interests for companies to defer or reduce their commitments to customers, in response to the regulatory cost efficiency challenge.

#### Population Growth

20. We note that there are differing sources of evidence of population growth forecasts used in Ofwat's Draft Determinations, companies' Water Resources Management Plans (WRMPs) and their business plans. As this can be a significant driver of both costs and revenue, Ofwat needs to ensure that its Final Determination allowance reflects the most valid forecasts, and ideally be consistent with those used in other water industry planning processes.

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

21. 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.
22. We are pleased to see support in Ofwat's Draft Determination for Dŵr Cymru's Project Cartref; its sewer flooding improvement plans, particularly its surface water management proposals; its National Environment Programme (NEP) which is deliverable across price reviews; its zonal studies proposal, which would aim to address increased customer contact about water appearance and supply resilience (customer priorities); and its lead removal programme.

23. Bearing in mind that resilience features prominently in WG’s SPS for Ofwat, we are concerned that the regulator’s Draft Determination for Dŵr Cymru does not sufficiently reflect the importance customers place on long-term resilience and aspects of Dŵr Cymru performance. The lower cost of capital and efficiency challenges currently drive bill reductions of 5% (if a 2%pa assumption of inflation is applied). In Dŵr Cymru’s PR19 research customers supported additional investment at higher bill levels. This was also evident in its Return of Value consultation in 2016, where customers were presented with a real choice, and supported the reinvestment of profits in services rather than bill reductions. The company is currently a poor performer on supply interruptions, water quality aesthetics and sewer flooding, all of which are high priorities for its customers. We would therefore like the regulator to consider the balance between the scope for additional investment (whilst also increasing Performance Commitments) and bill reductions beyond what Ofwat proposes in the Draft Determination. There might also be an opportunity to increase the commitment on social tariffs as part of this.
24. Dŵr Cymru appears to be taking steps to improve resilience of its services and network. We are encouraged that the company is looking at the interconnectivity and resilience of its water supply and network, for example through the Cwm Taf/Merthyr Water Treatment Works proposals. However, we note that whilst the need for the scheme has been recognised, the delivery of the outcomes for customers may be delayed due to the nature of the procurement process being proposed.
25. We are also encouraged by some of the company’s surface water removal proposals and its work to develop its drainage and wastewater management plan. However, we cannot be sure that it has identified and highlighted all of the risks. In Ofwat’s Initial Assessment of Plans (IAPs) and Draft Determination, Dŵr Cymru 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’*. 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.

26. 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 in line with this action plan.

#### **Water Resources: future trading and transfer**

27. We are aware that companies in the South East of England are investing time and resources to identify potential trading options for their zones, which are in deficit. Whilst this is not an issue for companies operating in Wales in this price review, we would like to note that any future consideration of trading or moving water from Wales to other companies should take into account the interest of Dŵr Cymru customers. The cost of any feasibility work on transfer options should be borne by the customers who will benefit from the transfers.

#### **Outcomes - Performance Commitments and Outcome Delivery Incentives**

##### Lead reduction

28. We are pleased to see that Ofwat's Draft Determination has supported the company's proposals for lead pipe reduction related work.

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

29. We welcome the clarity on the details of the shadow reporting of the Customer Experience Measure (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 such that companies may not have sufficient pressure to improve their complaint handling performance. They may also be able to achieve a financial reward even where their complaint performance is static or declining.
30. We are pleased to see that in response to our recommendations early in the PR9 process a Non-Household customer CMex has been accepted for companies in Wales. We think this will be a useful indicator of customer service quality for non-household customers in Wales.

### Outcome Delivery Incentives (ODIs):

31. We remain concerned that despite the clear evidence of the lack of customer support for ODIs, particularly rewards, in Dŵr Cymru's research, Ofwat has continued to expect this of the company and has made interventions in its Draft Determination in this respect. In addition to the findings of its previous research, the company's latest research in April 2019 continued to show inconclusive support (55%) for the range of rewards and penalties it tested. We are pleased to note that the potential impact of rewards has been limited in Ofwat's Draft Determination and that it is significantly lower than that of potential penalties (£6 increase from rewards and £20 reduction from penalties); this better reflects one aspect of the views of Dŵr Cymru on ODIs.
32. We strongly supported Ofwat's principle that companies must demonstrate customer support for proposals in their business plans. We previously raised concerns with Dŵr Cymru and with Ofwat about aspects of the company's business plan proposals where the 'golden thread' back to its customers' views were weak or non-existent. We also believe that this principle should apply to the regulator when making interventions. Ofwat's Draft Determination for Dŵr Cymru retains a range of rewards and penalties that are not supported by customers' views, thereby weakening that 'golden thread', not strengthening it.
33. Additionally, in the additional company research, which tested acceptability of financial incentives for specific performance measures in April 2019, there were only two measures where customers strongly support incentives: environmental regulations and drinking water regulations. We therefore agree with Ofwat that there does not seem to be conclusive evidence for the introduction of incentives for measures relating to education, visitor centres and customer trust. However, whilst agreeing that per capita consumption (pcc) is an important measure, we cannot see conclusive support for the rewards and penalties that Ofwat has introduced (44% against and 35% in support) in the Draft Determination.

34. We welcome Ofwat's acceptance in the Draft Determination of the company's proposals for a transparent profit-sharing scheme where outperformance rewards are shared with customers. This is in response to our challenges and discussions with the company during the last price review and we are pleased the regulator supports this commitment with some minor adjustments.

## Affordability & Vulnerability

### Affordability:

35. We are pleased to see progress being made to support customers who are struggling to pay. However, we believe companies still need to do more to resolve the affordability problem. Across England and Wales there will still be more than one million households who are in need of assistance but not receiving it, even after the improvements companies are making. Therefore, affordability should not be jeopardised in the final settlement and in its delivery.
36. Our [Water Matters research](#) (2018) found that 74% of Dŵr Cymru customers found their charges affordable. Our research into Ofwat's Draft Determination for Dŵr Cymru found that 68% of customers thought current charges were affordable but that this increased to 80% when they were shown the effect the Draft Determination proposals would have on their bills.
37. We are pleased to see Ofwat's Draft Determination supporting the company's proposals for a significant increase in the number of households receiving assistance through its social tariff and other assistance schemes.
38. We support the company's commitment to contribute 50% of the cost of this increase from future profits, however we recognise that this is conditional and may not happen. This support corresponds to customer evidence in Dŵr Cymru's Return of Value consultation (2016) supporting the use of financial outperformance to help low-income customers, as well as evidence of high customer altruism towards financially vulnerable groups across the company's PR19 research.
39. As the ambitious assistance target seems to be achievable only if there is sufficient funding available from the customer cross-subsidy and the company's contribution, it is important for customers experiencing financial hardship that this commitment is not jeopardised either by the company or by the regulator in its Final Determination.

40. We also consider it important to be mindful of possible unintended consequences if the focus is solely on achieving the delivery of this stretching target but without the funds needed, as this could result in the company reducing the assistance available, i.e. it could decide to spread the assistance more widely but also more thinly which may not be in those customers' best interests.

Vulnerability:

41. We are pleased that Ofwat has introduced a common Performance Commitment in this area with stretching targets, something which we called for in our response to the PR19 methodology. However, we believe that there is the potential that a target that focuses solely on numbers could drive the wrong behaviours. It is important to increase the number of households on its Priority Services Register (PSR) but we also want to see Dŵr Cymru addressing transient and temporary vulnerability (caused by water supply interruptions), for which a PSR is not well-suited. We discussed with the company that its vulnerability strategy needs to put more emphasis of different types of transient and temporary vulnerability, beyond increasing numbers of consumers on the register.
42. In order to get a good picture of how a company is providing support to consumers in vulnerable circumstances, including those in temporary and transient vulnerability, they must measure awareness of the help that is available and satisfaction with the service provided. For example, finding ways to monitor the effectiveness of support throughout the year but also during specific events affecting services is particularly important, as severe weather events such as Storm Emma/the freeze-thaw incident in 2018 affected customers in vulnerable circumstances in Wales and caused prolonged temporary vulnerability of consumers and businesses due to poor handling by the company. It is therefore important that the company seeks to address concerns about how its assistance is actually delivered in relation to all consumers in circumstances of permanent or transient vulnerability. Ofwat should require qualitative measures of Dŵr Cymru and across the industry to measure the effectiveness of support offered.
43. We also expect Dŵr Cymru to identify any non-household consumers who need additional support, and to collaborate and co-operate with neighbouring companies to provide assistance and support during severe weather events.

44. We will monitor for what help consumers in vulnerable circumstances are signing up. We will also liaise with companies to understand which consumers who would benefit from being on the PSR may be missing out.

### Other key company specific issues

45. Ofwat has made interventions in its Draft Determination for Dŵr Cymru, which might not support the company's proposals for the enhancements and improvements that would benefit local communities and wider society. This position could be in conflict with the principles of Welsh Government's Well-being of Future Generations Act. We would therefore like the regulator to consider this when making its Final Determination.
46. We are pleased to see the recognition of the company's and Natural Resources Wales' (NRW's) environmental proposals as there was customer support for action to be taken on environmental improvement throughout Dŵr Cymru's price review research. We are also pleased that the NEP will contribute to the company's performance commitments such as sewer flooding blockages and drinking water quality in Wales. We think it is especially positive that Ofwat's Draft Determination has approved an environment programme that takes a long-term perspective operating within a ten-year period improvement period.

### General Issues

#### Developer Measure of Experience (D-Mex)

47. While we have welcomed the introduction of new measures designed to improve the developer experience with companies, we have some questions about how this will operate:
48. 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, we question whether Ofwat review whether these metrics have incentivised good results, 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?

49. 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?
50. 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. Does this mean 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?

### Innovation

51. We understand that Ofwat is considering an additional revenue adjustment for its Final Determinations, to allow companies additional funds to drive further innovation. We consider it essential that the industry should constantly be looking for new and better ways to think and operate. We welcome companies finding innovative ways to effectively and efficiently address the challenges facing the sector and its customers, including climate change; aging assets; a growing population; and changing customer expectations.
52. Companies should 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.
53. 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.
54. More collaborative working between the appointed companies to identify and share good practice would also help achieve this aim.

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