

CONSUMER COUNCIL FOR

CYNGOR DEFNYDDWYR



Ofwat: Draft 2020-25 price control determination for Hafren Dyfrdwy

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 Determination for Hafren Dyfrdwy.

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 the draft determination found that 90% of Hafren Dyfrdwy 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.
3. Whilst the company did not undertake research at Draft Determination stage, its March 2019 research indicates low acceptability of a plan that proposed a 2% charges increase (instead of a 2% decrease at Draft Determination stage). More specifically, the company's latest acceptability research in March 2019 did not evidence support of its plan proposals. Acceptability in Wrexham (water only) was a mere 51% and Powys (wastewater customers) was at 73%. The research indicated heightened concerns about affordability amongst those considered to be 'just about managing' (JAMs) or where, for example in Powys, affordability of the plan dropped to 39% amongst respondents in this group. Whilst Ofwat's Draft Determination recommends a 2% increase before inflation, when inflation is added, the bill profile presented to customers is one of gradual increase during the five-year price cycle. Our research focuses on prices after inflation, which gives customers a more accurate picture of the bills they are likely to pay from 2020.

What we support

4. We are mostly supportive of Ofwat's Draft Determination in Hafren Dyfrdwy's case, in particular:

- The tightening of performance targets for sewer collapses, sewer flooding, leakage, water supply interruptions and the bespoke lead removal target.
- Support for the company’s qualitative affordability Performance Commitment.
- The requirement for a resilience Performance Commitment.

What we have concerns with

5. We are concerned about:

- The absence of a voluntary profit-sharing mechanism demonstrating the company is willing to share profits to reduce impacts on bills or improve services and resilience for customers.
- The absence of a long-term strategy and vision specific to Hafren Dyfrdwy, which should:
 - address the overall resilience of services in the company’s area;
 - reassure consumers, regulators and stakeholders that the right investment is taking place at the right time;
 - provide reassurance that associated bill impacts are fairly apportioned between current and future customers (i.e. ensuring intergenerational equity); and
 - consider how to improve the financial viability of providing resilient wastewater services to a relatively small number of customers in the mid-Wales part of Hafren Dyfrdwy.

6. We are disappointed that Ofwat made no reference to the legacy savings in its main Draft Determination document for Hafren Dyfrdwy, despite knowing that it is a matter of particular interest to the CCG and local stakeholders. Whilst recognising it is just one specific data input into Ofwat’s end-of-period price setting process, we believe that it would be helpful for the regulator to include a brief reference to this in its Final Determination, such that the company’s use and Ofwat’s subsequent treatment of these savings are on the public record.

Section B - Our detailed comments

Customer acceptability

7. 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 Hafren Dyfrdwy customers think that the Draft Determination proposals are acceptable. 90¹% of uninformed customers and 91% 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 Hafren Dyfrdwy ensure that the Final Determination continues to deliver a package that allows customers priorities to be delivered at a price that they accept.

8. 69% of customers found the potential impact of Outcome Delivery Incentives (ODIs) on their bills over the period to be acceptable. This is a pronounced decrease to the levels of acceptability achieved by the "base" plan. This highlights the potential for there to be a customer backlash against the impact of ODI outperformance payments on bills once this is fully realised.
9. We give a higher weight to uninformed acceptability scores than informed because this is a better reflection of how the majority of customers will react to a price determination. The average customer does not receive very much information about the price review outcome.
10. 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

11. We are pleased that Ofwat's Draft Determination moderates the proposed increase of charges to 4.5%² over the period 2020-25 (including inflation). This is less than the increase originally proposed by the company. We think that Ofwat's announcement of a 2% decrease in charges is misleading, as it does not take into account inflation, which when added presents a bill that steadily increases throughout the five-year period.

¹ Unweighted topline figures as of 23 August 2019. Figures may change slightly in the final report.

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

12. We know that customers' value bill stability and that low-income customers, in particular, can find it difficult to manage bill fluctuations. The qualitative research conducted by Hafren Dyfrdwy in developing its business plan found customer support for a bill profile that ensured stability of charges over the period of the plan. Similar feedback has been observed across the company's research projects. When considering the bill profile with inflation included, the bills proposed for the five-year period would increase (rather than decrease) incrementally. In line with customers' views, we believe Ofwat's Final Determination should deliver a smooth bill profile rather than one that might decrease at the beginning of the price cycle and then gradually increase when inflation is added.
13. We still have some concerns about potential impacts on future bills (past 2025), particularly in respect of investment needed for future resilience. However, we recognise that the company is already having to use financial levers to keep wastewater bills affordable for its customers in Powys.
14. We would like Hafren Dyfrdwy, prompted by Ofwat, to introduce a profit-sharing mechanism and a commitment to injecting some of its financial outperformance into improving its services. This should allow for improved transparency of the company's financial performance, and it would help to address customer feedback that charges should not be impacted when the company outperforms and the company should be transparent about how its performance affects customer charges. This is particularly important as, in addition to any penalties and rewards from the PR19 cycle, Hafren Dyfrdwy's customers' bills will still be impacted by Severn Trent Water's deferred PR14 wastewater rewards during the 2020-2025 period. We do not consider it to be fair that customers are impacted by reward payments accrued through service improvements that they may not benefit from.

Cost efficiency challenges

15. It is important for customers that Ofwat makes sure that companies deliver service improvements efficiently. However, the efficiency challenge to companies should not jeopardise 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.

16. 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. Therefore, Ofwat should ensure that its approach to assessing required Totex is valid and ensures there is an efficient delivery of services and improvements. It is the companies’ 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.

Weighted Average Cost of Capital (WACC)

17. An independent study commissioned by CCWater³ has recommended a range for the WACC of between 1.7% and 2.3%⁴, based on an analysis of water company financing, market evidence and financing assumptions in other regulated sectors.
18. 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.

³ 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/>

⁴ Real (RPI) appointee level

Population Growth

19. 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)

20. 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.
21. 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 the 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.
22. We also recognise that in Hafren Dyfrdwy's case, the company is having to use financial levers to keep wastewater bills affordable for its customers in Powys.

Safe, reliable services: maintenance and long-term investment

Resilience

23. Hafren Dyfrdwy appears to be taking some steps to improve resilience of its services and network, particularly in relation to wastewater networks and services in an area which did not previously benefit from adequate investment in its assets and network (when the company's mid-Wales area was previously part of Severn Trent Water). However, we cannot be sure that it has identified and highlighted all of the risks, or that it has taken a long-term perspective in its resilience planning. The absence of a published Hafren Dyfrdwy specific company vision and long-term strategy, focusing on the priorities of the Wales-only company rather than the wider Severn Trent Group, demonstrates this risk.

24. We support Ofwat's intervention requiring a resilience performance commitment and think that the company should present a detailed Hafren-specific resilience strategy to its consumers, regulators and stakeholders. We also support the need for a detailed resilience plan, which Ofwat has requested by the end of August 2019, but we have not taken part in any discussions towards its development for this company.
25. 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. We also think that companies should be more transparent and informative about the resilience of their services.

Flooding & Blockages

26. We support Ofwat's tightened aspirational target in relation to sewer blockages in Powys. Through our liaison with the company and the PR19 process, we have come to understand there has been lack of attention to recurring service issues in the Welsh parts of the company (which was previously part of Severn Trent Water). Hafren Dyfrdwy customers' charges will be affected by wastewater ODI outperformance rewards to Severn Trent Group, despite there being no evidence that Hafren's customers have benefited from the performance improvements that prompted these rewards. We think this is unfair and it is important that Hafren's aspiration to address blockages remains ambitious, so it can begin to give something back to these customers. The company should also aim to address negative customer feedback on its wastewater services, something that became apparent during our liaison with the company and through its negative SIM scores on wastewater services in 2018/19.

Water Resources: future trading and transfer

27. Any strategic solutions involving trading or transfer of water resources should be undertaken collaboratively between water companies.

28. We are aware that Ofwat has instructed companies in the South East of England to invest 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 Hafren Dyfrdwy customers first. The cost of any feasibility work into a transfer option should be borne by the customers who will benefit from that transfer.

Outcomes - Performance Commitments and Outcome Delivery Incentives

Performance Commitments

28. In general, we think that some of adjustments made to Hafren Dyfrdwy's Performance Commitments are more stretching (e.g. sewer blockages) and reflect customer priorities (e.g. water supply interruptions, leakage and sewer flooding target increases). They also take into account some of the customer evidence collected during the development of the Business Plan.

Lead reduction:

29. We are pleased to see that Ofwat's Draft Determination has allowed for lead reduction work. In the light of the importance that customers put on this service issue and the significance of lead removal as a Welsh Government priority, we want Ofwat to consider whether the targets should be tightened at Final Determination stage, as we feel that the company is not being sufficiently ambitious.

Customer Experience Measure (C-Mex):

30. We welcome the clarity on the details of the shadow reporting of C-Mex (which will inform its final design) and will monitor how this progresses. As Hafren has had issues with poor performance on complaints in the past, we remain concerned that there may be insufficient weighting given to a complaints performance in this Draft Determination. This could lead to Hafren not being under sufficient pressure to improve their complaint handling performance. The company may also be able to achieve a financial reward even where its complaint performance is static or declining.

31. We are pleased to see that in response to our recommendations early in the PR19 process, Ofwat has accepted a non-household customer C-Mex in its Draft Determinations for companies in Wales. We think this will be a useful measure of the quality of customer service for non-household customers in Wales.

Outcome Delivery Incentives (ODIs)

32. 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 and the regulator must demonstrate clear customer support for both the principle and range of ODI payments before they are included in price determinations.
33. Hafren Dyfrdwy's consumer research in March 2019 indicated that its customers were not supportive of the principle of ODIs and of paying more for outperformance against targets. We therefore remain concerned that despite the clear evidence of a lack of customer support for ODIs, particularly rewards, the regulator has continued to expect this of the company.
34. Following Ofwat's Initial Assessment of Plans (IAPs) in January and Hafren Dyfrdwy's resubmitted plan in March 2019, we expressed concern that some of the ODI rewards and penalties being proposed by the company were not sufficiently evidenced with customer support. More specifically, the company's ODI Choices research showed only a very small majority of support (i.e. just over 50% of respondents) for some rewards and penalties that it put forward, namely drinking water quality, lead pipe replacement, internal sewer flooding and sewer blockages.
35. We consider this level of support to be insufficient to justify the introduction of rewards and penalties for these aspects of service. We strongly support Ofwat's principle that companies must demonstrate customer support for proposals in their business plans. It is therefore counterintuitive that Ofwat has made interventions in its Draft Determination for Hafren Dyfrdwy to adjust its ODI rewards and penalties, which are not in line with the views expressed by the company's customers.

36. We therefore remain concerned that there is potential for bills to increase further after Ofwat's Final Determination as a result of the ODI mechanism if the company outperforms on measures where the regulator has adjusted incentives (e.g. internal sewer flooding and lead pipe replacement) and because of the deferred impact of Severn Trent Water's PR14 wastewater ODI rewards. From a customer evidence perspective, the regulator has been presented with evidence of inconclusive support for ODIs and clear resistance to impacts on bill as a result of outperformance. Importantly, as the impact of Severn Trent Water's PR14 ODI performance has not been presented to customers in any of the PR19 research undertaken by the company, customer views on the acceptability of Hafren Dyfrdwy's business plan and on ODI rewards and penalties have not taken that into account.
37. We would therefore like to see the introduction of a scheme that puts in place protection for customers, guaranteeing that outperformance payments achieved through ODIs will be capped with any outperformance over this level shared with customers. Without such a scheme, there remains the potential for significant impacts on customers' bills, which is likely to prove unpopular with some customers.
38. We would also like to see the introduction of a profit sharing scheme which would respond to customer feedback on transparency of company performance and how that influences their charges. We have discussed this further in paragraphs 5 and 14 of this response.

Affordability & Vulnerability

Affordability

39. We are happy to see some progress being made in the proposals being put forward to support customers who are struggling to pay but we believe companies still need to do more to deliver the step-change in this area that Ofwat talks about. 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. Our Water Matters research (2018) found that 75% of Hafren Dyfrdwy customers found their charges affordable whilst 12% find them unaffordable. Much of the company's research also indicated that customers were reluctant to accept increased charges. Hafren Dyfrdwy's March 2019 acceptability research also indicated low levels of affordability for their proposed business plan (51% in

Wrexham, 53% Powys). Affordability of the plan was lower amongst ‘just about managing’ consumers (JAMs) and financially vulnerable respondents.

40. Our [Water Matters research](#) (2018) found that 75% of Hafren Dyfrdwy’s customers found their charges affordable. Our research into Hafren Dyfrdwy’s Draft Determination found that 70% of customers thought current charges were affordable but that this increased to 80% when they were shown the effect the Draft Determination would have on their bills.

41. In relation to Ofwat’s Draft Determination:

- We are pleased the regulator has accepted the company’s proposals for qualitative measures to monitor the effectiveness of some of its assistance measures.
- We support Ofwat’s intervention to define a percentage target for the effectiveness of the company’s assistance. We did not consider the company’s ‘nil’ proposal acceptable and suggested that it considers the ‘success rates’ of other companies to determine appropriate targets.
- We support the principle of a more aspirational social tariff uptake target than the one proposed by Hafren Dyfrdwy. We think that as a minimum the target should be 12%, i.e. the percentage of Hafren Dyfrdwy customers who told us their bills are unaffordable in our Water Matters research (2018). The increase in the value of cross-subsidy supported by the company’s latest research (£1.75 water only and £3.50 combined bills) should facilitate improvements in social tariff uptake and assistance. If funds were deemed insufficient to meet these targets, we would expect Hafren Dyfrdwy to safeguard the levels of assistance being offered and not risk depleting the funds further. Instead, we would have liked the company to make a commitment to provide additional funds from its own financial outperformance to ensure assistance is delivered more widely and effectively, and are disappointed it has not committed to do so.

Vulnerability

42. While we welcome the new common Performance Commitment to measure the number of customers on companies’ Priority Services Registers (PSR), we are

concerned that a target to increase numbers on priority services can drive the wrong behaviours. We want to ensure that help is meaningful for consumers.

43. We are particularly pleased that Ofwat accepted Hafren Dyfrdwy's bespoke measure to help increase the number of households on its PSR receiving help during water supply interruptions. We believe that this is a good additional measure, as focusing solely on total numbers for these registers may drive the wrong company behaviours. Aiming to demonstrate that it supports all households on its PSR during transient or temporary vulnerability during extreme weather events, is a commendable response from the company to the industry's poor handling of consumers in vulnerable circumstances during Storm Emma / the freeze-thaw incident in 2018.
44. In general, we would like to see companies go further than focusing solely on PSRs to ensure that all consumers receive the support they need when in vulnerable circumstances (for example, in cases of transient or temporary vulnerability such as during a water supply interruption). It is important that 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.
45. We also feel that consumers 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 consumer satisfaction with services provided would be of benefit.
46. 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.
47. Following the IAPs, we challenged Ofwat's proposed vulnerability Performance Commitment 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 Performance Commitment 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.

Further general comments

Innovation

48. We understand that Ofwat is considering an additional revenue adjustment for the Final Determinations, to allow companies' additional costs to invest in 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.
49. 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.
50. 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.
51. More collaborative working between the appointed companies to identify and share good practice would also help achieve this aim.

Developer Services Experience (D-MeX)

52. While we have welcomed the introduction of new measures designed to improve developer experience with companies, we have some questions about how this will operate:
53. 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?

54. 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?
55. 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:

Lia Moutselou

Policy Manager

Consumer Council for Water

lia.moutselou@ccwater.org.uk

02920443805