



**Ofwat: Draft 2020-25 price
control determination for
Northumbrian Water including
Essex and Suffolk Water**

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 Northumbrian Water. This response also contains our thoughts on the impact on Essex and Suffolk Water customers.

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 92% of Northumbrian 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%¹, 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.
 - Northumbrian Water's commitment to contribute to the funding of its social tariff;
 - The increased focus by the company on its complaints performance including a bespoke PC; and

¹ Real (RPI) appointee level

- Northumbrian Water’s aim to eradicate Water Poverty and its initiatives to address affordability.

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 for static or declining performance.
- The potential impact of 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 Northumbrian Water customers think that the Draft Determination proposals are acceptable. 92²% (NWL) & 93% (ESK) of uninformed customers and 90% (NWL) & 92% (ESK) 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 Northumbrian Water ensure that the Final Determination continues to deliver a package that allows customers’ priorities to be delivered at a price they accept.

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

6. 76%(NWL) & 79% (ESK) of customers found the potential impact of 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 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.
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 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

Bill profile

9. The Draft Determination would see average bills reduced by 26%³ before inflation over the period 2020-25, compared to the 21.4% proposed by the company. The combined bill reduction for Northumbrian Water customers would be 28% - a reduction of around £110 over the five years. Essex and Suffolk customers would see an 18% reduction in their water bill, saving around £40. These figures do not include inflation and the impact of ODIs, so we expect the company and Ofwat to make this clear to customers when explaining bill impacts at Final Determination and beyond.
10. We note that Ofwat’s proposed bill profile is for a reduction at the start of the period. After the impact of inflation, this would produce a sharp fall in bills followed by subsequent increase over the period.

Cost efficiency

11. The scale of this bill reduction is the largest in the industry. Whilst lower bills for customers are to be welcomed, Northumbrian Water customers in well-conducted

³ Based on an assumption of 2%pa CPI-H

research expressed a preference for a balance to be struck between lower bills and investment in water and wastewater services. The removal from scope of investment designed to enhance resilience raises questions about whether the balance proposed in Ofwat's Draft Determination is optimal. Where schemes have been excluded because of insufficient evidence of need or the efficient choice of options, customers would expect a dialogue between company and regulator to ensure the best long-term outcomes, particularly in the context of the exceptional opportunity for bills to fall for this AMP.

12. The research conducted by Northumbrian Water in developing its business plan found customer support for a bill profile which ensured stability of charges over the period of the plan. 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 deliver a smooth bill profile rather than the one currently proposed.

Weighted Average Cost of Capital (WACC):

13. An independent study commissioned by CCWater^[1] has recommended a range for the WACC between 1.7% to 2.3%^[2], based on an analysis of water company financing, market evidence and financing assumptions in other regulated sectors.
14. We note that for the slow track and significant scrutiny draft determinations Ofwat has used a WACC of 2.19%. While this is within the range recommended by our consultants, it is at the top end. We therefore welcome Ofwat's comments that current market evidence suggests the cost of capital may be even lower when Ofwat comes to final determinations of price limits.

Cost efficiency challenges

15. We welcome Ofwat's challenge to all companies on efficiency. Companies can opt to appeal the Final Determination with the Competition and Markets Authority (CMA); customers do not have the option to appeal if their expectations are not met or if aspects of the price determination is unacceptable to them.

^[1] Update to our recommendations for the Cost of Capital 2020-25 (Economic Consulting Associates for CCWater, January 2019) – see [here](#).

^[2] Real (RPI) WACC appointee level

16. We are not in a position to make a judgement on the difference in views on costs and deliverability; we therefore look to Ofwat for assurance that customers' long-term interests are being adequately protected. We would also seek assurance that its monitoring regime will give early warning if companies do start taking short or long-term operational risks.
17. We would not want to see Ofwat's challenge to companies putting in jeopardy the delivery of any well evidenced Performance Commitments, service improvements and/or investment that customers value. While the cost efficiency requirement is likely to be a challenge for the company, commitments to customers should not be removed or deferred just to reduce overall costs.
18. It is the companies' responsibility to ensure that their commitments to customers are delivered. If Northumbrian have doubts that they can deliver customer commitments then they should go to the CMA.

Pay as you go ratio (PAYG)

19. 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.
20. 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. The costs that Ofwat has disallowed in the Draft Determination for Northumbrian Water are primarily CAPEX, yet it has not recalculated the PAYG rate, resulting in a lower PAYG rate in the Draft Determination than in the "natural rate" proposed in the plan. This means that future customers will bear an unfair proportion of the costs. While reverting to the natural rate will increase bills by 3%, this would reflect the views of current customers that they do not wish to pass costs on to future generations. Ofwat should be clear in the Final Determination where changes in the cost assessments have led to a revised PAYG and that the ratio strikes the appropriate balance of cost recovery from current and future customers.

Safe, reliable services: maintenance and long-term investment

21. In Northumbrian Water's business plan research, customers favoured a balance between bill reduction and service improvement. In particular, they did not want to delay investment in resilience. However, given Ofwat's challenges to the company in the Draft Determination to provide better evidence, we cannot be sure that Northumbrian has identified and fully addressed all of the risks.
22. In Ofwat's IAP and the Draft Determination, Northumbrian is asked to provide an action plan by 22nd 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'*.
23. 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.
24. 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 proposes to make if Northumbrian Water's action plan is viewed as sub-standard.
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.

Outcomes - Performance Commitments and Outcome Delivery Incentives

Performance Commitments

26. Overall we consider Northumbrian Water's PCs are stretching, reflect customer priorities and were developed based on extensive evidence of customers' views.

Customer Experience Measure (C-MeX):

27. 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. We remain concerned that there may be insufficient weighting given to a company's complaints performance so companies may not face 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. We are pleased to note that Northumbrian Water has committed to reply to 90% of its stage 1 complaints within 2 days, and stage 2 within 10 days by end of 2024-5. We believe that this will not only be good for customers but has the potential to improve C-MeX complaints and/or customer satisfaction. Northumbrian Water is one of only three companies that have proposed a PC related to complaints resolution and we support these companies in their approach. It is important that Northumbrian Water continues to focus on its complaints performance, which recently deteriorated following the introduction of a new billing system.

Mains Bursts

28. In Northumbrian Water's Draft Determination, we note that Ofwat is now consistently using the common 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 be likely to lead to the need for an increased number of repairs.
29. 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 to reduce over time as the network becomes more stable and the company, in the longer term, undertakes other activities to achieve its leakage target. Ofwat's Draft Determination for Northumbrian Water 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 Northumbrian Water is not disincentivised to find leaks on mains proactively if it is at (or close to) its PC target due to the number of customer-reported bursts/repairs.

Outcome Delivery Incentives (ODIs)

30. The use of ODIs has a risk of a negative customer reaction if customers do not support the use of these financial incentives, as outperformance payments will lead to bill increases. Therefore, companies must demonstrate delivery of exceptional performance in areas of service customers value, along with clear customer support for both the principle and range of ODI payments before they are included in price determinations.

31. Whilst Northumbrian Water's customers generally supported the principle of ODIs, not all customers wanted to pay rewards in all areas. We were concerned that Northumbrian Water's research was carried out by presenting the framework of rewards and penalties as the accepted regulatory orthodoxy. Previous research showed that most customers did not support rewards, particularly for what they thought were service failures in the first place. Similarly, our research to test customer acceptability showed a reduction from 92% to 76% (NWL) & from 93% to 79% (ESK) 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.

Affordability & Vulnerability

Affordability:

32. We are pleased to see some progress being made in the proposals being put forward to support customers who are struggling to pay and in particular welcome Northumbrian Water's aim to eradicate Water Poverty by 2030. This commitment seems to have encouraged other companies to replicate this ambition, which we welcome as a positive step for the industry. However, 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.

33. Our [Water Matters research](#) (2018) found that 75% (NWL) & 71% (ESK) of Northumbrian Water's customers considered their charges to be affordable.

CCWater's research into Northumbrian Water's DD found that 64% (NWL) & 65% (ESK) of customers thought current charges were affordable, but this increased to 81% (NWL) & 82% (ESK) when they were shown the effect the DD proposals would have on their bills.

34. Northumbrian Water has set an ambitious target to address affordability for the forthcoming AMP, and the bill reductions intimated in the Draft Determination will undoubtedly contribute to the delivery of this objective. We look forward to working with the company as it develops the detailed programme which will provide confidence that their targets for the next AMP and beyond can be delivered.
35. In addition, we welcome the other commitments the company has made, including to:
 - increase the number of customers receiving support through social tariffs and WaterSure from 34,000 in 2020 to 95,000 by 2024-25;
 - increase its social tariff cross-subsidy to £2.85 and either gain customers' support or - more importantly - self-fund any increase necessary;
 - introduce a new payment app to offer customers flexibility to adjust their payment frequency and the amount that they pay; and
 - improve satisfaction among customers receiving non-financial vulnerability assistance and increase awareness of this support.

Vulnerability:

36. We consider that the company is offering a wide range of well-targeted measures. In particular, we welcome the commitment to support the social tariff scheme with its own money should customers not agree to do so through their bills. While we welcome this commitment, our own research suggests that if the company were to contribute to the tariff in the first instance, customers would then be more willing to increase their contribution.
37. 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 create a focus on numbers rather than the quality of the assistance provided. We want to ensure that help is meaningful for customers.

38. We would like to see companies go further than focusing solely on PSRs to ensure that all consumers receive the support they may need when in vulnerable circumstances (for example, in cases of transient or temporary vulnerability such as during a water supply interruption). It is important that consumers receive support when they need it and that they are satisfied with the assistance provided. To support this, it is crucial that companies raise awareness of the support available so that consumers know what help they can access.
39. 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.
40. We expect retailers and wholesalers to collaborate to identify any non-household consumers who need additional support. We will be monitoring what help consumers are signing up for. We will also liaise with companies to understand which consumers who would benefit from being on the PSR may be missing out.
41. 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.

Significant Company Specific Issues

Flood Risk Reduction:

42. Northumbrian Water has proposed a number of schemes that will move the company towards its target to eradicate sewer flooding. The company allocated £86m in its business plan to fund a Flood Risk Reduction Enhancement Scheme. Ofwat has now moved this to base costs but with no uplift in funding. We are not in a position to say whether additional funding is needed but we are concerned that a scheme, which is

intended to address resilience issues and protect customers from flooding, as a result of climate change, could suffer. We would not want the company to remove or defer this just to reduce overall costs.

Drainage and Waste Water Management Plan (DWMP)

43. Similarly, funding to deliver the DWMPs has been moved to base costs and in the company's view, Ofwat has "disallowed" the cost. We are very supportive of the move to develop DWMPs and have participated in the Water UK steering group to develop the framework for DWMPs. We believe they will provide a step change in how the companies provide flood risk reduction and, more importantly, work with other stakeholders to secure better outcomes and reduce costs for customers and society as a whole. Engagement by all those responsible for drainage and flood risk, as well as those affected or who may be affected in future, is key to the success of these plans. We are therefore concerned that the efficiency challenge risks reducing investment and the quality of the engagement and therefore the plans themselves. We also note that there is regulatory precedent where funding for DWMPs has been allowed for other companies.

Resilience in Essex and Suffolk

44. The company has also proposed three schemes to address water resilience issues for Essex and Suffolk customers. The company tested customer acceptance of these schemes, as opposed to receiving a reduction in their bills. The Suffolk Resilience scheme received 100% support, Raw Water deterioration scheme 92% and Abberton Transfer scheme 89%. It is therefore clear that customers are willing to pay for schemes that will make the water supply for future generations more resilient and secure. We understand that the company will be providing Ofwat with further information to support these schemes and we hope that this, together with a greater consideration of customers' views, will ensure these schemes can be progressed.

Difference in charges between regions:

45. Since the merger of the two companies, the differential in bills for customers in the northern area and those in Essex & Suffolk has been maintained. Our analysis (and that of the company) suggests that this differential will widen significantly if the Draft Determination were to be adopted. This arises because of the variation in the

impact of improvements in efficiency between water and wastewater services. It has the potential to result in Northumbrian Water's customers having the lowest combined bill in the sector, while Essex & Suffolk's customers will have the second highest water only bill.

46. In the context of this discrepancy, and the very different water resource constraints projected for the two populations served by the company, it is important that Essex & Suffolk customers can see both the company and the regulator acting to secure resilient services for them and future generations of customers. The proposed schemes to connect Abberton and Hanningfield reservoirs and to enhance water treatment work resilience at Layer and March should be re-evaluated, using the additional evidence supplied by the company but not yet considered by Ofwat, with this context in mind. In the case of this company in particular, the tendency to quote the effects of the Price Review based on the impact on an "average customer" is - in our view - misleading.

Population Growth

47. We note that there are differing sources of evidence of population growth forecasts used in Draft Determinations, WRMPs and companies' 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 robust and valid forecast.

Other general comments

Developer Services Experience (D-MeX)

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

- We note that the quantitative D-MeX score is based on a survey of transactions and that the water companies are in the process of operating a shadow year. At the end of the shadow year, will Ofwat review whether these metrics have incentivised good behaviour, as planned? If so, how will it ensure that companies are incentivised to perform as well as possible and not just 'sufficiently' well in order to meet the minimum requirement? The qualitative score is given by developer customers surveyed in the customer satisfaction

survey. How does the mechanism reflect the experience of self-lay operators and new appointees in this market?

- According to the outcomes 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?

Innovation

48. The company's plan has been informed in part by outputs from a series of annual Innovation Festivals held over the last three years. The company should be commended for its willingness to engage with other water companies in these activities, and for facilitating engagement between stakeholders from many sectors, including academia.
49. We understand that Ofwat is considering an additional revenue adjustment for the Final Determinations, to allow companies' additional costs to drive further innovation initiatives. 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.
50. Companies may deliver innovative methods of delivering services that have a tangible positive impact on customers; for example, in areas such as service quality, affordability and vulnerability.
51. However, we question why additional revenue (that customers will pay for) is needed to encourage greater innovation. This is especially the case if companies are also challenged to be more efficient. A Draft Determination that places greater commitments on companies to improve service delivery, protect the environment,

and improve the resilience of their assets and operations should encourage innovative solutions without the need for a special revenue adjustment.

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

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