



# **Ofwat: Draft 2020-25 price control determination for Portsmouth 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 Portsmouth 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 83% of Portsmouth Water'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 can be found below.

### What we support

3. We are supportive of the following aspects of the Draft Determination:
  - The proposed 3% reduction in bills (after inflation<sup>1</sup>) followed by a 'smooth' bill profile for the 2020-25 period, which was supported by 85% of customers in our acceptability testing research.
  - 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.

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<sup>1</sup> Based on an assumption of 2%pa CPI-H

<sup>2</sup> Real (RPI) for appointees

- Portsmouth Water has been allowed an additional small company premium<sup>3</sup>, as it has demonstrated to Ofwat that the value of the uplift will be outweighed by the value of the benefits it is committed to deliver for customers. Ofwat should consider clawing back the premium if Portsmouth Water fails to deliver its commitments.
- The range of Performance Commitments, which we believe are stretching, reflect customer priorities and were based on robust customer evidence.
- The requirement for Portsmouth Water to deliver an action plan to demonstrate how their various Performance Commitments and investments will address current and future risk of resilience. We would like to see the Final Determination clearly show how Portsmouth Water will address risks and will work with them as they develop a framework for achieving this.
- The commitment to deliver the Havant Thicket reservoir and the separate price control required to finance it. We support the collaborative approach between Portsmouth Water and Southern Water, provided that the two companies come to an appropriate commercial agreement and in doing so Portsmouth Water customers are protected from any potential cross-subsidy.
- The increase in the number of customers receiving affordability and vulnerability support through the allowances made in the Draft Determination for Portsmouth Water. While this is welcome, we believe companies still need to do more because 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.

### What we have concerns with

4. We are concerned about the following issues:

- Any risks to the delivery of customer supported Performance Commitments, service improvements or investment as a result of Ofwat's cost efficiency challenge. While it is important to customers that Portsmouth Water delivers its service efficiently,

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<sup>3</sup> 30 basis points on the overall cost of debt

customer supported commitments should not be reduced or deferred to meet this challenge. We expect Ofwat to ensure that its cost assessment is valid and allows for customer commitments to be delivered.

- The potential bill impact of Outcome Delivery Incentive (ODI) outperformance payments. While we recognise that Ofwat has reduced the scope of rewards and applied protections to limit excessive rewards, there remains a number of customers who do not support ODIs.

## 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 acceptability research found that a high proportion of Portsmouth Water's customers think that the Draft Determination proposals are acceptable. 83%<sup>4</sup> of uninformed customers and 83% 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 the company ensures that the Final Determination continues to deliver a package that allows customers priorities to be delivered at a price that they accept.
6. 76% of customers found the potential impact of ODIs on their bills over the period to be acceptable. While this is a good level of acceptability, nearly a quarter of customers either did not know or found it unacceptable. This is also a pronounced decrease compared 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 is not generally well informed about water and wastewater services. Informed customers are more likely to have been made aware

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<sup>4</sup> Unweighted topline figures as of 23 August 2019. Figures may change slightly in the final report.

of some aspects of service that they had never considered before and may feel that their bill provides more value than they have previously understood.

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 bills reduce by 3% after inflation<sup>5</sup> over the period 2020-25. Ofwat's reported figure (12% reduction) does not include inflation and the impact of ODIs, so we expect Portsmouth Water and Ofwat to make this clear to customers when explaining bill impacts at Final Determination and beyond.
10. Portsmouth Water customers will see bills decrease in 2020-21, and then remain stable for the remainder of the price control period (not including inflation). As Portsmouth Water's research showed customers supported a smooth bill profile, the initial reduction followed by a smooth profile is acceptable to customers (as shown by the level of customers who say the Draft Determination year on year bill impacts are acceptable - 85% uninformed, 83% informed).
11. We are supportive of bills being reduced for customers; however, given that Portsmouth Water already has the lowest bills across the industry, we would not wish to see the company cut customer-supported schemes or fail to deliver promised improvements in areas that customers prioritise and value.

### Weighted Average Cost of Capital (WACC)

12. 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%

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<sup>5</sup> Based on a forecast 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

to 2.3%<sup>7</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.
14. We note the inclusion of a small company premium for Portsmouth Water based on Ofwat's assessment against three areas: level of uplift, customer benefits and customer support. We note that this has added 42 basis points to the cost of embedded debt equating to 30 basis points on the overall cost of debt. If Portsmouth Water fails to deliver its commitments to customers, and it is clear that customers have not been compensated for the increased cost of the small company premium, we think that Ofwat should consider clawing back the small company premium.

#### Cost efficiency challenges and categorisations

15. 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.
16. However, the efficiency challenge to Portsmouth Water should not put in jeopardy the delivery of any well-evidenced PCs, 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 no longer going ahead.
17. 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 Portsmouth Water's responsibility to ensure that its commitments to customers are delivered. It would

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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

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

18. We note the differing sources of evidence of population growth forecasts used by Ofwat and by 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 robust forecasts.

#### '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. However, the ratio can be used to improve the financeability of the determination or to help 'smooth' the short and long term bill profiles for customers.
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. Ofwat should be clear in the Final Determination for Portsmouth 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 Ofwat's initial assessment of business plans (IAP) and the Draft Determination, Portsmouth 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 Portsmouth Water’s response to this challenge and working with them as they develop this framework.
23. We would like to see how Portsmouth Water’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 Portsmouth Water’s action plan is viewed as sub-standard.
24. Resilience can be affected by factors that may be uncertain or unforeseen now but may affect the Portsmouth Water’s ability to deliver its services reliably and securely in the future. Therefore, we wish to see Portsmouth Water showing flexibility to adapt to changes to current and future risks, and demonstrating to its customers and stakeholders that it has done so.
25. Ofwat has increased Portsmouth Water’s Outcome Delivery Incentive penalties for mains repairs and unplanned outages target, and increased the target for the latter. This stretch should result in a better service for customers, and money going back to customers in the form of penalties, which customers supported.
26. A significant part of Portsmouth Water’s business plan is the proposed Havant Thicket Reservoir, which has been supported by Ofwat to be delivered by in-house procurement. We would expect Ofwat to choose the most cost-beneficial option for customers to deliver the project. We are supportive of water companies investing in resilience for current and future customers, and of collaboration between companies, provided that there are appropriate commercial agreements in place to protect Portsmouth Water customers.



## Outcomes - Performance Commitments and Outcome Delivery Incentives

### Performance Commitments (PCs)

27. Overall, we consider that Portsmouth Water's PCs are stretching, reflect customer priorities and were developed based on extensive evidence of customers' views collected during the development of the business plan.
28. The most significant change to the PC targets is that of per capita consumption (PCC), which has been stretched to a 6.3% reduction by 2024-25. We are supportive of the companies being pushed to reduce their customer's water usage, but do not feel that Portsmouth Water has successfully evidenced how it will reach its PCC target; particularly as it is unable to compulsorily meter on a universal basis, under legislation related to seriously water-stressed areas. A significant cultural change will be required in the Portsmouth area, encouraging customers to value water, as the prevailing view is that there is plenty of water and therefore no need to reduce consumption.
29. Portsmouth Water has an excellent record on customer service and has performed well in this area over the last price control period. However, its record against its operational targets has not been so strong. We hope, going forward, that the stretching PCs will help to address issues such as leakage, bursts, water quality contacts, PCC etc. We are, however, concerned that imposing such stretch targets with penalties whilst reducing all of the revenue streams proposed in the company's business plan, may affect the deliverability of these outcomes.

### 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. We note that specific C-MeX targets will be proposed later in the PR19 process. However, 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 where their complaint performance is static or declining.

31. Portsmouth Water has a good track record with customer services and complaints performance and has been rewarded £1.4m for its Service Incentive Mechanism (SIM) performance over the last price control period. We want to see the company continuing to be a top performing company once C-MeX is implemented.

#### 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 must have demonstrated clear customer support for both the principle and the range of ODI payments before they are included in price determinations. We do not believe that the research Portsmouth Water carried out for its business plan achieved this for rewards. Similarly, our research showed that customer acceptability reduced from 83% to 76% 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. In this context, we 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.
34. However, we remain concerned that the use of ODIs has a risk of a negative customer reaction as customers showed limited support the use of these financial incentives, and outperformance payments lead to bill increases.
35. Portsmouth Water's customers were supportive of penalties, but not rewards, so an additional £1m in ODI penalties is in line with customer's views. We are concerned by the increase in the upside ODI range in the company's resubmitted plan and the draft determination. Customers did not give clear support for the principle of rewards and we were supportive of the companies' response in limiting the potential impact of ODIs on bills in response to this.

## Affordability & Vulnerability

### Affordability

36. 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 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.
37. Our [Water Matters research](#) (2018) found that 77% of Portsmouth Water customers considered their charges to be affordable. CCWater's research into Portsmouth Water's Draft Determination found that 56% 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. This shows that despite the bill profile in the Draft Determination, there is still a number of customers who may struggle to pay.
38. Portsmouth Water customers are also in the position of having the lowest average water bill across the industry, often being lower than other companies' Social Tariffs. However, Portsmouth Water will still have customers who struggle to pay and the company needs to ensure that the help it is offering makes a difference.
39. We are pleased that Ofwat has increased the potential number of customers on the Social Tariff from 8,000 to 10,000 as proposed by Portsmouth Water in its resubmitted plan. The company will self-fund if there is not customer support for the additional 2,000 customers. Considering that Portsmouth Water's bills are already very low, it is good to see that the company is still aware that there are customers who struggle to pay their bill.

### Vulnerability

40. CCWater believes that in order to get a good picture of how a company is performing in providing services for customers in vulnerable circumstances they must measure awareness of the help that is available and satisfaction with the service being provided. We are pleased that Ofwat has introduced a common PC to track progress with Priority Services Registers (PSRs), something CCWater called for in our response

to the PR19 methodology. However, we believe that there is the potential for a target that focusses solely on numbers to drive the wrong behaviours.

41. We would like to see companies go further and ensure that all customers 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 customers 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 customers know what help they can access.
42. We will be monitoring companies' activities in this area closely to see which customers are being signed up for the PSR, for what services and whether the help being offered is meaningful.
43. 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. To support this, it is crucial that companies raise awareness of the support available so that consumers know what help they can access.
44. 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, we would like to see a measure of customer satisfaction with services in the final determination, as proposed by some other companies.
45. We also 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.
46. Following its Interim Assessment of Plans (IAP), 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 customer and the company? In the DD's Ofwat have provided reporting guidance on what "contact" means and have 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.

### Other key company specific issues

#### Havant Thicket

47. We are pleased that Ofwat is supportive of the Havant Thicket project, with Portsmouth Water providing additional water resources to another company in the South East region. We are not aware of the commercial arrangements for the project, but believe that the agreement should not introduce a cross-subsidy between either of the companies' customers.
48. The separate price control for the project could be beneficial to customers because the price control has a different cost of capital to the one applied to the rest of the business. This is good for customers because it suggests that the project can be funded at lower cost, and would be 'locked in' for ten years. We would be interested to know whether the cost of capital for Havant Thicket could be reopened if there were any material changes in circumstances.
49. We also note that Ofwat has proposed that if Portsmouth Water receives income above the economic cost of the scheme, then an arrangement will be introduced so that the profit is shared with customers. We would support and expect to see this.

#### Water Industry National Environment Programme (WINEP)

50. We acknowledge the number of obligations that Portsmouth Water will need to deliver under the WINEP, and are pleased to see that Ofwat has allowed funding for this, especially as a stronger level of environmental interest from stakeholders and customers was evidenced through research.

## Other general issues

### Developer Services Experience (D-MeX)

51. 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:
- 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. Self-lay operators and new appointees have a much smaller proportion of the market. How does the mechanism reflect their experience?
  - 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?

## Innovation

52. We understand that Ofwat is considering an additional revenue adjustment for the Final Determinations, to allow Portsmouth Water 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 Portsmouth Water 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.

53. Portsmouth Water should deliver innovative methods to delivering services that have a tangible, positive impact on customers; for example, in areas such as service quality, affordability and vulnerability.
54. However, we question why additional revenue (that customers will pay for) is needed to encourage greater innovation. This is especially the case as Portsmouth has been 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.
55. More collaborative working between the appointed companies to identify and share good practice would also help achieve this aim.

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