



# **Ofwat: Draft 2020-25 price control determination for SES 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 SES Water (SES).

## Section A - Executive Summary

### Customer Acceptability

2. CCWater has commissioned research to measure the customer acceptability of the Draft Determination package of prices and service improvements. 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.
3. Of 500 SES Water customers who were surveyed<sup>1</sup>, 93% found the package to be either 'acceptable' or 'very acceptable'. This percentage was the same for both uninformed customer views (when customers were presented with very basic information about the bill profile) and informed views (when customers also consider key service improvements in the package). This shows that the majority of customers found both the proposed bills and the package of service improvements to be acceptable.

### What we support

4. We support the following proposals in the Draft Determination for SES Water:
  - The revised Performance Commitment targets for both Per Capita Consumption and Leakage.

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<sup>1</sup> Unweighted top line findings from 23 August 2019 – final figures may differ slightly in final report

- The extra support 25,000 customers will have received under the Water Support schemes and the fact that SES Water shareholders will be providing the funding for this.
- 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 with the following:

- The profile of average bills across each of the five years of the price control, which sees a sharp fall in bills followed by subsequent increase. We know that customers value bill stability and would like to see Ofwat's Final Determination deliver a smoother bill profile.
- Any risks to the delivery of customer-supported Performance Commitments, service improvements or investment as a result of Ofwat's cost efficiency challenge, notably those related to long term resilience. While it is important to customers that SES Water delivers its service efficiently, 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 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, SES Water has failed to demonstrate that its customers support ODIs.

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

- Whether the ODI rate for SES Water’s Water Supply Interruptions Performance Commitment is appropriate.

## 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. CCWater commissioned DJS Research to carry out interviews with a representative sample of 500 customers from each water and sewerage company to test the acceptability of Ofwat’s Draft Determinations.
7. Our Draft Determination research found that 93% of SES Water customers surveyed think that the Draft Determination proposals are either “acceptable” or “very acceptable” (the same percentage for both uninformed and informed acceptability). This shows that the majority of customers found both the proposed bills and the ‘package’ of service improvements to be acceptable. Given this high level of acceptability for the price and service levels, it is important that Ofwat and SES Water ensure that the Final Determination continues to deliver a package that allows customers priorities to be delivered at a price that they accept.
8. Customer acceptability reduced to 87% when customers were presented with the potential impact of ODIs on their bills over the period. This shows that there remains a risk that customers do not support the potential 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 vast 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**

11. The Draft Determination would see bills reduced by 7%<sup>3</sup> after inflation over the period 2020-25. We are pleased to see bills being reduced for customers, although given the scale of this reduction we require greater clarity on how the company will deliver this reduction. We do not wish to see the company cut customer-supported schemes or fail to deliver promised improvements in areas that customers prioritise and value. Ofwat's reported figure (a 15% reduction) does 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.
12. The research conducted by SES Water in developing its business plan found customer support for a bill profile that ensured stability of charges over the period of the plan. We note that Ofwat's proposed bill profile is for a reduction at the start of the period. Given the impact of inflation, this would produce a sharp fall in bills followed by subsequent increase. We know that customers value bill stability and that low income customers in particular can find it difficult to manage bill increases. For these reasons, we believe Ofwat's Final Determination should deliver a smoother bill profile.

### **Cost efficiency challenges and categorisations**

13. While it is important to customers that companies deliver services efficiently, 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. Such commitments to customers should not be removed or deferred just to reduce overall costs.

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

14. 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 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 that customers have supported.
15. It is the company's responsibility to ensure that its commitments to customers are delivered and SES should seek referral to the CMA if they believe they cannot.

Weighted Average Cost of Capital (WACC):

16. An independent study commissioned by CCWater<sup>[5]</sup> has recommended a range for the Weighted Average Cost of Capital (WACC) between 1.7% to 2.3%<sup>[6]</sup>, based on an analysis of water company financing, market evidence and financing assumptions in other regulated sectors. 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.
17. We note that Ofwat has rejected the company's proposals for the inclusion of a small company premium based on its assessment against three areas: level of uplift, customer benefits and customer support. We would urge Ofwat to only include an uplift to the WACC at final determination if the company's further evidence is compelling. We would also ask that where a company does not deliver its commitments to customers, and it is clear that customers have not been compensated for the increased cost of the small company premium, Ofwat should consider clawing back the small company premium.

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<sup>[5]</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>[6]</sup> Real (RPI) WACC appointee level

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

18. The PAYG ratio should reflect the balance of short and long term cost recovery relative to the companies' balance of operational activity and longer term capital investment. 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.
19. In its Draft Determination, Ofwat has increased the company's proposed Pay As You Go (PAYG) ratio from 40.9% to 50.6% (effectively advancing £1m into the 2020/25 price control period that would otherwise have been recovered over a longer period). 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**

20. Resilience can be affected by factors that may be uncertain or unforeseen now but may affect the company's ability to deliver its services reliably and securely in the future. Therefore, we wish to see companies showing flexibility to adapt to changes to current and future risks, and demonstrating to their customers and stakeholders that they have done so.
21. We are concerned that the company has focused less than we would have liked on the long-term approach to resilience and could take a stronger position to do more as a regional player in the water-stressed South East, as we have seen from other companies in this region.
22. The company has embarked on a strategy to ensure none of its customers are served by a single source, therefore mitigating the risk of a major loss of supplies. Two schemes to complete this strategy by 2025 were included at Ofwat's Initial Assessment of Plan (IAP) stage but have subsequently been challenged in the Draft Determination. While we support Ofwat in challenging the company to make a stronger business case for these schemes, we would be concerned if the underlying strategy was not able to be taken forward, as security of supply and service resilience were priorities for SES Water's customers, and in the long term, this is essential for the wider water-stressed South East region.

23. Although SES Water is not currently part of any of the strategic supply options for the region, the company should continue to collaborate with neighbouring companies and think more strategically within the region, particularly around reducing leakage and PCC. SES Water will need to think more seriously about innovation and working efficiently in order to meet the new more challenging targets.
24. We note that Ofwat would like to see investment in drought resilience demonstrate a “twin track” approach within the Water Resources Management Plan (WRMP). We support SES Water’s work with the Water Resources in the South East (WRSE) group and would like to see SES Water continue play its part in delivering against regional priorities, balancing the need for customers’ security of supply with environmental impact.
25. In Ofwat’s initial assessment of business plans (IAP) and the Draft Determination, SES 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’*.
26. We support this action and look forward to seeing the company’s response to this challenge and working with it as it develops this framework

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

### Performance Commitments

27. Overall, we consider that SES Water’s PCs are now stretching and reflect customer priorities.

28. We are pleased that Ofwat has accepted both of SES Water's commitments for reducing per capita consumption (PCC) and leakage. We note that SES Water has historically performed reasonably well, compared to other water companies, when it comes to leakage, which is important for customers. We expect to see this performance continue but recognise that the company has not been allowed enhanced funding in this area. We do not feel that SES Water has successfully evidenced how it will reach its PCC target but we are aware that it has been allowed £19.5m of funding to install 80,000 meters, which may help contribute to this reduction.
29. SES Water is currently a strong performer on Water Supply Interruptions (WSIs) but we are concerned that the company may be able to achieve considerable ODI outperformance payments in this area by simply maintaining current performance (or even deteriorating slightly as it is currently above the industry upper quartile). We look to Ofwat to ensure that any ODI payments the company is able to achieve are appropriate and only reward exceptional performance.

Customer Experience measure (C-MeX)

30. 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 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. The C-MeX incentive needs to prompt improvement in the complaints performance of companies. SES Water has struggled with its complaints performance over the last couple of years, and whilst this has seen improvements, it needs to improve further. We believe that complaints are an important indicator of customers' experiences and we believe that Ofwat thinks this too. We hope that there will be continued improvement to this area, and that this will be reflected in SES Water's C-MeX scores.

### Outcome Delivery Incentives (ODIs)

32. 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 as outperformance payments lead to bill increases. There is potential for bill levels to be significantly higher than those set out in Ofwat's Final Determination as a result of the ODI mechanism.
33. Despite our challenges to the contrary at various points during the process (and as evidenced in the challenge log through the Customer Scrutiny Panel), we are disappointed that SES Water did not carry out customer research on the potential impact of ODIs, for its original or resubmitted business plans. SES Water felt that this was sufficiently tested with customers through its Willingness to Pay (WTP) research. We disagree however; research<sup>4</sup> that we published in 2016 concluded that WTP research should only be used for calculating ODIs where it was explicitly designed for this purpose and it should not be retrospectively applied to derive ODI values.
34. We have raised concerns with the company over the lack of customer testing in regard to the ODIs, and how this may impact bills. Therefore, 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.

### **Affordability & Vulnerability**

#### Affordability:

35. While we are happy to see progress being made to support customers who are struggling to pay, 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. We are pleased that Ofwat has included the capacity to help 25,000 customers through SES Water's Water Support scheme, and it is good to see that shareholders will fund this additional amount.

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<sup>4</sup> [CCWater: Improving Willingness to pay research in the water sector; July 2017](#)

36. Our [Water Matters research](#) (2018) found that 75% of SES customers found their charges affordable. CCWater's research into SES Water's DD found that 78% of customers thought current charges were affordable but that this increased to 89% when they were shown the effect the DD proposals would have on their bills.

### Vulnerability

37. SES Water's research for the business plan on non-financial vulnerability aspects was less comprehensive and targeted than the financial elements. The wider Customer Scrutiny Panel agreed that this was an area where the company could further improve its assistance, particularly the non-financial aspects affecting consumers in vulnerable circumstances.
38. We believe that in order to get a good picture of how a company is performing in providing services for customers in vulnerable circumstances, it must measure awareness of the help that is available and satisfaction with the service being provided.
39. We are pleased that Ofwat has introduced a common Performance Commitment (PC) to track progress with Priority Services Registers (PSR), something we 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.
40. 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. It is crucial that companies raise awareness of the support available so that customers know what help they can access.
41. 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.

42. 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. We will also liaise with companies to understand which consumers who would benefit from being on the PSR may be missing out.
43. Following the IAPs, we challenged Ofwat's proposed vulnerability PC requiring companies to contact 90% of customers 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 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.

#### **Other key company specific issues**

##### Population Growth

44. There is a lack of consistency in sources of population growth forecasts used for the business plan, the Water Resource Management Plans and the Draft Determination. As this is a significant driver of both costs and revenue, Ofwat therefore needs to demonstrate that the assumption in its Final Determination allowance reflects the most robust forecasts and to help ensure that this investment is delivered to meet customers' expectations.

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

45. It is good to see that the Water Industry National Environment Programme (WINEP) schemes for SES Water have been included in the Draft Determinations; SES Water now has 24 schemes to deliver under this.

### Water Softening

46. SES Water's water softening cost adjustment claim has been allowed, and we are aware that a PC has been introduced for this. This will have a financial penalty, which may be incurred if there is any fluctuation in water hardness. This situation could arise when the company prioritises water quality compliance over its softening commitments. We think that setting the Softening PC target as a running average rather than an absolute figure, which has been the established practice, would allow the company the flexibility to strike the right balance between delivering customers' priorities on both water hardness and water quality. However, we would always defer to the Drinking Water Inspectorate (DWI) on matters of water quality compliance.

### First Contact Resolution:

47. The company had set its PC for first contact resolution at 85%, which has been increased in the Draft Determination to 90%. We understand that this is likely to be a big stretch for SES Water, and would encourage the company to take on this challenge and to seek out current best practice in complaint resolution, within and beyond the water sector.

### **Other General Comments**

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

48. 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.
49. 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?

50. 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?
  
51. 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 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.
  
53. Companies should identify innovative methods of 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 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.

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

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