



# **Ofwat: Draft 2020-25 price control determination for South East 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 South East 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 88% of South East Water 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 reduction in the Weighted Average Cost of Capital to 2.19%<sup>1</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.
  - Funding for the delivery and evaluation of resilience and water resource schemes to help address the water scarcity issues in the South East.
  - The acceptance of the company's Per Capita Consumption target.

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<sup>1</sup> Real (RPI) appointee level

- Bespoke Performance Commitments for customer satisfaction relating to customers receiving financial support.

### 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.
- While we welcome Ofwat’s efficiency challenge to South East Water, we do not want customer-supported Performance Commitments, service improvements or investment removed or reduced because of this challenge. We therefore expect Ofwat to reassure us that their models have validity. 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.

## 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 research found that a high proportion of South East Water’s customers think that the Draft Determination proposals are acceptable. 88%<sup>2</sup> of uninformed and 84% 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 South East Water ensure that the Final Determination continues to deliver a package that allows customers priorities to be delivered at a price that they accept.

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

6. We give a greater 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.
7. 77% of customers found the potential impact of ODIs on their bills over the period to be acceptable (71% when considering the potential impact of sewerage service ODIs). This is a pronounced decrease to the levels of acceptability achieved by the “base” plan and highlights the potential for there to be a customer backlash against the impact of ODI outperformance payments on bills once this is fully realised.
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 reduced by 1% after inflation<sup>3</sup> over the period 2020-25. The figures Ofwat published (10% real term reduction) 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. We remain concerned about the impact inflation and ODIs could have on the bills customers actually pay in future.
10. As South East 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 number of customers who found the year on year combined bills proposed in the DD to be acceptable in our research, 88% uninformed).

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

### Weighted Average Cost of Capital (WACC)

11. An independent study commissioned by CCWater<sup>4</sup> has recommended a range for the WACC of between 1.7% to 2.3%, based on an analysis of water company financing, market evidence and financing assumptions in other regulated sectors.
12. We note that for the slow track and significant scrutiny Draft Determinations, Ofwat has used a WACC of 2.19%. While this is within the range recommended by our consultants, it is at the top end. We therefore welcome Ofwat's comments that current market evidence suggests the cost of capital may be even lower when Ofwat comes to Final Determinations in December 2019

### Cost efficiency challenges

13. 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, customers do not have the option to appeal if their expectations are not met or the price determination 'package' is unacceptable to them.
14. The efficiency challenge to companies should not put in jeopardy the delivery of any well-evidenced Performance Commitments, service improvements and/or investment that customers value. We would be concerned if the company responded to the cost efficiency challenge by trying to draw back from some of the commitments it made to its customers or failing to deliver improvements in the areas we know are priorities for them.
15. At Draft Determination, there is a substantial difference (of £133m) between the resources sought by the company to deliver its proposed business plan and those allowed by Ofwat.
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:

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<sup>4</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/>

- Reassurance that the basis of its cost models are sound; and.
- 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.

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

17. 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.
18. 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 that the ratio strikes the appropriate balance of cost recovery from current and future customers.

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

19. In Ofwat's IAP and the Draft Determination, South East 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'*.
20. 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.
21. We would like to see how South East 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 South East Water's action plan is viewed as sub-standard.

22. 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.
23. South East Water has faced some serious operational challenges in recent years through extreme weather and major mains bursts as well as some raw water quality issues. It is also operating in an area that will see significant growth in the future. It is therefore essential that its plans are robust and fit for the future.

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

#### Performance Commitments (PCs)

24. Overall, we consider South East Water's Performance Commitments are now stretching, reflect customer priorities and were developed based on good evidence of customers' views collected during the development of the Business Plan. It has also included some that support new ways of working and developing partnerships (working with local landowners for example) and understanding and communicating with customers in a more targeted way (customer satisfaction/segmentation).

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

25. We welcome the clarity and details on 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 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.

#### Leakage

26. We note that Ofwat has accepted the company's leakage reduction proposals of above 15% on an annual average basis - which will keep it at industry upper quartile by 2024-25 - and has allowed some enhancement expenditure for this. South East

Water has a good track record on leakage and given that it operates in a seriously water-stressed area it is extremely important that it continues to demonstrate to its customers that it is doing all it can to reduce leakage.

#### Per Capita Consumption (PCC)

27. Given that the company currently has the highest average per capita consumption in England and Wales, we support Ofwat's intervention to increase the target for reduction in PCC to 8% by 2024-25. The company was one of the first to successfully roll out universal metering and has done a lot of good work to promote water efficiency both in its own area and as part of the wider South East group of companies. Customers have also been provided with practical support during the transition to metered charging. We hope South East Water will continue to build on these good foundations.

#### Mains Bursts

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

#### Outcome Delivery Incentives:

30. 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 demonstrate clear customer support for

both the principle and the range of ODI payments before they are included in price determinations.

31. Our research to test the customer acceptability reduced from 88% to 77% (71% when considering the potential impact of sewerage ODIs) 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.
32. CCWater welcomes 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 starting mechanism if this is breached. We remain concerned that there is potential for bill levels to be somewhat higher than the real terms figures set out in Ofwat's Final Determination because of the ODI mechanism, although, with the added stretch in PCs and asymmetrical ODI range in favour of penalties, this seems less likely.

### **Affordability & Vulnerability**

#### Affordability:

33. 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 1 million customers who are in need of assistance but not receiving it, even after the improvements companies are making.
34. Our Water Matters research (2018) found that 77% of South East Water customers found their charges affordable. CCWater's research into South East Water's DD found that 66% of customers thought current charges were affordable but that this increased to 78% when they were shown the effect the DD proposals would have on their bills. This indicates that there will still be a significant proportion of customers who will struggle to afford their bills and will require additional support.

## Vulnerability

35. While we welcome the new common PC to measure the number of customers on companies' Priority Services Registers, we are concerned that a PC target to increase numbers on priority services can drive the wrong behaviours. We want to ensure that help is meaningful for customers.
36. We would like to see companies go further than focusing solely on PSRs to 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.
37. We also feel that those customers receiving the support (and/or their representatives) are best placed to advise on whether the help is meaningful and there should be more focus on establishing and measuring this. We are therefore pleased that South East Water has included a series of customer satisfaction measures that include ones relating to those receiving financial and non-financial support as part of business as usual and during supply incidents.
38. 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.
39. 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 DDs, 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 issues

### Population Growth

40. 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.

## General Comments

### Innovation

41. We understand that Ofwat is considering an additional revenue adjustment for the Final Determinations, to allow companies additional costs to invest in further innovation. CCWater considers 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.
42. 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.
43. 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.
44. More collaborative working between the appointed companies to identify and share good practice would also help achieve this aim.

### Developer Services Experience (D-MeX)

45. While CCWater has welcomed the introduction of new measures designed to improve developer experience with companies, we have some questions about how this will operate
46. 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?
47. 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?
48. 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?

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