



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

## 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 91% of Yorkshire 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 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.
  - Ofwat's interventions on internal sewer flooding, pollution, sewer collapses, leakage and water supply interruption performance commitments (PCs).

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

- Yorkshire Water doubling its contribution to Social Tariff funding from £5m to £10m.
- An increase from 50,000 to 83,000 in the number of customers struggling to pay who are helped.
- Bespoke PCs for satisfaction and awareness of help available for vulnerable customers.

### 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 DD research found that a high proportion of Yorkshire Water's customers think that the Draft Determination proposals are acceptable. 91%<sup>2</sup> of uninformed customers and 89% 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 companies 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. 80% 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 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 vast 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 bills reduce by 1% after inflation<sup>3</sup> over the period 2020-25. We support measures to keep bills low, providing this does not have a detrimental impact on the company’s ability to deliver the outcomes that its customers have supported.
10. Ofwat’s reported figure (a 10% 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.
11. Due to Ofwat intervening to reduce bills in the Draft Determination, the bill profile has been adjusted such that all of the decrease in bills occurs in the first year, followed by a flat bill, before inflation, to 2025. Given the impact of inflation (and possibly ODIs), this would produce a sharp fall in bills followed by subsequent increase. This fluctuation is not in line with customers’ views.

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<sup>3</sup> Based on an assumption of inflation at 2% p.a.

12. The research conducted by YW in developing its business plan found 82% customer support for a smooth (flat) 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.

Weighted Average Cost of Capital (WACC):

13. The cost of capital has a large impact on customer bills. 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.
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 in December 2019.

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. However, the efficiency challenge to companies 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 such as leakage improvements and planned investment to improve wastewater services no longer going ahead.

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<sup>4</sup> Update to our recommendations for the Cost of Capital 2020-25 (Economic Consulting Associates for CCWater, January 2019) – see [here](#).

16. 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 the companies' responsibility to ensure that their commitments to customers are delivered. It would not be in customers' interests for companies to defer or reduce their commitments to customers, in response to the regulatory cost efficiency challenge.

#### Population Growth

17. 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 valid forecasts, and ideally be consistent with those used in other water industry planning processes.
18. YW has shared outperformance in the past and we are pleased it will continue to do so. YW has committed to meeting the expectations set out in Ofwat's 'Putting the sector back in balance' position statement. YW has proposed to share any outperformance achieved on the actual cost of embedded debt below the notional cost of debt set in Ofwat's determination. However, it is not proposing to commit to outperformance sharing beyond that. We do welcome the commitment by the company to double its contribution to its social tariff during 2020-25 from the £5m it initially proposed to £10m.

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

19. Through our membership of the Yorkshire Forum for Water Customers (CCG), we saw considerable evidence from YW linking priority risks to PCs. However, we are concerned about the lack of evidence on how resilience risk has been identified and prioritised, what mitigation options have been considered, and what mitigation options have been presented to customers. We want the company to provide further clarification on this.
20. Where risks have been identified, we are concerned as to whether the outcomes of the PCs set by YW are sufficient to mitigate the risk. As such, we support Ofwat's intervention to set higher ambition on PCs where YW was an outlier.
21. In Ofwat's IAP and the Draft Determination, Yorkshire is 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 the company's response to this challenge and working with them as they develop this framework.
23. 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 Yorkshire 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 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 (PCs)

25. PCs should be stretching, reflect customer priorities and be developed based on extensive evidence of customers' views collected during the development of the Business Plan. We felt that YW should have been more ambitious in the targets it sets for its PCs in its Business Plan so that customers receive at least the same level of service as customers from other companies.
26. We are therefore pleased that Ofwat has made some key interventions on outcomes in its Draft Determination for YW.

27. YW has scored very low for customer satisfaction with wastewater services in the Service Incentive Mechanism (SIM) period over the last five years. We have raised our concerns with YW and intervened to challenge them to improve these services for customers. We were disappointed to note in their PR19 plans that for some key performance commitments YW showed a lack of ambition and would not improve sufficiently to avoid being an industry outlier. As such, we support Ofwat’s intervention to set targets to bring them in line with other water and sewerage companies for the following PCs:

PC	Priority for YW Customers
Internal sewer flooding	Very high
Pollution incidents	Very high
Sewer Collapses	High

28. We also support Ofwat’s intervention to set improved targets for water services.

PC	Priority for YW Customers
Leakage	Very High
Water supply interruptions	High

Customer Experience Measure (C-MeX):

29. We welcome the clarity on the details of the shadow reporting of the Customer Experience Measure (CMeX) - 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 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.

### Mains Bursts

30. In its Draft Determination for YW, 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 be likely to 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.
31. Ofwat's Draft Determination 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 (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 YW carried out for its business plan achieved this. Similarly, our research showed that customer acceptability reduced from 91% to 80% 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. We are pleased that YW proposes to set Ofwat's standard sharing mechanism, where 50% of outperformance payments that exceed 3% of return on regulatory equity (RoRE) in any year are shared with customers in the following year. We would like to see companies involving customers in decisions about how money from outperformance payments is used - whether this be in the form of bill reductions or investment in improving services.

34. Ofwat is intervening to remove the 3% RoRE collar that the company is proposing to apply, as it is not in line with Ofwat policy. We support this, as we agree that imposing a limit on the penalties the company is exposed to will negatively affect customer protection. We also believe that the company does not provide any justification to support its proposal. We welcome the steps taken by Ofwat to moderate the potential bill impacts which 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. 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.
36. Our [Water Matters research](#) (2018) found that 76% of YW's customers considered their charges to be affordable. CCWater's research into Yorkshire Water's DD found that 68% of customers thought current charges were affordable but that this increased to 80% when they were shown the effect the DD 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.
37. We believe YW's plan includes comprehensive measures to help address Affordability issues.
38. While we believe the industry as a whole need to do more to help customers who are struggling to pay, we welcome the focus YW has given the issue, and the financial contribution it is making to help address it.
39. The company has committed to fund £14.5 million of affordability support directly from its financial outperformance. We welcome this additional company funding, which means that direct support given to customers increases from a target of 50,000 to 83,000 by the end of the period. We have been calling on all companies to

play their part in funding support for customers who are struggling to pay and believe this should form part of the common PCs used to assess companies.

40. We are pleased that Yorkshire Water also offers a wide range of varying support for customers who are struggling financially.
41. YW has also committed to provide other affordability support to 60,000 customers per year through flexible payment arrangements, signposting to third party support and targeted face-to-face visits.
42. YW will also increase its social tariff cross-subsidy to £1.75 per customer, and findings from the research the company has conducted show that this is supported by customers.

#### Vulnerability

43. We welcome YW's commitment to improving its services for customers in vulnerable circumstances. The company has set itself a stretch target of 10% of customers being on the priority services register, which is greater than the minimum 7% set by Ofwat.
44. 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 drive a focus on numbers rather than the quality of support provided. We want to ensure that help is meaningful for customers.
45. We would like to see companies go further than focusing solely on PSRs to ensure that all customers 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 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. As such, we are very supportive of YW having a bespoke awareness PC.

46. Ofwat has changed the company's awareness PC to reputational from financial due to lack of evidence of customer support. We do not consider that companies should receive financial gain for doing the right thing by ensuring their services are accessible for all customers, and as such we support Ofwat's change of the PC to reputational.
47. We also feel that customers receiving the support (and/or their representatives) are in the best position to advise on whether the help is meaningful and there should be more focus on establishing and measuring this. To support this, a measure of customer satisfaction with services provided would be of benefit. We are very supportive of YW's PC for the percentage of residential consumers on the PSR who are satisfied with their experience of the company's priority services.
48. 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.

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

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

49. YW's WINEP is currently unconfirmed. We are supportive of amber schemes being included upfront (particularly where the EA thinks the scheme will go ahead) and that this is the approach taken by Ofwat for YW. If a scheme is confirmed as not required for the period 2020-25, YW and Ofwat will make adjustments at the end of the price control period.
50. We continue to urge Ofwat and the EA to explore ways in which customer views can be taken into account when considering the costs and impacts of investments to improve the environment.

## Other General Issues

### Developer Services Experience (D-MeX)

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

55. We understand that Ofwat is considering an additional revenue adjustment for its 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.

56. Companies may 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.
57. 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.
58. More collaborative working between the appointed companies to identify and share good practice would also help achieve this aim.

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