Centre City Tower, 7 Hill Street, Birmingham B5 4UA
21 Bloomsbury Street, London WC1B 3HF

Meeting note

Thursday 19 August 2021
1pm to 3pm
Meeting held virtually

Cost assessment working group (CAWG) – Residential Retail

Attendees

Anglian Water	Richard Goodwin
Dŵr Cymru	Charlotte Beale
Hafren Dyfrdwy	Kristinn Mason
Northumbrian Water	Crawford Winton
Severn Trent Water	Nathanial Sear
South West Water	Judith Corbyn
Southern Water	Kevin Wightman, Michael Kearns
Thames Water	Rebecca Weaving
United Utilities	Sam Crook
Wessex Water	David Peacock
Yorkshire Water	Liv Walton
Affinity Water	Nicky Fomes
Bristol Water	George Clarke
Portsmouth Water	Jamie Jones, Steve Morley
SES Water	Van Dang
South East Water	Matt Hersey
South Staffs Water	Clare Tiller
Ofwat	Alex Whitmarsh, Jeevan Jones, Tim Griffiths, Daniel Mitchell, Shaun Kent, Stewart Loftus

Introduction

We opened the meeting and set out the objectives of the afternoon and the agenda. The meeting focused on four key areas:

- Session 1: Overall approach;
- Session 2: Cost drivers;
- Session 3: Benchmarks; and
- Session 4: Other issues.

For each session, we gave introductory remarks as per our presentation. This presentation is being published on our website, so this meeting note focuses on the points raised by stakeholders.

Please note that:

- some points have been recorded below under the appropriate discussion theme, even if they were made in a different session;
- the points made are not comprehensive;
- we have aimed to include key points made and have not attributed these to individual companies; and
- in general, unless otherwise stated, the points made reflect the view of one attendee.

Session 1: Overall approach

Indexation

A number of companies considered there was merit in indexing retail costs. Points included:

- at least some retail costs are likely to be linked with the general level of inflation;
- no indexation in the control obfuscates the on-going efficiency challenge – it would be clearer to have indexation and a separate, explicit efficiency challenge;
- by PR24 there would not have been indexation for ten years which would have taken a lot of cost out of retail already;
- Ofwat could examine retail cost inflation in other sectors;
- a large part of retail costs are wage costs, which could see a sharp increase in wage inflation in future;
- Ofwat has allowed indexation of business retail costs.

Historic vs. forecast costs

A number of companies were concerned about placing undue weight on forecast costs. Points made by individual companies included:

- forecast costs were inherently less reliable than historic costs;

- some companies applied their own efficiency challenge but then Ofwat applied their own challenge on top, leading to an excessive cost reduction;
- there would be ten years of historic data to rely on thus reducing the need for supplementary forecast data;
- forecast costs could be a useful cross-check.

Cost-service link

There was some discussion of this issue across different sessions. Points included:

- whether C-MeX was sufficient to incentivise good service (Ofwat noted that SIM/C-MeX scores were getting better, suggesting this indicated it was);
- although companies are funded through C-MeX, a high-performing company, for example, might then be penalised through cost-assessment by appearing to have higher costs;
- there was some debate about whether good service should necessarily cost more (Ofwat noted that we had looked at this in PR19 and found no relationship between better service and higher costs);
- the impact of a number of options were discussed if good service did cost more.

Other issues

Other individual points raised in discussions were:

- a simple unit-cost analysis could be a useful cross-check on Ofwat's econometric assessment;
- the benefit of the more granular models was unclear;
- a single model covering both wholesale and retail costs to account for potential cost allocation issues (although companies did not identify specific cost allocation issues);
- lumpy investment might be deterred if it shows up as costs in one period, making the company look inefficient;
- it will be important to understand the different business models of WASCs and WOCs and the linkage between these two.

Session 2: Cost drivers

Session 2 focused on the explanatory variables and cost drivers to be captured in our econometric modelling. Points included:

- a number of companies considered that the existing factors looked right / did as intended; points related to this included: i) support for a transience variable; ii)

capturing the probability of default was good; and iii) previous work on deprivation measures showed there was marginal differences between measures;
- Ofwat should consider the relative costs of single vs. dual customers;
- Ofwat should undertake a root-cause analysis of customer contacts (although one company questioned how variable and significant this cost would be) to better understand what drives companies' costs;
- if Ofwat were to use customers' income in order to model the probability of default then income after housing costs would be appropriate in capturing income available for water bills;
- a mix of views about moving away from total bill size, with points in support of the current approach including that the simultaneity bias would be small and including retail costs could reward companies with higher bills/penalise those with lower bills.

Cost allocation and other issues

Further points were raised in relation to cost allocation and other cost issues:

- ensuring cost allocation was right (Ofwat noted their recent guidance on this subject);
- the distribution of variables, e.g. deprivation, was important and not just the average level across a companies' region;
- one company is exploring a new variable about the ability to engage with digital channels;
- Ofwat should disaggregate metered and unmetered customers when implementing the control – this aligns to be companies' approach to setting charges and would more accurately reflect costs.

Session 3: Benchmarks

General comments

A number of companies raised both the potential for, but also the limitations of, benchmarks. Points included:

- that disaggregation of costs may make sense, but Ofwat would need to ensure cost allocation issues were addressed;
- some costs may be comparable (such as customer service costs), but others were less so (e.g. bad debt costs with other sectors);
- the regulatory environment for water was different than for other sectors, e.g. energy;
- the big six energy companies would be more comparable then smaller companies;
- a joint study with the energy industry may make sense to come to a more joined-up view of relative efficiency.

New appointees

Points raised regarding the use of NAVs as benchmarks included:

- Ofwat would need to make sure service and other relevant factors were comparable;
- customer service costs may be relatively comparable;
- NAVs could face higher costs due to their small scale and higher and dispersed metering;
- NAVs may benefit from having a different type of customer/demographics which may have lower costs and possibly their small scale gives an advantage to adapting to Covid-19 issue (e.g. home working);
- NAVs may not offer the same level of retail service, e.g. the range of communication channels with customers, as incumbents;
- there could potentially be cost allocation issues and limited data;
- Ofwat should ensure the new data being collected on NAVs would be available to others.

Session 4: Other issues

Impact of COVID-19

Points on this issue included:

- questioning whether doubtful debt is appropriate as it may be inherently unstable and vary between companies. That said, debt written off may also share similar weaknesses. Another option could be using the amount of provision used up each year;
- companies suggested that bad debt provisions for Covid-19 may only be fully unwound after a couple of years (implying that this might not be reflected in the data until 2023-24);
- there could be a range of other impacts, e.g. long-term unemployment which should be considered and which could push up companies costs (although, it was noted by Ofwat that some impacts could get picked up by explanatory variables in the model, e.g. on deprivation);
- some companies considered that the impacts could be small and so not a significant issue, whereas others considered it could have a major impact;
- there were mixed views on whether it was worth collecting additional information on this issue.

Definition of customers/connections in cost models

Points made regarding this issue included:

- that Ofwat needs to take care and be clear on definitions, i.e. distinctions between customers and connections;
- there were a mix of views on whether to remove voids, with some supporting this and some opposed;
- on balance there was more support for removing un-billed customers;
- it was noted that companies take different approaches to unbilled customers – some companies bill all customers, whereas other do not;
- it was noted that serving voids still incurs costs;
- there would still be merit in a voids ODI – the point is to charge occupied voids, not to charge genuine voids.