



The voice for water consumers
Y corff sy'n rhoi llais i ddefnyddwyr dŵr

**CCW's response to the Competition and
Markets Authority about Bristol Water's
statement of case in its request for a
redetermination of its 2019 Ofwat Final
Determination**

Date: 11 May 2020

CCW submission to the Competition and Markets Authority (CMA) on Bristol Water's statement of case

1. Introduction

1.1 The Consumer Council for Water (CCW) is the statutory consumer organisation representing household and non-household water and sewerage consumers in England and Wales. We welcome the opportunity to submit our views to the Competition and Markets Authority (CMA) on Bristol Water's appeal against Ofwat's Final Determination (FD).

1.2 We draw our views and opinions from a range of sources/evidence:

- Daily contact with hundreds of water customers who contact us for advice and support.
- A programme of research that engages customers so we can understand their views, including longitudinal tracking studies of both household and non-household customers, and recently an online panel of customers.
- Data which water companies are required to share with us relating to their own handling of customer complaints and their own performance on a range of key measures. An independent view of the Weighted Average Cost of Capital (WaCC) and a report on water companies' financial performance.
- Regular contact, through our teams and our Board members, with every water company, following structured agendas to understand their work.
- Active membership of the Customer Challenge Groups that each water company is required to maintain as part of the price review process.
- Playing a major role in the sector-wide arrangements for policy and strategy making across England & Wales.

- Being a statutory consultee on many aspects of the work of the sector, particularly those relating directly to the interface with customers including those living in circumstances of heightened vulnerability.
- 1.3 Our submission draws on evidence of customers' opinions (and our view of the credibility of this evidence) and data to show how well the company has served its customers.
- 1.4 While we are not equipped to suggest solutions to some of the more technical arguments and modelling, we do offer views on:
- the required outcome for customers;
 - both the quality of the customer evidence used to underpin Ofwat's and Bristol Water's arguments, and how well this evidence was taken into account in both parties' decision-making; and
 - A view on the appropriate range for the WaCC.

2. Executive Summary

- 2.1 Through the 2019 Price Review, CCW has consistently challenged water companies and Ofwat to:
- Ensure that decisions on prices and service delivery reflect credible evidence of consumers' views and expectations; and
 - Deliver a package of prices and service improvements that serves the needs of current customers, while making progress in improving the resilience of water and wastewater services in the longer term to help serve future customers.
- 2.2 We consider the Business Plan developed by Bristol Water (Bristol) reflects its customers' views on their priorities established through extensive customer engagement and research. Ofwat's Draft Determination received a very high level of customer acceptability in our research. As the FD package is not significantly different, it seems likely that the FD would attract a similar level of customer acceptability.

- 2.3 It is Ofwat's role to ensure that its FDs meet the needs of customers effectively while allowing efficient companies the financial returns necessary to deliver on their Plans. Ofwat's challenge on efficiency is a very important regulatory role because companies have the option to seek a referral of their FDs to the CMA in the event they are not happy with Ofwat's decisions, but customers do not have this same opportunity.
- 2.4 It is not in the interests of customers for expenditure to be allowed unless the case to do so is sound, so we would like the CMA to apply the same strong challenge on cost efficiency. Customers want resilient services now and in the future; they want the balance of bills between current and future customers to be appropriate, and they expect the regulatory process to ensure that their money is only spent when it is justified and represents good value.
- 2.5 We look to the CMA's redetermination to challenge the company to deliver its commitments efficiently, while ensuring that the interests of both current and future customers are considered.
- 2.6 This should ensure that the company delivers its promised customer priorities without hidden customer detriment. If the CMA concludes that Ofwat's approach to efficiency and financing costs are sound, and recognises the regulatory protections that are in place, we feel that the FD should not change given the high level of acceptability it is likely to have with customers.
- 2.7 On this basis, our key points from the assessment of Bristol's Statement of Case (SoC) are as follows:
- **We would like to see the FD's package of improvements, and a robust efficiency challenge, retained in the CMA's redetermination.** The FD's package of prices, Performance Commitments (PCs) and investment reflects areas of service customers viewed as priorities, and areas of performance where the company needs to improve. Only if the CMA believes that Ofwat's efficiency challenge is flawed and would jeopardise delivery of customer priorities should it

move away from a determination that is likely to receive a high level of support from customers.

- **We do not support Bristol's claim for an uplift to the Weighted Average Cost of Capital (WaCC). Our evidence points to a significantly lower WaCC than that suggested by the company.** We do not believe that Bristol, or any company, should receive a small company premium (SCP) in the absence of value added to offset the impact on bills. This would look perverse to customers and would fail to incentivise Bristol, and other small companies, to find ways of adding value or of mitigating any additional costs caused by their scale.
- We also support Ofwat's use of a notional capital structure in setting the WaCC rather than a company's actual structure. This is because companies and their investors – not their customers - should bear the risk of a company's choice of its actual capital structure.
- We think that the company should bear the risk of any higher costs that emerge above the partial allowance given in the Final Determination to cover Canal and River Trust abstractions, albeit with the safety net of the notified item. We do not consider it in customers' interests to pay higher costs for uncertainty.
- **If the CMA's redetermination allows Bristol an additional totex allowance for reducing leakage, we would suggest that it should take this into account in the Outcome Delivery Incentive (ODI) penalty.** We would not want customers to pay for a service they have not received.
- **We would like the CMA to ensure that the ODI framework benefits customers and is not a mechanism for protecting companies against underperformance.** We think that this provides greater incentive for companies to achieve their PCs. Our research shows there remains a significant proportion of customers who do not support the potential impact of ODI outperformance payments on bills once this risk is fully appreciated. Bristol's own research found that a majority of its customers favoured penalties greater than rewards.

- 2.8 We note that the regulatory system contains significant protections for companies. In terms of the current coronavirus pandemic, we expect Ofwat to deal with this consistently for all companies once the full effects can be determined. Therefore, we do not think the current pandemic should have a bearing on the CMA's redetermination.

Our response

3. Company performance

- 3.1 Bristol is not a strong performer when compared to its peers. While it has performed well on leakage, with the lowest rates across all water companies, its performance on interruptions to supply, complaints and its relative efficiency are areas where the company does not compare well. In our recent Water Matters report, (2018/19)¹, which tracks customer perception, Bristol is in the lower half of performance for the majority of measures. Our report 'Under Pressure'² highlights the need for companies to deliver strongly, and to take measures that will strengthen the extent to which they are trusted by their customers.
- 3.2 Our Water Mark report shows that Bristol ranks sixth out of the ten water only companies across the various measures of performance it covers³. With regard to cost efficiency, Ofwat's FD ranks Bristol 15th of the 17 companies.
- 3.3 This shows that the company needs to improve in terms of its operational performance and to improve customers' perceptions of the company. The stretching PCs set in the Ofwat FD package should drive this, so we would like to see these retained in the CMA's redetermination.**

¹ <https://www.ccwater.org.uk/research/water-matters-householdcustomers-views-of-their-water-and-sewerage-services-2018/>

² <https://www.ccwater.org.uk/wp-content/uploads/2019/06/Under-pressure-the-gap-between-performance-and-perceptions.pdf>

³ <https://www.ccwater.org.uk/households/company-performance/>

4. Customer Support

- 4.1 Customer engagement and research was an integral part of Ofwat's PR19 methodology in the development of companies' Business Plans, and in securing customer acceptability of them.
- 4.2 As part of the PR19 process, CCW was a part of Bristol's Customer Challenge Group (CCG) – the Bristol Water Challenge Panel (BWCP). In accordance with Ofwat's methodology, the BWCP scrutinised and challenged all aspects of Bristol's customer research and engagement strategy to ensure the views of customers were central in the development of the company's Business Plan. **CCW considered that Bristol's approach was ambitious, clearly thought through and contained innovative customer engagement strategies. The company adhered to our triangulation principles in considering the outcome of various research methods in reaching an overall view of customers' priorities and opinions and using these to shape its plan.**
- 4.3 The BWCP also concluded that overall, Bristol's Business Plan accurately reflected its customers' views and **CCW is content that its PCs are appropriate and set the company stretching targets based on the customer priorities established through engagement and research, at bill levels they find acceptable.** We are therefore encouraged that Bristol accepts the package of PCs set out in Ofwat's FD.
- 4.4 As part of its research, Bristol sought the views of customers, through its Customer Forum⁴, in relation to local company-specific challenges, which formed the basis of its claim for special cost factors. The research looked at the additional costs of being served by a comparatively smaller company and costs due to local operating conditions. The BWCP accepted that it showed that customers accepted that there

⁴ The Customer Forum is a group of 40 informed customers that meets regularly to discuss the company's future plans. Its membership is representative of the six segmentation groups used by the company in its PR19 research (young urban renters, mature and measured, social renters, comfortable families, safely affluent, and thirsty empty nesters).

would be a cost penalty to being served by a small, local company and that some factors would be outside management control.

- 4.5 This research showed that customers were more sympathetic to cost factors they considered outside management control, but the majority of customers engaged preferred to retain Bristol as their supplier notwithstanding what they perceived would be a small additional cost. **However, just over half of this majority of customers expected the benefits of being served by Bristol to outweigh any additional borrowing costs that the company might incur. Customers also considered costs that were within management control should not be considered as special cost factors, but contained within the company's base allowance.** It must be noted that this was a qualitative research exercise using a small sample of customers, and we consider it should be viewed an indicative view only and not a comprehensive measure of Bristol Water customers' opinions, or support for a small company premium for Bristol.
- 4.6 CCW commissioned DJS Research to carry out its own research of Ofwat's Draft Determinations (DDs) to understand what customers thought about the price and service levels that they would deliver. Based on a representative sample of 500, our research found that 91% of Bristol's customers considered the Draft Determination proposals either "acceptable" or "very acceptable" on an 'uninformed' basis. We therefore do not believe that this high level of acceptability means customers supported the inclusion of a small company premium. Customer acceptability rose to 92% when customers were more informed about the service improvements proposed.
- 4.7 However, acceptability fell to 82% when customers were presented with the impact of Outcome Delivery Incentives (ODIs). This reflects wider research and the negative views customers have on, particularly, ODI outperformance payments and the impact they can have on bills and the bill profile. CCW notes that Bristol, in its own research on ODIs, established that customers preferred a package that would impact bills by no more than £4 in any year.
- 4.8 **Our research suggests that customers were happy with the package of Performance Commitments in the Business Plan and that customer**

acceptability of the package is closely linked to bill levels. Given the high levels of acceptability, we expect the CMA to seek to ensure the stretching PCs are retained, with a robust challenge to the company's totex and financing costs applied. In our view, any increase in bills arising from either less challenging efficiency targets, or inclusion of a small company premium, is likely to reduce customer acceptability. It is important for customers that PCs are delivered efficiently, so we ask the CMA's redetermination to show whether Ofwat's FD has been sufficiently challenging.

5. Financing Issues

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- 5.1 **Only if the CMA believes that Ofwat's efficiency challenge is flawed and would jeopardise delivery of customer priorities should it move away from the Ofwat Final Determination that reflects customer priorities and areas of service where the company needs to improve.**
- 5.2 We are not in a position to make a judgment on the difference in views of costs and deliverability between the company and Ofwat. Customers clearly supported investment in resilience and we want customers' long-term interests to be adequately protected, but it is not in consumers' interests for money to be spent unnecessarily, ineffectively or inefficiently.
- 5.3 We expect the CMA to determine the appropriateness of Ofwat's approach to catch-up efficiency. From a customer perspective, it is important that they pay only for costs that are efficiently incurred. **Where other companies demonstrate higher levels of efficiency it is right that comparatively inefficient companies such as Bristol Water are challenged to catch up to their better performing peers. We agree with Ofwat that customers should not pay for inefficiency. Nor should PCs be easy to outperform. We would like the CMA to reflect this in its redetermination.**

- 5.4 Bristol Water also has a recent record of outperforming past regulatory cost assumptions. CCW's annual report on company financial performance for 2018-19 shows that cumulatively between 2015-19 Bristol has underspent the totex allowance Ofwat set at PR14 by around £23m, leading to an outperformance share to the company of £4m. As we note in Section 2 – Company Performance, Bristol ranks 15th of the 17 water companies on Ofwat's efficiency assessment.
- 5.5 We agree that cost-sharing rates should incentivise the efficient delivery of outcomes. We also recognise that they protect against risks and uncertainty. We would ask the CMA to consider the implications of any change in approach to sharing rates on the wider incentives they create for the submission of efficient plans, and the broader detriment that a change could bring to the industry as a whole.
- 5.6 We know from our research that customers prefer stability of prices. It would not be in customers' interests to include a real price effect (RPE) for energy costs, and any associated PR24 true-up mechanism, unless that RPE was well evidenced. It will be important for the CMA to determine the extent to which energy price movements are significantly different to general measures of inflation to warrant inclusion as an RPE.

Weighted Average Cost of Capital (WACC) - including Small Company Premium and overall financeability

- 5.7 **We do not support Bristol Water's case for an uplift in the WaCC (including the company's claims for a small company premium):**
- We do not believe that customers should pay for an increased cost of financing due to financing decisions a company made in the past. Companies should carry the risk associated with such financing decisions.
 - Bristol Water, unlike Portsmouth and South Staffs Water, was not able to pass Ofwat's evidential test for a small company uplift, particularly with regard to whether the additional cost is offset by the value of the benefits delivered to

customers. CCW welcomed Ofwat's evidential test in its PR19 methodology, as the value of what the company will deliver to customers should be greater than the value of any additional allowance. We do not think an uplift is warranted unless Ofwat's evidential test is met.

- Bristol's claim for a 0.38% uplift on the cost of debt is higher than the 0.33% uplift Ofwat included in the WaCC for Portsmouth and South Staffs in its FDs. Both these companies have subsequently accepted their price limits with South Staffs' claim of 0.4% being higher than Ofwat's determination. In its work for us, our consultancy, Economic Consulting Associates (ECA) suggested a small company debt premium of 0.3% was appropriate (adding 0.18% to the WaCC assuming 60% gearing).
- We agree with Ofwat that it is inappropriate, in principle, to use a company's actual cost of debt financing as a starting point for estimating its efficient cost of financing.
- While rating agencies have reviewed companies' credit metrics in the light of the FD, all companies remain investment grade.
- 13 of the 17 regulated water companies in England and Wales (including water companies of a similar size and financial structure to Bristol Water) have accepted the Ofwat WaCC as part of their final determination 'package'.

5.8 Our evidence⁵⁶ points to a significantly lower WaCC than that suggested by the company. Our consultants - Economic Consulting Associates (ECA) - recommended a WaCC in the range 2.65%-3.31% (real CPIH; appointee). Ofwat set its WaCC at 2.96% (real CPIH; appointee) in its FD, roughly at the midpoint of the ECA range.

5.9 While we welcomed Ofwat's WaCC, as it was within ECA's recommended range, we believe evidence supported a lower WaCC than Ofwat used in its FD. In particular, we think that there was scope for a lower equity beta as Ofwat's estimate is higher than we would expect for a monopoly industry. We are also mindful that Ofwat has repeatedly overestimated financing costs at successive price reviews, and that there

⁵ ECA report for CCW - link [here](#)

⁶ ECA update report for CCW – link [here](#)

has been frequent outperformance of regulatory assumptions. This has been noted in our research on water company financial performance and by the Public Accounts Committee⁷ and the National Audit Office⁸.

5.10 We note that the company refers back to a previous decision by the CMA to agree a small company premium for Bristol without any consideration of any customer benefit to offset the resultant higher customer bills. We do not agree with this approach because:

- While we recognise that customers' bills vary from company to company for many reasons, we believe customers would find it perverse that, due to regulatory action by the CMA (or Ofwat), they are paying higher bills without the need for the company to demonstrate that it is providing extra value as a small company to offset this.
- Such a pass-through of this higher cost to customers does nothing to incentivise management either to seek to add value for customers to justify higher bills or to find ways to deal with the higher cost, such as by considering a merger. A mismatch of the CMA's approach with that of Ofwat's more consumer-focussed requirement to demonstrate value to customers from a small company could produce a perverse incentive for a company merely to seek to appeal to the CMA. We note the comments attributed to Bristol Water's Chief Executive about CMA "precedent" in this context⁹.
- Two other small water-only companies have demonstrated added value to customers to justify a small company premium. These companies have accepted Ofwat's Final Determinations. We would not want to see these customer benefits undermined by regulatory intervention that reduced the need for companies to demonstrate added value in future price reviews. We suggest that the CMA should require a demonstration of strong evidence of added value to customers before

⁷ <https://publications.parliament.uk/pa/cm201516/cmselect/cmpublic/505/505.pdf>

⁸ <https://www.nao.org.uk/report/the-economic-regulation-of-the-water-sector/>

⁹ <https://utilityweek.co.uk/karam-ofwat-didnt-follow-precedent-bristols-fd/>

agreeing a small company premium for Bristol as part of the CMA's duty to protect customers.

- 5.11 **We understand and support Ofwat's financeability assessment based on notional capital structure.** It is not for Ofwat to use financeability levers to support the credit metrics of companies' actual capital structures, particularly for those companies adopting significantly higher gearing than Ofwat's notional capital structure. As Ofwat indicates, it is companies and their investors rather than customers that should bear the risk of a company's choice of its actual capital structure to the extent that it departs from Ofwat's notional capital structure.
- 5.12 The use of the notional efficient firm to assess financeability is also supported by Economic Insights in its report for four water companies¹⁰. It concludes that "*it is appropriate to assess financeability with respect to the notional firm and, relatedly, it is for the regulator to determine or identify what the notional firm is able to achieve with respect to efficiency (both costs and outcomes)*".
- 5.13 We agree that Ofwat's financeability assessment should reflect no out/under performance. As Ofwat suggests, companies and their investors should bear the consequences of inefficiency and underperformance in delivery of their obligations and commitments to customers.
- 5.14 Notwithstanding that Ofwat did not allow an uplift on the WaCC for Bristol, Ofwat did not have to use financeability levers (PAYG or RCV run-off) to make the company financeable on the notional structure as the company's metrics were considered financeable (setting it apart from the other three appellants to the CMA).
- 5.15 With regard to run-off, we note that Ofwat included the company's proposal to reduce run-off to assist affordability for customers in 2020-25. This signals that the company's financeability under the notional structure was stronger than most other companies.

¹⁰ Financeability of the notionally efficient firm: top-down analysis - A PR19 representations report for Anglian Water, Northumbrian Water, Welsh Water and Yorkshire Water. Link [here](#)

- 5.16 **We support Ofwat’s gearing benefit sharing mechanism and do not agree with Bristol’s view that this mechanism should be removed**, even though the company’s gearing is at the 60% level. We think a consistently-applied mandatory gain share mechanism where companies’ level of gearing is higher than Ofwat’s nominal gearing assumption is appropriate. This would see 50% of the gearing benefit shared with customers. We note that of the six companies whose gearing was higher than 70% in 2018/19, four have accepted Ofwat’s FD.

Canal & River Trust

- 5.17 We recognise that Ofwat has made a partial allowance for Bristol’s cost adjustment claim and that a notified item is in place should actual costs vary significantly from those allowed.
- 5.18 **We think that the company should bear the risk of any higher costs albeit with the safety net of the notified item. We do not consider it in customers’ interests to pay higher costs for uncertainty.**
- 5.19 If the CMA decides to include additional costs for the Canal & River Trust abstractions it should be demonstrable that;
- Ofwat’s cost allowance for the scheme is insufficient, as shown through an assessment of modelled / unmodelled costs or cost adjustment claims, and
 - The additional cost allowance is based on an expectation of efficient abstraction costs.
- 5.20 The CMA should also consider whether there is need to continue with the notified item if it allows additional costs.

Leakage

- 5.21 Bristol has shown strong performance on leakage through AMP6 and is forecasting to earn an ODI outperformance payment for the period. The company has a stretching

target for further reduction through AMP7, in line with Ofwat's direction to the industry on this common PC for PR19, and its customers' priorities.

5.22 The company did not research the acceptability of individual PC targets but suggests that 83% of customers support its leakage reduction plans as part of its strategy prioritising the reduction in use of existing supplies rather than developing new supplies. This remained a priority even after customers understood the concept of the economic level of leakage and Bristol's already strong performance. The research was part of a wider exercise to measure customers' views on the company's overall approach to strategic supply/demand management, and CCW and the BWCP viewed it as a credible source of evidence to inform Bristol's Business Plan.

5.23 The Ofwat FD confirms that the additional enhancement allowance was given as the company's evidence showed how Bristol would deliver '*a quality of service beyond the base level*' in reducing leakage. We agree that companies should only be allowed enhancement costs where evidence shows that it will efficiently deliver additional value for customers beyond the base cost allowance, for areas of service customers view as a priority.

5.24 **We support the ODI penalty on leakage whereby failure to achieve the targets would mean the underperformance rate recovers any enhancement funding. If the CMA allowed Bristol more funding for reducing leakage, we would suggest that it should take this into account in the ODI penalty. We would not want customers to pay for a service they have not received.**

6. Performance Commitments (PCs) and Outcome Delivery Incentives (ODIs)

6.1 **Overall, we considered that Bristol's PCs are stretching, reflect customer priorities and their willingness to pay, and are based on extensive evidence of customer views, established through research and engagement during the development of the company's Business Plan. Overall, Ofwat's FD matches or is**

closely aligned with Bristol's Business Plan – including PCs, ODIs and resilience investment.

- 6.2 We recognise that during the PR19 process, Ofwat made a number of interventions regarding PC targets, incentive rates and the use of caps, collars and deadbands. **The result has been a shift in the balance between potential rewards and penalties with a greater emphasis on penalties. In general, CCW supports this change as it gives companies more incentive not to miss targets.**
- 6.3 It also reflects the views of Bristol's customers, who generally preferred the company to set targets and be penalised if they do not achieve them. The company's own research showed:
- While customers in general supported the concept of financial ODIs, a majority of its customers favoured penalties greater than rewards - at 7.3% of the bill and 4.7% respectively (though the level of reward/penalty varied with the service delivered);
 - Customers considered the performance measures that should have the strongest incentives are; drinking water quality, leakage, environmental legal obligations, and mains repairs. These are the performance targets that customers want Bristol to have the strongest financial incentives to meet and beat;
 - Developer experience, meter penetration, PCC, and other asset health measures are ranked lower by customers, and should have reduced or lower financial incentives;
 - An equal support for the package of ODIs proposed by Ofwat and that proposed by the company; and
 - 90% of customers consider stable bills important for budgeting purposes, which suggests little appetite for the bill volatility large ODI rates could produce.
- 6.4 In our research, based on the Ofwat DD, customer acceptability reduced from 92% to 82% when customers were presented with the potential impact of ODIs on their bills over the period. This demonstrates that there remains a significant proportion of customers who do not support the potential impact of ODI outperformance payments on bills once this risk is fully appreciated. This suggests that the CMA should be wary

of varying the balance of risk or the potential levels of reward in the overall ODI package in the FD.

6.5 Bristol Water carried out some limited quantitative research on the ODI package through the Customer Forum at a general level. Customers who participated in a Customer Forum event in July 2018 supported a balanced ODI package including the use of caps and collars, and a general collar on the overall package. We therefore welcomed the company's proposal to limit the maximum variation due to outperformance in any year. We would like to see that any protection put in place by the CMA in relation to ODIs should be for the benefit of customers and not act as a protection mechanism for companies against underperformance.

7. Conclusions

7.1 In summary, we consider the FD package of prices, service performance commitments and investment to be highly acceptable to customers because:

- 91% of customers in our research found the DD acceptable or very acceptable
- It reflects customer supported priorities and areas of service where the company needs to improve; and
- Is not significantly different to the DD package.

7.2 We think that the CMA should retain this package in its redetermination. We support a strong cost efficiency challenge, as Bristol has been relatively less efficient than other companies have. The CMA's redetermination should assess whether Ofwat's cost efficiency challenge has been sufficient.

7.3 We do not support an increase in the WaCC, including Bristol's claim for a small company premium. Our evidence supports a lower WaCC than Ofwat has used in its FD is appropriate.

Enquiries

Please direct any enquiries about this consultation to:

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Date: 11 May 2020