



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

# **CCW's response to the Competition and Markets Authority about**

# **Northumbrian Water's statement of case in its request for a redetermination of its 2019 Ofwat Final Determination**

## **CCW submission to the Competition and Markets Authority (CMA) on Northumbrian Water Limited's (NWL) 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 NWL's appeal against Ofwat's 2019 Final Determination (FD).
- 1.2 CCW draws the evidence on which it bases its views and opinions from a range of sources:
- 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 In our submission, CCW 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 CCW is not equipped to offer solutions to some of the more technical arguments suggested and modelling, we do offer:
- A view on the required outcome for customers; and
  - A view on both the quality of the customer evidence used to underpin Ofwat's and NWL's arguments, and how well this evidence is taken into account in both parties' decision-making.
  - 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, whilst making progress in improving the resilience of water and wastewater services in the longer term to help serve future customers.
- 2.2 This means that the 2020-25 price control should act as a milestone towards a longer-term goal. In order to achieve this, we challenged companies to use credible and robust sources of evidence of customers' views and expectations, and for Ofwat to consider such evidence in its decision-making.
- 2.3 In CCW's view, NWL's business plan offered short-term bill reductions for current customers alongside investment to improve asset resilience to benefit future customers, based on credible and robust evidence of customers' views. The plan reflected evidence of customers' priorities and expectations.
- 2.4 However, customers would expect such proposals to be based on sound technical evidence and be delivered at an efficient cost. We support Ofwat challenging

companies hard on cost efficiency, as it is not in consumers' interests for customers' money to be spent unnecessarily or inefficiently.

2.5 Ofwat's FD contains largely the same package of outcomes and Performance Commitments as its Draft Determination, with a greater bill reduction for customers. It is reasonable to assume that, as the Draft Determination received a very high level of customer acceptability in our research (83%), the FD would also be acceptable to the vast majority of NWL customers. Therefore, we would like to see this package of outcomes and Performance Commitments retained in the CMA's redetermination.

2.6 On this basis, the key points from our assessment of the statement of case are as follows:

- Ofwat's Final Determination (FD) includes improvements to areas of service that reflect:
  - Customer priorities as shown in the company's research; and/or
  - Areas of performance where the company is comparatively poor.
  - The company's evidence of customers' priorities and expectations was based on credible customer engagement.
  
- Customers would also expect this package of service improvements to deliver value for money, so we support a strong cost efficiency challenge to achieve this. This is especially important in areas of expenditure where the company has been comparatively inefficient in the past (wholesale wastewater, household retail). The CMA's redetermination should show whether Ofwat's cost efficiency challenge has been sufficient.
  
- We do not support NWL's argument for a higher cost of capital, and we have evidence to suggest that Ofwat's Weighted Average Cost of Capital (WaCC) could have been lower in the FD.
  
- 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 should bear the risk of a company's choice of its actual capital structure, rather than customers.

- As there is evidence that customers have reservations about the use of Outcome Delivery Incentives (ODIs), we support a greater weighting on the potential penalties in the ODI package to strengthen the incentives to prevent failure. Any rewards available to the company should reflect challenging and stretching performance targets.
- Customers supported investment to secure longer-term resilience to reduce sewer flooding risk in the North East and water supply demand in Essex and Suffolk. The CMA's redetermination should consider whether Ofwat's decision to move the sewer flooding risk enhancement costs to base costs, and exclude further investment in water resilience in Essex and Suffolk was correct. While customers support 'fast tracking' future investment at a time when bills are coming down, this should also be based on sound business case evidence and efficient costs.

2.7 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 How well the company serves its customers**

3.1 When considering where NWL needs to improve in 2020-25, the company's current level of performance should be considered.

#### Service performance and customer perceptions

3.2 CCW's 'Water Mark' comparative assessment of industry performance<sup>1</sup> shows that NWL is ranked 'good' or 'above average' for the Northumbrian region in 9 out of the

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<sup>1</sup> . <https://www.ccwater.org.uk/households/company-performance/>

16 service performance measures we use, making it the highest performing water and sewerage company in our rankings. For the Essex and Suffolk region, the company is ranked 'good' or 'above average' in 6 out of the 16.

- 3.3 Both regions' scores are below average or poor in more customer service related measures (such as complaint handling, due to the recent introduction of a new customer billing system<sup>2</sup>) and in customers' perceptions of the fairness of bills. The Northumbrian region also compares poorly in operational performance measures on reducing leakage and dealing with internal sewer flooding, but scores favourably against the other operational measures.
- 3.4 The Ofwat FD does include stretching performance targets in the areas of operational performance where NWL is comparatively poorer, while the new customer experience regulatory incentive (C-MeX) should help address customer service issues. The reduction in customers' bills should also help to improve customers' perceptions of the fairness of water and wastewater bills.

#### Financial performance and efficiency

- 3.5 When considering future efficiency, NWL's past financial performance should be taken into account. NWL ranks in the upper quartile of Ofwat's cost efficiency models looking at the last eight years. NWL has outperformed both the efficiency baseline set by Ofwat at PR14 for the 2015-20 period and the cross industry average outperformance to date.
- 3.6 Over the 2015-20 price control period, NWL outperformed Ofwat's totex assumption by 9%. However, Ofwat's FD shows this was largely achieved in wholesale water expenditure. NWL is less comparatively efficient in wholesale wastewater and

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<sup>2</sup> Although, based on current data, the number of complaints due to this issue is gradually decreasing.

household retail<sup>3</sup>, which has led to Ofwat's FD efficiency challenge across both of these areas of expenditure.

- 3.7 Customers would expect regulators to ensure companies deliver their commitments efficiently. Therefore, we agree that NWL's past inefficiency should be challenged in price determinations, with all companies pushed to become more efficient by gradually moving the benchmark efficiency towards the frontier. We expand on this further in section 7 below.**

## **4 Customer engagement**

### Overall view

- 4.1 Evidence of customers' views and expectations underpin NWL's proposed service performance and investment. This evidence is based on credible and robust sources and has been interpreted correctly in the development of the company's business plan.**
- 4.2 While this is credible evidence to inform service performance and investment decisions, it does not provide a customer view of efficient costs. However, customers would expect the regulator to ensure that their priorities and expectations are delivered efficiently.
- 4.3 NWL's approach to customer engagement was ambitious, clearly thought through and contained some innovative customer engagement strategies. The company adhered to CCW's recommended principles for triangulating varied sources of customer evidence. NWL's subsequent customer evidence synthesis report was

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<sup>3</sup> Ofwat's FD highlights that NWL's totex efficiency deteriorated in 2018-19, but the company states that this was due to challenges associated with the extreme weather in that year, consistent with expenditure across the industry due to this factor.

produced to a high standard. This report helped to demonstrate how customer views had shaped the plan.

- 4.4 **CCW was supportive of NWL's customer research and how it was used to inform the business plan, which reflected the customer priorities this work identified. There is one exception - NWL's customer research to inform the Outcome Delivery Incentive rates** (which we comment on further in section 6).

Customers' views on bill reduction vs investment

- 4.5 **NWL's customer engagement for its business plan shows that customers preferred having a smaller bill reduction than ultimately appeared in Ofwat's FD, with increased investment to improve the resilience of both the water and wastewater networks in the North East and Essex and Suffolk.**
- 4.6 NWL's customer engagement in the preparation of its business plan included research where customers were asked directly whether they would prefer reductions in bills of up to £67 per annum (15%) or if they were prepared to forego some or all of the reduction in order that the company could invest in a range of areas needed to address the impacts of climate change. NWL's customers did not want lower bills in the short term if this risked deferring costs into the future when further investment would be needed. The subsequent business plan package of prices and service improvements received 91% approval from customers in acceptability research carried out by the company. However, this research was conducted before Ofwat's FD, where reduced costs (from regulatory efficiency challenges) led to a greater bill reduction than proposed in the business plan.

The Ofwat FD included some, but not all, of the resilience investment customers supported, with a greater bill reduction (28% on average) than the company proposed in its plan. This is explored further in section 8.



4.7 CCW carried out its own research of Ofwat's Draft Determinations to understand what customers thought about the price and service levels that the package would deliver. Our research found that 87% of NWL customers surveyed think that the Draft Determination proposals are either "acceptable" or "very acceptable" on an 'uninformed' basis. This reduced slightly to 86% on an 'informed' basis, when more details about the proposed service improvements were presented.

4.8 **It is reasonable to assume that customers would view the FD on a similar basis, but taking into account customers' preferences in the company's business plan research, the package could go further in terms of delivering more investment in resilience – though this must be delivered efficiently and be based on sound evidence.**

## **5 Performance Commitments (PCs)**

5.1 **NWL's package of bespoke and commonly applied PCs reflect customer priorities and areas of service where NWL needs to improve. The level of stretch for many of these PCs shows that these performance targets should not be easy to outperform.**

5.2 **Therefore, customers would expect to see the PCs retained in the redetermination. We would not like to see a reduction in the commitments that customers supported, either in terms of the levels achieved or the quality of the work to deliver the outcome.**

5.3 In Ofwat's 2019 Service Delivery Report, NWL ranked at six out of 17 companies in terms of meeting its 2015-20 PC targets. In this context, NWL's package of commonly applied PC targets are largely stretching in areas where it needs to improve to address comparatively poor performance (internal sewer flooding, leakage, customer experience) and reflects the research the company undertook to identify customers' priorities (reliability and resilience of the services they receive).

5.4 **Customers would expect the regulator to ensure that these PCs are delivered efficiently, without the risk of companies cutting back on essential maintenance or asset renewal/replacement where this is needed to improve**

service delivery. We ask the CMA to conclude in its redetermination if the regulator's efficiency challenge is correct.

## 6 Outcome Delivery Incentives (ODIs)

- 6.1 **There is evidence to show that many customers do not support the concept of paying additional charges where companies have outperformed their PC targets, especially in areas of service that customers consider to be service failures (e.g. sewer flooding) or areas of service that customers consider to be the company's 'day job'.**
- 6.2 While we recognise the regulatory rationale for ODIs, it is also important that these incentives are acceptable to customers, as it will affect their bills. CCW provided guidance to companies and Ofwat on our expectations for customer research on ODIs where we recommended that companies should test the principle of using these incentives with their customers.
- 6.3 NWL's research on customers' views on ODIs criticised by CCW and Ofwat, as they did not ask customers about the principle of using these incentives. While the company did carry out research on customers' views on the 'package' and value of ODIs proposed in the plan - and gained customer support for it - this research was criticised by Ofwat for the lack of an adequate sample size.
- 6.4 **If ODIs are retained in the redetermination, penalties should be strong enough to deter failure, and any rewards achieved must be reflective of challenging targets in areas of performance customers' view as a priority.** The ODI package for NWL in the Ofwat FD is skewed more towards the 'downside', which means the value of potential penalties for failure is greater than the available rewards for achieving its targets. Customers across industry have also indicated greater acceptability of the potential penalties than rewards. **We consider the greater weighting towards penalties in the Ofwat Final Determination to be appropriate to help prevent a failure in delivering customer priorities.**

## 7 Totex allowance

- 7.1 **Customers expect company operations, asset maintenance, resilience investment and statutory commitments to be delivered to the required standard at an efficient cost to achieve value for money. Therefore, the CMA's redetermination should reflect the FD if the efficiency challenges applied by Ofwat are sound and enable the delivery of customers' expectations.**
- 7.2 Where companies have previously been inefficient compared to their peers, customers would expect to see a stronger efficiency challenge to move the company to a more comparatively good position. Over the last five years, NWL has previously been less efficient compared to its peers in two areas: wholesale wastewater and household retail costs.
- 7.3 **In this context, CCW agrees that it is appropriate for there to be a strong efficiency challenge to move the company to a comparatively better position. We also agree that Ofwat's efficient cost baselines should be lower for 2020-25 than in the past to challenge the companies to improve.** Customers are likely to take a dim view of a company that spent money inefficiently in the past being allowed a further cost allowance without such a challenge.
- 7.4 **A company should also not be allowed enhancement costs where evidence shows that its required improvements can be delivered fully and efficiently within a base cost allowance, as otherwise this may result in customers paying twice.**
- 7.5 While NWL has evidence of customer support for bringing forward resilience investment, it is important that the CMA's assessment also shows that any allowed enhancement costs are based on credible evidence. Any allowed 'enhancement'

investment should provide customers with value over and above what the 'base' allowance provides for. The case for asset investment should also be based on a convincing assessment of risk. Customer support alone cannot justify such investment if it does not offer value for money.

## 8. Resilience

### North East wastewater resilience programme

- 8.1 Evidence from NWL's customer engagement shows that customers support 'fast tracking' resilience investment so that customers are protected against sewer flooding in the long term. This involves more proactive actions to protect properties at risk of flooding in the future, due to the effects of climate change and urban creep.
- 8.2 While 61% of customers surveyed in NWL's business plan research supported the wastewater resilience proposals for the North East, NWL's overall business plan acceptability research showed the majority of customers supported further resilience investment to help mitigate against potential price rises in the future.
- 8.3 Ofwat's FD includes a base cost allowance that the regulator says should enable NWL to deliver its wastewater resilience programme. The additional 'enhancement' resilience investment to finance more proactive actions to deal with longer term flooding risks was rejected as it failed Ofwat's 'need for' and 'efficient cost' tests.
- 8.4 **As customers support longer term resilience investment, we would like the CMA's redetermination to assess whether Ofwat's decision was correct. While there is customer support for it, the additional investment must also be based on clear evidence of both the risk of future flooding and that the proposed 'outputs' offer the best long term solution. Customers would also expect any solutions to be delivered efficiently.**

## Abberton to Hanningfield water resilience scheme

- 8.5 In NWL's research (which was developed and agreed with CCW and the Water Forum<sup>4</sup>), 90% of customers that participated supported this £20m water resilience proposal for the Essex and Suffolk region.
- 8.6 The proposal was rejected by Ofwat as it failed the regulator's 'need' test due to insufficient evidence. Ofwat's FD says that NWL can deliver these improvements within the allowance set for base costs. It has allowed for improvements to resolve raw water deterioration at Layer Water Treatment Works, which it says will '*mitigate the same principal risk*' that the Abberton to Hanningfield connection was designed for.
- 8.7 **It is unclear whether the improvements to Layer Treatment Works offer the level of protection from risks of supply interruption and water quality that the transfer main scheme offers. As customers support the transfer main scheme, the CMA's redetermination should assess whether Ofwat's decision was correct. Even if customers support 'fast tracking' resilience investment, this must be based on a sound evidence based case and a strong cost efficiency challenge.**

## **9. Financeability & Weighted Average Cost of Capital (WACC)**

- 9.1 **We do not support NWL's proposed WaCC in its statement of case.** We disagree that the company requires such a significant increase above Ofwat's WaCC to achieve financeability when:
- 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.
  - 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.

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<sup>4</sup> The Customer Challenge Group for Northumbrian Water

- Rating agencies have reviewed companies' credit metrics in light of the FD and all companies remain at investment grade.
- 13 of the 17 regulated water companies in England and Wales have accepted the Ofwat WaCC as part of their FD 'package'.

9.2 **Our evidence<sup>56</sup> 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.

9.3 While we welcomed Ofwat's WaCC as it was within ECA's recommended range, we believe evidence supported a lower WaCC than Ofwat concluded. 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 there has been frequent outperformance of regulatory assumptions. This has been noted in our research on water company financial performance and by the Public Accounts Committee<sup>7</sup> and the National Audit Office<sup>8</sup>.

9.4 We understand and support Ofwat's financeability assessment based on a 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.

9.5 The use of the notional efficient firm to assess financeability is also supported by Economic Insights in its report for four water companies<sup>9</sup>. It concludes that "*it is*

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<sup>5</sup> ECA report for CCW - link [here](#)

<sup>6</sup> ECA update report for CCW – link [here](#)

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

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

<sup>9</sup> 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](#)

*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)”.*

- 9.6 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.
- 9.7 Of the 17 companies in the sector, Ofwat used financeability levers for 12 of them. We recognise that Ofwat’s use of the ‘pay as you go’ cost recovery and RCV run-off ratio is similar to approaches that other regulators use. CCW has previously advised Ofwat that the PAYG ratio should reflect the balance of long and short-term cost recovery, relative to a company’s balance of operational activity and longer-term capital investment.
- 9.8 We recognise that Ofwat’s intervention will advance £25m of revenue from future customers, which should enable NWL to finance the future investment customers support. From a consumer perspective, it is important that advancing revenue in this way is NPV neutral. We would be concerned if customers effectively paid twice in the current and subsequent price control periods.
- 9.9 In view of the company’s RCV growth, we are also supportive of Ofwat’s approach to reduce dividends for companies whose RCV-growth over the 2020-25 period exceeds 10%. We believe that it is right that equity plays its part. NWL has issued cumulative dividends of £1.6bn since 2011, which is large in relation to its RCV of £4.3bn in 2018-19.
- 9.10 **We support Ofwat’s gearing benefit sharing mechanism.** 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.

## 10 Conclusions

10.1 In summary, CCW considers the Ofwat FD package of price, service Performance Commitments and investment to be acceptable to customers because:

- It reflects customer-supported priorities and areas of service where the company needs to improve.
- As the Draft Determination received a very high level of NWL customer acceptability in our research, it is reasonable to assume that the FD (which has a lower customer bill ) would have a similar level of acceptability. We would not like to see any of the Performance Commitments to investment in the FD reduced or removed.
- However, customers also supported increased investment in future resilience and the FD removed or reduced costs NWL proposed to provide this. The CMA's redetermination should assess whether Ofwat's reduction of this additional investment to improve resilience against sewer flooding in the North East, and water demand issues in Essex and Suffolk in the FD was correct. If the evidence justifies the investment, and it can be delivered efficiently, customers would support this additional long-term resilience added to the FD package.

10.2 As customers also expect regulators to ensure such commitments are delivered efficiently, we support a strong cost efficiency challenge (especially in areas where NWL has been comparatively inefficient in the past). The CMA's redetermination should assess whether Ofwat's cost efficiency challenge has been sufficient.

10.3 We do not support an increase in the WaCC, and believe that Ofwat's FD could have been lower in its assumption of financing costs.

### Enquiries

Enquiries about this consultation should be addressed to:



[REDACTED]

Date: 11 May 2020