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By email to: waterdetermination2020@cma.gov.uk

Dear Kip

Bristol Water Challenge Panel response to the Provisional Findings of the Competition and Markets Authority

Background. In December 2019, Ofwat, the water regulator, published the 2020 to 2025 price controls for every water company in England and Wales. The price control establishes the maximum amount that the company can raise through customer bills to meet customer expectations on the performance targets set for the business and the financial returns available for operations, investment and shareholders.

Bristol Water argued that the price controls determined by Ofwat for the coming period should be challenged through a referral to the Competition and Markets Authority (CMA). Issues raised included that the economic models developed by Ofwat disadvantaged the business or that the level of efficiencies required by Ofwat had implications on service, performance or investment. The Bristol Water Challenge Panel (BWCP) participated in this process through submissions to Bristol Water, Ofwat and the CMA with a view to ensuring that customer preferences and priorities were uppermost in the decision making process. Three other water companies also challenged the price controls for their organisations at the same time as Bristol Water.

The work of BWCP has encouraged Bristol Water to focus on and reflect customer priorities and preferences and, in general, has encouraged the setting of highly ambitious and stretching performance targets. Over 26% of challenges put to the business in PR19 resulted in changes to its practices. The Challenge Panel was also pleased that the CMA listened to its submissions and testimony during the hearings. They provided every opportunity for the Challenge Panel to express its concerns on behalf of customers and to participate in the process of reaching the provisional findings.

We note that neither Ofwat nor the CMA were in dispute with the performance of the Challenge Panel. There was agreement that our scrutiny of Bristol Water's customer engagement framework and its expression of customer views contained within business plan was of good quality. There was no concern that BWCP was anything other than independent from both Bristol Water and Ofwat, despite lack of independence being of concern in the case of several other companies.

In September 2020, the CMA published its Provisional Findings on the price controls determined for Bristol Water and the other three water companies. These findings examine the evidence put forward by the various parties involved and determines the best approach or outcome for the companies. The response to the CMA by the Challenge Panel is based on, and enables customer views to be expressed based on, the customer research gathered during the development of the Bristol Water business plan. The Challenge Panel appreciates that, as a regulator, the CMA will have a broader view of the marketplace, of trends within regulation and on the various performance targets the government expects or requires.

Base costs, enhancement costs and Totex. In particular the Bristol Challenge Panel welcomes the company-specific cost adjustment reflecting the cost of water abstraction from the Gloucester and Sharpness Canal, which itself accounts for some 46% of water for the company.

In the business plan submitted by Bristol Water in September 2018, the average water bill for customers was set at £174, a savings of £12 against the 2019 bill. The Ofwat determination set the price at £160 which was far below that which customers thought reasonable for a small, local company with clear community links to meet the promises customers expected. 93% of respondents in acceptability research (involving 700 customers distributed across Bristol Water's demographical segments) supported the final proposed plan by Bristol Water. When inflation was added in, this decreased to 83% with younger customer groups most concerned about the impact of inflation on their water bill.

The CMA provisional findings recommend an average bill of £166, which still remains well below that which customers feel is acceptable. In balancing customer concerns for lower bills against the acceptability of the final plan proposed by Bristol Water, the Challenge Panel identifies scope for the CMA to award Bristol Water a slightly higher uplift. Such an increase will continue to provide customers with greater savings than at present, making customer bills more affordable. The findings also ensure that a priority services register is available for the most vulnerable and that a social tariff, although the latter lies outwith the scope of the price control. The findings ensure that performance targets set with customer input remain stretching and ambitious.

The Challenge Panel notes that the base costs assessed by the CMA differ from that set by Ofwat. According to the CMA, their assessment results in a slightly less demanding model which lessens the likelihood of a company being unable to achieve sufficient revenue to carry out the service level improvements expected by customers. However, Bristol Water maintain that the model used by both Ofwat and the CMA put a smaller company at a great disadvantage, and an even greater one given the high performance levels expected by customers and delivered by the company. Customer research indicates a preference for the cost of operations and maintenance to be paid for upfront while keeping bill profiles low. Might there be scope for the CMA to review the impact of the base cost model used provide a slightly higher uplift for Bristol Water?

The provisional findings provide an overall TOTEX uplift of £5million. While this addresses some of the financial risk taken on by Bristol Water, there remains a gap of a further £25million which the company set in its business plan and which must be found through efficiencies which, in turn, may impact on performance and service levels.

Changes to PCs and ODIs.

- BWCP welcomes the base cost adjustment for **leakage**, given that Bristol Water is one of the best performers in leakage reduction in the sector. This adjustment will enable the company to continue its investment in maintaining this high standard for its customers. We look forward to the additional research and analysis into Bristol Water's leakage performance between now and the final determination by the CMA. We anticipate that this additional investigation will acknowledge the high cost associated with driving and keeping leakage down and increase the adjustment.
- Regarding per **capita consumption**, we note the reduction of ODI rates to £0.03m and £0.025m.
- Regarding **mains repairs**, a deadband change of 10.
- Regarding **unplanned outage**, a deadband of 1.2 x PCL

It must be acknowledged that BWCP has no remit to challenge and scrutinise financial matters, beyond areas such as executive pay and shareholder reward. However, in relation to financeability constraints, it should be noted that the major shareholder for Bristol Water has not taken dividends for some time, effectively injecting capital back into the business and that this is a remedy recommended by the CMA to improve financeability. However, for the CMA to recommend that this practice of foregoing dividends continues into the next Asset Management Period raises questions regarding fairness and equity. Deliberative customer research indicates that customers understand and appreciate the need for investors to make a profit, albeit of a reasonable size. Such an approach by the CMA could be seen as a signal for the shareholder to sell the business, which currently just barely slips into Moody's investment grade category. There is no certainty that an efficiency gain by any new owner would result in the high level of service customers currently receive. Contrary to the CMA's judgement that this will provide an opportunity to invest in the business, the opposite could also be true. Customers are concerned that the drive to achieve greater efficiency will result in the loss of staff, thereby weakening the company's ability to meet the ambitious performance commitments in its business plan.

Company Specific Adjustment. Bristol Water sought an adjustment to reflect structurally higher costs faced by smaller companies in the respect of an uplift to the cost of debt and the cost of equity allowance. We welcome the small uplift of 0.1% in embedded debt to reflect the cost of being a smaller company and note that there is no allowance for the cost of equity. With regard to support for a small company premium, customer research conducted by Bristol Water found that 87% of customers supported an increase of £1.80 on the average bill to receive services from a local company. All customer segments preferred Bristol Water to remain their supplier. The overriding customer priority is for a low and stable bill.

Weighted Average Cost of Capital. Ofwat set at 12.6% fall in customer bills compared with a 9.6% fall by the CMA. The cost of capital, an indicator of how much profit the company needs to earn in order to repay investors, was a key source of Bristol Water's dispute with Ofwat. Bristol Water assessed that the level set by Ofwat would make it unfinanceable, partly due to historic debt. The balance between the investments the company needs to make to satisfy its customers and what it pays its shareholders has been tested by customer research through a full day deliberative research project with 38 customers. While the numbers participating in the project do not confer statistical validity, customer preferences were for bill profile stability, a low customer bill, well maintained asset health, operating costs paid for either upfront or in the very short term, maintenance costs and investment costs spread (where possible) during the life of the asset and accepted the necessity for a profit for investors.

The Challenge Panel notes the CMA states that judgements are used to determine matters such as the point estimate when making its assessments. This is particularly so in the case of historical debt. We note the small uplift awarded. The issue of historical debt for Bristol Water was considered in the previous referral to the CMA by Bristol Water and this continues to be an issue for the business where resolution seems distant and refinancing the debt is not a viable option. In exercising such judgements, the Challenge Panel would encourage the CMA to arrive at a solution that does not penalise the customer with high bills given that the company has significantly turned around its operational excellence, the reliability of data collection and asset and network performance during this asset management period.

On a wider point, it may be worth noting that residents in the Greater Bristol Area, i.e. that covered by Bristol Water, have an enormous pride in local services being delivered by local companies. Bristol Waste, Bristol Energy, Bristol City Football and Bristol International Airport, along with Bristol Water, are but some of the organisations of national and international renown that were founded in Bristol, maintain high standards and obtain great customer loyalty. We appreciate that this phenomenon may not be as prevalent elsewhere as it is in Bristol. However, the traction gained by Bristol Water with its Social Contract illustrate the bond between companies and local consumers.

Implications of Covid-19 pandemic. We note that the CMA has investigated the impact of Covid-19 on the water sector. We support the view that consideration at some point in the future should be given to reassessing the regulatory framework. Whether a universal, company-specific or hybrid adjustment to the price controls is needed will become clearer as the impact of Covid-19 continues to affect the overall economy. Three significant matters arise:

- The increased likelihood that a larger number of customers than planned at the time of the submission of the business will find themselves less able to pay for water is a serious concern.
- The increase in water usage in the domestic setting will continue to put pressure on the distribution network and could result in unplanned maintenance, mains bursts and other unfortunate events as traditional patterns of water usage will be subject to changes and greater fluctuation.
- Water supply patterns, such as those from business to domestic premises, will vary and will be subject to the influence of government restrictions on working and gathering in public and private spaces. The variable and unpredictable impact of these restrictions across the

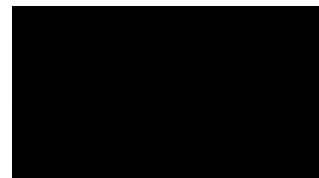
country may well require a sensitive and local approach to negotiating changes in Performance Commitments and ODIs.

In closing, the customers of Bristol Water have a right to be concerned about the provisional findings of the CMA due to the effect it has on their water bills. As a Challenge Panel, we have an obligation to challenge where we find reasonable evidence of a concern. We welcome the uplift awarded by the CMA in some of their provisional findings. We expect the further analysis of data will provide an even greater uplift in respect of leakage. We are disappointed that the provisional findings reject the small company premium and fear that this may start a chain of instability from which performance commitments and outcome delivery incentives set in the business plan could be unmet.

Given the acceptability of the work of the Challenge Panel and the way customer priorities have been woven into the stretching business plan by Bristol Water, customers will be left wondering why both Ofwat and the CMA continue to go against their wishes. Customer engagement research addresses and underpins decisions and approaches made by Bristol Water in its business plan. The bill profile, the company specific adjustment and the various ways that companies earn revenues have been tested with customers. There is an opportunity for the CMA, for example, to award Bristol Water a less onerous underperformance collar. While the CMA state that their approach to regulation differs from that of Ofwat, the outcome remains that the preferences, priorities and wishes of customers continue to be ignored or down-played.

In closing, the Challenge Panel wishes to thank the CMA for enabling us to put forward a customers' perspective on the provisional findings for the Bristol Water determination. There is an overarching level of support for the company in its local communities and the service provided by the company is highly valued. While customers expect a stable bill profile, they also welcome the ambition set out in the company's business plan. On balance, where judgements are made by the CMA are subject to analysis and research, customers would urge that the level of efficiency imposed on Bristol Water is reduced when possible to enable the company to continue to provide services and investments of the quality its customers expect.

On behalf of the Bristol Water Challenge Panel



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INDEPENDENT CHAIR