



**The Consumer Council for Water's assessment
of the 2014 Price Review:
A Step In the Right Direction**

1. Introduction

- 1.1 The Consumer Council for Water (CCWater) is the statutory consumer organisation representing the interests of customers of regulated water and sewerage companies in England and Wales. CWater has four regional committees in England and a committee for Wales.
- 1.2 This report is CWater's assessment of the 2014 price review (PR14), covering:
- what price setting processes worked well and what did not work so well (and why); and
 - recommendations for improving customer influence at future price reviews.
- 1.3 The assessment draws upon our 2014 research on the Customer Challenge Group's (CCG's) role in shaping company business plans¹, and our recent customer research into what customers think about representation and engagement at price reviews². The assessment covers:
- the role and effectiveness of CCGs in influencing company business plans and Ofwat price setting decisions;
 - Ofwat's role and methodology for the price review; and
 - how customer research was used and interpreted and its influence in business plans and Ofwat decisions.

2. Background

- 2.1 PR14 was different to earlier price reviews, with a number of innovations introduced in the price setting process:
- CCGs were established for stakeholders (including CWater, the Environment Agency and the Drinking Water Inspectorate) to challenge companies' business plan proposals. This built on CWater's Quadripartite Groups³ initiative at the 2009 price review.
 - Separate retail and wholesale price controls to facilitate the introduction of non-household retail competition in 2017.
 - A focus on identifying and delivering outcomes for customers and the environment, with less emphasis on "outputs", i.e. specific schemes.
 - Ofwat's new incentives to drive the delivery of required outcomes.

¹ Customer Challenge Groups: review of lessons learned (Research By Design for CWater, June 2014) <http://www.ccwater.org.uk/wp-content/uploads/2014/07/Customer-Challenge-Group-process-Review-of-lessons-learned2.pdf>

² "A Tide of Opinion - The Customer Voice Within the Price Setting Process" (July 2015) <http://www.ccwater.org.uk/blog/2015/07/06/a-tide-of-opinion-the-customer-voice-within-the-price-setting-process-3/>

³ Quadripartite Groups involved companies, CWater, the EA, the DWI, and for some groups, Natural England. In Wales, Welsh Government led the Wales Water Forum.

- An assessment of totex (total expenditure) rather than capital and operating expenditure separately, intended to reduce a bias towards capex-based solutions seen in earlier reviews.
- Ofwat's award of "enhanced" status for high quality business plans. "Enhanced" companies received draft and final determinations that closely mirrored the business plan's investment programme, outcomes and performance commitments.
- Overall, there was greater emphasis on companies "owning" their business plans and being responsible for the investment and prices allowed by Ofwat in its determinations. There was also greater customer involvement than ever before, with an increase in customer engagement and research to ensure business plans and, therefore, Ofwat determinations reflected customer views.

3. Executive Summary

- 3.1 The final determinations set by Ofwat in December 2014 have been generally viewed as a positive outcome for customers, with real term price reductions and outcomes that reflect evidence of customers' priorities and expectations.
- 3.2 This has been due to a process that has seen companies challenged to deliver customers' expectations, using a greater volume and breadth of customer engagement and research than in earlier reviews. This evidence was used to influence both company business plans and Ofwat's determinations.
- 3.3 Our assessment of PR14 has raised the following key recommendations:

Customer Challenge Groups (CCGs)

- a. CCGs should continue to be a platform for scrutiny and challenge of company business plan proposals, but need to ensure they are (and are seen to be) independent in both their role and chairmanship. Strong governance is needed to underpin this.
- b. CCWater should continue to be members of CCGs as evidence of our PR14 involvement shows how we led many challenges, often using comparisons between company proposals and performance to inform this, and ensured the groups maintained their customer focus.
- c. CCGs' challenges could be more effective if more comparative data was provided to them at an early stage to show how an individual company's performance and cost proposals compare to others. Comparative data could include financial and efficiency data as well as that relating to operational and customer service performance.
- d. Consideration needs to be given as to when Ofwat publish cost of capital and cost menu information (i.e. baseline efficient retail and wholesale costs). If revealed too early, this may be advantageous to companies as the regulator has 'shown its hand' early. However, if released too late it does not give the CCGs adequate opportunity to challenge company assumptions. We would welcome discussion with Ofwat and the industry ahead of the 2019 price review to look at when would be the right time to release such information to inform CCG challenges.

Ofwat's role and methodology

- a. Ofwat should continue to set separate retail and wholesale price controls to facilitate greater retail competition from 2017, and use the totex approach to cost setting to help reduce the earlier bias toward capex-based solutions.
- b. Ofwat should prepare and consult stakeholders on its price setting methodology and timetable early in the process, and adhere to this plan, to give CCGs and other stakeholders' certainty through the price review. Changes to the methodology and timetable disrupted the PR14 process, particularly for companies and CCGs.
- c. Incentive rewards achieved by companies for delivering required outcomes should be clearly explained to customers (by companies and Ofwat) in terms of what benefits customers are receiving in return. Limits should also continue to be in place to restrict potential adverse bill impacts due to these incentives.
- d. Ofwat's "enhanced" status for business plans should produce demonstrable benefits for customers. Evidence of a company's past performance should also be taken into account when evaluating whether "enhanced" status should be applied to a business plan.
- e. Compared to the evidence based recommendations for the Weighed Average Cost of Capital (WACC), provided for CCWater by Economic Consulting Associates (ECA)⁴, the Ofwat WACC for 2015-20 over-estimated the level of risk as represented by the equity beta. This may lead to companies' being more profitable than appropriate given the low risk of the industry.

Customer Research

- a. The diversity of customer research used by companies at PR14 should be reviewed to establish good practice methods that can be shared across industry for consideration at future price reviews⁵. This could improve the overall quality of research in future reviews through the take up of innovative practices. However, we recognise that, as companies will continue to 'own' their research, there is likely to be diversity of approaches which will mean no comparability.
- b. CCWater should continue to measure the customer acceptability of Ofwat's draft determinations, and could extend this to business plan proposals at future reviews. Testing business plans and Ofwat determinations for customer acceptability is a key measure of how well a price review will deliver in the eyes of customers. The added value of CCWater testing these key proposals comes from the fact that we would apply the same research methodology in testing all draft determinations and business plan proposals, and this would allow comparability. This would inform further challenges to the companies and assist Ofwat in focussing more attention on companies that have lower levels of customer acceptability.

⁴ ECA recommendations of the Weighted Average Cost of Capital - <http://www.ccwater.org.uk/wp-content/uploads/2014/07/ECA-CCWater-Cost-of-Capital-summary-report.pdf>

⁵ This has already started, with UKWR (water industry research body) undertaking two projects in 2015 to evaluate both broad customer engagement in price reviews (and how it can be used to influence regulatory decisions), and specific customer research/engagement methods. CCWater is a member of the Steering Group for these projects.

4. Findings and recommendations

4.1 The role of Customer Challenge Groups (CCGs)

Our findings

- CCGs are a step forward in giving stakeholders a platform for challenging company business plans. While they are not 'customer groups', some of the stakeholders who are members of a CCG may represent the views of customers.
- CCG membership through PR14 was representative of a wide range of interests, but some CCG members with non-water industry backgrounds struggled at times to cope with the complexity of the subjects under discussion, and the time commitment over a long period.
- CCWater was a key contributor in the CCGs, often leading challenges to companies and making sure there was a focus on customers.
- While CCG terms of reference showed their independence from companies, CCWater Chairs' focus on being independent also meant their CCWater voice for customers was lessened somewhat.
- Generally, CCG's were very effective in challenging company proposals. This is reflected in the 'challenge logs'⁶ CCWater and some CCGs used.
- CCGs were most effective in analysing and challenging how companies were engaging with customers and using this evidence to build plans.
- Some companies needed greater pressure applied than others to change plans to meet CCG's requirements, particularly earlier in the process.
- There was limited challenge on proposed costs because Ofwat did not expect this from CCGs, and therefore provided no or limited information or guidance to help CCGs do this. CCGs that did challenge costs did so to try and ensure company plans represented value for money for customers, rather than to try to duplicate Ofwat's role. However, CCGs were limited in this due to the lack of comparative data available to inform their challenges.
- CCGs also challenged the statutory programmes presented by the Environment Agency and the Drinking Water Inspectorate in terms of how they compared to customer priorities and to assess their value for money.
- Some CCGs used external consultants (paid for by companies) to assist in analysing company proposals and/or writing the CCG's reports for Ofwat.
- Some companies brought single proposals to CCGs, rather than demonstrating the range of options they had considered, to allow CCGs to consider the proposal in the round.

⁶ Tables used to record challenges or requests to companies (or other CCG members) during CCG meetings, updated to record what the company (or CCG member) has done in response. This was intended to act as a reference tool to track how well the group was challenging companies and how companies were responding, and complemented the CCG meeting minutes.

- There is evidence of CCG influence on company business plans, particularly in the setting of outcomes (based on customer evidence), performance commitments and (in some cases) companies' aims for cost efficiency.
- Ofwat provided some indications in the Draft and Final Determinations of how CCG reports influenced its decisions, but not much detail. Similarly, where an Ofwat decision appeared to disregard or contradict customer evidence, the regulator did not always explain the justification for this.
- Ofwat's changes to the price setting methodology and timetable in 2013 and 2014 were disruptive to the CCG process. The frequency of meetings and volume of documents to assess also led to a risk of fatigue for some CCG members.
- The timing of when papers were provided by some companies before meetings did not always allow sufficient time to consider the issues and prepare challenges. There was some frustration from CCWater's CCG members with some companies not allowing papers to be taken out of meetings or shared with colleagues within CCWater. Otherwise, companies were generally transparent to CCGs and provided the information CCGs asked for.

Our recommendations

1. CCGs should be used at future price reviews, but need to demonstrate their independence from the company with strong governance to reflect this.
2. Our research shows that customers want an independent Chair for CCGs and recognise that they have to be paid⁷. However, customers believe that direct payment undermines their view of Chairs' independence from companies. A centrally held pot, funded by companies, could be one way around having companies directly paying Chairs, and give distance to the companies.
3. CCWater should no longer chair the groups, as our focus should be on contributing to the groups (through CCWater Chairs, Local Consumer Advocates, and/or Policy Managers) to ensure they challenge and stay focussed on customer evidence.
4. While CCWater should not be prescriptive around group membership or how they are set up, CCGs should continue to represent a broad range of stakeholder and consumer representatives. Training and support should be provided for CCG members, particularly those who are new to the industry. Sub-groups within CCGs can be used to allow members to look at the detail on specific issues or topics (e.g. customer research). This will help maximise value from individual CCG members' specific knowledge and/or skills.
5. CCGs (or their Chairs) should regularly hold two-way dialogue with company Boards to increase the CCG's influence.
6. Ofwat should produce clear guidance on the CCG's role in a price review and what it expects CCGs to challenge. Ofwat also needs to provide information to CCGs to

⁷ 'A Tide of Opinion - The Customer Voice Within The Price Setting Process' (Blue Marble for CCWater, July 2015). This customer research is about what engagement and processes at price reviews would give customers most confidence that their voice is being listened to. The research also explores' customers' views what makes a credible CCG that can represent customer views through the price setting process. See [here](#).

- support this. While the PR14 Ofwat/CCG Chairs workshops through PR14 did this to a limited degree, Ofwat should provide more information to CCG members in the future.
7. The use of 'challenge logs' should be retained as a useful way of recording and tracking challenges and how well companies respond to them.
 8. To get the best results for customers, CCGs should also maintain a focus on what company proposals mean for customers (or how customer evidence influenced them). CCWater can lead on providing this focus in CCGs.
 9. CCGs ability and scope to challenge could be enhanced by providing more 'tools' to them. More comparative data from Ofwat and CCWater should be made available on current and future costs and performance commitments to enable CCGs to challenge their companies in the context of how they compare to others.
 10. CCGs should continue to challenge companies' methods of customer engagement and research, and how this evidence is used to develop business plans that reflect customer's priorities and expectations. If Ofwat provides information to enable it, CCGs should also challenge proposed costs (including the cost of capital) at a high level as part of ensuring companies' proposals provide value for money for customers.
 11. The Ofwat CCG Chairs workshops should also be retained and should allow CCG Chairs (and sometimes members) to share good practice. CCWater will also offer to host regular forums for CCG Chairs to share information, views and experiences to help improve the process.
 12. CCGs should also continue to challenge statutory programmes to ensure these deliver value for money (such programmes may be key drivers of bill impacts at future reviews).
 13. The use of external consultants adds value, but only if these external parties (whilst paid for by companies) are working to terms that make them accountable to the CCG and independent of the company.
 14. CCG terms of reference should place an onus on companies to show how options for delivering outcomes have been evaluated, to allow CCG input to this, rather than presenting CCGs with a recommended 'answer' without this context.
 15. Ofwat should be more explicit in its determinations about how it used CCG reports and reflected CCG views in its decision making. Similarly, Ofwat should provide an explanation where its decision making does not reflect, or contradicts, customer evidence.
 16. Ofwat should develop a timetable and methodology for the price review that is agreed and followed without change to allow CCGs and other stakeholders to plan around it with minimal disruption. The price review process should also start earlier, to help CCG members build knowledge before business plan proposals and customer engagement/research is looked at.
 17. Companies' CCG papers should be shared with others within CCG member organisations, to allow for more input, particularly around comparators, though we accept that some commercially sensitive information may have to be redacted.

4.2 Ofwat's role and methodology

Our findings

- The rationale for separate retail and wholesale controls is understood, but it is important that the overall impact of both controls on customers' bills is not forgotten.
- Totex should reduce the bias towards capex-based solutions and encourage innovation. The industry is still nervous of innovation, however, because of the risk of regulatory short-falling at a later date.
- The outcomes approach is a welcome innovation as it focuses on the 'end result' for customers.
- Evidence from CCWater research (and from some companies' research⁸) shows that customers do not support the principle of incentivising what is seen as basic service delivery through the introduction of Outcome Delivery Incentives (ODIs). There is a danger that if companies have a successful five years, ODI rewards could be a driver of price increases and, especially if inflation is high, could cause customer or media reaction.
- The two companies with 'enhanced' business plans (Affinity and South West) had Ofwat determinations that broadly reflected their business plans, albeit with a higher cost of capital than Ofwat set more generally at Final Determinations. Both companies received a financial reward for attaining this status, but were immune to most challenges later in the process.
- The diversity of outperformance commitments (522 across all companies) means that, while these performance commitments were reflective of evidence of what customers want, there is a lack of comparability between companies.
- In response to our concerns that some companies were targeting average performance, Ofwat conducted a review of performance commitments across six key areas of performance and increased the performance targets (and therefore incentive thresholds) for many companies.
- Ofwat set a Weighted Average Cost of Capital (WACC) of 3.74% (including retail margins), just within the range our consultants, Economic Consulting Associates (ECA)⁹, recommended to us (3.00% to 3.75%). Ofwat took a more risk averse view of the cost of equity than ECA recommended, specifically its view that the equity beta was 0.8, which was higher than ECA's assessment of 0.5 - 0.6. This may lead to companies' being more profitable than is appropriate given the low risk of the industry.
- Ofwat introduced the 'pay as you go' ratio (PAYG), which sets the ratio of cost recovery between current customers (from their bills in 2015-20) and future customers (through returns based on the company Regulatory Capital Value). The

⁸ Outcome Delivery Incentives - the customer view (SPA research for CCWater, March 2014) <http://www.ccwater.org.uk/wp-content/uploads/2014/03/Outcome-and-Delivery-Incentives-Report-FINAL.pdf>

⁹ ECA recommendations of the Weighted Average Cost of Capital - <http://www.ccwater.org.uk/wp-content/uploads/2014/07/ECA-CCWater-Cost-of-Capital-summary-report.pdf>

PAYG ratio was increased for those companies able to demonstrate that without it, they would face financing constraints.

- After publishing its PR14 methodology in 2012, Ofwat provided little information to companies or stakeholders about the direction of the price review until its risk based review of business plans in early 2014 and draft and final determinations later that year.
- Ofwat also made several changes to the PR14 timetable and methodology, removing the categories for 'standard' business plans and 're-submission' whilst retaining the 'enhanced' category.

Our recommendations

18. As part of its own review of PR14, Ofwat needs to assess to what extent separate retail and wholesale price controls will facilitate the introduction of retail competition for non-household customers, and how the introduction of totex has reduced companies' earlier bias towards capex-based investment. We recognise that this may take some years to fully assess.
19. Further price controls within wholesale may be needed in the future to accommodate the possibility of upstream competition. If this happens, it should be introduced in a way that minimises complexity.
20. The outcomes approach should be retained for future reviews, as it focused on what is needed to meet customer expectations, and drives customer engagement in the process.
21. Despite evidence of customers' antipathy, Ofwat has moved forward with ODIs. It is important that if companies get ODI rewards, customers are informed of what benefits they are getting in return. Similarly, if penalties are incurred, companies should explain what they are doing to improve performance. We will continue to monitor ODIs in terms of customers' perception of both their use and future impact on bills. We also continue to support the use of cap and collars to restrict the potential bill impact of ODIs.
22. The customer benefits from companies achieving 'enhanced' status must outweigh the value of the rewards a company will receive for this status. Existing company performance should also be taken into account in considering whether to award 'enhanced' status, as it might appear perverse to customers if companies with comparatively poor service or complaint performance receive this status.
23. While there is limited comparability of companies' performance commitments, companies should still be challenged to aim for the top end of industry performance. Where there is a degree of comparability, company's proposed performance commitments should reflect the upper tier of industry performance. Where a company is using a measure that cannot be compared with others, we should expect to see a company' aim to improve performance from its 'starting level'.
24. Ofwat should extend its review of performance commitment targets, and use 2015-20 performance as a baseline for more challenging targets for 2020-25, particularly for key performance commitments that have greatest customer impact.
25. Ofwat should set the WACC based on demonstrable market evidence, with particular emphasis on the level of risk it factors into the calculation. Our

consultants have shown how risk is overestimated in the WACC in what remains largely a monopoly industry¹⁰.

26. The PAYG ratio should not be used as a mechanism (by Ofwat or companies) to offset a lower WACC by increasing short-term revenue. The PAYG ratio should only be increased if there is robust evidence that customer detriment may be caused by financing constraints if a company's short-term revenue allowance is not increased. PAYG ratios should not be re-adjusted at the expense of customers at a later date. Changes to the PAYG ratio proposed by companies at future reviews should only be allowed if there is a clear customer benefit in doing this.
27. Some companies conducted research at PR14 to measure customers' views on the balance of the bill impact on current and future bills. This informed company and Ofwat decisions on the PAYG ratio. This form of research should be used further at future price reviews.
28. If retained, Ofwat's Customer Advisory Panel (CAP), a platform for stakeholder engagement early in the review, needs to address, at an early stage of the process, the fundamental issues that drive price determinations. These include the cost of capital, efficiency and the use of comparative data to drive improvements. Ofwat should show how it uses the CAP's views and recommendations.
29. Ofwat could do more to strengthen the CCGs challenges by providing comparative analysis, and more detailed guidance on its expectations of what CCGs should do (see recommendations 9 and 10 in section 4.1 on CCGs).
30. Consideration needs to be given as to when Ofwat publish cost of capital and cost menus (i.e. baseline efficient retail and wholesale costs) information. If revealed too early, this could be advantageous to companies as the regulator has 'shown its hand' early. However, if released too late it does not give the CCGs adequate opportunity to challenge company assumptions. We would welcome discussion with Ofwat and the industry ahead of the 2019 price review to look at when would be the right time to release such information to inform CCG challenges.
31. Ofwat should give an early indication of its views on costs, but with a caveat that it can change if new evidence emerges in the intervening period to justify this.
32. Ofwat's changes to the process caused disruption to the CCGs, but we recognise that this was a radically different price review that always had the risk of changes needed along the way. PR19 should be a more settled process, and we recommend Ofwat sets a methodology and timetable early in the process so that this can be adhered to and allow CCG members to set their expectations over the time commitment needed.

4.3 Customer research

Our findings

- Companies were encouraged to develop their own customer engagement and research strategies to gain understanding of customers' priorities and

¹⁰ Please see ECA's recommendations for the Ofwat cost of capital at PR14 here - <http://www.cewater.org.uk/wp-content/uploads/2014/07/ECA-CCWater-Cost-of-Capital-summary-report.pdf>

expectations, and willingness to pay. We also pressed companies to test business plans for customer acceptability.

- CCWater issued high level guidance to companies and CCGs on our expectations of how research should be considered in a representative and non-leading manner¹¹.
- There were some cases where it was felt by CCWater's CCG members that companies' research was designed to measure customer acceptability of the option or answer companies wanted, rather than asking customers for views more generally.
- There was some innovation, but companies' research methodologies and findings could not be compared as there was diversity across the methods used by company researchers. Each company's approach to testing business plans for acceptability was also different and could not be compared.
- CCWater used a consistent methodology to measure the acceptability of each company's draft determinations - the only research in PR14 in which each company's results could be compared.
- Some companies and Ofwat inappropriately used 'willingness to pay' (WTP) customer research to justify applying financial incentives to performance commitments, stating that WTP indicates customers may be willing to pay rewards for exceeding performance targets.

Our recommendations

33. Ofwat should retain the approach where companies continue to 'own' their research to develop the sense that their customers' views should be reflected in business plans. This should now be an intrinsic part of the 'culture' of the price setting process. We recognise that by allowing companies to 'own' their research and be responsible for delivering it, there will be diversity and non-comparability of research methodologies and findings.
34. To ensure such research reflects good practice, companies should not seek to measure approval for a company's preferred option, but should gather customers' views on issues or proposals.
35. CCGs should continue to have a role in challenging and influencing how company research is carried out and how the results are interpreted and reflected in business plan proposals.
36. As there was an increase in the volume and influence of research at PR14, the industry should conduct analysis to identify best practice in the research that was used at PR14, and use this as a baseline for future research. CCWater should be involved in this process¹². This should include acceptability testing, with an emphasis on prices that are proposed to customers that take into account a

¹¹ Our customer engagement principles can be found on this webpage -

<http://www.cewater.org.uk/waterissues/pr14/futurepricesettingccwatersviews/>

¹² This has already started in 2015. The water industry research group, UKWIR, has evaluated customer engagement techniques used by water companies through PR14, and looked at customer engagement more widely in other sectors to identify and recommend good practice. Later in 2015, UKWIR will look specifically at how evidence from customer engagement and research is used in regulatory decision making. CCWater is involved as a Steering Group member for both projects.

forecast of inflation (as this reflects 'real life' bills). While companies' are responsible for 'testing' their plans for acceptability, the take up of 'good practice' should improve this research, though it would not increase comparability, unless a more prescriptive approach is taken and all companies follow exactly the same methodology.

37. Future price reviews should see business plans and Ofwat determinations tested for acceptability as the result can potentially see changes made that benefit customers. By measuring customers' views on whether the 'final package' is acceptable and affordable, we can see to what extent the price review has delivered what they want.
38. CCWater should continue to use a consistent methodology to measure the acceptability of Ofwat's draft determinations, to allow comparability. We could also extend our acceptability testing to company business plans to provide a comparable measure. This would assist CCWater, Ofwat and CCGs in focussing attention on plans that have a lower level of customer acceptance, and having a comparable measure of customer acceptability across all companies.
39. WTP should not be used as evidence to justify ODI proposals as it is not a literal measure of the amount of money customers would be willing to pay for specific service improvements. Rather, it produces numerical outputs which feed into cost-versus-benefit modelling to derive potential service improvements.
40. WTP research measures customers' service preferences and places a numeric value on their choices. It is a feature of price review research that is well understood by market researchers and water companies. To avoid misinterpretation (as the phrase 'willingness to pay' can be taken literally), explanation should be provided to CCG members as to what this research does.

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