Citizens Advice

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Dear Sir / Madam

Response to "Setting price controls for 2015-20 – draft price control determination notice"

Citizens Advice is the statutory consumer representative for consumers in the energy and postal markets in England and Wales. While it has no formal remit in other regulated sectors, we maintain a watching brief on major developments in order to understand how practice differs and what we can learn from this. This submission is our response to your consultation on "Setting price controls for 2015-20 – draft price control determination notice." It is entirely non-confidential and may be published on your website.

Return on Regulated Equity (RoRE)

We welcome the focus that Ofwat has given to ensuring that the potential rewards available to water networks are proportionate to the risks that they face and the need to keep bills affordable. In its draft determination, you propose a materially (0.35%) lower cost of equity than Ofgem is proposing in its current determination on power distribution networks. This will save consumers money. However, we think you should consider whether further reductions to this figure would be merited.

Consumers rely on regulation to set a level of return that adequately encourages the necessary investment in these essential services while being proportionate to the level of risk associated with that investment and the performance of the businesses involved. Investors have a choice of where to put their money, so it is worth considering the alternatives available to them when looking at the level of return that is proportionate to encourage investment in the sector. The long-run real rate of return on UK equities is in the region of 5 to 6%, although this has declined to 1.2% thus far this century (source: Credit Suisse Global Investment Returns Yearbook 2014).

In any investment decision, it is reasonable to expect risk and reward to be linked. There are a number of factors that make water networks a lower risk than most other companies:

- They are monopolies; there is no risk of predation of their domestic customers (and, for a proportion of this price control period, their non-domestic customers);
- There are a wide range of uncertainty mechanisms contained within price control processes that allow for further business uncertainty to be stripped out; and
- The nature of the regulated settlement and of the commodity itself (an essential service) means that returns are relatively inelastic and comparatively immune to economic boom & bust cycles.

These factors suggest that water network companies are engaged in a low risk economic activity. One might therefore expect a low level of reward to be the norm. It would appear intuitive that baseline returns would be set at a discount to average equity returns, reflecting this lower than average risk. While we do not consider that a figure anywhere near as low as the 1.2% market equity return seen thus far this century would be credible or sufficient to drive investment we do think that you still have room to manoeuvre to drive out further consumer savings through a lower RoRE baseline than the 5.65% you are proposing. It looks a very generous reward for an ultra-low risk business activity in otherwise uncertain equity markets.

In energy, our ability to provide adequate scrutiny of acceptable levels of returns has been hampered by the difficulty in understanding likely actual returns once incentives and penalties have been factored in. This can result in baseline RoRE giving a highly misleading reflection on the likely actual level of reward that networks will achieve. For example: in the last completed electricity and gas transmission price controls, every single network outperformed its base allowed return; in the last completed gas distribution price controls, every single network outperformed its base allowed return; and in the first year of the current electricity distribution price control (the last one for which published data is available), every single network outperformed its base allowed return. It appears to us that this has resulted in a cognitive disconnect when assessing business plans: that (non-network energy) stakeholders interpret baseline RoRE as the result that an averagely performing network might expect to get – when in practice even the worst performing network is highly likely to outperform that figure.

We are unsighted on the extent to which this problem is replicated in water. But if it is possible, or probable, that everyone can or will outperform the baseline then this needs to be articulated in order to ensure that non-network stakeholders can give an informed view of acceptable returns. While figure 5 gives a sense of the range of possible overall returns that each water company could achieve, it does not give a sense of their probable distribution. If the latter could be attempted, we think this could greatly improve understanding of whether returns offer consumers value for money.

We welcome your decision to apply an upper quartile efficiency challenge on all companies' wholesale costs. We fully agree with your stated intention to avoid situations where companies can gain financially for delivering a level of performance that is not stretching.

We likewise agree with your intention to apply an aggregate cap on rewards and penalties in order to reduce the risk of over or under rewarding networks given the relatively innovative nature of some of the rewards and penalties that are being proposed. You note that it would be open to a Consumer Challenge Group (CCG) as well as to a network to apply to Ofwat to amend the cap and collar in the event that they consider the arrangement was working against the interest of customers. We think this is a prudent inclusion and would welcome a further discussion with you on the practical mechanics of how this safeguard will work because this principle/model could form a basis for considering appeals rights in other sectors. For example, there is no equivalent mechanism for a consumer group to launch a mid-term appeal of excessive returns in energy price controls.

Reputational incentives

We note, and welcome, the material shift in the balance of incentives from reputational to financial between December and the revised business plans (from 68%:32% to 41%:59%). We are sceptical that reputational incentives can ever have anything more than limited value in affecting the behaviours of monopoly utilities. Consumers, at domestic level at least, will not have the ability to reward or punish a water or sewerage company with a good or bad reputation by shopping around. Nor is it credible that they would relocate simply to ditch their water company. Indeed, because of the lack of comparator providers and the relatively low profile of the sector it is highly unlikely that an ordinary consumer will even have a sense of whether the company that serves them is outperforming or underperforming compared to its peers. Given the fiduciary duty of the companies to maximise returns to their shareholders, we would expect networks to concentrate their management time on maximising/mitigating their exposure to those incentives with a financial reward/penalty.

We recognise, however, that there can be a limited beneficial effect in having a reputational incentive *when compared to having no incentive at all* insofar as it can provide a means for the regulator to monitor and challenge networks relative performance and, in some instances, as a stepping stone towards having a financial incentive in subsequent price controls. If data quality is an issue, or out/under-performance cannot be robustly quantified, there may also be reasonable arguments that a reputational incentive reduces the risk of unmerited rewards or penalties.

We would therefore encourage you to seek to only agree reputational incentives where you are convinced that a financial incentive would not be robust.

Cross subsidy

Non-domestic competition will be introduced during the course of this price control; in order to facilitate this you are introducing differential retail margins for domestic and non-domestic consumers. Given that assets may be used for multiple purposes this will raise issues around the allocation of costs between household consumers, who by definition will be sticky given that they cannot choose their water supplier, and non-domestic consumers, who could shop around.

It would be prudent to be aware that the issue of cross-subsidy – whether real or simply perceived – between sticky and non-sticky customers has become a thoroughly toxic issue in the energy sector that has materially undermined consumer trust to the point of becoming a focus of the current CMA investigation. We would strongly encourage you to ensure that you have robust public reporting in place from the earliest days of market opening in water to ensure – and to provide public confidence that you have ensured – that costs cannot be unfairly loaded onto non-competitive parts of the sector in order to underwrite competition elsewhere.

Cost of debt

You “note that current market evidence suggests a downward movement in the cost of debt since we issued our risk and reward guidance.” Noting the acute cost of living concerns facing many families, we encourage you to act on this evidence and to reduce allowances for the cost of debt if evidence continues to support this.

External price pressures

It is clear to us from your draft determination that you have challenged the companies to try and consider affordability issues when developing their business plans and that this also features in your own thinking when assessing them. However it is less clear to us how either the companies or Ofwat have sought to take into account wider affordability issues when determining whether the price controls meet the needs of current and future consumers.

Consumers in the water market are also consumers in other markets, and there is likely to be significant external inflation in at least some of these sectors during the period covered by this price control. For example, although energy bills have already doubled in the last eight years, most forecasts suggest that they will continue to rise above inflation for the remainder of the decade. We think that anticipated inflation or deflation in other essential services should have an influence on whether investment should be brought forward or deferred in the water sector but cannot see a clear audit trail to understand how, or indeed if, it has been taken into account.

Both the Public Accounts Committee and the National Audit Office (“NAO”) have been highly critical of the lack of a robust co-ordinated framework to assess the cumulative impact of infrastructure investment on consumers. As the NAO has put it:

“Government and regulators do not know the overall impact of planned infrastructure on future consumer utility bills, or whether households, especially those on low incomes, will be able to afford to pay them. It seems critical to know ‘how much is too much’, based on reliable information.”

We would like to see the development of a robust structural framework to monitor and report on the projected cumulative impact of infrastructure investment on consumers across all the utilities and extending beyond the immediate price controls into the medium term (to 2030). Such a framework appears imperative to us if we are to be able to identify any investment and affordability pinch-points or types of consumer that will particularly adversely affected. We would like to see Ofwat, in partnership with the other members of the UK Regulators Network (UKRN) and HM Treasury, develop a model for how such a framework would work. We think this should be a priority work area for the UKRN in its next workplan.

We hope that this submission has been helpful and clear. We would be happy to discuss any issue raised in more depth if that would be helpful.

Yours faithfully

[unsigned as submitted via email]

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