

Competition and Markets Authority
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14th May 2015

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Welsh Water initial submission to CMA - Price Determination for Bristol Water plc

I am writing in response to the request for submissions from interested parties on matters relevant to the inquiry.

Overall we have found the approach and transparency of the 2014 price review for the period 2015-20 to be beneficial to securing the best outcome for our customers. There have been some material changes from previous price reviews. Our views on two of the major changes in methodology and their effect on the final outcome are set out below.

Arguably, the most significant change was to the process and methodology for assessing the level of allowed expenditure, in particular the setting of a total expenditure baseline. We welcome the more innovative approach taken which recognises the inherent complexity of modelling heterogeneous companies. This is manifest in three areas:

1. The use of a forward looking cost assessment which recognises the challenges companies, themselves, have put forward within their business plan;
2. The use of a suite of panel data models improving on the limitations inherent in using the single cross sectional modelling approach; and
3. The post modelling plenary “deep dive” process assessing the evidence for specific aspects within a company’s plan.

This measured approach to recognising the differences that exist between the companies contrasts with the approach to “horizontal interventions”: the setting of the industry wide performance level targets and ODI’s in the autumn of 2014. The Business Plans were constructed after careful consideration of customer preferences and cost and bill impacts of the various options. This resulted in the balanced final plan submission within which the financing of the plan and the performance targets proposed were inextricably linked. A unilateral change to these performance targets at a late stage in the process without time or process for proper consideration and little or no recognition of the cost or price consequences, or even our customers’ preferences, means that the outcome was more crude and unsatisfactory than it had to be.

For your convenience I have attached our letter to Ofwat following the Final Determination which outlines a summary of our main issues.

I trust that you may find this submission a helpful contribution to the work of the panel. If you have any queries or wish to discuss this submission, please do not hesitate to contact me.

Kind regards

Mike Davis
Director of Strategy & Regulation

Enc. C Jones letter to Cathryn Ross 28/1/2015



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Cathryn Ross, Chief Executive
Ofwat
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28 January 2015

Dear Cathryn

On behalf of Dŵr Cymru Welsh Water (DCWW) I am writing in response to your letter of 12th December 2014, which formally determined our price controls for the period 2015-20.

We have examined the detail of the final determination very carefully, and our Board has given it thorough consideration, notably at a specially-convened meeting earlier this month. I am pleased to inform you that it has decided not to ask Ofwat to refer the determination to the Competition and Markets Authority.

Overall, we consider that the final determination represents a very good result for customers. They will continue to see bills falling steadily for a further five year period, yet will also experience service improvements in a number of important areas. We believe that this outcome vindicates the unprecedented role that customers and representative bodies played in shaping our Business Plan and, ultimately, the final determination. It also reflects the positive way in which we were able to work with Ofwat's price review team during the course of the review, and the openness and flexibility that characterised the process. This creates the prospect of good working relations going into the AMP6 period. In particular, we are looking forward to working closely with Ofwat in connection with the important early preparations for the next major price review in 2019.

Given the complexity of the final determination, there are inevitably a few issues on which we were not able to reach agreement. Notwithstanding that we accept the determination as a package, these areas will pose particular challenges for us now, and ongoing dialogue with your colleagues will be important. In addition, there are comparatively minor points of clarification that we will be seeking to establish over the coming weeks. The attached schedule provides a summary of the main issues on which we plan to engage.

Finally, please pass on our thanks to Sonia and her team for their handling of the review, and in particular the constructive way in which they engaged with us during the course of the critical stages of the process, especially over the summer of 2014

Yours sincerely

Chris Jones
Chief Executive
glas
Glas Cymru Cyfyngedig

We welcome correspondence
in Welsh and English.

Rydym yn croesawu gohebiaeth yn
y Gymraeg neu yn Saesneg.

Matters for future dialogue with Ofwat

Areas of note

1. *viability of the retail business*: although Ofwat accepted much of our argument in relation to the reasonable level of costs to be allowed, it will nonetheless be a challenge for our retail business to break even on the basis of the resulting price controls. We have carried out a root-and-branch review of our retail functions, and have embarked on a major programme of cost reductions. It may still be the case, however, that the business is loss-making after the first year or two of the five year period, which we do not regard as a sustainable situation for the longer term;
2. *non-household price controls*: we were disappointed that, having approached this issue in our October submission in what we considered to be a much better way than we had used for the May business plan, Ofwat reverted to the original approach in the final determination. We have read the reasoning for this decision, but nonetheless are not persuaded that the final determination reflects the right outcome. We welcome the opportunity to put this right in the non-household “mini-review” in 2016, and will be looking to work closely with Ofwat to this end; and
3. *performance commitments adjusted through horizontal comparisons*: we believe firmly in the power and effectiveness of comparative performance measures in this industry. However, we were disappointed with the interventions that Ofwat made towards the end of the price review, especially in relation to the interruptions-to-supply and customer-contacts measures. They were made comparatively late in the process without, we believe, sufficient consideration of the validity of simple benchmarking in these areas, and were not supported by customers. This risked undermining the sense of ownership of business plans by companies that Ofwat had rightly been keen to foster. As a consequence, we are in the difficult position of having to evaluate the benefits of diverting resources to the achievement of targets that do not appear to be the highest priorities for our customers, and which were not part of our plans, and away from the delivery of other priorities that were. We will keep Ofwat regularly informed of our thinking in these areas, and our progress in delivering what we believe to be the right overall outcomes for customers.

Other points of clarification

4. *“Mean Zonal Compliance” (MZC)*: we think that the final determination has inadvertently altered our primary measure for drinking water quality to MZC. Although this is the measure that is generally used by other water companies, it is not appropriate for DCWW because it is highly volatile in our case. Given the nature of the water supply system in Wales, we have a significant number of small discrete supplies in rural areas which have a disproportionate impact when included in the MZC calculation. (For example, we had some 65 failed samples in 2013 and achieved a MZC of 99.97%. However, in 2014, 50 failed samples gave rise to a MZC of only 99.94%.) We had explained this in our representations, where we pointed out that Ofwat had mistakenly stated that all companies had chosen MZC as a performance commitment, but it was not addressed either way in the final determination (table AA4.1) and the description of the performance commitment A1 on page 133 nonetheless referred to MZC. We firmly believe that the overall compliance measure that was proposed in our Business Plan is more appropriate as it encompasses all regulatory water quality results, including water quality supplied from our water treatment works and service reservoirs. The MZC measure does not incorporate any samples taken from these assets; and

5. *Serviceability – reference levels and control limits:* when we put forward serviceability as a performance commitment in the December 2013 Business Plan we noted that the sub-measures, together with the reference levels and control limits, need to be updated and refined for the AMP6 period, notably in the light of the track record of using these measures during AMP5. We did not share our detailed thinking with Ofwat during 2014 because the issue did not arise during the course of our working-level exchanges. We were disappointed, therefore, to note that Ofwat provided, for the first time, detailed reference levels and control limits in the final determination. Of particular concern are the reference levels for sewage infrastructure where the inclusion of transferred sewers in the measurement for the first time means a step change in performance, which has not yet been adjusted for. We have already indicated to the relevant colleagues at Ofwat that we wish to discuss what we consider to be a more appropriate set of measures going forwards, and will be engaging with them in due course.