



# **Utility Regulator's PC21 Draft Determination**

## **December 2020**

## **The Consumer Council's response to the Utility Regulator's PC21 Draft Determination**

**Our reference: PD20010/3083**

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### **1. Introduction**

- 1.1. The Consumer Council is a non-departmental public body (NDPB) established through the General Consumer Council (NI) Order 1984. Our principal statutory duty is to promote and safeguard the interests of consumers in Northern Ireland.
- 1.2. The Consumer Council is pleased to respond to the Utility Regulator's (UR) PC21 Draft Determination (DD). We look forward to ongoing engagement with UR in the development of its PC21 Final Determination (FD).
- 1.3. The Consumer Council contracted SLG Economics to provide additional analytical support in preparing this response.

### **2. Summary**

- 2.1. The main points of our PC21 DD response are we:
  - Agree with the overall approach UR is taking to PC21;
  - Stress the importance that consumers' views continue to be central in developing the FD and the delivery of PC21;
  - Agree with the balance of consumer outcomes presented, but challenge why targets have been set at the lower end of performance;
  - Share the concerns of the impacts on delivery of funding constraints and the lack of medium term budget security for NI Water;
  - Support the tariff profiles in the DD, with mitigation measures;
  - Agree with the new consumer measures, but challenge the targets set for increases to at least meet current performance levels;
  - Request a review of the introduction of guaranteed service standards;
  - Propose a lower Cost of Capital and suggest that UR should wait to finalise its decision based on the final CMA determination;
  - See scope for greater Opex efficiency to underpin an ambitious but realistic target;
  - Propose regulatory oversight of senior NI Water management incentives to complement reputational incentives; and
  - Support a move from RPI to CPI or CPIH for PC27.

### **3. Funding PC21**

- 3.1. It is clear that the main threat to the delivery of PC21 will be the constrained availability of public expenditure funding. We have serious concerns about the significant difficulties that would be presented through a constrained public expenditure budget and the additional burdens placed on NI Water through a lack of medium term funding security.
- 3.2. We share the view that establishing medium to long term budget certainty for NI Water would have a positive impact and would welcome the confidence and savings that would be delivered if a multi-year budget could be agreed for NI Water.
- 3.3. The governance and funding of NI Water are political decisions. The Consumer Council supported the full funding of the PC15 FD. While not pre-judging the outcome of the PC21 determination process we would see The NI Executive as having a responsibility to fund NI Water correctly in line with the PC21 FD and the New Decade New Approach agreement. Deficits in investment and funding security will lead to consumer detriment.
- 3.4. We remain open to discussions about future governance and funding options for NI Water.

### **4. PC21 Approach**

- 4.1. We agree with UR that the “outcome of PC21 should be consumer centred with clear performance commitments”.<sup>1</sup> The strong emphasis on putting the consumer at the centre of the PC21 process is clear and welcome. Overall, the PC21 DD provides a robust set of challenges to NI Water to deliver on behalf of consumers.
- 4.2. The Consumer Council uses the eight consumer principles shown in Figure 1. The principles provide a framework that asks important questions about service design and delivery, consumer impact and how services should look and feel to the consumer, and helps assess regulatory decisions from a consumer perspective.
- 4.3. The consumer principles also establish a common language that all stakeholders (Government, Regulator, Consumer Body, and the Company) can use to meaningfully and constructively engage with consumers to develop trust and a better understanding of the value for money a company/price control can provide.

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<sup>1</sup> UR PC21 MainDD report, paragraph 1.17.

When reviewing the proposals put forward by NI Water in its PC21 business plan and the UR's PC21 DD, it is against this framework that we make our assessment of benefit for consumers.

**Figure 1: The Consumer Council's Eight Consumer Principles**



- 4.4. We support the approach of continuation of planning and delivery from PC15 into PC21 that UR has set out, and that the aims of PC21 should build on the strengths of PC15 and continue the delivery of the long-term objectives set out in the Long Term Water Strategy (LTWS).
- 4.5. The collegiate method taken by UR in the development of PC21 through 1-2-1 engagement and the PC21 working group structures worked well. We welcome the UR's transparent and collaborative approach.
- 4.6. In our response to UR's consultation on its approach to PC21 we noted that flexibility would be required in the planning and delivery of PC21. The impacts and duration of the Covid-19 crisis are unknown. Given the increased uncertainty created by this, and Brexit, the PC21 approach must remain flexible and adaptable

to deal with the unusual amount of uncertainty and the possible consequences. To achieve this, UR should consider what regulatory mechanisms would ensure that the regulatory framework is flexible and robust to the extra uncertainty.

- 4.7. One method to provide flexibility is the PC21 mid-term review. We agree that a mid-term review should be conducted, and the opportunity taken to review and recalibrate targets and revenues, and facilitate any necessary changes.
- 4.8. Given the potential complexity of the PC21 mid-term review, we do not think that the 2 month timetable set out in the DD (NI Water making its submission by 15 September 2023 and UR completing its determination by 15 December 2023) gives sufficient time for stakeholder review, scrutiny, challenge, consultation and agreement.
- 4.9. The existing stakeholder monitoring and reporting structures and change management protocols worked well for previous price controls. To ensure the regulatory framework continues to deliver for consumers will require even closer monitoring and reporting by UR given the increased uncertainties and the increased scale of PC21. UR must ensure that its monitoring arrangements are robust and adequately resourced.
- 4.10. In our responses to Gas Supply Price Controls 2020 and Gas Distribution Networks GD23 Price Control, we noted that RPI has been discredited as a measure of inflation, and is no longer classified as a 'national statistic' by the ONS. Paul Johnson in his report for the UK Statistics Authority on the use of price indices concluded: "RPI is not a credible measure of consumer price change ... Taxes, benefits and regulated prices should not be linked to RPI ... Government and regulators should work towards ending the use of RPI as soon as practicable".<sup>2</sup> The government has recently announced its plan to discontinue the supplementary and lower level indices of the RPI by 2030.<sup>3</sup> Other regulators such as Ofcom, Ofwat, CAA and Ofgem have already moved partially or completely to using the Consumer Price Index (CPI/CPIH) or are considering its use in their current regulatory reviews. Therefore, UR should move from using the RPI to using the CPI or CPIH as the inflation measure for PC27.

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<sup>2</sup> <https://uksa.statisticsauthority.gov.uk/news/uk-consumer-price-statistics-a-review-2/>

<sup>3</sup> *A Response to the Consultation on the Reform to Retail Prices Index (RPI) Methodology*, HM Treasury, UK Statistics Authority, November 2020

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/938008/RPI\\_Response\\_FINAL\\_VERSION.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/938008/RPI_Response_FINAL_VERSION.pdf)

## **5. Consumer views**

- 5.1. We agree with UR that the consumer engagement delivered by the Consumer Engagement Oversight Group (CEOG) for PC21 “has been beneficial to all parties and should enable improved delivery of service to the consumer”.<sup>4</sup>
- 5.2. The Consumer Council has long advocated that engagement with consumers should be ongoing, and move beyond the cyclical Price Control process. We are glad to see the DD stresses this need as a development objective, and actively encourages ongoing engagement by NI Water with its consumer base. This aligns with NI Water’s commitment in its 2021-2046 Strategy to continue to listen to consumers to “embrace more personalised customer engagement through a variety of channels to better understand ... customers’ needs and be customer-led in redesigning our services”. We look forward to working with NI Water on the development of its plans.
- 5.3. To be truly ‘customer-led’, and deliver fully against the PC21 development objective, we expect to see clear evidence of how NI Water has used the consumer insight gained to better understand the consumer benefit it is trying to deliver and how to deliver it. This move through engagement to targeted consumer participation and co-design will strengthen the focus on consumer outcomes and outcome based accountability being encouraged through PC21. We welcome that the DD asks NI Water to report on the initiatives and service improvements delivered as a result of consumer engagement.<sup>5</sup> This must be repeated in the FD. We would like to see the regulatory regime develop to more directly recognise and value excellent customer engagement and challenge poorer engagement.

## **6. Consumer outcomes**

- 6.1. We agree with the outcomes proposed in the DD, with the additional comments below.
- 6.2. It is clear that the full investment programme proposed for PC21 will not resolve all issues or remove all development constraints. The need to invest significantly to compensate for past under-investment, particularly to address lack of capacity in the sewerage network, is well recognised. The stepped increase in investment over PC21 will increase access, choice and safety for consumers, but we recognise

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<sup>4</sup> UR PC21 DD Main report, paragraph 3.23.

<sup>5</sup> UR PC21 DD Main report, paragraph 1.18.

that not all capacity issues and development constraints will be addressed during PC21.

- 6.3. We agree the protection of existing services is the priority, and maintaining the agreed policy to prioritise expenditure to ensure that there is no overall deterioration in the services provided to consumers. Consumers' fundamental expectations from NI Water are a constant supply of high quality drinking water, wastewater services that remove waste, treat it and return it safely to the environment, and excellent customer services (and for non-domestic customers for these to be provided at an affordable price). Repeatedly, surveys and consumer views<sup>6</sup> tell us that there is a high level of consumer satisfaction with the services NI Water provides. Any regression in these service levels would be unacceptable.
- 6.4. We share the concerns raised by the quality regulators about when projects will be delivered during PC21, and welcome the review proposed by UR of the profile of benefit delivery to see what investment and beneficial use can be brought forward in PC21.
- 6.5. A large number of outputs are proposed to be delivered during PC21. UR must ensure that NI Water is not remunerated for those outputs if it fails to deliver and consumers do not receive the benefit, or is remunerated for periods when consumers receive the benefit late. As noted above, the change control processes established to monitor changes during PC15 worked well. Given the increased scale of the PC21 programme it is vital that these monitoring and approval processes are able to track and meet the expected increased demands that will be placed on them.
- 6.6. The PC21 targets, service levels and performance commitments have been set at the lower end of the likely level of performance.<sup>7</sup> We are unclear as to why this approach has been taken consistently as the default position across performance measures. We believe that it is in the interests of consumers for targets to be set at a more stretching level – at least at the mid-point of likely levels of performance.
- 6.7. UR states that NI Water exceeding the targets set at the low end should not be seen as out-performance, and that NI Water will only be out-performing when it is

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<sup>6</sup> Most recently the CEOG research for PC21.

<sup>7</sup> Main report paragraph 3.9.

consistently operating at the upper end of the expected range.<sup>8</sup> The reality is that exceeding targets set by the UR in the PC21 FD will be reported or interpreted as out-performance. To provide appropriate stretch and avoid potential confusion about out-performance, targets should be set at the mid-point of the performance range as default, unless justification for selecting a lower (or higher) point in the range can be provided. Targets can be adjusted at the mid-term review if external factors materialise.

- 6.8. Adjusting targets, if necessary, at the mid-term review would allow targets to be fine-tuned, linked more directly to actual company performance and take account of emerging and exogenous factors. This dynamism in target setting would help drive continuous improvement. The FD should clearly indicate the potential for recalibration of targets at the PC21 mid-term review.
- 6.9. We support the move away from activity measures to service level outcomes. The continuation of this progress is the translation into service promises in NI Water's Codes of Practice (CoPs) and the setting of guaranteed minimum or overall service levels.
- 6.10. Under NI Water's Licence its existing CoPs are due for review in the first year of PC21. We have consistently stated that we expect to see PC21 investment and improved service provision translated into clear performance commitments and improved service promises in NI Water's CoPs. The CEOG consumer research clearly showed that improvements are required to the CoPs. These improvements should recognise and be aligned with the extra funding for investment that NI Water is receiving in PC21. The CM/Sat working group or CEOG can review the appropriateness of the service level promises made in the CoPs.
- 6.11. To complement NI Water's reviewed Codes of Practice we request UR re-examines the introduction of guaranteed or overall minimum service standards for NI Water. This would bring parity with electricity and natural gas consumers, who enjoy the protection provided by GSS schemes, provide confidence to consumers that NI Water must deliver a guaranteed minimum level of service, and strengthen UR's regulatory enforcement powers should NI Water fail to deliver certain minimum service standards for consumers.

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<sup>8</sup> Ibid.



- 6.12. We agree that the current high levels of drinking water quality should be maintained<sup>9</sup>, with investment targeted through a risk management approach. We expect specific drinking water targets to be challenging. We note that three water quality targets are set below 2019/20 outturn compliance figures, and question if this meets the PC21 Social and Environmental Guidance policy to prevent deterioration in drinking water quality.<sup>10</sup>
- 6.13. In addition to the proposed water quality measures NI Water should monitor and report consumers' satisfaction of the management of drinking water quality events and supply interruptions exceeding 6 hours.
- 6.14. The reduction in the number and duration of supply interruptions is welcome, along with the proposed 'step change' improvements to be delivered in reducing interruptions through the Smart Networks Strategy.<sup>11</sup> We agree that this Strategy should proceed as a development objective for the reasons UR specifies, and expect to see service improvements reflected in future targets and service promises.
- 6.15. We look forward to more detail from NI Water on the proposal to change to 'minutes lost per property' as the interruptions to supply measure.
- 6.16. UR rightly notes that reducing the risk of sewer flooding is consistently a top priority for consumers, and that a suitably ambitious target should be set for PC21. We share UR's expectation that once a property has been confirmed as at risk from sewer flooding it would be removed during a six year price control period.
- 6.17. It is not clear in the DD what additional impact the delivery of the LWWP will have on reducing the risk of sewer flooding. Clarity in the FD would be welcome.
- 6.18. There is no measure for sewer flooding of external areas to complement DG5 as a measure of sewer performance. We do not expect a target to be set, but believe that there would be benefit in measuring and monitoring this output.
- 6.19. We welcome NI Water's trials of contacts and customer service offerings, for example HVCA/IVR and webchat. We also agree that savings from reducing

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<sup>9</sup> UR PC21 DD Annex E, paragraph 3.49.

<sup>10</sup> PC21 Social and Environmental Guidance, Aim SEG DW 1D.

<sup>11</sup> UR PC21 DD Annex E paragraph 3.21.

contact handling costs should be prioritised initially to go to other customer service offerings.

- 6.20. We agree that some M&G investment should be paused until the mid to longer term impacts of Covid-19 on work practices are understood. We support the investment in new laboratories.
- 6.21. We support the introduction of four new output metrics for PC21 - the number of economic constraint areas removed, the number of serious development restrictions removed, the number of treatability studies completed, and the number of catchments where management plan recommendations have been delivered.
- 6.22. We welcome the target for NI Water to derive all its power usage from renewable sources by the end of PC21 and this should be reported on and monitored to ensure that NI Water maintains progress towards its achievement. It would be beneficial to set out the proportion that is to be purchased from renewable energy generators and the proportion from self-generation to highlight progress.
- 6.23. We support the 'semi-retirement' of the OPA, with continued monitoring as set out in the DD.
- 6.24. Given the recast of the European Drinking Water Directive an additional performance measure should be considered for public access to drinking water.
- 6.25. Over PC21 it may be necessary to review the definition of contacts and complaints to ensure the appropriateness for contacts and complaints made through wider contact methods such as social media and webchat or online support.

## **7. Consumer measures**

- 7.1. We agree and welcome the suite of new consumer measures introduced for PC21: Unwanted Contacts; First Point of Contact Resolution (FPOCR); and Net Promoter Score (NPS). This suite of measures will encourage consumer focused behaviours within NI Water to meet the consumer priorities of preventing the need to contact the company due to service fault or failure, resolving issues promptly if they arise, and ensuring a satisfactory service is provided.
- 7.2. We do not believe that the proposed targets for the three measures are sufficiently challenging for NI Water, and will lead to a worse outcome for

consumers. All three targets are set below current levels of performance. It is important for consumers that the encouragement to deliver the behaviours driven by the three new measures is maximised. Increased ambitious, but achievable targets will provide this. The targets should be reviewed and adjusted to reflect recent and current performance levels.<sup>12</sup>

- Unwanted Contacts – UR proposes targets reducing unwanted contacts from 74,000 to 70,000. NI Water reported 75,500 unwanted contacts in 2018/19<sup>13</sup>, dropping to 67,000 in 2019/20<sup>14</sup>. NI Water is currently reporting unwanted contacts at approximately 16,000 per quarter. The PC21 first year target should be set at current full year performance levels of 67,000.
- Unwanted Contacts trajectory – UR target removes on average 1.8 unwanted contacts per day over PC21. Removal on the same trajectory would provide a final year PC21 target of 62,500.
- FPOCR – UR proposes increasing FPOCR from 84% in 2021/22 to 85% in 2026/27. NI Water reported 90% FPOCR in 2018/19<sup>15</sup> and 2019/20<sup>16</sup>. This level of performance seems stable with NI Water reporting 92% in Q1 and 92% in Q2 of 2020/21. The PC21 target should be set at 90% (current full year performance level) until PC21 mid-term review.
- NPS – UR proposes a year 1 target of +32 rising to +35 in 2026/27. NI Water reported an NPS of +32 in 2018/19, increasing to +42 in 2019/20. Performance above the UR's proposed PC21 targets seems stable with NI Water reporting NPS of +49 in Q1 and +39 in Q2 of 2020/21. The PC21 target should be set at +42 (current full year performance level) until PC21 mid-term review.

7.3. The three consumer measure targets should be reviewed at the PC21 mid-term review.

7.4. NI Water performance to deliver against the targets should be closely monitored to ensure that pushing for higher targets does not result in any unintended consequences of a lowering of other standards. The package of measures (FPOCR, NPS and Unwanted Contacts) have been designed to counter this, with each

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<sup>12</sup> UR has projected PC21 targets for other outputs based on current actual performance.

<sup>13</sup> NI Water AIR 19 return

<sup>14</sup> NI Water 2019/20 Annual Report and Accounts

<sup>15</sup> NI Water AIR 19 return

<sup>16</sup> NI Water 2019/20 Annual Report and Accounts

supporting the other, but we need to make sure they are working as intended. The Consumer Council conducts three annual assessments of NI Water's telephone and written contact and complaint handling. With the agreement of NI Water this could be increased for the first 2 years of PC21 to provide closer monitoring to complement the ongoing work of CM/Sat working group.

- 7.5. As UR states, these new measures are not an end in themselves. We agree with UR that, in addition to monitoring and reporting on the new consumer measures, NI Water should be required to report on the initiatives and service improvements delivered as a result of these and the continuous engagement and learning from consumers. The existing CM/Sat working group could provide the mechanism for review, discussion and agreement on consumer initiatives.

## **8. Consumer vulnerability**

- 8.1. In response to UR's consultation on the approach to PC21 we requested "the inclusion of a performance commitment for the help provided to consumers in vulnerable circumstances", and for the PC21 Social and Environmental Guidance (S&EG) we secured agreement that support services should be reviewed and targets created for awareness of and satisfaction with the support NI Water provides around consumer vulnerability. Given the clear instruction in the PC21 S&EG we had expected more in the DD than a statement that consumer vulnerability measures should be a development objective with the consideration of potential targets for the latter half of PC21.<sup>17</sup> We believe that clear statements on consumer vulnerability measures and timelines should be included in the PC21 FD and that any delay beyond this would be detrimental to vulnerable consumers.
- 8.2. The PC21 S&EG aim on consumer vulnerability (SEG WSS 3C) contains four main aspects – review and update the support provided to registered consumers; achieve and sustain an appropriate number of consumer registrations on the Customer Care Register (CCR); set a target for consumer awareness of the support available; and the measurement of satisfaction of consumers receiving support.
- 8.3. In November 2019 we responded to the UR's call for evidence on consumer vulnerability.<sup>18</sup> This included commentary against each of these four service aspects and our detailed proposals on UR and utility companies' approaches to

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<sup>17</sup> UR PC21 DD Main Report paragraph 3.52.

<sup>18</sup> <https://www.consumer council.org.uk/sites/default/files/2019-11/Utility%20Regulator%20call%20for%20evidence%20on%20vulnerability%20-%20November%202019%20-%20Consumer%20Council%20response.pdf>

consumer vulnerability, for example we proposed that utility companies be required to gain BS 18477 accreditation and become JAM Card registered organisations. The requirement for NI Water to do this should be reflected in the FD.

8.4. In our response we stated that it is essential that companies act now and do not ‘do nothing’ or wait until the end of UR’s projects on vulnerability (then scheduled for the end of 2020/21) to take action. We have been clear with UR and companies for some time that more direct action is needed from utility companies on vulnerability. The response was pre Covid-19 – given the impact of Covid on exacerbating consumer vulnerability, it makes progressing this work even more urgent. UR is undertaking a ‘best practice’ project, and we welcome this and the reviews on the improvements made and lessons learnt during the pandemic. We recognise that NI Water has made plans and is making progress, including targets in the PC21 FD would accelerate this progress.

8.5. We welcome the engagement from UR on consumer vulnerability measures since the publication of the DD. As a minimum the FD should change the timetable for delivery of vulnerability targets to be trialled by the end of PC21 year 1, to be agreed and in place by the end of year 2. This would allow review at the mid-term review.

8.6. We agree that the CM/Sat is the correct group to progress this work, with input from Consumer Vulnerability Working Group and alignment to UR’s ongoing Best Practice work.

## **9. Tariffs**

9.1. We support the proposed tariff profiles in the DD.

9.2. To help non-domestic unmeasured customers avoid the proposed tariff increases NI Water should continue its metering programme. UR notes metering as an option in the DD.<sup>19</sup> Clarity on the numbers of unmeasured non-domestic customers targeted by NI Water to be converted to metering should be provided in the FD.

9.3. As part of the consultation on NI Water’s 2021/22 Scheme of Charges we have asked NI Water to investigate the feasibility of transferring all unmeasured non-

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<sup>19</sup> UR PC21 DD Main report paragraph 2.28.

domestic customers where a meter cannot be fitted to assessed charges. This will give non-domestic customers the choice of having a water and sewerage bill based more closely on usage, which is a better cost-driver than property size and/or location.

- 9.4. In our support of the Revenue Adjusted Price Cap methodology for PC21 we set out that over-recovered revenue should be fully reflected in reset charges (rather than an adjustment to the RCV) and be returned directly to consumers through timely adjustments. We note that £57.9m of PC15 over-recovered revenue is being returned through a lowering of NI Water's revenue requirement. Final year PC15 revenue, once confirmed, should be dealt with in a similar way at the PC21 mid-term review.<sup>20</sup>
- 9.5. We note UR's intention to review customer numbers and volumes for PC21 based on new information incorporated after the DD. The FD must make clear what if any alterations have been made and the effect this will have on tariffs. It will be important to gain stakeholder agreement to the adjusted tariffs if the revisions result in material changes to the tariff.
- 9.6. Living with Water Programme (LWWP) – LWWP is a needed and significant investment programme. When NI Water submitted its PC21 Business Plan we supported the significant costs of LWWP being off-tariff. The DD includes the costs of LWWP in-tariff for PC21 due to the savings provided through UR's cost and efficiency challenges. To maintain affordability we would support future LWWP costs being off-tariff.
- 9.7. Regulatory oversight must create and maintain clarity between PC21 deliverables and LWWP deliverables, and their associated costs.

## **10. Cost of Capital**

- 10.1. Appendix O of the DD provides an assessment of NI Water's cost of capital by First Economics (FE). FE uses the standard CAPM approach and has particular regard to Ofwat's PR19 determination for the England & Wales water and sewerage companies (E&W wasc) and the CMA decision for NATS. We agree that this is the appropriate framework and approach for assessing NI Water's cost of capital.

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<sup>20</sup> Annex B paragraph 1.17.

#### NI Water's Beta

- 10.2. FE compares the risk characteristics of NI Water with the E&W wasc and concludes that because of its slightly higher operational gearing due to its small RCV, NI Water's beta should sit towards the upper end of Ofwat's range of 0.58 to 0.66. We agree with FE on operational gearing.
- 10.3. However FE has not considered an important difference in the exposure to demand risk between NI Water and the E&W wasc. As NI Water's domestic consumers do not pay for their water and sewerage services directly, NI Water does not face any risk of bad debt from domestic consumers. In contrast, E&W wasc face significant risk from bad debt. The cost of bad debt to E&W wasc, including the cost of uncollected debt, associated financing costs and debt management costs, amounts to around £21 per customer<sup>21</sup> (over 5% of the average bill<sup>22</sup>) – this is likely to increase with the medium term impact of Covid on low income and vulnerable consumers, who are most likely to be in arrears with their payments. We believe that this additional risk faced by E&W wasc increases their exposure to demand risk compared to NI Water and means that NI Water's beta should sit at the lower end of Ofwat's range of 0.58 to 0.66. We would recommend the use of a beta of 0.60 rather than FE's suggestion of 0.64.
- 10.4. We agree with the use of 50% gearing in the CAPM calculation for the reasons stated by FE.

#### Cost of Debt

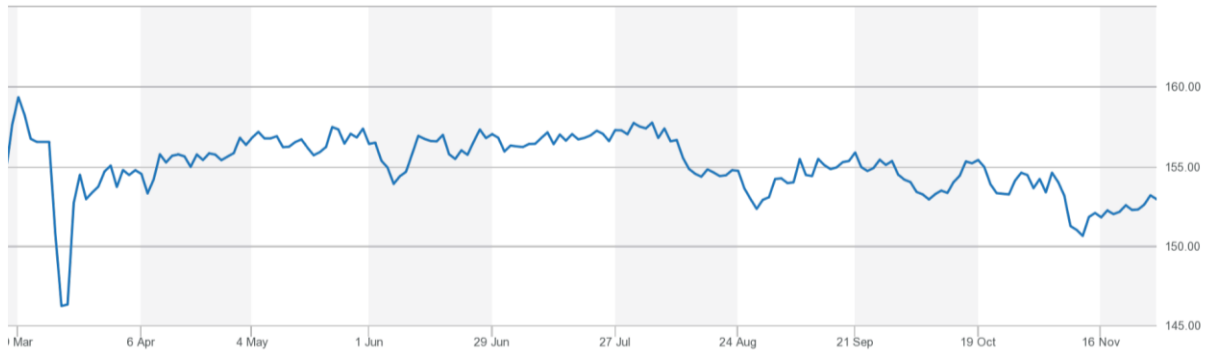
- 10.5. Since FE's calculation of NI Water's cost of capital in February 2020, 2034 government gilt rates (which directly determine the interest rates on new NI Water debt) have moved down – see Figure 2. This would feed directly through into lower borrowing costs for the company.

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<sup>21</sup> *Delivering more of what matters to customers on bad debt* Speech by David Black, Ofwat Senior Director Water 2020 <https://www.ofwat.gov.uk/wp-content/uploads/2017/09/David-Black-Retail-Services-Efficiency-event-28-September-2017-1.pdf>

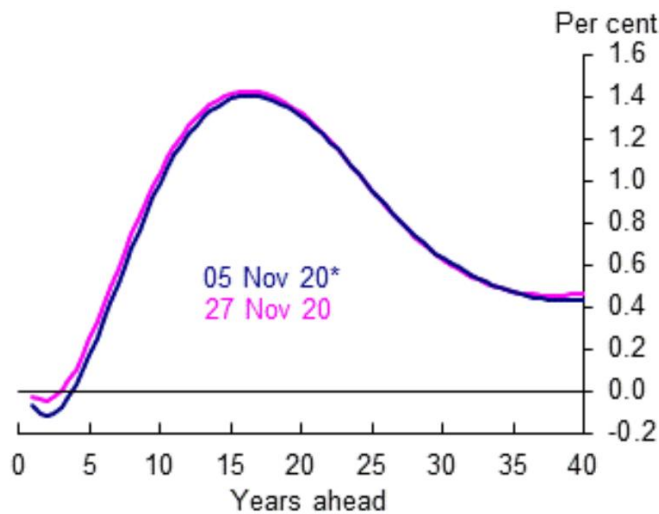
<sup>22</sup> The average E&W customer water bill in 2019/20 was £415, WaterUK

**Figure 2: Treasury gilt 2034 interest rate<sup>23</sup>**



- 10.6. FE note that the best forecast of future gilt yields comes from the forward yield curve. Figure 3 shows the latest available forward yield curve from the Bank of England. It is clear that the expectations about interest rates have fallen significantly since the FE report was produced – short term yields are now negative. The latest (30 Nov 2020) 15 year yield is around 1.4%, compared to over 1.6% for Feb 2020 and over 1.8% for Nov 2019 (shown in Figure 7 of the FE report). We believe that the forward looking interest rate on new NI Water debt should be adjusted down by 0.25% to reflect lower interest rate expectations.

**Figure 3: Instantaneous gilt forward yield curve (%)<sup>24</sup>**



<sup>23</sup> Source: London Stock Exchange, downloaded 30/11/2020

<sup>24</sup> Source: Bank of England, downloaded 30/11/2020



- 10.7. We agree with FE's proposal that year-specific cost of debt should be calculated as the weighted average cost of all new debt raised since 2019. Using our proposed lower cost of new debt gives the results shown in Table 1.

**Table 1: Cost of debt calculation (%)**

	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27
<b>Embedded debt</b>	4.44	4.44	4.44	4.44	4.44	4.44
<b>New debt</b>	1.66	1.71	1.75	1.80	1.86	1.90
<b>Weights</b>	87:13	80:20	73:27	66:34	59:41	55:45
<b>Weighted average cost of debt</b>	4.08	3.89	3.71	3.54	3.38	3.30
<b>RPI Inflation</b>	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0
<b>Real cost of debt</b>	1.05	0.87	0.69	0.53	0.37	0.29

- 10.8. We agree with FE's use of the CMA estimate in its NATS decision of -2.25% for the risk free rate.
- 10.9. We agree with FE's use of the CMA estimate in its NATS decision of 5.5% for the expected market return.

Overall Cost of Capital

- 10.10. Table 2 combines the different individual component estimates together to calculate the weighted average cost of capital. It shows a declining cost of capital from 1.72% in 2021/22 to 1.34% in 2026/27

**Table 2: NI Water's Cost of Capital**

	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27
<b>Gearing</b>	0.5	0.5	0.5	0.5	0.5	0.5
<b>Risk-free rate (%)</b>	-2.25	-2.25	-2.25	-2.25	-2.25	-2.25
<b>Market return (%)</b>	5.5	5.5	5.5	5.5	5.5	5.5
<b>Equity beta</b>	0.60	0.60	0.60	0.60	0.60	0.60
<b>Post-tax cost of equity (%)</b>	2.40	2.40	2.40	2.40	2.40	2.40
<b>Cost of debt</b>	1.05	0.87	0.69	0.53	0.37	0.29
<b>Vanilla WACC (%)</b>	1.72	1.63	1.55	1.46	1.39	1.34

#### Impact of the CMA Provisional findings on NI Water's Cost of Capital

10.11. CMA's provisional findings in its review of the Ofwat price controls<sup>25</sup> suggest a cost of capital of 3.50%, which is 0.54% higher than Ofwat's PR19 decision. If UR were to use the CAPM components in the CMA provisional findings in place of those in the Ofwat decision and the CMA's previous decision for NATS, then it would lead to a higher cost of capital for NI Water. However the CMA provisional findings have been strongly challenged by Ofwat<sup>26</sup>, who has published a response stating that the CMA has made "*a number of fundamental errors in its approach*" which relates to: "*the consistency and rationality of its approach*", "*the adequacy of its reasoning*" and the "*selective and flawed use of evidence*". The CMA's findings have also been heavily criticised by CC Water<sup>27</sup>. Ofwat believes that the CMA's Provisional Findings:

- Are not consistent with previous CMA determinations and depart from established regulatory policy;
- Are not supported by an adequate statement of reasoning;
- Are based on a materially incomplete evidence base;
- Contain serious and avoidable errors;
- Make selective and flawed use of evidence; and
- Use invalid assumptions, erroneous calculations and flawed data.

10.12. The CMA has stated that it intends to publish its final determination in December 2020, although Ofwat have stated that this will not allow the CMA proper time to consider the full determination with the degree of fairness and thoroughness required and that the CMA should make use of the full statutory period available (to 18 March 2021).

10.13. Given:

- the size of the difference between the CMA's provisional findings on the water price controls and their previous July 2020 determination on NATS price controls at well as Ofwat's final PR19 determination;

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<sup>25</sup> Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations: Provisional findings, CMA, September 2020 <https://www.gov.uk/cma-cases/ofwat-price-determinations#provisional-findings>

<sup>26</sup> Reference of the PR19 final determinations: Fundamental errors of approach - response to CMA provisional findings, Ofwat, October 2020 <https://www.ofwat.gov.uk/wp-content/uploads/2020/10/Reference-of-the-PR19-final-determinations-Fundamental-errors-of-approach-response-to-CMA-provisional-findings.pdf>

<sup>27</sup> CCW's response to the Competition and Markets Authority's Provisional Determinations for Anglian Water, Bristol Water, Northumbrian Water and Yorkshire Water, October 2020 <https://www.ccwater.org.uk/wp-content/uploads/2020/10/Competition-and-Markets-Authoritys-consultation-on-Provisional-Determinations-October-2020.pdf>

- the strength of the challenge to the CMA's provisional findings by Ofwat and CC Water; and
- the importance of the Ofwat and CMA decisions for the assumptions underpinning the FE calculations of NI Water's cost of capital.

We do not believe that it would be appropriate for UR to reach a firm decision on NI Water's cost of capital at this point. We believe that the UR should wait until the CMA reaches a final determination that has been accepted by Ofwat and then use the resultant numbers as inputs into the NI Water cost of capital calculation (taking account of the differences between NI Water and the E&W was pointed out above).

10.14. Taking the above into consideration, we recommend that:

- for generic parts of the WACC calculation such as the risk-free rate and expected market return, the UR should wait until the CMA reaches a final determination that has been accepted by Ofwat and use those values in its calculations;
- the cost of debt should reflect the most recent information on forward yields - which have fallen significantly since FE made its calculations in February 2020;
- for company-specific elements of the WACC calculation (particularly the impact of demand risk on the beta), UR should take account of the specific circumstances of NI Water and adjust the values accordingly.

## **11. Operational costs and efficiency challenge**

11.1. We agree with UR's overall approach to assessing operational costs and efficiency which involves:

- establishing a baseline,
- adjusting the baseline for one-off or atypical elements,
- establishing a relative efficiency gap,
- estimating the frontier shift, and
- the reasonable rate of catch-up towards the efficiency frontier.

11.2. We have no comments on UR's approach to setting the baseline or adjusting it for new opex or opex from capex, all of which seem reasonable and in consumers' interests.

- 11.3. We agree with UR's approach of including pension costs within base year opex and rolling it forward across PC21. The inclusion of an extra allowance for pensions would be double-counting and UR is correct not to allow the amount claimed by NI Water for pensions. Similarly, UR should not allow additional funding for transformation costs where they have previously been funded, effectively making consumers pay twice for the same improvement.
- 11.4. The efficiency catch-up rate of 1.7% per annum is significantly lower than the efficiency challenges NI Water has faced in the past (2.3% per annum in PC15, 5.0% in PC13 and 7.2% in PC10). While we understand that this reflects the fact that the gap with the E&W water and sewerage companies' efficiency has significantly reduced, it would be in consumers' interests for UR to set a more demanding challenge that does not see the E&W company comparators as a ceiling to catch-up to, but rather as competitors to outperform. We believe that setting a target of using the 85<sup>th</sup> percentile rather than the upper quartile (75<sup>th</sup> percentile) would show greater ambition and still be a realistic target for NI Water to achieve.
- 11.5. The approach to accounting for special factors is reasonable. We would request that for the FD additional consideration is given to the recognition of the difference between factors that are likely to lead to higher costs (discussed in the first three bullets on page 71 of the DD Main Report) and factors that lower costs (the fourth bullet). In the former case, NI Water has a strong incentive to identify and make the case for the higher costs to support higher cost allowances. In the latter case, there is no such incentive (in fact the reverse – an incentive to argue against the significance of such costs). As a result, unless the lower costs are very obvious (eg lower regional wages) there is a risk of a systematic bias in the approach that is likely to identify increases rather than decreases in special factor costs.
- 11.6. The approach underpinning UR's assessment of opex and capex frontier shift is reasonable. However, as shown in Table 3, in its PR19 determination Ofwat has used a more challenging estimate of frontier shift of 1.1% per annum for the E&W wasc, which was adjusted down slightly to 1% per annum by the CMA in its provisional findings on the water price controls. This is significantly higher than the UR's proposal of around 0.8% pa. It means that over PC21, UR estimated a frontier shift of only 4.7%, compared to Ofwat's estimate of 6.8% and the CMA's estimate of 6.2%. We see no reason to use a different figure for NI Water than is used for

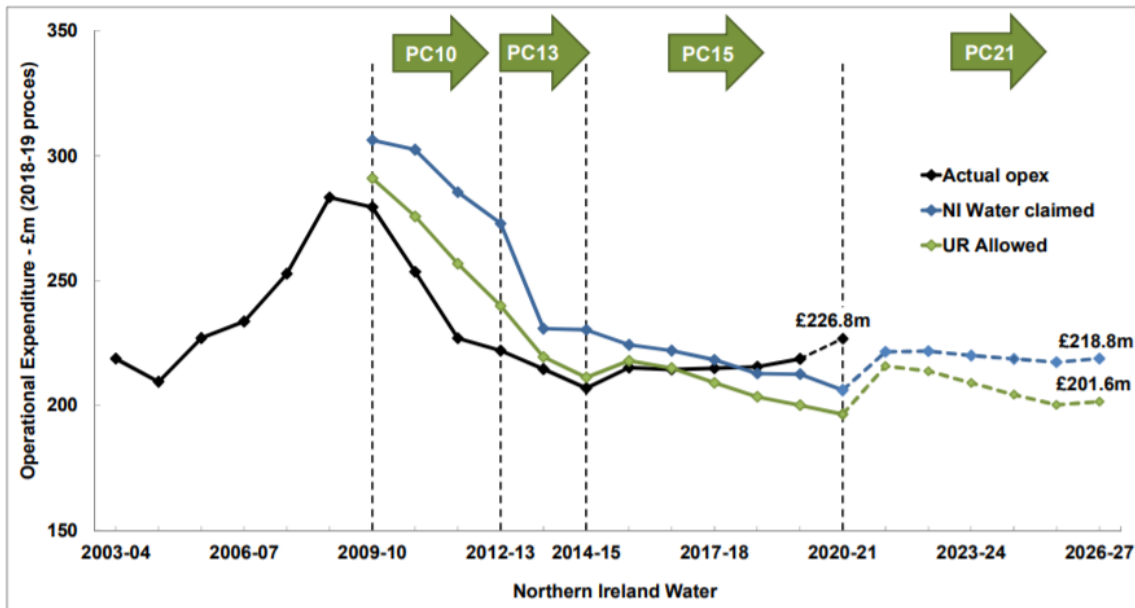
the E&W wasc. We would therefore recommend that UR uses a figure of 1% to 1.1% for the annual frontier shift target for NI Water.

**Table 3: Comparison of Frontier shift estimates for E&W wasc and NI Water (%)**

	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2021/22-2026/27
<b>CMA</b>	1.0	1.0	1.0	1.0	1.0	1.0	6.2
<b>Ofwat</b>	1.1	1.1	1.1	1.1	1.1	1.1	6.8
<b>UR</b>	0.79	0.6	0.84	0.8	0.8	0.8	4.7

- 11.7. Figure 4<sup>28</sup> shows that NI Water has outperformed both its own predictions of the operational costs achievable in the forthcoming price control and also UR's allowance for operational costs. This outperformance is good for consumers as it allows efficiencies to be shared with consumers in terms of lower prices at future price controls.

**Figure 4: Claimed versus actual Opex expenditure (2018-19 prices)**



- 11.8. Figure 4 shows the pattern of NI Water underestimating the potential for cost savings. It also shows the difficulty UR faces in estimating the potential for efficiency. Based on this we are concerned that the UR's approach to assessing the efficiency gap and frontier shift is likely to lead to an underestimate of the true opportunity for NI Water to reduce its costs during PC21. It is in customers'

<sup>28</sup> Figure 5.1 in the Draft Determination

interests that costs (and therefore prices) are as low as possible; therefore deliberately aiming-off at a point below the formulaic application of UR's methodology is likely to (a) correct for any systematic underestimation of efficiency that is apparent with UR methodology and (b) provide NI Water with a more challenging target that motivates the identification and delivery of stretching efficiency opportunities and so improve the actual efficiency delivered. We believe that this approach is particularly appropriate given the lower efficiency challenge UR is setting for PC21 compared with previous price controls.

#### Efficiency incentives – Reputational and managerial incentives

- 11.9. For government-owned companies like NI Water, without a direct profit incentive or equity pressures, regulators have looked for other approaches to seek to incentivise companies to improve efficiency and performance. Regulators often use reputational incentives through closely monitoring and publicising efficiency and quality outcomes. This can work reasonably well in sectors where there are comparators (for example the GB water sector), allowing the construction of league tables of the relative performance of different companies that take account of the common factors that affect all companies and therefore help to single out the impact of the performance of the individual company. However it is less effective where there is an absence of appropriate national comparators (for example Royal Mail and Network Rail).
- 11.10. Even if a regulator is prepared to publically “name and shame” the company where it is under-performing, or “name and acclaim” where it is out-performing, it is often the case that the company's performance is sufficiently ‘grey’ and multi-dimensional, that it is difficult to give a clear regulatory message that spurs the company to improve performance. This approach is therefore generally most effective at the extremes of performance outcomes, rather than for the vast majority of cases where the company is neither strongly out- nor under-performing (unlike financial incentives which apply across the range of corporate performance outcomes).
- 11.11. The loss of efficiency incentives can have a significant impact on the actual efficiency delivered by a company. An alternative (or complementary) approach to using reputational incentives is for the regulator to consider the use of management incentives as a way of improving the performance of a company.
- 11.12. There is UK regulatory precedent for a regulator approving a regulated company's management incentive plan. Network Rail's Licence requires Network Rail (NR) to

obtain approval from the Office of Rail and Road (ORR) for NR's management incentives of its senior executives. These focus on a delivery objective, an outperformance objective and an accountability and transparency objective which are aligned with ORR's regulatory objectives for the rail sector. In the October 2018 periodic review final determination<sup>29</sup>, ORR wrote:

*"We have also identified a number of improvements to the ways in which we can hold the company to account, ... Where Network Rail reflected these sanctions in its management incentives schemes, this would provide a sharper incentive on the relevant management teams, and reduce the need to resort to financial penalties (which have the disadvantage of reducing the resources available to the company)."*

- 11.13. UR should consider greater regulatory oversight of NI Water's senior management incentives. This should be at the level of setting high-level objectives (along similar lines to the ORR regime) rather than detailed scrutiny of personal objectives or bonuses - which would lead to micromanagement. Like the NR regime the regulatory oversight need only focus on the incentives of the key senior executives (the formal ORR regime only applies to NR's Chief Executive and Chief Financial Officer), but this then cascades down through the organisation to all employees. It should ensure that NI Water's managers' objectives and any incentives are aligned with and supportive of the regulatory objectives for the company and that they provide a powerful incentive towards cost efficiency and quality of service improvement.

## **12. Education**

- 12.1. The CEOG research identified a clear need and desire for consumer education. We would encourage higher targets for NI Water's school visits (176 per year) and other educational events (57 per year) than currently proposed in the DD. Both targets repeat PC15 targets and are set below 2019/20 performance (229 and 143 respectively). These activity measures should be complemented by measurement and monitoring of the effectiveness of different education campaigns, especially given the CEOG evidence "that there was limited to weak evidence recent company [information] campaigns had changed behaviours".<sup>30</sup>

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<sup>29</sup> [2018 periodic review final determination - Overview of approach and decisions - October 2018 \(orr.gov.uk\)](#) Paragraph 3.85

<sup>30</sup> UR PC21 DD Main report, paragraph 3.27.

- 12.2. The DD includes notice that NI Water should do more to develop trial projects as development objectives<sup>31</sup>. We would like to see educational initiatives included in this suite of trial projects.

### **13. Regulatory monitoring**

- 13.1. We support the continuation of the publication of UR's annual Cost and Performance report as a valuable source of information for consumers. NI Water performance against vulnerability measures should be included in the UR's annual report.

### **14. Summary**

- 14.1. We look forward to continuing to work with UR on the development and delivery of PC21. If you wish to discuss any aspect of this response please contact Graham Smith [graham.smith@consumercouncil.org.uk](mailto:graham.smith@consumercouncil.org.uk)

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<sup>31</sup> UR PC21 DD Main report, paragraph 1.27.





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