

BRISTOL WATER PRICE DETERMINATION

Summary of hearing with the Local Engagement Forum on 17 April 2015

Background

1. The Local Engagement Forum (LEF) consisted of some 20 representatives of stakeholders from the Bristol Water supply area including customers, regulators, consumer groups (including CCWater) and Local Authorities.
2. The LEF had been operational for three and a half years and provided challenge and scrutiny to Bristol Water's planning process. This planning review was the first to require a Customer Challenge Group (CCG) and required the LEF to be set up from scratch, and its establishment was independent of the Water Services Regulation Authority (Ofwat) and Bristol Water with its constitution written and agreed by its members. The LEF sought to strike a balance between ensuring the best value for customers while ensuring an appropriate level of investment in the network to ensure sustainability of the water supply of an appropriate quality at an affordable level.
3. The LEF considered the PR14 process to be a success for both consumers and the industry. The LEF considered that Ofwat was well-prepared at the beginning of PR09, but that PR14 represented the breaking of new ground and thus a degree of process creation.

Business plan development

4. The LEF engaged with Bristol Water early in the business planning process so that the LEF could engage with Bristol Water's proposals and Bristol Water could respond to the LEF's challenges. As a result, Bristol Water developed its business plan in two stages, allowing it to incorporate the views of the LEF. In the LEF's opinion Bristol Water's business plan evolved significantly from the version shared with the LEF at the first stage to the final version.
5. Although the LEF was able to understand how Bristol Water's network operated in significant detail, it was not possible for the LEF to appreciate how relatively efficient Bristol Water was, and it was difficult to reconcile Bristol Water being classed as inefficient with statistics on Bristol Water's costs that

showed it to be significantly cheaper than the industry average. The LEF said that the Competition Commission had not found Bristol Water to be inefficient in the previous price review, and, on the basis of there being no major systematic changes since then, it did not understand why Ofwat did now.

6. The LEF was concerned that Ofwat's process and challenge of business plans would lead to expenditure being unnecessarily delayed into future planning reviews to avoid difficult messaging of price increases necessary to deal with issues in the present period.
7. The LEF said that the need to satisfy Ofwat, the Environment Agency, and the Drinking Water Inspectorate was difficult, as there was pressure to reduce bills while also maintaining or improving water quality, and the environment. Bristol Water's customers clearly accepted a price rise to prevent a reduction in maintenance which would be likely to cause problems in later years.

Modelling

8. The LEF thought that the finance model adopted by Ofwat was sophisticated but had weaknesses and was untrusted in some regards. The LEF thought the principal weakness was that the models used lacked any significant bespoke elements and was not sophisticated enough to reflect differences in the operating circumstances of different water companies.
9. One example of an area of the model that did not reflect Bristol Water's particular operating challenges was the absence of a 'demand dynamic'.
10. The LEF attempted to gain an understanding of Ofwat's modelling approach, but considered that a full understanding of the modelling was beyond its combined expertise.
11. The LEF noted that Ofwat did not consider it sufficient for Bristol Water's (and other companies') engineering consultants to state that a particular engineering solution was appropriate without being subject to Ofwat scrutiny.

Cost of capital

12. The LEF perceived that there was a tension between the industry and Ofwat, with Ofwat seeking to drive down the cost of capital and the industry seeking to increase it.
13. It was the LEF's opinion that whatever the cost of capital identified by Ofwat, it was the job of the industry to demonstrate why the cost of capital was unsustainable. The LEF noted that in infrastructure works, it was Ofwat that

challenged company plans (which were based on third party advice) but that in determining the cost of capital, it was the water companies who had to demonstrate that the Ofwat model was inappropriate.

14. The LEF's view was that a lower cost of capital might prejudice delivery of customer benefits or risk Bristol Water being unfinanceable.

Customer engagement

15. The LEF said that Bristol Water had been criticised by CCWater in the previous price review for the quality of its approach to customer engagement.
16. The LEF included a number of lay members who were Bristol Water customers, but the LEF sought to obtain evidence of customer views through surveys rather than direct customer participation to ensure that views were representative of Bristol Water's customers as a whole. The LEF sought customer views through a research company chosen by Bristol Water but approved and overseen by a sub-committee led by CCWater to ensure balance.
17. The LEF sub-committee had responsibility for approving the questionnaires used by the research company and the scenarios presented to customers. The LEF sub-committee decided on the scenarios to test with customers based on information supplied by Bristol Water on how different programmes of infrastructure improvement or maintenance would affect the network. A key aspect of the research commissioned by the sub-committee was that the customers would understand the questions to ensure that a meaningful response would be obtained. If the LEF did not think customers could offer a meaningful response via a questionnaire, it chose not to ask that question in that way, but instead asked questions of the company directly to seek its own advice and then form its own views using the specialist expertise available to it, including from CCWater.
18. The LEF then had to decide how to reconcile consumer views with those of other stakeholders, such as the Environment Agency and Drinking Water Inspectorate's requirement for Bristol Water to achieve certain standards. While the DWI target had always been 100%, the horizontal challenge had imposed penalties without considering the company position and performance, customer wishes or the cost of achieving the imposed targets.
19. The LEF said that customers would always prefer a lower water bill when asked, but that could be at a cost of reduced resilience or by delaying expenditure into later price review and thus increasing future customers' bills. Similarly, customers would want to reduce leakage to zero but would not

appreciate the concept of an economic level of leakage. Customers had shown a willingness to pay for some environmental measures requested by the Environment Agency, but not all. The customer survey demonstrated that customers did not like any reduction in maintenance and were prepared to pay more to retain the same maintenance level.

20. The LEF was surprised that Ofwat considered that there were weaknesses in the customer engagement supporting Bristol Water's business plan because the LEF had received positive feedback from Ofwat on its processes and had regular engagement to ensure it was discharging its duties effectively. The LEF felt that Ofwat chose not to give more proactive feedback or challenge to avoid the risk of being seen to interfere with the process. The LEF said that the Bristol Water Business Plan had a 92% customer approval rating, which was the highest out of all water companies, which posed a difficult question as to why Ofwat was challenging Bristol Water to such an extent.

Performance commitments

21. The LEF said that Ofwat had sought to offer companies a bonus for exceeding targets and a penalty for failing to meet those targets. The LEF was concerned that companies should not be rewarded for 'doing their day job'. It was the LEF's view during the business planning process that no company would seek to award themselves such a bonus given the reputational damage of seeking to be additionally rewarded for achieving the minimum service level. The LEF wrote to Ofwat highlighting its concern that customers would not be happy based on survey data (and that Bristol Water itself was not in favour of a reward). The LEF said that despite opposition to the performance reward, Ofwat retained it in the price control.
22. The LEF did not think the performance commitments adopted by Ofwat were achievable by Bristol Water.

Investment appraisal

23. The LEF's assessment of individual projects was driven by the reports commissioned by Bristol Water as part of its own option appraisal. The LEF challenged Bristol Water's decisions in a number of areas, which led to a number of amendments.
24. The LEF said that Cheddar 2 reservoir had been assessed by Bristol Water as the best option out of 150 to address the level of population growth it anticipated. The LEF said that the need for Cheddar 2 was in part driven by the boundaries of Bristol Water's supply area, and that as there was no obligation for other water companies to sell water to Bristol Water, it needed

to develop resilience. The LEF said that in the case of Cheddar 2 there was a difficult question on whether to develop resilience as early as possible or delay its construction until there was certainty over its need, but at the risk of increasing cost. Although Cheddar 2 could be delayed by possibly one review period, it should not be allowed to drift any later.

25. The LEF said that investment appraisal was difficult as the price review period was five years but that some investment decisions were far more strategic with the benefits only achieved perhaps 20 years later and that a ten year period would be more appropriate.

Final determination

26. The LEF was concerned that there were a number of late interventions by Ofwat in the final determination. Because of the timing and scale of Ofwat's intervention that went against the proposals that the LEF had found that customers had supported, it concluded that Ofwat did not adequately weight or value the views that customers had expressed.