Draft Determination Representations

WSH.DD.CE.11

Residential Retail

30 August 2019

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1. Introduction

In the draft determination (DD) Ofwat set expenditure of £207 million for the residential retail control compared to expenditure of £268 million in our April Business Plan. We have serious concerns in respect of the methods used and the judgements made by Ofwat to arrive at its determined expenditures. In section 2 we set out the principal flaws that we have identified in Ofwat's approach, and we urge Ofwat to re-visit it for the final determination.

Nonetheless, in preparing our revised August Plan we have been determined to put forward a set of proposals that we believe that Ofwat should be able to accept and reflect in its final determination. Accordingly, we have reduced our projected expenditure by an additional £38m to a total of £230m over the AMP7 period. The profile of this revised expenditure is presented in the updated business plan tables.

This still leaves a residual gap of £23m between our updated proposals and the draft determination of £207m. However, we think this additional allowed expenditure can be justified with reference to a number of factors that are not reflected in Ofwat's modelling, and this is the subject of section 3.

We have also subjected the cost efficiency of our retail business activities to further scrutiny, including external review by PwC, which found that our activities tend significantly towards "leading practices and performance in debt management" – see section 4.

2. Principal flaws in Ofwat's approach

2.1. Introduction

We acknowledge that modelling industry costs is an imprecise science, and cannot produce "perfect results". However, there are four major areas where we believe Ofwat could have improved its derivation of allowed AMP7 expenditures, namely:

- recognition that Ofwat has not been able to produce models for residential retail that are statistically robust;
- continued (partial) use of the forward-looking upper quartile;
- failure to take into account differential service quality; and
- reliance on company reported data that reflects different accounting policies and practices.

These points are addressed in the following sub-sections.

2.2. Quality of models

As we have said elsewhere, we have commended Ofwat for the process that they have followed in developing their cost assessment modelling for PR19, and in general the models that have emerged are about as good as they could have been. The exception, however, is residential retail modelling. *A priori*, given that residential retail is a comparatively homogenous business function by comparison with wholesale activities, albeit with significantly differing customer bases, one would expect the range of modelling residuals to be narrower, all else equal. As Ofwat has acknowledged, a wider range of modelling residuals is

more likely to be indicative of the fact that the model in question has not captured one or more important cost drivers. It may also reflect inconsistencies in the underlying data.

The range of residuals on Ofwat's residential retail models is, in general, wider than the corresponding measures for the wholesale models. This suggests that there are shortcomings in either the models or the underlying data, or both, which means that the results should be treated with more caution than usual. We think this justifies a move away from the proposal that companies should be expected to achieve upper quartile costs straight away: this could mean introducing a glide path to upper quartile, an abatement factor so that companies only have to make up x% of the gap, or indeed the uncertainty around the models could justify setting allowances on the basis of average cost, rather than the upper quartile.

2.3. Use of Forward-Looking Upper Quartile

At the IAP stage, in line with several other companies, we objected to the use of the forward-looking upper quartile to set allowed residential retail costs. In the draft determination Ofwat has partly met this concern by moving to a 50:50 weighting of historical and forward-looking upper quartile. However, it still insists that use of the forward-looking element is valid:

"We consider that using business plans to inform the efficiency challenge is appropriate, particularly for retail services. The retail control has started only in 2015 and retail services can transform more quickly than wholesale services (e.g. due to lack of long-lived infrastructure assets). The fact that the majority of companies submitted stretching forecasts that are significantly more efficient than historical expenditure is evidence of the pace at which this service is transforming. It is important that customers share the benefits. We consider that the forward looking upper quartile provides a credible challenge as it does not rely on a single efficient business plan but on five business plans that project efficient costs. What is more, there were companies that have achieved this level of performance in recent years."

We do not think this explanation justifies continued use of the forward-looking upper quartile, even with the 50% weighting. Ofwat's decision to allow no indexation of residential retail costs, nor any real price effects (e.g. for labour, notwithstanding that an allowance for this is now made in the wholesale price controls) already provides a considerable amount of "stretch". Experience shows that there is often a marked difference between the bold claims made by companies and out-turn performance. For example, Ofwat's draft determination allowances would require the industry as a whole to reduce residential retail operating costs from £848m in 2017/18 to £769m in 2020/21, and to maintain that level in nominal terms thereafter. Given the forecasts on which Ofwat relies in setting AMP7 expenditure, one would expect significant progress to have been made in 2018/19 towards the achievement of that £79m per annum reduction, yet the industry only achieved £6m, leaving the remaining £73m reduction to be achieved in just two years. Clearly there is a serious question mark over whether companies are going to achieve their own forecasts.

In sum the use of the forward-looking upper quartile cannot be justified, and Ofwat should move to 100% reliance on historical performance for the final determination, in line with its approach for wholesale costs.

2.4. Differential Service Quality

Ofwat's Draft Determination of the Residential Retail Control has failed to adequately recognise the interaction between costs and service. Ofwat's retail cost assessment triangulates a number of separate econometric models taking into account several cost drivers; a scale variable, deprivation, the average household bill, metering levels and transience. However, no driver has been included to accommodate differential service quality even though there are many measures available. Examples include:

Satisfaction with aspects of contact in 2018	Ease of contacting someone who was able to help you	Quality/clarity of information provided	Knowledge and professionalism of staff	Feeling that contact has been/would be resolved	Was kept informed of progress
Welsh Water	91%	86%	94%	84%	80%
Industry	82%	81%	85%	80%	75%
Water & sewerage companies	82%	81%	85%	81%	75%
Satisfaction with aspects of contact - Eight year rolling averages					
Welsh Water	89%	85%	87%	85%	78%
Industry	82%	81%	84%	80%	74%
Water & sewerage companies	81%	81%	84%	80%	74%

Source: Water Matters, Consumer Council for Water (June 2019)

Customers' satisfaction with the way they are dealt with when they contact companies is clearly an important service measure and is without doubt a driver of cost in residential retail (e.g. expertise and availability of staff).

Overall customer satisfaction is again a well understood and independently measured metric for customer service.

Satisfaction with overall customer service	2016	2017	2018
Welsh Water	89%	86%	87%
Industry	82%	80%	83%
Water & sewerage companies	83%	80%	83%

Source: Water Matters, Consumer Council for Water (June 2019)

2.5. Companies who score highly on quality of service metrics such as Welsh Water (we are consistently the industry leader on these measures) are being disadvantaged in Ofwat's cost modelling by the exclusion of service quality metrics.

2.6. Ofwat's own measure of service quality, C-MeX, shows that service varies significantly across the industry:

C-MeX by company in 2019/20 Q1	C-MeX
Top quartile:	
Welsh Water	82.7
Portsmouth	81.6
Anglian	80.4
Wessex	80.1
Yorkshire	79.8
Bottom quartile:	
SES	74.2
Southern	72.9
Affinity	72.6
South East	72.3
Thames	65.8
Industry average	76.3
Source: Ofwat	

Ideally, Ofwat would develop its models for residential retail in order to accommodate the effects of differential service quality. This could be attempted in a number of ways, and we would be happy to work with Ofwat to explore feasible options.

If service quality cannot be reflected in the models themselves, it should be accommodated by means of post-modelling adjustments. Again, this could be done in a number of ways. If a measure of the incremental cost of higher service quality is not readily available, Ofwat could make reasonable adjustments. For example, allowed costs for companies that are "top quartile" on service performance could be based on "modelled average" costs. Again, we would be willing to explore possibilities with Ofwat.

2.7. Accounting policies and practices

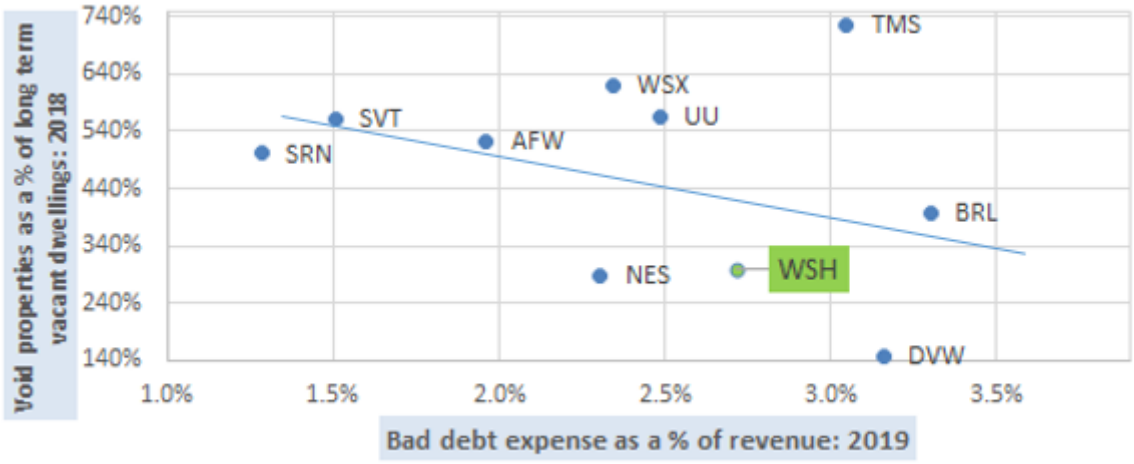
Reported retail expenditures are sensitive to accounting policies and practices to a far greater degree than wholesale costs, because the doubtful debt charge constitutes a significant proportion of retail costs for all companies. In our view, at the commencement of the cost assessment modelling process for PR19 Ofwat should have conducted a horizontal audit across the industry in order to identify inconsistencies and ensure that they are properly allowed for, in much the same way that the allocation of costs between the wholesale and retail price controls was the focus of detailed analysis across the industry at PR14.

In our view, it seems more than likely that differences in accounting policies and procedures will have accounted for a significant proportion of the unexpectedly wide range in residuals produced by Ofwat's residential retail models. For example, we observe that there appears to be a broad trade-off between companies' bad debt costs and the level of void properties.

The following diagram plots:

- voids reported by water companies as a percentage of the number of properties identified by local councils as "long term vacant"; against
- the ratio of bad debt expense to revenue.

Voids as a percentage of long term vacant properties vs bad debt expense as a % of revenue: 2019



With the exception of Thames Water, there is a clear inverse relationship between the two variables. Companies such as SRN and SVT which have relatively low bad debt costs report unexpectedly high levels of voids, in comparison to the local council baseline. By contrast, companies such as ourselves with relatively high reported bad debt costs report comparatively low numbers of voids. It is likely that there are examples of properties which we have treated as occupied, but non-paying, that other companies would have classified as void.

We also note that there is a third category of connected property, namely properties that are neither void, on Ofwat's definition, nor "billable". These are properties that are occupied, but do not receive a bill because it would be uneconomical to send them one. It seems likely that companies may have interpreted and applied this in quite different ways.

In sum, in the absence of confidence that there is reasonable consistency between companies' accounting policies and practices, the results of botex modelling for residential retail should be treated with additional caution. In our view this reinforces the case, as set out above, to take a more moderate approach in translating the modelling results into allowed expenditures for AMP7.

3. Additional cost items not accounted for in the Draft Determination

3.1. Introduction

As noted above, there remains a difference of about £23m between our revised August Plan and the expenditure allowed in the draft determination. It is likely that much or all of this gap can be explained by the inherent limitations of the cost modelling approach, as identified in section 2 above. In addition, we have identified three further factors which, by themselves, explain some £16 million of the difference, and ought to be taken into account at the final determination, namely:

- the additional costs of complying with the 1993 Welsh Language Act (£8m);
- the additional costs of implementing our sector-leading social tariff strategy (£4m); and
- the fact that Ofwat reflects deprivation in its models differently for Welsh companies, as compared with the English companies (£4m).

Details of these factors are set out in turn in the following sub-sections.

3.2. Welsh Language Costs

Companies providing water and sewerage services for customers in Wales are specified as public bodies for the purposes of the Welsh Language Act 1993. As a result of the Act, Welsh Water is required to have a statutory Welsh Language Scheme.

Our statutory Welsh Language scheme requires us to treat the Welsh and English languages equally and to ensure customers can deal with us through their language of choice.

The only water and sewerage companies to which the requirements of the Welsh Language Act would apply are Welsh Water and Hafren Dyfrdwy. Consequently the associated costs of offering this service are not taken into account in Ofwat's cost modelling.

The specific costs incurred by Welsh Water in offering this dual language service include;

- a dedicated Welsh language phone line, staffed by 11 FTEs to manage inbound calls and correspondence.
- the availability of Welsh speakers in all customer-facing roles.
- the additional cost to recruit this skill – on average staffing costs are 6% higher when recruiting Welsh speakers;
- additional printing costs to provide all publications and correspondence in English and Welsh; and
- the cost of translation for all customer facing documents and systems including the website, TV adverts and adjacent offerings – the cost of which is specific to each external provider, but on average adds 50% additional cost to each system employed. Additional costs are also incurred where simultaneous translation facilities are required to support company corporate events or meetings.

We have analysed management accounts for the current period to identify the Welsh Language-related costs, and projected these forwards over the AMP7 period, taking into

account the effect of the related performance commitment. We have also reflected the expected introduction of the new Welsh Language Standards, due to come into effect in 2020, which will *inter alia* require us to offer to conduct any external meeting (e.g. with a stakeholder or a supplier) in Welsh.

Welsh language costs	20/21	21/22	22/23	23/24	24/25	AMP7
	£m	£m	£m	£m	£m	£m
Printing	0.5	0.5	0.5	0.5	0.5	**2.6**
Campaigns	0.3	0.3	0.3	0.3	0.3	**1.6**
Welsh Language Line	0.4	0.4	0.5	0.5	0.5	**2.3**
Back Office	0.1	0.1	0.2	0.2	0.2	**0.8**
IT Costs	0.1	0.1	0.1	0.1	0.1	**0.6**
Total Opex	1.4	1.5	1.6	1.6	1.7	7.8

3.3. Costs of administering Social Tariffs

Welsh Water's track record on social tariffs is second to none in the industry. We have 133,000 customers on social tariffs forecast by 31 March 2020 (11% of all household customers).

The administration of our social tariff strategy entails a range of dedicated costs. These primarily comprise our team of vulnerability specialists, who are specially trained so that they have the skills and the wider knowledge set to deal effectively with potential social tariff applicants. Calls from potential candidates are routed to them, and they are in a position to ascertain effectively the needs of the customer, and advise them on the best course of action (e.g. opt for a meter, choose a social tariff, etc.).

In addition, in order to address the challenge of making social tariffs available to "hard to reach" low income customers, we have embarked on an outreach strategy, beginning with our Rhondda Fach Water Resilient Community pilot project which ran for the whole of 2018. The success of this initiative means that we will roll it out to other areas during the course of AMP7. This accounts for the bulk of the promotions and travel-related costs shown below.

We have analysed management accounts for the current period to identify the costs of social tariff administration, and projected these forwards over the AMP7 period, taking into account the effect of the performance targets for assistance tariffs. These figures are presented below.

Social Tariff Admin Costs	20/21	21/22	22/23	23/24	24/25	AMP7
	£m	£m	£m	£m	£m	£m
Vulnerability Specialists	0.5	0.5	0.5	0.5	0.5	**2.6**
Promotion Materials and Travel	0.1	0.1	0.1	0.1	0.1	**0.4**
Events and Customer Research	0.0	0.0	0.0	0.0	0.0	**0.1**
Training off Front Line Staff	0.1	0.1	0.1	0.1	0.1	**0.3**
Systems Development	0.1	0.1	0.1	0.1	0.1	**0.5**
Total Opex	0.7	0.7	0.8	0.8	0.8	3.9

3.4. Modelling of Income Deprivation

Due to the limitations of available data in England, Ofwat uses the 2014 value of income deprivation for each company for each of the modelled years, effectively assuming that it is constant throughout the period.

For Wales, individual values for income deprivation are available for each year, and Ofwat has used these figures in its modelling, thereby using one approach for us and another for the rest of the industry.

To be consistent in its treatment of us vis-à-vis the other companies, Ofwat should take the value of income deprivation for 2014 and assume that it is the same throughout the modelling period. We calculate that this would increase Ofwat's allowed costs by £4m.

4. Review of the cost efficiency of Welsh Water's retail business services.

4.1. Cost benchmarking reviews

In view of the apparent large gap between our forecast household retail costs and those allowed by Ofwat through its retail cost modelling, we have carried out further reviews of the cost efficiency of our retail service activities, to ensure that they are efficient and in line with best practice at other water companies and beyond.

Over recent years, we have conducted a number of benchmarking exchange visits with water companies which generally feature as efficient in Ofwat's cost models and also with top performing retail service companies in other sectors. A consistent theme of these benchmarking visits has been that we generally find that we have similar numbers of people involved in the provision of the service, with the same full range of contact channels and with similar business processes. One area of difference is that revenue recognition policies and practices do appear to vary between companies, for example in how individually negotiated payment arrangements for customers are accounted for, whether as revenue foregone or as bad debt.

We also note that our business retail costs appear to be very low by industry standards, whereas for some companies with comparatively low reported household retail costs, business retail costs are rather high. This suggests that there may be differences between companies in their approach to cost allocation.

Comparison of the components of the retail cost bases of companies in the sector demonstrate that the areas where our costs are above industry averages are: bad debt charges; overheads allocated to retail; and in asset depreciation (which is effectively zero for some companies). This analysis suggests that differing accounting practices between companies have a material impact on their levels of reported cost and, in turn, their assessed efficiency relative to Ofwat's cost models.

4.2. Welsh Water's cost efficiency plans

Detail of our ambitious plans to harness new technologies to deliver substantial cost efficiency improvements in our retail activities in the period after 2020 were included in our September 2018 Business Plan (3.6 PR19 Costs: Efficiency, benchmarking and recovery).

In summary, the key initiatives are:

Personalised services (saving £4 million pa by 2024-25)

We are rolling out an integrated digital platform across all contact channels and for all processes that will allow customer to manage their accounts directly, without the need for our advisors to process these transactions, either from our web forms or through our contact centre. This will be supplemented by developing our systems to allow us to introduce more segmentation into our services.

Support for vulnerable customers (£4 million pa by 2024-25)

We are setting up a specialist affordability team that will work closely with our existing debt and customer teams to ensure that customers are on the appropriate tariff, billing regime and payment methods for their individual circumstances. This involves us making changes to our systems to provide greater flexibility to our billing and payment services.

Managing problems in real time (£1 million pa by 2024-25)

We are integrating our customer systems to provide a single coherent interface for our advisors. This multi-channel/multi system view will reduce errors and facilitate faster resolution of customer queries. In addition we will make further investment in our telephony systems to develop speech analytics and skills based routing.

Team capability and skills (£1 million pa by 2024-25)

We are introducing the concept of 'specialist' teams, using skills based routing to target contacts to subject matter experts whilst maintaining the economies of scale of a contact centre environment.

These initiatives will deliver significant reductions in the level of contacts and underlying activity levels:

- A reduction of 30,000 (22%) in complex account investigations
- A reduction of 250,000 (20%) in inbound telephone and written contacts
- A reduction of 750,000 (26%) in paper bills
- A reduction of 20,000 (11%) in the number of accounts in debt
- An increase of 120,000 (11%) in the number of customers paying by direct debit
- An increase of 5,000 (50%) in the number of customers paying through their benefits

In total these initiatives will deliver cost reductions in retail operations of around £10 million a year, or some 18%, by 2025 and a headcount reduction of some 120 FTEs (including 40 roles currently offshored), from a current headcount of 570 FTEs.

4.3 PwC Review of our debt management activities

Early in AMP6, we engaged PwC and their working capital experts (the same team that undertook the review of Retail Services Efficiency for Ofwat in 2017) to ensure that our debt management processes matched best practice within and outside of our sector. We made changes to our recovery processes to improve our management of customer data, tailoring our collections processes, improving the availability and take up of our affordability schemes,

provide consequences for non-payment and increase the level of customer prepayments. Our plans for AMP7 will bring further improvements.

Following the results of Ofwat's cost assessment modelling for PR19, we asked PwC to look again at our debt management costs (see Supporting Appendix 7: PwC Report B2C maturity model: billing & collections – August 2019). In summary, PwC conclude that contrary to the results of Ofwat's models, our debt management costs compare very favourably with the rest of the industry. The report concludes:

> *"This creates a profile that tends significantly towards the Advanced end of the spectrum – an area where we would expect the leading practices and performance in debt management."*

Therefore, whilst we are always looking for ways to deliver further improvements in cost efficiency, the evidence does not support the magnitude of the 'catch-up' margins implied by Ofwat's analysis.