



Water charges and company profits: Position Paper

Why do the companies need to make profits?

Water and sewerage companies implement large-scale investment programmes to maintain their assets and meet their legal environmental and quality obligations. By 2010 the companies in England and Wales will have invested almost £70 billion since privatisation in 1989.

We set price limits to allow companies to collect from customers, through the bills they pay, all company running costs in the year in which they are incurred. At the price review in 2004, we assumed the water and sewerage sectors would invest £17 billion to maintain and enhance their assets in 2005-10. Not all of this investment expenditure is collected from customers in the year in which the company spends the money. Therefore, companies must fund a large proportion of this investment from the competitive financial markets, either through borrowing (debt) or through investment from shareholders (equity).

Just as mortgage providers for homeowners expect a return on the finance (or capital) they lend, water companies must provide a reasonable return to providers of capital. They must therefore make a profit to reward their investors.

Although the water and sewerage companies are largely monopoly service providers they must compete for capital with other companies. If they do not offer comparable returns to other companies, after taking into account relative risks, they will be unable to secure the capital they need to finance their investment programmes.

The cost of capital is not intended to guarantee shareholders' returns. A poorly managed water company might earn a lower return because it underperforms our assumptions, for example on efficiency savings. On the other hand, outperformance of our efficiency assumptions will increase returns. This is important for preserving incentives.

Does Ofwat regulate profits?

We have no formal powers to control profits. We set price limits, which control the revenue the companies can collect from their customers in bills. In setting price limits we must make a judgement on what is a reasonable rate of return on the capital investors have provided. This return must be sufficient for the company to attract investors and lenders to finance the investment programmes. The water and sewerage sectors have a large volume of infrastructure to maintain and are required to make new investment to meet European Union Directives, quality standards and to improve the balance of supply and demand.

As the economic regulator of the water and sewerage sectors in England and Wales we have a statutory duty, under the Water Industry Act 1991, to secure that companies are able (in particular by securing a reasonable return on their capital) to finance the proper carrying out of their functions.

In setting price limits our aim is to get a return on capital employed that is no more than necessary for an efficiently run company to maintain access to the capital markets.

What is the balance between debt and equity?

Our approach to setting price limits seeks to create conditions where the funding for additional investment can come from either debt or equity.

We do not decide on the capital structure of the sectors, but we recognise the importance of each company's structure being sustainable in the long term. The balance between debt and equity varies between companies.

Do we control dividends?

We have no formal powers to control dividends. But each company's licence requires it to declare or pay dividends only in accordance with a dividend policy which has been approved by its Board and which complies with the following principles:

- the dividends declared or paid will not impair the ability of the company to finance the regulated water and sewerage business; and
- under a system of incentive regulation, dividends reward efficiency and the management of economic risk.

We require the regulated companies to report any dividend paid to their parent company in their regulatory accounts. They must also explain the basis of the dividend.

We encourage the companies to explain to their customers, and to the public generally, what returns they have made in the regulated business and what they intend to do with them.

How do we make sure the companies meet their obligations and improve their services to customers?

All companies must report annually to us on the progress of their investment programme in their annual returns. We publish information about the industry's progress and monitor companies' outputs. We work with the quality regulators – the Environment Agency and the Drinking Water Inspectorate – to check that the companies deliver the outputs required in the price limits we set. If companies do not meet their obligations we take regulatory action where necessary and make sure that shareholders do not benefit financially from delays or for non-delivery of outputs. This ensures that customers do not pay for services that companies have not delivered. If companies do not deliver all their outputs, we take this into account at the next price review.

How do efficiency savings benefit customers?

We expect companies to be efficient. A regulatory system that gives incentives to companies to be efficient, and to make profits, is in the best long-term interests of customers.

Setting limits on prices rather than on profits or rates of return provides incentives to companies to pursue their objectives as efficiently as possible. Customers benefit from these efficiency savings when price limits are reset. We set price limits that assume a

continuous improvement in efficiency for all companies. We expect less efficient companies to catch up with the most efficient companies and at price reviews set targets to ensure they do so.

What other information is available?

We produce a wide range of information about our work and the water and sewerage sectors, for example:

- [Future water and sewerage charges 2005-10: Final determinations](#);
- [Financial performance and expenditure of the water companies in England and Wales 2006-07 report](#);
- [Security of supply 2006-07 report](#);
- [Levels of service for the water industry in England and Wales 2006-07 report](#);
- [Relative efficiency assessment 2006-07](#); and
- [Setting price limits for 2010-15: Framework and approach](#) (the methodology paper).

Is our approach fixed?

We carry out a detailed evaluation of our approach to ensuring companies can finance their functions at each price review. This allows us to modify aspects, incorporate new ideas and react to changing financial market conditions.

For further information

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