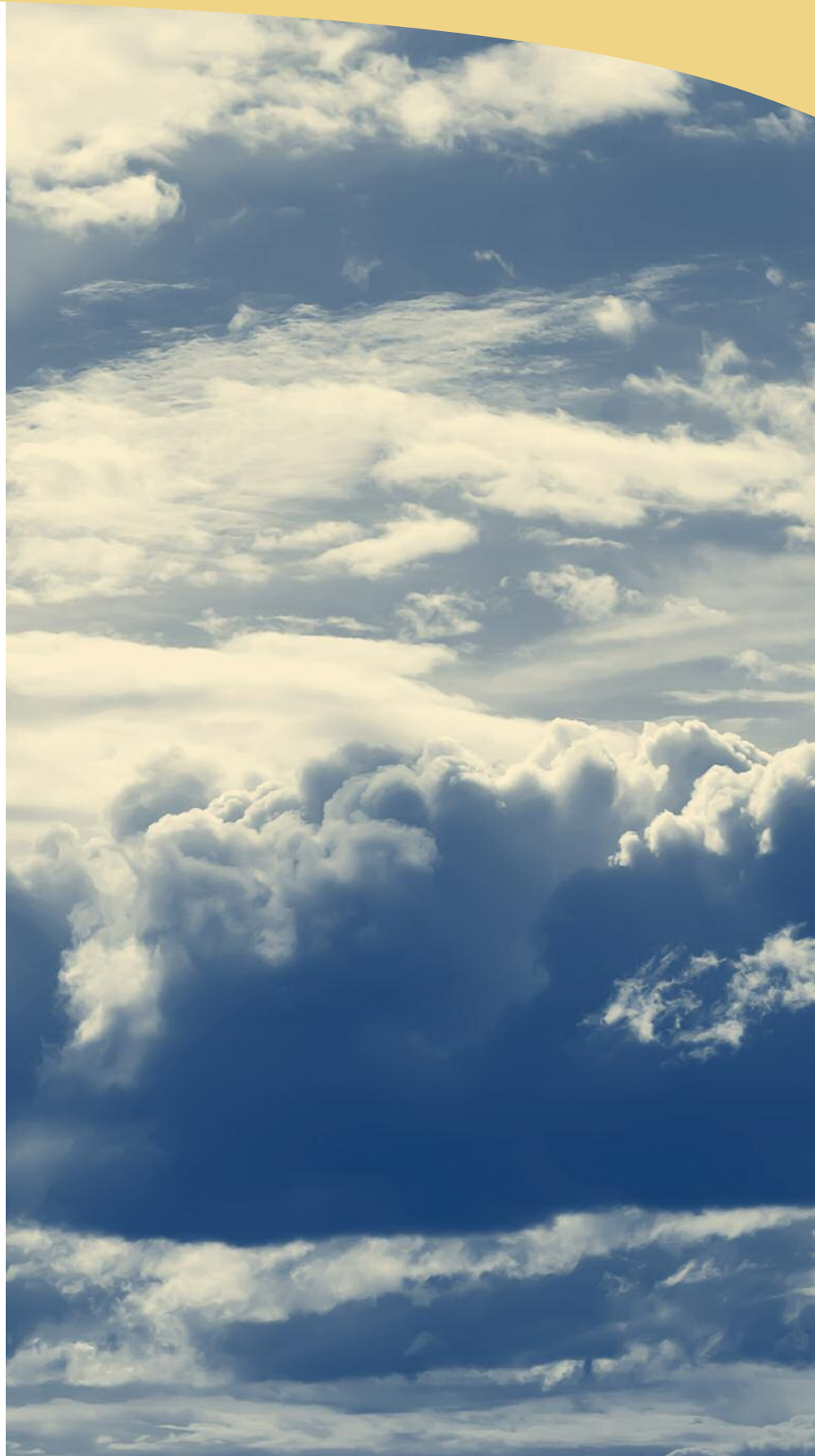


Future price limits – a consultation on the framework

Appendix 12: Analysis of responses to the preliminary model



A12.1 Background

We received 25 responses to the informal consultation on our [preliminary model](#) that we published in April of this year – 17 from the water and sewerage or water only companies and 8 from other stakeholders, including the Consumer Council for Water (CCWater), Water UK and investors. This appendix explores the various responses, and indicates where we have taken some of the issues raised into account in this consultation.

A12.2 Responses

We published the [responses](#) we received from the following stakeholders in full on our website.

- **Water and sewerage companies:**
 - Anglian Water;
 - Northumbrian Water;
 - Southern Water;
 - Severn Trent Water;
 - South West Water;
 - Thames Water;
 - United Utilities;
 - Wessex Water; and
 - Yorkshire Water.
- **Water only companies:**
 - Bristol Water;
 - Cambridge Water;
 - Dee Valley Water;
 - Portsmouth Water;
 - Sembcorp Bournemouth Water;
 - South East Water;
 - South Staffs Water; and
 - Veolia Water.
- **Other stakeholders:**
 - the Consumer Council for Water (CCWater);
 - a group of investors in Yorkshire Water;
 - Gemserv;
 - JP Morgan;
 - Ptarmigan Land;
 - Society of British Water and Waste Water Industries (SBWWI);
 - Scottish & Southern Energy (SSE); and
 - Water UK.

Not all respondents answered the consultation questions as set out. We have adapted these responses to fit them in to a common structure, and are aiming to indicate the range of responses. When we mention a company by name, it does not indicate either acceptance or rejection of the views expressed. After each question there is a reference to where we discuss the issues further. Note that the numbers in the headings below relate to the question numbers in the preliminary model consultation.

2.1 Are there other benefits we should seek to deliver through the way in which we set price limits in future?

Seventeen respondents considered this question. Thames Water considered that there needs to be more focus on intergenerational equality, while Wessex Water highlighted the need for stability and predictability in the reform agenda – given the significant investment required in the water and sewerage sectors.

Dee Valley Water thought that keeping prices as low as possible should be a key benefit, as well as preserving water quality and reliability. South East Water thought that the benefits identified in the preliminary model could be delivered through accounting separation and the creation of internal functional separation, without the added complexity of splitting up the RCV.

The draft impact assessment in appendix 1 discusses the main costs and benefits we expect from our proposals.

2.2 How should we best secure the benefits we have identified? In particular how could the way we set price limits in future contribute to reducing the regulatory burden?

Eighteen respondents considered this question. Almost half found it hard to envisage how the preliminary model will simplify the current process – they considered that it would lead to more data, more commentary and more reconciliation issues. For example, Cambridge Water thought that removing the draft business plan would actually increase the burden on both sides, as the companies would overload their single business plan with supporting information.

On the subject of reducing the regulatory burden, Thames Water considered that we should achieve outcomes through high-level and directional incentives, rather than data-intensive detailed regulation. The company added that it is important that there is better regulatory stability, which may be achieved by adhering to the better regulation principles. It suggested that we could also introduce longer-term regulatory policy statements beyond the end of price review periods.

We discuss costs and benefits in the draft impact assessment (appendix 1). In chapter 3, we discuss the way outcomes would affect the regulatory burden, and changes to the business plan process in appendix 9.

3.1 What are your views on the preliminary model? What other models should we consider?

Twenty-two respondents considered this question. Sembcorp Bournemouth Water welcomed the model as a step beyond the previous academic debate, and said it allowed stakeholders to start to contextualise the proposed shape of the water and sewerage sectors.

More than one water and sewerage company – including Anglian Water – thought that it was a move in a positive direction, as they support the greater participation of customers in price setting and the focus on outcomes. SBWWI said our preliminary model has merit because it allows the three separate entities (resource, network plus and retail) to specialise and focus on delivering efficiencies in their respective areas, while SSE recognised the importance of preserving the contestability of network investment, if competition is to be maintained and enhanced.

On the other hand, Portsmouth Water considered the model to have “serious flaws” or to be “ill-conceived” – it thought that it focuses on promoting competition and encouraging restructuring rather than incentivising good behaviour. Also, Yorkshire Water considered that the model places customers at arm’s length, destroys value and compromises the environment.

To summarise, a number of respondents emphasised that we need to assess realistically what is credibly achievable by the next price review.

We discuss our preferred option in chapter 2.

3.2 How should we provide incentives for the retail activity to procure services in the most efficient way?

Twelve respondents considered this question. SSE thought that if the retail unit was responsible for procuring the resources it needed to service its customers, this would create an incentive to minimise the costs it faces. Cambridge Water considered that the ownership structure would provide incentives to become more efficient and that if the retail market was opened up to competition, we would not need to incentivise retailers, as – in theory – this would happen automatically.

Portsmouth Water said that separate price limits will not improve on the current incentives, and will only serve to make the situation more complex. United Utilities considered that separation would be likely to give rise to additional overheads, as well as reducing flexibility and responsiveness because of the need for contracts.

We discuss the incentive effects of retail and wholesale controls in chapters 5 and 6.

3.3 How should we provide incentives for the efficient management of water resources and discharges to the environment?

Fourteen respondents considered this question. Dee Valley Water said that there was a need for a reliable method for valuing water. The company considered that this may reveal that water is not a “conventional commodity”, and so could alter views on the necessity for structural change.

Portsmouth Water thought that the water resource management plans (WRMP) already provide incentives, and that we should focus on changing bulk supply incentives rather than setting separate price limits. South West Water noted that efficient use of water resources is best driven by marginal cost pricing rather than the average cost pricing, which appears to be the basis of both accounting separation and a price-setting framework.

Wessex Water argued that source abstraction licences should be enhanced along the lines of proposals made by WWF’s ‘[Itchen Initiative](#)’. For abstractors causing significant damage, the licence should be changed (revoked or modified), but the decision must be made on robust, local and hydro-ecological evidence. Finally, Cambridge Water noted that environmental management is the role of the Environment Agency, and so it should decide how to incentivise efficient use of water resources.

We are consulting on how we can promote more water trading and how we can mitigate any adverse impact of increases in abstraction from areas already under stress in chapter 6.

3.4 How can we use our regulatory tools to create better incentives to trade water so that both buyer and seller have a motivation to carry out the transaction?

We received 16 responses to this question. Respondents raised a number of suggestions, including mechanisms to share benefits between the companies and their customers, and to share risks between ‘donor’ and ‘recipient’ customers. Severn Trent Water noted that getting the right pricing structure is key, and thought that pricing for trading needs to be on the basis of long-run marginal cost (at a resource zone level), so that additional water is supplied from areas where new resource development is cheapest.

Yorkshire Water noted that trading is available now, but it is constrained by static licence conditions imposed by the Environment Agency and also by summer drought provisioning. Severn Trent Water also noted that rebalancing operating expenditure (opex) and capital expenditure (capex) incentives would remove the incentive to use internal resources rather than bulk supplies.

We discuss how to enable water trading and moving to a total expenditure (totex) approach in chapter 6.

3.5 How should we provide incentives for the effective provision of retail services?

There were 12 responses to this question. Respondents made a number of references to the service incentive mechanism (SIM), as it has provided the companies with an incentive to deliver efficient services. Dee Valley Water considered that we should wait and see how SIM performs before doing anything else, while Wessex Water thought that the SIM should be the focus of an outcome-based measure. Thames Water said that performance against defined outcomes could be assessed by the use of high-level key performance indicators (KPIs).

We discuss the incentive effects of retail and wholesale controls in chapters 5 and 6.

3.6 In the absence of a functionally separate system operator, how can we create incentives for the activities it carries out?

Fourteen respondents considered this question. A number of them thought that the activities listed in our preliminary model are activities that the companies already carry out, and that system operator functions are already incentivised very effectively. For example, Yorkshire Water created a system operator function a number of years ago, in response to the incentives present at the time. It considered that there is no requirement to create incentives for system operator functions if neither the need nor the economic case are present.

Severn Trent Water said that we do not need to encourage system operator activities – the companies should be able to make their own decisions about how to run their network. Portsmouth Water questioned the need for an incentive, considering that if we developed an upstream model, we should only introduce incentives if problems arise – otherwise, we risk incentivising sub-optimal behaviour now.

We consider the introduction of incentives for system operator functions in chapter 6.

3.7 What would be involved in practically implementing such a model? What would be the costs involved in doing so?

Ten respondents considered this question. Northumbrian Water noted that the sectors would be likely to see an increased overall cost of capital, increased cost to customers and increased cost of regulation. For example, Cambridge Water thought that the costs of the accounting separation work would increase as it moved from being an extra data burden in the June return being a fundamental component of the companies' profitability.

Southern Water added that, overall, the model represents a long-term vision, and there needs to be clarity on which proposals are for the next price review, and which are longer-term aspirations.

We discuss the possible costs of our proposals in appendix 1.

4.1 Which parts of the value chain, if any, might benefit from longer or shorter control periods?

We received 16 responses to this question. South West Water noted that the price control period for network plus could be lengthened compared with that for retail and resources. But the company said that this would risk losing the benefits of vertical integration, and adding extra risk to delivery of outcomes.

A number of water and sewerage companies – including United Utilities – thought that extending the period to six years was feasible and desirable, primarily because of the synergy with the timing of future environmental outputs. Yorkshire Water considered that the price control for base maintenance (for infrastructure, serviceability, discolouration and sewer flooding) could be for up to ten years, while the price control for enhancement spending should remain at five years. But Cambridge Water sounded a note of caution that different lengths of price review could be confusing for customers, with elements of the bills changing more frequently than the current five-year period.

We are not consulting on any changes to the control period at this time.

4.2 What issues should we consider if we create separate retail and wholesale price controls?

There were 17 responses to this question. Anglian Water said that it will be important to assess financeability separately for each individual business unit. Several respondents – including Southern Water – raised ownership and control of meters as an issue. Similarly, more than one respondent – including South Staffs Water – was concerned with the proposal for a retail arm, much smaller than the current integrated company, but expected to absorb risks around bad debt and consumption variance.

Dee Valley Water added that we need to consider the effect on prices to customers, risks to water supply and ownership of all risks. For example, it questioned how risks such as revenue requirement and regulatory capital value (RCV) protection – which are currently dealt with through established means such as the revenue correction mechanism, the costs of capital and the capital expenditure incentive scheme (CIS) would be managed in the new model.

We discuss the financeability issues caused by separate retail and wholesale controls in chapter 7.

4.3 What should we consider for the scope and content of a wholesale control?

We received 13 responses to this question. A number of respondents – including Wessex Water – thought that our proposal to allocate existing metering to wholesale and new meters to retail is inefficient and not workable.

Cambridge Water said that separate price controls were not needed, and that the access pricing process could be amended (by removing the costs principle) to achieve the same ends. Bristol Water also did not think that resources and network plus should be separated. The company said that this was because they are tightly integrated and it would be difficult to separate them out in a meaningful way, as well as adding significant cost.

We discuss the wholesale control in chapter 6.

4.4 What should we consider for the scope and content of a retail control?

Nine responses considered this question (although there is some overlap with the responses to question 4.3 above). Some respondents mentioned the allocations between wholesale and retail – for example, Southern Water considered that bad debt should sit with the retail business as it is the only party that can influence it, and that our preliminary model did not make this clear.

United Utilities highlighted that we should consider implementation costs, as structural change brings friction between parties. Roles and accountabilities need to be clearly defined. Additional incentive mechanisms would be necessary to make sure the benefits of integrated planning and operation are not lost completely.

Thames Water noted that our preliminary model suggested an approach where retail costs are set on an average cost to serve, rather than taking into account differences between companies and areas. While some variant of an average cost to serve may be an appropriate method to set prices, the company did not think that ignoring regional differences would deliver the most efficient outcome.

We discuss the retail control in chapter 5.

5.1 Where does our regulation help or hinder the development of new retail services?

There were nine responses to this question. Cambridge Water and Dee Valley Water considered that current regulation does not necessarily hinder the development of new retail services. This is because there is nothing to stop unregulated companies providing these services – for example, an intermediary providing multi-site billing, or private companies operating bill saving-sharing schemes.

On the other hand, Severn Trent Water thought that the development of new tariffs is currently stifled by regulation, and a lighter touch is required. United Utilities added that licence condition E (that charges should not be unduly discriminatory or preferential) will always be a barrier to variable pricing options, and to entering into price negotiation with customers. But the company considered that many customers may not consider this situation to be overly disadvantageous.

Thames Water thought that the comparative framework drives convergence in services, which may not be the desired outcome for customers. Allowing more flexibility in line with customers' preferences would allow the companies to offer more diverse retail services. Changing the thresholds for business customers would allow them to seek new services, and allow the companies to offer new services.

We discuss the retail control in chapter 5 and our approach to governance of charges in chapter 8.

5.2 In the absence of a value for water, how should we recognise the value in the resources unit?

Nine respondents considered this question. Sembcorp Bournemouth Water thought that introducing a shadow price for raw water would help, while Northumbrian Water said this would be inferior to abstraction reform, as it would only apply to water companies, would only affect new decisions, and would not influence operational policy on ongoing use. Wessex Water considered that the concept of the 'value of water' is potentially misleading – in a market, 'value' is the cost of the most efficient provider, but in a non-competitive market, 'value' is the operators' cost of efficient delivery and financing.

Portsmouth Water thought that recognising the value of water in bills is an issue on which Government should decide – if it does not want it, then we should not be looking to introduce it artificially. It should be a matter of Government policy based on a full, clear assessment of the benefits compared to the affordability implications.

We are continuing our work on how to promote efficient water trading. We discuss this in more detail in chapter 6.

5.3 How can we change the way we regulate in order to promote more innovation in all parts of the value chain that benefits customers?

Twelve respondents considered this question. Yorkshire Water thought that the incentive framework should drive management action to deliver benefits through innovation. Southern Water supported the move to outcome-focused regulation, as it will provide the companies with greater flexibility to pursue innovative solutions. But it noted that where there are innovative solutions, there need to be mechanisms to share the benefits and risks of these with customers, and that there also needs to be recognition of the fact that pilot schemes may not succeed. United Utilities agreed that innovation requires sufficient rewards for success to recover the costs of failure.

United Utilities was also concerned that we assume a lack of innovation from the companies, or that a capex bias is prevalent. There are other regulatory barriers, and United Utilities urged us to work with the companies and quality regulators to develop a more outcome-focused approach.

We discuss changes to incentives in chapter 4, to outcomes in chapter 3 and a totex approach in chapter 6.

6.1 How flexible and robust do you think our preliminary model is?

We received 15 responses to this question. Cambridge Water thought that the proposal seems flexible, but it depends on what the future of the water and sewerage sectors might look like. Water UK cautioned that we should ensure that we do not overestimate the degree to which future-proofing is necessary or desirable and ignore the near-term requirements to deliver the next price review.

Gemserv thought that introducing a disaggregated model for price controls has much to commend it, and the business units identified provided a good foundation to develop. But more than one stakeholder – including JP Morgan – thought that it was not clear what evidence there was to justify the changes proposed in the model.

We set our view of costs and benefits in appendix 1.

6.2 What future developments do you think our future price limits model will need to cope with?

Fifteen respondents considered this question. Northumbrian Water agreed with the developments identified in our preliminary model, but did not consider them to be more demanding than those the water and sewerage sectors had met in the past. On the other hand, Portsmouth Water considered that the model will need to deal with the impact of environmental legislation and climate change on water resources, and that the situation is more complex than we portray.

Dee Valley Water noted that, in light of the recent Walker consultation by Defra and the Welsh Government on affordability in the water and sewerage sectors, it will be necessary for the model to cope with new social tariffs and cross-subsidy issues. Gemserv added that they thought the future models must include provisions to introduce appropriate and targeted incentives, on a regional and national basis, to promote investment in technologies such as rainwater harvesting, grey water use and the recycling of domestic water.

We have tested a number of our most important proposals against future scenarios (see appendix 10).

7.1 What are your views on regulatory capital value?

We received 18 responses to this question. As an overall theme, respondents considered that the RCV approach has worked well for customers, companies, and stakeholders, and it should remain the principal mechanism for rewarding investors. It allows policymakers to calculate bill impacts when they are considering imposing new obligations on the water and sewerage sectors. Any change to the way the RCV is calculated will unsettle investors and may increase the perceived level of risk in the sectors.

A number of respondents noted that offering an attractive margin for retail can only increase costs to customers. Anglian Water expressed doubts about the nature of the guarantee of historic RCV protection, saying that investors were more interested in the stream of returns on RCV rather than the RCV figure itself.

We discuss RCV in chapter 6.

7.2 What issues should we consider when we consult in the autumn on how to treat the RCV?

Fourteen respondents considered this question. The Yorkshire Water investor group thought that the proposals appear to conflict with our primary duty to ensure that efficient companies can finance their functions. Both the Yorkshire Water investor group and Yorkshire Water itself, among others, referred to the May 2011 report from Moody's that was critical of our proposed approach, and thought that it was crucial for us to consider how the treatment of the RCV will affect investors.

Anglian Water noted that we need to consider in detail the risks and consequences of actual and price control separation. We should not consider the RCV in isolation of the allowed cost of capital, as it is the stability of the appropriate level returns that determines the attractiveness of the sectors.

We discuss RCV in chapter 6.

8.1 To what extent do you think the preliminary model is in line with better regulation principles?

Eight respondents considered this question. Cambridge Water felt that the model was not "proportionate", as it did not think there is a need to overhaul the whole process radically. It would also not be "consistent" if it created profit generation in the retail area of the business at the expense of incumbents. On the other hand, it is "transparent" and makes Ofwat "accountable" for our actions. It is "targeted", as it replaces a broad brush approach with multiple approaches and price limits. But the company questioned whether this was an improvement.

CCWater considered that – in order to comply with the BIS principles of economic regulation – the model should aim to reduce regulatory complexity, provide transparency to show how and why prices have been set, and clearly show the benefits of this new approach. It also said that the principle of “accountability” in this context also includes accountability to customers. To reinforce this, CCWater noted that our preliminary model needs to emphasise the incentives needed for companies to build business plans based on evidence from robust customer engagement.

Bristol Water considered that the balance of risks in our preliminary model would make challenges such as population growth and climate change harder to address – it would like to see a cost-benefit analysis.

We discuss costs and benefits in the draft impact assessment (appendix 1). In chapter 3, we discuss the way outcomes would affect the regulatory burden, and in appendix 9, we consider changes to the business plan process.

9.1 We have already received some views on our incentive schemes in response to our focus report. We welcome other responses.

We received five responses to this question. Also, a number of respondents noted that their views have not changed since they responded to the focus report in question.

Thames Water noted that incentives should be simple, proportionate, and objective and outcome focused. It added that incentives should be based on an absolute basis (that is, specific to each company), rather than on a comparative basis, and should be defined by customer research. Dee Valley Water considered that incentives should drive behaviour that would occur in a competitive market, but without putting the reliability of water supply at risk.

South East Water thought that the suggestion that incentives could be provided for splitting out the system operator function was entirely inappropriate – it would be intrusive regulation, and tantamount to us “designing organisations by incentives”. Portsmouth Water said that our preliminary model seeks to incentivise all sorts of behaviour and does not seem consistent with a focus on outcomes, citing company structure and the development of the system operator function as examples.

Gemserv suggested that in order to gain a full picture of the incentive mechanisms faced by market players, it is important to consider external incentives – which can be of considerable importance – in addition to those set by the regulator.

We describe our approach to incentives in chapter 4.

9.2 Which incentives work best for wholesale services and which for retail? Which incentives may need to be part of a price cap regardless of what its aims are?

Seven respondents considered this question. Southern Water was of the opinion that fewer and simpler incentives are likely to be more effective in driving company behaviour than the large number of mechanisms currently in place. But regardless of incentives, while there is only a simple separation of price limits, the companies will continue to make trade-offs across the value chain.

Cambridge Water thought that wholesale activities should be incentivised to “do the right thing” with their assets and operations, competitive retail activities will not need to be incentivised, and non-competitive retail activities should be incentivised (as they are at present) to reduce costs while delivering agreed levels of service.

We discuss the incentive effects of retail and wholesale controls in chapters 5 and 6.

9.3 How can we create incentives that promote innovation that creates customer benefits?

Seven respondents considered this question (although there is some overlap with the responses to question 9.2 above). Wessex Water said that incentives need to be simpler, stronger and rebalanced. As the water and sewerage sectors are perceived to be low in innovation, the company considers that the most pressing need is to strengthen the incentives that reward the companies. On the other hand, Southern Water thought that the sectors do not need specific mechanisms to promote innovation – instead, we need to make sure that the benefits of outperformance exceed the risks associated with failure.

Water UK thought that we could drive the sectors more effectively to deliver desirable outcomes by setting clear regulatory incentives that address directly the most significant customer objectives, whether these relate to tariffs, service levels, security of supply or other outcomes.

A number of our proposal together can help to support innovation. We discuss changes to incentives in chapter 4, to outcomes in chapter 3 and a totex approach in chapter 6.

11.1 We invite stakeholders to participate in the working groups [planned for the summer]. We also welcome views on this as an approach and whether there are other topics we should consider in detail in this way.

We received 12 responses to this question. Most respondents welcomed the formation of working groups and would like to contribute. This included water and sewerage companies, water only companies and one other stakeholder. Southern Water noted that these groups should focus on examining alternative approaches to delivering the benefits, rather than examining the details of implementing a particular model. Also, Yorkshire Water thought that working groups must consider the evolution of the existing model as a benchmark comparator.

SBWWI suggested that the proposal to include a network plus working group should be extended to look at how the network plus value chain can deliver innovation (and so lower unit costs). Thames Water suggested that we add a working group focused on aligning the various regulators throughout the price review process.

We held workshops in the summer on totex and incentives, issues for a possible retail control and issues for a possible wholesale control. [Notes and slides](#) used at these workshops are available on our website.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water and sewerage sectors in England and Wales provide customers with a good quality and efficient service at a fair price.



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