

Ofwat's draft Water2020 framework: What does it mean for investors?

Water and wastewater services are vital for public health, for our economy and society. Across England and Wales, we all rely on them every day. Increasing pressures on these services mean that, if we are to continue to have trust and confidence that they will be delivered reliably, the way they are delivered needs to evolve. Ofwat's Water 2020 consultation paper sets out proposals to promote wholesale markets and begin to provide a framework for the 2019 price review (PR19). Investors play a vital role in supporting and challenging company management to make the best use of scarce resources and find creative ways of doing more for less. We welcome your views on our proposals.

Key proposals

Our proposals are built on the approach to the 2014 price review (PR14), which:

- challenged water companies to take ownership of their business plans and deliver the outcomes that customers and society need and desire,
- used a total expenditure approach to improve incentives and provide more flexibility for companies to be more efficient; and
- implemented separate price controls for the retail and wholesale parts of the value chain enabling more targeted regulation and support for the opening of the non-household retail market.

Building on our approach to PR14, we have worked collaboratively with the sector and other stakeholders, to develop our approach to wholesale markets and PR19. The key elements of our proposed new regulatory framework are:

- promote markets for water resources and sludge. Markets will help optimise the delivery of services across company boundaries and other sectors;
- facilitate these markets by splitting the wholesale water price control into water resources and network plus (covering raw water transport, water treatment and distribution) and wholesale wastewater into sludge and network plus

(wastewater collection, sewage treatment) and establishing information platforms to inform market participants about opportunities to enter the market;

- we see scope for third parties to provide sludge processing and transport services for both new and existing volumes – although the ‘make or buy’ decision would remain with companies.
- about 11% of the industry RCV being allocated to sludge and water resources with investment made up to 31 March 2020 protected (see diagram); and
- migrate from the retail price index (RPI) to index both prices and regulatory returns by the increasingly prevalent consumer price index (CPI) - with transition mechanisms to assist customers, companies and investors to make this change.

Why sludge?

A market will provide companies with more choices in terms of service provision that could include other water companies and firms operating

in wider waste markets. The scope for interplay with wider waste markets could deliver material benefits, as innovative technologies unlock new ways of generating value from waste.

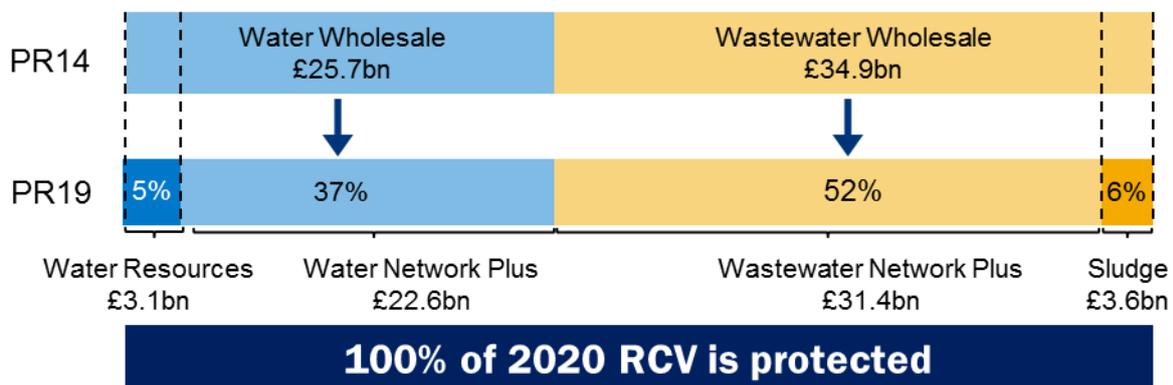
Why water resources?

Increasing pressure on water resources from population growth and climate change mean it is essential that we enable and encourage better optimisation. The evidence shows that there remain significant unrealised gains from water trading, which we estimate to be up to £1 billion over the lifetime of assets.

Why change the method of indexation?

RPI is no longer an official statistic and a recent [review](#), led by Paul Johnson, stated that: “RPI is a flawed statistical measure of inflation”, and that “taxes, benefits and regulated prices should not be linked to the RPI”. Ofcom, Ofgem and the Civil Aviation Authority have also either moved towards CPI or sought views on this issue.

What are the implications for the RCV?



Note: 2015/16 opening RCV in 2012/13 prices with the split based on 2013/14 MEAV

We consider that continuing with RPI until 2025 would undermine trust and confidence in this vital public service and are proposing a change to CPI. Any change would be **neutral to both company (nominal) revenues and customer bills in net present value terms** and require a transition to limit

the impact on customers, investors and companies. We are proposing to 'phase in' the introduction of CPI, by continuing to apply RPI to 50% of the RCV and CPI to the remainder. This will help existing debt that is index linked on an RPI basis, to unwind.

If you want to find out more and contribute your voice on this vital public service, please read and respond to our consultation by 10 February 2016.

More information

[Water 2020: Regulatory framework for wholesale markets and the 2019 price review](#)

[Towards resilience: how we will embed resilience in our work](#)

[UK Consumer Price Statistics: A Review](#), Paul Johnson, January 2015

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a leading economic regulator, trusted and respected, challenging ourselves and others to build trust and confidence in water.

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