

Setting price controls in 2014

A briefing note for Board members of water companies in England

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Delivering sustainable water

Customers of water and sewerage and water only companies deserve excellent service at a fair price. Companies and Boards that innovate to find new and efficient ways of delivering this should be rewarded. We are consulting on our proposed price limits methodology framework, which sets out how we will set price controls for each of the five years from 2015 to 2020.

We have developed our proposals through extensive consultation and engagement with:

- the companies;
- the UK and Welsh Governments;
- customers; and
- other key stakeholders.

This briefing note sets out what our proposed framework means for the appointed water companies in England, and now we expect Boards – including independent Board members – to respond in order to ensure that the interests of customers are protected and respected.

Overview

The Water White Paper, 'Water for Life', describes "a vision for future water management in which the

A key feature of our proposals is, for the first time, to set separate price controls for:

- retail water and sewerage services to household customers;
- retail water and sewerage services to non-household (business) customers;
- wholesale water services; and
- wholesale sewerage services.

By setting these distinct price controls, we want to incentivise companies to focus on the long-term outcomes that customers value, instead of short-term outputs set by us and other regulators. Our new price control framework gives greater ownership to companies over risks where they are best placed to manage those risks.

We want to reward innovation and drive efficiency while, at the same time, protecting asset management and improving investment opportunities across the medium and long term. We want high-quality business plans from companies that represents the views and wishes of customers. There will be rewards – both financial and reputational – for companies that do this.

water sector is resilient, in which water companies are more efficient and customer focused, and in which water is valued as the precious and finite resource it is". It also notes the need to encourage innovation and dynamism. The Draft Water Bill develops the framework to achieve this vision.

We want to drive companies to innovate, in the same way that companies are driven to innovate in competitive environments – this

means balancing the risks from innovation failure with rewards for success. Our framework seeks to encourage a new approach to managing risk, while also maintaining the longstanding opportunity for stable investment across the water and sewerage sectors.

Our methodology framework supports both the Water White Paper and the Draft Water Bill, by helping to drive sustainable water and sewerage sectors, thereby:

- ensuring growth and investment;
- creating greater accountability and responsibility for water companies; and
- ensuring sustainable water for the future.

1. Regulating for growth and investment

The sectors have invested more than £108 billion over the past 24 years to deliver improvements to services, infrastructure and the environment. Each year, water companies spend about £4 billion on improving services for customers and safeguarding the environment.

We need to make sure that this vital investment continues and is used correctly because the solutions of the past are not necessarily the right solutions for the future. Emerging challenges – such as new industries and uses for water, climate change, and population growth – will change the demand for water within the economy. They will also require the sectors to innovate to deliver more efficient and sustainable solutions for the long term.

What we intend to do and why

Our framework will provide your company with greater flexibility to respond as new challenges emerge. Our targeted retail price controls will work alongside the UK Government's proposals to give choice to all non-household customers in England. And they will work alongside our own proposals to increase the

influence of household customers on what companies deliver. This will improve the legitimacy of the sectors in the eyes of those customers who currently do not have a choice of supplier.

At the same time, we recognise that water companies still need to raise significant investment to meet future challenges. Our framework will ensure companies and Boards can do this by protecting existing investment – and by providing a stable environment to enable companies and Boards to attract ongoing investment in the future.

The wholesale part of the sectors represents 90% of water companies' business. We will continue to set wholesale price controls using tried and tested tools – such as the concept of the regulatory capital value (RCV) and the linkage to RPI, while it remains the most appropriate index. This will provide companies with a stable and predictable operating environment. We will also create greater flexibility for companies and Boards to propose how much of your expenditure should be recovered through the RCV – handing more control to companies and Boards over the risk/reward balance they want to adopt.

Using targeted incentives like the service incentive mechanism (SIM) for retail services to households will encourage the sectors to improve efficiency and customer service while boosting innovation and keeping costs down. Companies that perform

well will attract investment, while those that perform less well will be incentivised to improve.

2. Greater accountability and responsibility for water companies

To help you address your customers' priorities in your planning, we have required your company to set up a customer challenge group (CCG), but this is not a substitute for direct engagement by company Boards. As you develop your plans, your company will be able use the CCG's feedback to ensure their outcomes reflect your customers' priorities. Companies that are able to demonstrate good engagement and that they have reflected customer priorities in their plans will benefit from lighter regulatory scrutiny – but this will be a very high hurdle.

What we intend to do and why

We will set two binding retail controls in 2014 – one for household customers and one for non-household customers. To bring the sectors in line with others, retail controls for household customers will no longer be indexed to RPI. Instead, water companies will be encouraged to focus on reaching, and beating, the average cost to serve each household customer. This will help to keep bills manageable for hard-pressed households.

For non-household customers, we will set a default tariff – a maximum price for a minimum level of service. The Draft Water

Bill proposes that all non-household customers in England the right to choose their water and sewerage supplier. Innovative companies that are able to differentiate their services clearly in response to customer demand will benefit by maintaining the loyalty of their existing customers – and attracting and winning new customers. They will be able to do this because of the new, less burdensome way we will regulate charges to these customers. And they will be able to take greater ownership of the risks they are best placed to manage.

3. Sustainable water for the future

Water is arguably our most precious resource and is often undervalued. And managing it sustainably is becoming ever more challenging in the face of changing weather patterns. The year 2012 was the second wettest since records began in the UK. And [four of the top five wettest years have occurred since 2000](#) – part of a global trend towards more extreme rainfall events. The impact of this is devastating – during 2012 almost 8,000 properties in England and Wales were flooded, keeping families out of their homes for an average of nine months.

In stark contrast, in April 2012, several companies were preparing to find extra water supplies and had imposed hosepipe bans, restricting the volume of water their customers

could use. These drought conditions were caused by exceptionally low groundwater levels in many areas of England because [the previous 18 months were the driest for more than 100 years](#).

At the same time, our population is growing, where people are choosing to live is affecting water demand and new water intensive industries are emerging – like ‘fracking’ (exploiting shale gas).

We need to make sure water is available where and when we need it most. According to the Environment Agency, more than half of the UK’s rivers are over-abstracted, while others have plentiful supplies. But at the moment, less than 5% of the water in the UK is traded between companies across regions.

The challenges we face here in the UK reflect what is happening globally, which means that water is rising up the agenda worldwide. Indeed, some energy commentators have suggested that water is the new oil¹.

What we intend to do and why

We want to give your company greater freedom and flexibility to innovate and find more sustainable solutions to meet demand, while also increasing resilience. To achieve this, we propose to introduce targeted incentives and mechanisms – both for sellers and buyers – to encourage efficient water trading. Through the

abstraction incentive mechanism (AIM), our proposed changes will also reward companies that source water from where it will not damage the environment, and discourage them from taking it from where it does.

Conclusion

As outlined in the Water White Paper, it is essential that the water and sewerage sectors are resilient, efficient and customer focused – and that water is valued as a precious and finite resource. Our framework will help to achieve this – by providing greater freedom and incentives to innovative and efficient companies that deliver improved service to their customers.

The tools we are introducing will help to ensure that you and your investors face an appropriate balance of risks and rewards. This will help to maintain the investment attractiveness of the sectors. We look forward to working with you to achieve these objectives.

¹ Forbes magazine, 3 May 2012

More information

[‘Involving customers in price setting – Ofwat’s customer engagement policy statement’](#), Ofwat, August 2011

[‘Future price limits – statement of principles’](#), Ofwat, May 2012

[‘Consultation on retail price controls for the 2014 price review’](#), Ofwat, July 2012

[‘Consultation on wholesale incentives for the 2014 price review’](#), Ofwat, August 2012

[‘Review of the 2010-2012 drought and prospects for water resources in 2013’](#), Environment Agency, December 2012

[‘Met Office: 2012 was UK’s second wettest year on record’](#), BBC News, January 2013

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 consumers with a good quality and efficient service at a fair price.

Water today, water tomorrow



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