

# Setting price controls in 2014

A briefing note for Board members of water companies in Wales

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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 Welsh Government;
- the UK Government;
- customers; and
- other key stakeholders in the water sector.

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

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 separate price controls, we want to incentivise companies to focus on the long-term outcomes that their customers value, instead of short-term outputs set by us and other regulators. Our new price control framework gives greater ownership of 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 to long term. We want high-quality business plans from companies that represent the views and wishes of customers. There will be rewards – both financial and reputational – for companies that do this.

### Overview

In 2011, the Welsh Government published its '[Strategic Policy Position Statement on Water](#)', which set out its key priorities for the water sector. This follows its 2010 'Programme for Government' and builds on other strategy documents that focus on driving

forward sustainable development across Wales.

The Welsh Government's priorities for the water sector in Wales include:

- keeping bills at affordable levels by allowing choice of charging options, protecting vulnerable groups and reducing bad debt;

- putting customers at the heart of the water sector in Wales and reducing the regulatory burden; and
- delivering a higher water quality environment, as well as meeting European environmental obligations.

Our framework supports these priorities and will help to deliver a sustainable water sector by regulating for:

- **sustainable water use;**
- **greater accountability and responsibility for water companies;** and
- **efficiency and growth.**

## 1. Sustainable water use

The Welsh Government recognises that water is a precious and valuable resource. 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. The impact of this is devastating – during 2012 just over 1,000 properties in Wales were flooded.

And while Wales did not experience any drought in 2012, several companies in south-east England were imposing restrictions on 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](#). This is a key issue in Wales

where [UKCP09 data](#) points to an increased threat of flooding in winter, and droughts in summer.

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 boundaries. Many of these are based on legacy agreements that do not necessarily reflect the true value of water.

The challenges we all face in Wales reflect what is happening globally, which means water is rising up the agenda worldwide. Indeed, some energy commentators have suggested that water is the new oil<sup>1</sup>.

### 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 for customers. 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. Water trading could be an area in which your company can grow its business in the future alongside other demand management measures, as well as improving resilience for current and future customers.

We will also treat companies’ operating expenditure (opex) and capital expenditure (capex) together (a total expenditure or totex approach), to encourage them to deliver ‘softer’ solutions – such as catchment management and water management at source where these deliver value – rather than more traditional capital (and carbon) intensive investment.

## 2. Greater accountability and responsibility for water companies

There is significant pressure on all customers in these tough economic times. According to [figures from the Department for Work and Pensions](#), average UK household incomes fell by about £30 a week (or 5%) in real terms between 2009-10 and 2010-11.

Meanwhile, the Welsh Government estimates that bad debt in the water sector currently adds about £20 onto every customer’s bill each year.

We want to make sure Welsh customers get the service and

<sup>1</sup> Forbes magazine, 3 May 2012

delivery they deserve and value. We want water companies to take customers' needs into account in their long-term plans.

### **What we intend to do and why**

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 to use the CCG's feedback to ensure your 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 high hurdle.

We will set two binding retail controls in 2014 – one for household customers and one for non-household customers. To bring the sector 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.

Welsh Government policy does not currently propose to extend choice for business customers beyond those that use more than 50 million litres of water a year. So while we will regulate the retail service to non-household customers in Wales in a broadly

similar way to England, we recognise that we will need to use targeted and proportionate regulation to protect those in Wales that do not have choice.

As for English non-household water customers, we will set a default tariff – a maximum price for a minimum level of service. But unlike England, we will continue to regulate your company to drive service improvements in Wales using a form of the service incentive mechanism (SIM) that we use in the household retail sector.

### **3. Efficiency and growth**

The sectors in Wales has invested about £7.8 billion over the past 24 years to deliver improvements to services, infrastructure and the environment. Each year, Welsh water companies spend about £350 million on improving services for customers and enhancing and maintaining the natural 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 sector 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 our other proposals to increase the influence of household and non-household customers in Wales on what companies deliver. This will improve the legitimacy of the sector 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 sector 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, in order to best protect the interests of current and future customers.

Using targeted incentives like the SIM for retail services to households – and a form of SIM for non-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.

## Conclusion

The Welsh Government is clear that a sustainable water sector is essential in Wales. It wants to make sure that customers are kept at the heart of the companies' delivery and that the sector works

to improve the natural environment. It has also set the goal that Welsh water companies' performance should be among the best across England and Wales.

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.

## 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

['High emissions scenarios'](#), UK Climate Projections, May 2012

['Households Below Average Income, An analysis of the income distribution'](#), Department for Work and Pensions', June 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**



Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

Phone: 0121 644 7500  
Fax: 0121 644 7699  
Website: [www.ofwat.gov.uk](http://www.ofwat.gov.uk)  
Email: [mailbox@ofwat.gsi.gov.uk](mailto:mailbox@ofwat.gsi.gov.uk)

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