

Setting price controls in 2014

A briefing note for water companies in England

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Delivering sustainable water

We all agree that water and sewerage customers deserve excellent service at a fair price. Companies that innovate to find new and efficient ways of delivering this should be rewarded. Following an extensive consultation process, we have now developed our proposed price limits methodology framework for how we will set price controls for each of the five years from 2015 to 2020. This briefing note summarises the framework and what it means for your company.

Overview

Water is one of our most precious resources. While the demands on water supplies continue to increase, we need to ensure it is available when and where your customers need it most. At the same time, those customers deserve to pay a fair price and receive a high-quality service. The UK Government's Water White Paper, 'Water for Life', described "a vision for future water management, in which the 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 notes that we need to "encourage innovation and dynamism while

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 their 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 represent the views and wishes of customers. There will be rewards – both financial and reputational – for companies that do this.

ensuring the sector remains a low-risk choice for investors". The Draft Water Bill develops the framework to achieve this vision.

Our proposed methodology framework proposes targeted and proportionate regulation that will support both the Water White Paper and the Draft Water Bill in their ambition to drive sustainable water and sewerage sectors. We will:

- **regulate for growth and investment;**
- **create greater accountability and responsibility for water companies;** and
- **ensure 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 improved services,

infrastructure and environmental measures. Water companies spend about £4 billion on improving services for customers and safeguarding the environment each year. We need to make sure that the level of investment that is needed can continue. And we need to make sure that the finance raised is invested in the right things at the right time. This is because the solutions of the past are not necessarily the right solutions for the future.

Emerging challenges – like 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.

That means your company can consider opportunities to expand by providing retail services to businesses located anywhere in England. You will be able to respond to your customers' requests for innovative and efficient services, without the restriction of only being able to serve customers in your company area.

For customers, the choice will:

- enable them to choose the balance they want between service and price;
- empower them to seek efficiencies;
- encourage you to deliver more innovative solutions to help keep their input costs down; and
- support economic growth.

Our framework supports this agenda by:

- setting separate price controls for retail services to non-household customers, using a default tariff and service approach; and
- removing restrictive blanket regulation of all other charges to non-household customers.

At the same time, we recognise that your company will still need to invest significant amounts to deliver for customers in the future. Our proposed approach will ensure that you will be able to collect the revenue you need to finance the efficient delivery of your activities. We will do this by protecting existing investment, and encouraging new investment.

Wholesale activities represent 90% of water companies' business. We will continue to set wholesale price controls using the tried-and-tested concepts of the regulatory capital value (RCV) and the linkage to RPI. We will use the RPI+/-K framework, where K is a yearly adjustment factor we set in our price determinations.

Continuing to link wholesale controls to RPI will provide a stable operating environment for your company and the predictable returns you need to attract investment.

But to give you freedom and flexibility to respond better to the challenges we face, we will change some of the detail of how we set the wholesale controls. For example, we propose to use a mix of total revenue and revenue yield approaches to controlling revenue for the water wholesale control.

This will allow you to adjust your charges each year for the differences between your actual and allowed revenues from previous years. We are also proposing that you will be able to recover the costs of providing additional water and servicing metered connections by adjusting your charges from year to year and varying bills to customers over time. This will give you the choice of how you manage the profile between your revenues and your customers' bills – allowing you to smooth your revenues and profit in the face of demand risks.

We propose that the sewerage wholesale control will use a simpler total revenue control because there does not appear to be enough variation in sewerage revenue to justify a different mechanism. But we welcome your views on this.

Again, to give you more ownership of how you manage your business,

we propose to adopt a total expenditure (totex) approach to assessing your allowed wholesale costs. We will use both econometric and non-econometric models to set baseline costs for totex menus. You will be able to recover a fixed percentage of your total expenditure on a pay-as-you-go basis (PAYG ratio) following review of your own business plan, with the remaining expenditure being added to the RCV.

We will use the weighted average cost of capital (WACC) to determine the return on capital, both for 2015 RCV and for additions in 2015-20. This will be depreciated using separate run-off rates and tax will be calculated using average capital allowance writing down rates. This approach allows you to propose, within defined corridors and subject to our challenge, your own PAYG ratio, run-off rates and capital allowance writing down rates.

In summary, our approach maintains stability by linking wholesale controls to RPI, while giving you the ability to adjust charges to better manage your revenues and your customers' bills. Combined with a totex approach to wholesale cost assessment, we are providing you with greater flexibility to identify the most effective use of your customers' money and manage your revenues and costs and cashflows effectively.

The incentives we are putting in place will encourage you to improve efficiency and customer service, while boosting innovation

and keeping costs down. You will also be able to take greater ownership of the risks you are best placed to manage.

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

Delivering water and sewerage sectors in "which water companies are more efficient and customer focused, and in which water is valued as the precious and finite resource it is" will require you to take greater responsibility, both for your long-term planning and for delivering those plans. To achieve this, we recognise that you need to have the freedom to innovate and find more sustainable solutions.

What we intend to do and why

We want to incentivise you to focus on the long-term outcomes your customers value. We understand that collecting the disparate views of a wide range of customers and balancing and reflecting these in your business plan is a challenge. So to help you, we have asked you to set up an independent customer challenge group (CCG).

As you develop your plans, you will be able to use the CCG's feedback to ensure your proposed outcomes reflect your customers' priorities. Where you are able to demonstrate clearly that customers are willing to pay for service beyond your committed

levels, you will be able to propose reward and penalty incentives – providing you are able to demonstrate that this does not exceed your customers' willingness to pay for this extra delivery.

To bring water and sewerage in line with other sectors, retail price rises will no longer be indexed automatically to RPI. Instead, we will set two binding retail controls in 2014 – one for household customers and one for non-household customers – using a new approach.

Household customers cannot choose their supplier, so we propose to set retail controls that offer an appropriate level of protection to ensure that they do not cross-subsidise the market

For the purposes of the retail controls, retail activities and services will include:

- billing;
- payment handling;
- calls;
- managing debts;
- meter reading;
- demand-side efficiency services; and
- repairing customer-side leaks.

Retailers will also:

- help determine which meters should be installed;
- decide on disconnection and reconnection; and
- carry out customer-facing developer activities.

where there is choice. To help keep customers' bills manageable we will use an average cost to serve approach to set retail controls for households. We expect all companies to drive efficient delivery and strive to reach and beat the average cost to serve these customers.

Once again, because these customers are unable to choose their retailer, we will continue to regulate to drive improvements in services. We will use the well-understood service incentive mechanism (SIM) to do this.

For **non-household customers** we will set a default tariff – a maximum price for a minimum level of service – and expect to see customers choose their supplier based on service, price and value. This will allow you to compete more effectively, with a reduced regulatory burden. It will include a mix of financial and non-financial rewards and penalties.

This approach will encourage the best companies to deliver services to business and other non-household customers beyond their own area. It will also incentivise those companies that are not delivering the service their customers require to improve. By focusing on outcomes as well as total expenditure, this framework will give you far greater freedom to change the way you deliver your commitments compared with the past.

Introducing choice for non-household customers will create the opportunity for you to gain

market share through innovation and to improve customer loyalty by offering a wider choice of new value added services, such as improved water efficiency and account management. We will support this process but also provide protection until the market is more mature.

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 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 you to be able to innovate and find more sustainable solutions to meet demand, while also increasing the resilience of supply. We want you to be able to make informed decisions based on understanding the true value of water.

We propose to introduce new, targeted incentives to encourage efficient water trading, both for sellers and buyers of water. To encourage you to export water, we will increase the proportion of lifetime profits you can keep from exporting water to up to 50%. This is greater than the amount you currently retain and so should make water trading more attractive.

We are capping this at 50% to protect customers from paying

¹ Forbes magazine, 3 May 2012

excessive amounts while we all learn and the market for water trading develops. This is in response to comments from companies that they preferred this gradual approach to the alternative of deregulating water trading entirely. And to make sure that water is imported where it is efficient, we propose to let you recover a fixed percentage of your import costs.

Finally, to reduce levels of over-abstraction and protect against the danger that our water trading incentives would encourage more unsustainable abstraction, we propose to introduce the abstraction incentive mechanism (AIM). The AIM will cover sites where the risk of environmental damage from over-abstraction is greatest. It is designed to reward

you for abstracting less water from these areas than you have done historically.

Both of these incentives are designed to reward you for sourcing water from where it does not damage the environment and to discourage you 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. Building on this vision, the Draft Water Bill introduces choice for non-household customers in England to create a competitive market, bringing new ways of

working to the sectors, improving customer service and helping to keep bills down.

Our framework will provide the platform to help deliver these objectives. It will help you to make the right, value-based decisions for customers and the environment and will incentivise you for being more innovative and efficient. Combining a competitive market with efficient water trading and targeted incentives will also ensure more efficient use of water and secure supplies over the long term.

We think the tools we are introducing will help to ensure that you and your investors face an appropriate balance of risks and rewards, thereby helping 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

[‘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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Printed on 75% minimum de-inked
post-consumer waste paper
January 2013

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