

Setting price controls in 2014

A briefing note for water companies in Wales

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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.

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.

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 into 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.

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 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 excessive amounts while we all learn and 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-abstracted 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-abstracted 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.

2. Greater accountability and responsibility for water companies

Delivering a water sector in which bills are kept at affordable levels, customers are at the heart of decision-making and there is higher water quality 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

¹ Forbes magazine, 3 May 2012

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 the sector in line with others, 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 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.

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. But unlike England, we will continue to regulate your company to drive service improvements in Wales using a form of the SIM that we use in the household retail sector.

3. Efficiency and growth

The sector 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 a form of the SIM to encourage you to deliver the services that non-household customers in Wales expect.

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

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.

Retail activities will also include:

- helping determine which meters should be installed;
- deciding on disconnection and reconnection; and
- carrying out customer-facing developer activities.

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 also propose 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.

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 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. 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 sector. 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

[‘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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