

# Setting price controls in 2014

A briefing note for environmental stakeholders

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## Delivering sustainable water

Customers of water and sewerage and water only companies deserve excellent service at a fair price. As the economic regulator for the water and sewerage sectors in England and Wales, we want to ensure this is delivered, while at the same time protecting the natural environment.

We are now consulting on how we will set the price and service package ('price controls') that the monopoly water and sewerage and water only companies must deliver for each of the five years from 2015 to 2020. We have developed our price limits methodology framework through extensive consultation with:

- environmental regulators;
- customers;
- water companies;
- Government; and
- other key stakeholders within the water and sewerage sectors.

This briefing note sets out the implications of our proposed framework for the natural environment. It also explains how we will make sure that the sustainable use of water is at the heart of how we regulate the sectors.

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 controls, we can target our regulation on the different activities that companies carry out. This is essential if we are to keep prices down, while encouraging innovation and sustainable solutions to manage this valuable and precious resource.

### Overview

The UK Government's recent Water White Paper and Draft Water Bill describe "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".

We share this vision and want to make sure that the sectors can deliver for their customers today and in the future on a sustainable basis. We aim to set price controls in a way that will:

- ensure more **sustainable water use**;

- give **customers a voice on environmental issues**; and
- regulate for **efficiency and growth**.

### 1. Ensuring sustainable water use

Water is arguably one of our most precious resources 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

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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, only 4–5% 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 oil<sup>1</sup>.

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

We want water companies to focus on long-term outcomes

instead of short-term outputs. This will mean they have more freedom to decide how to deliver for the long term – finding new ways of working that deliver the services customers want, for less money and with less impact on the environment.

For example, rather than increasing bills by building an expensive water treatment plant to meet environmental standards, they might carry out catchment management schemes – working with local farmers and land owners to avoid pollution entering rivers in the first place, where this delivers better value to customers.

We want to encourage water companies to find more sustainable ways to meet their customers’ needs while also improving resilience. By incentivising water trading, we will reveal its true environmental, social and economic value. Then companies can make better informed decisions about where to invest and how to balance supply and demand pressures. Together, the incentives we are putting into our wholesale price controls will encourage them to manage water resources more sustainably and ensure supplies are more secure.

We are also introducing the abstraction incentive mechanism (AIM) to make sure that the water trading we encourage is environmentally efficient. The AIM will incentivise companies to source water from where it does not damage the environment, and penalise them if they take it from where it does.

We also intend to change the way water companies decide on which solutions they should invest in. Currently, we treat capital expenditure (capex) and operating expenditure (opex) differently. Environmental colleagues consider that because of this companies prefer capital-intensive – and often carbon-intensive – solutions, even if this is not the best thing for the environment.

Under our new total expenditure (totex) approach, both operating and capital costs could be treated in the same way. Where a company may historically have preferred to tackle sewer flooding by increasing its underground equipment to store more rainfall during storms, it might consider other options in future – such as working with customers to manage the rainfall close to source, preventing it entering the sewers in the first place.

## **2. Giving customers a voice on environmental issues**

The general public and the business community are increasingly aware of the importance of behaving sustainably. For example, the Chief Executive of a major UK-based food and consumer goods manufacturing company said recently that his company’s move towards sustainable business practices was “not altruistic ... just common sense”.

Customers want to know that their water is sourced sustainably and their wastewater is disposed of

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

responsibly. This is not just for the clear environmental benefits. It also:

- minimises waste;
- has the potential to lower bills; and
- ensures security of supply.

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

We want water companies to focus on long-term outcomes that customers value. So, we have required each of them to improve their customer engagement and set up a customer challenge group (CCG). These groups will hold companies to account on the views of their customers. Companies will be expected to show that they know what the environmental concerns of their customers are, and to take this into account when developing their business plans.

In England and Wales, non-household customers currently use about one-third of all the water supplied. Our proposed framework regulates services and prices to these customers differently – supporting the proposals in the Draft Water Bill to give these customers more choice in England. That choice means they will be able to demand a wider range of value-added services – such as improved water efficiency.

Suppliers will have to respond to these demands if they want to retain the business of such customers. We know from the experience of Business Stream in

the Scottish water market that this can benefit both customers and the environment. Since 2008, when the market in Scotland was opened, Business Stream has saved non-household customers about £10 million worth of water through efficiency measures, which has also reduced CO<sub>2</sub> emissions by 5,000 tonnes.

### **3. Regulating for efficiency and growth**

We think that sustainable companies will be successful companies delivering benefits to all stakeholders. Yearly turnover in the water and sewerage sectors is currently £10.5 billion. More than £108 billion has been invested over the past 24 years in improving services, infrastructure and the environment. Each year, companies continue to spend about £4 billion on improving services for customers and enhancing and maintaining the environment.

But the solutions of the past are not necessarily the right solutions for the future. Emerging challenges – such as the need to adapt to climate change – require water companies to be innovative and deliver more efficient and sustainable solutions for the long term.

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

As new challenges emerge, our framework will provide the sectors with greater flexibility to respond. Our targeted retail price controls

will empower non-household customers to:

- seek efficiencies;
- drive their suppliers to deliver more innovative solutions; and
- keep their input costs down, supporting wider economic growth.

Where customers have no choice, we will use targeted incentives like the service incentive mechanism (SIM) to improve customer service, and through the CCGs customers can influence their water company to deliver sustainable outcomes.

Our setting of separate price controls for the first time will enable us to keep prices down, while encouraging innovation and sustainable solutions.

We estimate that our regulatory reforms and the retail competition proposed in the Draft Water Bill could deliver nearly £500 million of net benefits to the economy. Another £2 billion of benefits could come from the draft Bill's proposed reforms to upstream water management. Our initial incentives to reveal value and increase water trading will provide the platform for these reforms.

Water companies will also be able to take greater ownership of the risks they are best placed to manage. Those that perform well will attract investment, while those that perform less well will be incentivised to improve.

## 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. Protecting the natural environment is a critical aspect of this. Through this framework, we want to ensure that:

- companies can make the right decisions based on the real value of water to our economy, environment and society;
- investors retain their confidence in the sectors and the finance needed to continue to invest can be sourced at a good price to customers;
- businesses – and, in turn, the economy – can benefit from greater choice and influence over the services they receive; and
- consumers have a resilient service and pay a fair price.

## 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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