

# Setting price controls in 2014

A briefing note for UK Government stakeholders\*

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## Delivering sustainable water

Customers of water and sewerage and water only companies deserve excellent service at a fair price. To help deliver this we are consulting on how we will set the price and service package ('price controls') the companies must deliver for each of the five years from 2015 to 2020.

We have developed our price limits methodology framework through extensive consultation and engagement with:

- the companies;
- the UK Government;
- the Welsh Government;
- customers; and
- other key stakeholders within the water and sewerage sectors.

This briefing note sets out the implications of our proposals for the sectors in England.

### Overview

The Water White Paper, 'Water for Life', describes "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

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 encourage them to focus on what their customers want, while driving efficiency. We want to keep prices down, while encouraging innovation and sustainable solutions to managing this valuable and precious resource.

it is". It notes that we need to "encourage innovation and dynamism while ensuring the sector remains a low-risk choice for investors". The Draft Water Bill develops the framework to achieve this vision.

Our proposed framework supports both of these in:

- helping to drive sustainable water and sewerage sectors while **regulating for efficiency and growth**;
- helping to drive a renewed **focus on customers**; and
- **ensuring sustainable water use**.

### 1. Regulating for efficiency and growth

Turnover in the water and sewerage sectors is currently £10.5 billion a year – and more than £108 billion has been invested over the past 24 years in delivering improved services and infrastructure. Each year, water companies 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. New, emerging challenges mean the companies need to be innovative to deliver more efficient and sustainable solutions for the long term.

\* There is a separate briefing for the Welsh Government

## What we intend to do and why

As these challenges emerge – including new industries and uses for water that change the demand for it – our framework will provide the sectors with greater flexibility to respond. Our targeted retail price controls will work alongside the UK Government’s proposals to give choice to all non-household water and sewerage customers in England. That will empower them to:

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

At the same time, we still need significant investment to deliver for customers in the future. Our framework will protect existing investment – and encourage new investment. The wholesale part of the sectors represents 95% of the companies’ business. We will continue to set wholesale price controls using tried and tested tools – including linking them to RPI, while it remains the most appropriate index. 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 the stable and predictable returns needed to attract investment.

Using targeted incentives will encourage water companies to improve efficiency and customer service, while boosting innovation and keeping costs down. 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.

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.

## 2. A focus on customers

There is significant pressure on all customers in these tough economic times. Household income has fallen by about 5% in real terms since 2010, while bad debt in the sectors currently adds £15 onto every bill each year. Meanwhile, businesses are struggling to meet costs, and their ability to control the cost of managing their water and sewerage services is severely restricted.

For example, large retail customers have each of their stores treated as separate accounts, often spread across numerous water companies. A [Policy Exchange report](#) in July 2011 highlighted one business that would be able to save between £80,000 and £200,000 by receiving just one water and sewerage bill, instead of its usual 4,000 bills from a number of different companies.

## What we intend to do and why

We want water companies to focus on the long-term outcomes their customers value instead of on short-term outputs set by the regulator. So, we have required

each of them to improve their customer engagement and set up a customer challenge group (CCG) that will hold them to account as they develop their plans.

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, water companies will no longer be allowed to increase the retail part of their bills automatically every year by RPI (although wholesale controls will remain index-linked RPI to keep financing costs low). Instead, we will challenge them to improve their retail services to household customers by focusing on reaching, or beating, the average cost to serve such customers. This will help keep bills for hard-pressed households down.

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 be allowed to choose their water supplier. We expect to see companies respond to the demands of more empowered customers that can choose to switch supplier if they do not get what they want.

That choice for non-household customers means they will be able to demand and get better services, driving administration costs for the business down. This will create crucial pressure on water companies to innovate and give a wider choice of value-added services like improved water

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efficiency and account management. We will support this process – and also provide protection until the market is more mature.

We know this works from the experience of Business Stream in the Scottish water market. Since 2008, 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. 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 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 that 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 allow water companies greater freedom to innovate and find more sustainable solutions to meet demand, while increasing resilience. To do this, they need to base their decisions on the true economic, environmental and social value of water. Our framework will help reveal this value and allow companies to make better informed decisions on what and where to invest to meet supply and demand.

We will encourage innovation by removing regulatory barriers,

which will lead to more sustainable approaches. We will:

- equalise incentives for different types of expenditure, by rolling together operating expenditure (opex) and capital expenditure (capex) in a total expenditure (totex) approach;
- incentivise efficient water trading across company boundaries; and
- create the abstraction incentive mechanism (AIM) to reward companies that source water from where it does not damage the environment – and to penalise them if they take 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. Through this framework we want to make sure 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.

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

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## More information

'Water retail services competition in England and Wales. Still Hobson's choice?' Policy Exchange, July 2011

'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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