

Setting price controls in 2014

A briefing note for Welsh Government stakeholders

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Delivering sustainable water

Customers of water and sewerage and water only companies in Wales 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, including those operating wholly or mainly in Wales, must deliver 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 within the water sector.

This briefing note sets out the implications of our proposed framework for the water sector in Wales.

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

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 can target our regulation on the different activities that the 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 manage this valuable and precious resource.

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**;
- a renewed **focus on customers**; and
- **efficiency and growth**.

We will work with the Welsh Government and the two suppliers that operate mainly in Wales (Dŵr Cymru and Dee Valley Water) to make sure they develop business plans that deliver the best deal for customers at the fairest price.

1. Ensuring 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, only 4–5% 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 face here 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 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 them to make better informed decisions on what and where to invest to meet supply and demand.

One way we will do this is to encourage more water trading where this is efficient. This could be an area in which Welsh water companies can grow their business in the future alongside other demand management measures.

We also want to increase the scope for innovation by removing regulatory barriers, allowing water companies to explore more sustainable approaches. We will:

- 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;
- 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.

2. A focus on customers

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.

What we intend to do and why

We want to make sure Welsh customers get the service and delivery they deserve and value. We want water companies to take customers’ needs into account in their long-term plans. So we have required each of them to improve their customer engagement and set up a customer challenge group (CCG).

These groups will challenge the companies to engage with customers properly and reflect

¹ Forbes magazine, 3 May 2012

Welsh customers' needs and views in their business plans. This will mean the following.

- Companies will draw up the outcomes they will deliver based on customers' views and priorities, alongside their legal obligations.
- The CCGs will challenge companies, focusing on how well they have engaged with their customers, and whether their proposals reflect customers' priorities.
- We will make the final assessment of companies' proposals, and we will listen carefully to the views of the CCG when we do this.
- Where companies have listened to their customers and done a good job, we will accept their version of what they propose to deliver and concentrate on challenging costs.
- If business plans do not take customers' priorities into account, we will challenge costs and also require changes to make sure that Welsh customers' needs are recognised.

We will set two binding retail controls in 2014 – one for household customers and one for non-household customers – enabling us to regulate services to both these groups in a distinct, targeted way. To bring the sector in line with others, water companies will no longer be allowed to increase the retail part of their bills automatically every year by inflation (although wholesale controls will remain

index-linked to RPI to keep financing costs low).

Instead, we will challenge water companies to improve their retail service to household customers by reaching, or beating, the average cost to serve such customers in England and Wales. This will help keep down bills for hard-pressed households.

And we will continue to drive improved service through targeted regulation. For example, each year we score and compare water companies' performance on things like:

- complaints;
- call-out times; and
- the time taken to make repairs.

The best performing companies are rewarded while those that perform badly are incentivised to improve. This is our service incentive mechanism (SIM), which we will continue to use. [SIM has shown significant benefits in Wales](#), with Dŵr Cymru receiving 58% fewer customer complaints between April 2011 and March 2012 compared with the previous year, and Dee Valley Water receiving nearly 15% fewer complaints.

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 to drive service improvements in Wales using a form of the service incentive mechanism (SIM) that we use in the household retail sector.

3. Regulating for efficiency and growth

Efficient and effective water companies are important to the Welsh economy. Turnover in the Welsh water sector is currently about £700 million a year and about £7.8 billion has been invested over the past 24 years in delivering improved services and infrastructure – and in reducing environmental impacts. 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 the right level of investment can continue. But at the same time, we need to recognise that the solutions of the past are not necessarily the right solutions for the future. New, emerging challenges require water companies to be innovative to deliver more efficient and sustainable solutions for the long term.

What we intend to do and why

As new challenges emerge – including new industries and uses for water that change the demand for it – our framework will provide the water sector with greater

flexibility to respond. We are creating an environment where water companies are better able to serve customers, while still keeping costs fair. Our targeted retail price controls will ensure they seek efficiencies, and are encouraged to deliver more innovative solutions. This approach is aimed at keeping input costs down and supporting growth.

This will mean better solutions for customers, at an affordable price. Our retail reforms, alongside retail market reform in England are estimated to deliver £500 million to

the UK economy². Our upstream reforms (like supporting water trading that recognises the true value of water) could help deliver another £2 billion of benefits across England and Wales.

And to make sure water companies can raise the investment needed on capital markets to deliver these benefits, we will continue to regulate the monopoly aspects of the water sector in a transparent low-risk way, including linking wholesale prices to RPI. The stability this delivers will keep the cost of borrowing for water companies

low, enabling them to secure affordable long-term financing and keep customers' bills down.

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 right incentives for Welsh water companies to deliver the Welsh Government's priorities. It will ensure that companies can:

- deliver for customers;
- make the right decisions about improving the environment; and
- continue to invest in the services that both customers and the environment rely on.

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

['Written complaint handling in the water industry England and Wales: April 2011 – March 2012'](#), Consumer Council for Water, September 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

² ['Future price limits – statement of principles. Appendix 1: Impact assessment'](#), Ofwat, 2012



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