Protective Marking – (Protect)

RESPONSE TO OFWAT CONSULTATION SETTING PRICE CONTROLS FOR 2015-20 – FRAMEWORK AND APPROACH

The Environment Agency welcomes the opportunity to comment on Ofwat's proposed framework and approach for setting price controls for 2015-20. We support the ongoing commitment to simplify the price review process. We look forward to working with Ofwat and others in supporting customer focused change, innovation and streamlining regulation in the water industry, so that we all operate complementary regulatory regimes for the benefit of society.

1.0 Environment Agency response

1.1 We note that the consultation document is high level. We will need more detailed information to understand fully and comment on the likely environmental impact of the proposed changes. We note there will be a separate consultation on the information requirements in business plans later in March 2013. Our comments will need to be considered in context once we see this further consultation.

1.2 We support the move towards companies setting outcomes that their customers value as a potential means of moving to a lighter touch regulation. We believe this can build greater company ownership for the environmental programmes they deliver. We note that flexibility in managing the outcomes based approach will be needed, giving well performing companies more freedom to explore the efficiency and innovation benefits available. At the same time we would like to see appropriate checks and balances embedded to ensure that companies that do not fully embrace the change to outcomes maintain their statutory and discretionary environmental performance through the mechanisms proposed below. Within this framework, companies should remain aware that many environmental requirements are statutory and not subject to choice or trading. However, some environmental objectives required by, for example, the Water Framework Directive contain the scope to consider wider, innovative and more sustainable solutions. The Environment Agency welcomes early and open engagement with companies to use the outcomes based approach to this end.

1.3 Success will require companies adopting outcomes that are SMART (specific, measurable, achievable, realistic and time-bound) along with corresponding milestones, outputs and performance measures. The Environment Agency will seek to work with companies and Customer Challenge Groups (CCGs) on defining specific, measurable and achievable outcomes and performance measures and in identifying opportunities for regulatory innovation and efficiency. Success will require a high standard of outcomes and associated outputs and performance measures to be set by the Customer Challenge Groups and to be required at plan determination by Ofwat. This will help remove potential uncertainty for regulators and companies on how to define and track the transition to an outcome based approach.

1.4 The transition to an outcomes approach should not undermine the current ability within set customer prices to deliver statutory environmental outcomes even if they cost more or less than expected (currently achieved via the change protocol). The proposal to introduce the outcome delivery incentive is not clear in this respect, and we would need to see further detail to be able to comment on this option. We would wish to see an assurance that if a new statutory environmental obligation or a change in permit standards becomes apparent during the price control period, there is an allowance for this in the prices set. A mechanism for such delivery changes needs to be available mid-AMP period.

1.5 We see potential for delivering more sustainable and greater environmental performance for less investment through the changes proposed. To do this, we think that mechanisms will be needed in the following areas in company business plans:

- A risk-based assessment of the costs for upgrading assets to meet climate change risks and future growth.
- Clarity over company responsibility for the delivery of partnership solutions to manage flood risk and resilience, and to set sewerage performance indicators and standards to achieve joint outcomes.
- Clarity over the assessment of catchment management options, working with land owners and managers to reduce pressures on the water environment associated with water company activities. Ultimately this approach can deliver outcomes, reduce costs to water customers and deliver a wider range of benefits to society.
- Water efficiency work in businesses and homes, preferably with a national incentive mechanism to reduce demand.

The Environment Agency is looking forward to working with Ofwat to consider the adoption of a minimum requirement on companies to consider these approaches in their business plans.

1.6 We would like assurances that the proposed ability of companies to allow trade-offs (for example, between environmental performance and customer service) will not extend to statutory environmental requirements or to the environmental mechanisms detailed in paragraph 1.5 above (if adopted).

1.7 The Environment Agency welcomes the move to equalising incentives for different types of expenditure by combining operating and capital expenditure in a total expenditure (TOTEX) approach. We believe this can help companies that wish to fund, for example, catchment based approaches and water efficiency campaigns, to do so more effectively.

1.8 We will continue to work with Ofwat and the companies to provide as much certainty on likely Water Framework Directive (WFD) requirements as possible under the second cycle of river basin management plans. We would like companies to include an appropriate allocation to meet these WFD requirements in the forthcoming business plans. The size of this allocation should be based on information that we will be providing during the remainder of 2013.

1.9 To fulfill our statutory role effectively, the Environment Agency needs to work directly with Ofwat when Ofwat is making its final determinations to assess the degree to which companies' business plans meet statutory environmental standards. This is in addition to our input to joint Customer Challenge Group reports on business plans.

1.10 Without means to address the issues raised in sections 1.3, 1.4, 1.5, 1.6. 1.8 and 1.9 above, the Environment Agency believes there is a risk that environmental requirements will not be delivered, or worse, that current environmental performance slips.

1.11 We welcome the opportunity provided by the proposed framework to simplify the price review process and streamline regulation of the water industry. We look forward to working with Ofwat to develop further clarity on the mechanisms to improve the delivery of environmental and customer outcomes, while safeguarding and building on the environmental gains of recent Price Review periods.

Further information

Further information to this response can be obtained from Ian Barker, Head of Land and Water, by post at Environment Agency, Horizon House, Deanery Road, Bristol, BS1 5AH, by telephone on 01179 345075 or by e-mail at ian.barker@environment-agency.gov.uk

March 2013

RESPONSE TO OFWAT CONSULTATION

SETTING PRICE CONTROLS FOR 2015-20 – FRAMEWORK AND APPROACH

RESPONSE TO DETAILED QUESTIONS

Question 1: Do you agree with the process for deciding on the nature of the incentive (non-financial, one- or two-sided and for allowing trade-offs where appropriate)?

There are advantages to having financial and non-financial incentives and we feel it is appropriate that a combination of these should be used. In this regard, we would welcome links being made to other regulatory incentives such as our Environmental Performance Assessment (EPA).

We do not believe that statutory environmental programmes can be subject to trade-offs with other incentives. However, we understand the delivery and detail of statutory environmental programmes could be negotiated to achieve more delivery for greater efficiency, for example, and would welcome the opportunity to work with companies and Ofwat on their individual programmes to achieve this.

With the above caveats, the process for companies deciding the nature of incentives seems well thought out. The broader issue is one of striking a balance between the requirements on companies to interpret customer's wishes when setting incentives, and the need to take up statutory and longer term environmental delivery. This may not feature as highly in short term financial priorities within a customer or company business investment cycle.

For this reason, we believe that the visibility of longer term environmental requirements needs to be improved for companies when making decisions on incentives. There are a number of critical longer term environmental pressures building which companies should be encouraged to start planning for now. We would therefore welcome the inclusion of approaches for the following within your forthcoming "information requirements for business plans consultation":

- Financial mechanisms for upgrading assets to meet climate change risks and future growth.

- Clarity over company responsibility for the delivery of partnership solutions to manage flood risk and resilience, and to set sewerage performance indicators and standards to achieve joint outcomes.

- Clarity over the assessment of catchment management options, working with land owners and managers to reduce pressures on the water environment associated with water company activities. Ultimately this approach can deliver outcomes, reduce costs to water customers and deliver a wider range of benefits to society.

- Water efficiency work in businesses and homes, preferably with a national incentive mechanism to reduce demand.

For the same reason that statutory environmental requirements will need to be funded despite other pressures, we would not welcome longer term environmental requirements as given above being subject to trade–offs in company business plans.

Question 2: Do you agree with our proposal to consider delivery incentives for the next five years? If not, how should we use longer-term delivery incentives?

The focus signalled by the consultation is increasingly moving to longer term planning. Long term planning also fits with an outcome focused approach. Environmental statutory drivers have long term time frames (For example, Water Resources Management Plans (WRMPs) look forward 25 years, the Water Framework Directive to 2027, Drainage Strategy Framework and Flood Risk Management Plans to PR24). Given the long term nature of the investment needed for these and other statutory and non-statutory environmental drivers (see answer to Question 1), we would like to see incentives for delivering these measures introduced over more than one price review period starting with PR14, to signal the long term change in approach needed.

Question 3: Under what circumstances do you think we should set consistent performance commitments and incentives across all companies? Are there particular examples where consistent incentives would be beneficial?

We advocate moving away from a “one size fits all” approach as this enables tailored incentives to recognise the differences between companies. We believe that this would provide flexibility, but at the same time, we would like to see a minimum requirement for incentives to deliver against longer term environmental requirements included in the information required for business plans (as detailed in our answer to Question 1). We would like to see this applied to the upgrading of assets to meet climate change risks and future growth, delivering partnership opportunities for reducing flood risk, undertaking catchment solutions and prioritising measures for reducing water demand in businesses and homes. We see a need for the clear use of measures of success to be applied on an industry wide basis to monitor performance and achieve the desired level of accountability in these areas.

Question 4: Do you agree with our definition of retail? Specifically, do you agree with our preferred option for demand-side water efficiency services, customer-side leaks and developer services?

As a general point, we see a need to define clearly the roles and line of sight of retail and wholesale arms of businesses during the planning and response to incidents such as flooding.

We note that there is a proposal that the wholesale side of the business would set and finance water efficiency services for delivery by the retail side. We would like to see this done in a way that gives an overall incentive for the retail arm to introduce and implement water efficiency. We would welcome the opportunity to work with you on such an incentive structure.

Question 8: How do you suggest we incentivise companies to prepare and update accurate demand assumptions to apply our proposed forms of wholesale control?

We believe your proposals for menu regulation and symmetric incentives to deliver outcomes will ensure it is in the interests of water companies to forecast demand accurately. We do not see a need for further incentives in addition to this approach. We see potential in using a menu approach to incentivise companies to increase accuracy with waste water demand assumptions, and to adopt an incentive/penalty structure to supply first time sewerage in a timely manner.

We also note that a demand forecast is a statutory requirement as part of water companies' Water Resource Management Plans (WRMPs) and should feed directly into their business plans.

Question 22: Do you agree with our preferred option of funding additional water efficiency services and customer-side leaks through the wholesale control?

We are conscious that under this proposal, wholesalers will need strong incentives to set and monitor the delivery of water efficiency measures by retailers. We believe this means that efficiency measures need to be explicitly included in the requirements for wholesale control. We would welcome the opportunity to work with Ofwat and companies to develop an incentive structure for this so that wholesalers face penalties if retailers fail to deliver (and rewards if they over deliver). We would welcome the opportunity to work with Ofwat to ensure the Average Cost to Serve (ACTS) structure provides the retail business with the right balance of incentives between short term costs savings and incentives for longer term water efficiency services. This will ensure adequate delivery agreements for efficiency measures are drawn up and enforced between wholesale and retail arms.

Question 32: Do you agree with our preferred option for implementing water trading incentives?

We explained in our response to the wholesale consultation that the clear preference must be to neutralise any disincentives for trading water rather than introduce incentives. We understand this to mean that so-called "status quo bias" in favour of current practices needs to be overcome, but once up and running a market for trading water should not receive financial incentives.

The disadvantage of an incentive is that it may continue to drive trades that are not economically efficient and that cut across options in WRMPs. For this reason we agree with you that any incentives should be explicitly short-term to tangibly demonstrate the potential gains from trading, but avoid the market becoming dependent on subsidies.

We welcome the opportunity to work with you to assess existing evidence of trades that did take place during the drought months of 2012, with a view to understanding how this may be creating the conditions for a market in water trading.

Question 34: What evidence should we take into account in setting incentive rates for importers (buyers) of water?

In general terms, importers should receive incentives equal to the value of the barrier preventing them from trading – a clear articulation of this barrier and its value is therefore important, and we would welcome the opportunity to work with you on this.

We believe it is likely that bargaining over the price of the trade will result in any incentives being shared between exporters and importers, according to who has most bargaining power. Thus, the incentive may need to be adjusted to account for the degree of bargaining power importers have.

Question 35: Do you agree with our preferred approaches to securing efficient trades and protecting the interests of customers? Please provide your reasons and supporting evidence where possible.

The proposed import incentive seems to be disincentivising exports in order to ensure “allocative efficiency”. But it seems likely that this mix of double incentives (for imports and for exports), coupled with a disincentive for exports, will add complexity to potential trades, and risks damping down the willingness to trade.

Question 36: Do you agree with our preferred option for implementing the AIM?

We have worked with you to develop the AIM mechanism and are broadly comfortable with the option chosen. We will continue to work with Ofwat to develop practical procedures to deliver the mechanism and to overcome potential obstacles.

Question 37: Do you agree with our preferred limit to the scope of the AIM?

We would welcome the opportunity to continue to work with Ofwat to evolve the practical application of the AIM in the light of operating experience, and particularly to consider whether it would be suitable to expand the scope of AIM beyond WFD sites only to wider sites where it has been identified that reducing abstraction is recommended (for example on wider Habitats Directive sites).

Question 38: What evidence should we take into account in calibrating the AIM?

We believe that the most practical way to introduce AIM is to use national Willingness To Pay (WTP) data. Ideally, this would evolve, in time, to use more locally generated and agreed input values. We consider local WTP values are in principle the right approach, but in practice, robust local values (calculated on a consistent basis) will not be available in time for the PR14 control period. If AIM were to continue beyond the next price control period, we would want a switch from national to local WTP values on the basis that the large majority of benefits from better management of water resources accrue locally.

We are aware of the many constraints and qualifications over the use of WTP data and welcome further opportunity to work with you to improve the confidence of using this data. We can provide relevant evidence if required.

Question 39: What are your views on our proposed phased implementation of the AIM?

We understand that trading will be encouraged via incentives for 12 months before the AIM comes in. We understand that a trial year would be sensible, but would rather that the AIM is introduced at the same time to ensure that during early trades, the full value of environmental damage is reflected in any trades.

Question 45: Do you agree with our preferred option of implementing adjustments for legacy tools through wholesale controls?

The transition to an outcomes approach should not replace the current change protocol mechanisms which make room within set prices for delivering statutory environmental outcomes even if they cost more or less than expected. The proposal to replace the change protocol with the outcome delivery incentive is not clear in this respect, and we would need to see further detail to be able to comment on this option. We would wish to see an assurance that if a new statutory environmental obligation or a change in permit standards becomes apparent during the price control period, there is an allowance for this in the prices set. A mechanism needs to be available for such delivery changes to be made mid-AMP period. Both companies and regulators will need this certainty.

Question 47: What are your views on our emerging criteria for identifying high-quality business plans? Are there other criteria we need to consider?

We welcome a move to a proportionate and targeted assessment of company business plans based on customer's views, financeability, and statutory and non-statutory environmental needs. For the reasons given in our answer to Question 1, we believe that longer term environmental commitments need to be included in company business plans and look forward to seeing more detail on this in the forthcoming consultation on information requirements for business plans. We would welcome the opportunity to work with you and companies to inform these requirements. We would want to see companies' business plans contain clear outcomes, SMART (specific, measurable, achievable, realistic and time-bound) measures of success and milestones for the services they provide.

We will continue to work with you and the companies to provide as much information on requirements to meet the Water Framework Directive (WFD) as early as possible under the second cycle of river basin management plans. We are aware that allowance needs to be made for this in the PR14 price review and for this to be a requirement in the forthcoming business plans. We would therefore want companies to include an appropriate financial allocation, based on information that we will be providing during the remainder of 2013, to meet the WFD requirements.

Question 48: What factors should we take into account in further developing our process for a risk-based review?

The Environment Agency has a duty to regulate the companies to ensure statutory environmental obligations are met. To discharge this duty we would need to assess the ability of the plans to meet statutory environmental standards directly with companies and yourselves when making their final determinations, in addition to our input to the Customer Challenge Group reports on the business plans.

Question 55: Do you agree with our preferred approach to financial incentives for network information reporting?

We agree that better network information will help companies manage networks more efficiently in the future. This would be in the companies' interests, and it could be argued that water companies shouldn't need incentivising to provide this data.

Nevertheless, the provision of this information will help water companies manage their existing networks more effectively if it is used to highlight differences in company's approaches and help the transfer of best practice.

The Drainage Strategy Framework that we are developing with you will help companies to obtain better information and understanding of the sewerage network and share this information.

We would welcome more detail to understand how the "network plus" and network management overlap link to the Drainage Strategy Framework. Open sharing of data will be useful in identifying best practice, agreeing strategic solutions and ensuring systems are resilient now and in the future. Therefore, we support the sharing of information.

Further information

Further information to this response can be obtained from Ian Barker, Head of Land and Water, by post at Environment Agency, Horizon House, Deanery Road, Bristol, BS1 5AH or by telephone on 01179 345075 or by e-mail at ian.barker@environment-agency.gov.uk

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