Water today, water tomorrow

Setting price controls for 2015-20 – framework and approach

A consultation

OFWAT

About this document

This document describes the methodology we propose to use to set price limits for water and sewerage services to customers for the five years from 2015 to 2020. We invite comments and submissions from interested parties to help us to develop and finalise our methodology for publication in summer this year.

Our proposed methodology has been developed following discussion and engagement with all our stakeholders, including:

- customers;
- companies;
- Government;
- other regulators; and
- environmental stakeholders.

It is based on the principles set out in our statement 'Future price limits – statement of principles' which was in turn, informed by extensive consultation and engagement with our stakeholders.

Since then, we have refined our proposals further through a range of informal and formal consultations, including our:

- 'Consultation on retail price controls for the 2014 price review'; and
- 'Consultation on wholesale incentives for the 2014 price review'.

The views and input we have received have been invaluable and we look forward to the continued engagement and involvement of all our stakeholders.

Our methodology recognises that the water and sewerage sectors face significant challenges, from the impact of climate change and volatile weather, to the need to meet the demands of a growing and changing population. A backdrop of difficult economic times challenges both customers, who might be struggling to pay bills, and companies who continue to need to raise investment to finance needed improvements in services.

Both the UK and Welsh Governments also recognise the challenges the sector faces, and both have developed their policies to help shape the future of the sector including the UK Government's Water White Paper and the Draft Water Bill. The Welsh Government has published its policy statement on water.

We are setting out a methodology that we will use to set price limits to support a sustainable water sector now and in the long term. It seeks to:

- improve on how we set price limits;
- support the UK and Welsh Government's policies for the sector;
- enable companies to innovate and meet the challenges they face; and
- protect the customers of today and tomorrow.

We invite comments on this consultation by **Tuesday 26 March 2013** and we describe how you can do this, as well as what other opportunities there will be to engage on the methodology in the chapter on 'Responding to this document' on page 10.

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Key messages

Delivering a better price setting process

- Our proposed methodology for setting prices builds on the successes of the past, and updates and modernises our approach to help tackle the new and emerging challenges faced by the water and sewerage sectors.

- We have developed our proposals with widespread engagement and input from all those who will be affected – from customers to companies, from Government to investors.

- Our methodology recognises and supports the policy goals of both the UK and Welsh Governments as set out in their respective policy statements.

Regulating for efficiency and growth

- Our separate retail price controls will give retail businesses greater incentives and focus on delivering efficient best cost services to business and household customers; they will also support the UK Government policy in England of allowing choice of retailer to business customers.

- We are safeguarding investment in the sector by allocating all of the existing assed base to the wholesale business, keeping the tried and tested tools in this price control including using the regulatory capital value (RCV) and indexation to the Retail Price Index (RPI) for the wholesale control; this will deliver the stability and returns that will allow the sector to continue to raise low-cost finance on the capital markets to fund investment.

- Our more targeted incentives, along with greater ownership by companies of what they deliver, will give greater scope for companies to innovate in delivery and boost efficiency.

A focus on customers

- We are putting ever greater emphasis on customer views and challenging all companies to develop business plans that deliver in the long term; the customer challenge groups we have required companies to set up will challenge them on this.

- By setting separate retail price controls, we will increase the focus of the retail businesses on their customers, improve the scope for innovation in delivery and the drive to keep costs down; our new retail price controls will not automatically increase retail costs to customers by inflation every year.

- To support the UK Government policy of giving business customers a choice of retailer we will reduce the regulatory burden on this segment of the market, freeing up companies to respond to the demands that their business customers make.

Ensuring sustainable water use

- Our wholesale price control gives companies greater responsibility and accountability for how they deliver outcomes; allowing them to find more innovative and sustainable solutions to managing our precious water resources.

- We are ensuring that companies are not biased towards using capital and carbon intensive solutions but can chose the best sustainable solutions, by changing the way we assess their costs.

- To proactively encourage more flexible and sustainable use of water, we are giving companies incentives to trade water, where that is the best thing to do for the environment and their customers, while at the same time, ensuring that their use of water remains sustainable.

Consultation questions

Throughout this consultation, we raise a number of specific questions, which we have summarised here. As well as responses to these specific questions, we welcome views from stakeholders on any of the issues we raise in this document.

Delivering what matters – an outcomes-focused approach

Q1 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)?

Q2 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?

Q3 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?

Defining retail (and wholesale) services

Q4 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?

Setting wholesale controls

For controlling wholesale revenues

Q5 Do you agree with our proposed scope for the wholesale water and wastewater controls, given the proposed scope of the retail business we have defined in chapter 3?
Are there any revenues of the regulated wholesale business you think should be excluded from this scope – if so, please give your reasons?

Q6 Do you agree with our proposal for a mixed revenue and revenue yield form of water wholesale control, including our proposed adjustment mechanisms to smooth allowed revenues within the control period? Are there any adjustments you would suggest?

Q7 Do you agree with our proposed simple revenue control for wastewater wholesale services? Do you have any evidence that suggests a revenue yield element should also be included?

Q8 How do you suggest we incentivise companies to prepare and update accurate demand assumptions to apply our proposed forms of wholesale control?

For cost assessment

Q9 Do you agree with our draft process for developing baselines? If not, how might it be improved?

Q10 What areas of expenditure do you consider we should exclude from the general cost assessment methodology (that is, advanced econometric models and econometric models)? How should we assess these costs?

Q11 What special factors should we consider for your company as part of our cost assessment? What criteria should we use to assess whether we need to take account of these in our view of your costs?

For cost performance incentives

Q12 Do you agree with our criteria for excluding costs from the general cost performance incentive framework? What types of costs should we exclude from the general framework? Please explain how these meet the cost exclusion criteria and how we should incentivise cost performance for these costs.

For cost recovery

Q13 At what point should we take the MEA values to split the 2015 RCV in order to set water and wastewater price controls?

Q14 Do you agree that it is possible to simplify our approach to calculating tax?

Retail controls for household customers

Q15 Should the ACTS be calculated on the basis of historic cost data or forecast cost data?

Q16 Do you agree with our proposed criteria for assessing other adjustments to the ACTS? Are there other factors we should take into account, and (if so) how?

Q17 Do you agree with our preferred option of applying an industry-wide adjustment to the ACTS for levels of metering?

Q18 How do you think we should apply the ACTS for those above the industry ACTS? Do you think that we should use a glide path and (if so) of what form?

Q19 How should we set a forward-looking efficiency challenge for those companies below the industry ACTS?

Q20 Do you think we should use a net margin to remunerate household retail invested capital and risk over the period 2015-20? How can we avoid over-recovery of returns and take into account any implicit margin that exists in the difference between efficient retail costs and the retail price?

Q21 Do you agree that we should retain the service incentive mechanism (SIM), in a modified form, to encourage good customer service for households?

Q22 Do you agree with our preferred option of funding additional water efficiency services and customer-side leaks through the wholesale control?

Retail controls for non-household customers

Q23 Do you agree with our preferred option of rolling over existing tariff structures to form default tariffs?

Q24 What are your views on our approach to customer churn under the proposed form of control for default tariffs?

Q25 What approach should we take to determine the aggregate level of operating costs to include in the non-household retail control? For example, should we use historic costs or forward-looking costs?

Q26 Do you think we should use a net margin to remunerate non-household retail capital employed and risk over the period 2015-20? How can we avoid over-recovery of returns and take into account any implicit margin that could exist in the difference between efficient retail costs and those used to set default tariffs?

Q27 What constraints, if any, should we place on companies' ability to set the gross margin levels for individual default tariffs for non-household customers?

Q28 Is there evidence that demonstrates that the costs of providing retail services to non-household customers are driven by uncontrollable changes in input prices? Are these difficult to predict? Given this, what is the appropriate approach in non-household retail controls for 2015-20 for uncontrollable changes in input prices?

Q29 Do you agree with our preferred option of setting the default tariff minimum service level using the existing GSS standards?

Q30 What aspects of service should we target in setting a service incentive for non-household customers in Wales?

Q31 Are there other options for setting an efficiency challenge for non-household retailers in Wales we have not considered? If so, what are they? Which approach do you think best meets our objectives?

Making better use of water resources

Q32 Do you agree with our preferred option for implementing water trading incentives?

Q33 What are your views on the sharing of export profits that the incentive should aim to deliver? Please provide your reasons and supporting evidence where possible.

Q34 What evidence should we take into account in setting incentive rates for importers (buyers) of water?

Q35 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.

Q36 Do you agree with our preferred option for implementing the AIM?

Q37 Do you agree with our preferred limit to the scope of the AIM?

Q38 What evidence should we take into account in calibrating the AIM?

Q39 What are your views on our proposed phased implementation of the AIM?

Overall incentives, risk and financeability

Q40 Do you agree we should develop the balance of our proposed incentives using initial quantitative analysis of notional companies, and refine the calibration of incentives to reflect individual companies' business plan proposals?

Q41 Do you agree that we should evaluate the overall risks relevant to each price control in assessing the allowed returns?

Q42 Do you agree with our broad approach to setting the WACC for wholesale services, given our proposals for the remuneration of retail services in chapters 5 and 6?

Q43 In setting the WACC are there specific considerations we should bear in mind taking account of the profile of relevant risks to wholesale service provision?

Q44 Do you agree with our broad approach to assessing financeability? Are there specific factors we should take account of in the next price control review?

Assessing performance during 2010-15

Q45 Do you agree with our preferred option of implementing adjustments for legacy tools through wholesale controls?

Q46 What factors should we take into account when determining whether to spread adjustments over the price control period?

Delivering price controls in 2014

Q47 What are your views on our emerging criteria for identifying high-quality business plans? Are there other criteria we need to consider?

Q48 What factors should we take into account in further developing our process for a risk-based review?

Q49 Is the timetable we propose for introducing menus feasible? How could we improve it? What can we and the companies do to address the challenges of the timetable to allow companies to make a real effective menu choice?

Building for price reviews in 2019 and beyond

Q50 Do you agree with our preferred scope for network plus?

Q51 Do you agree with our preferred option to implementing network plus?

Q52 Do you agree with our preferred scope for network management?

Q53 Do you agree with our preferred approach to implementing network management?

Q54 Given our objectives for network management reporting over the period, what questions should be included in the first round of reporting within business plan requirements?

Q55 Do you agree with our preferred approach to financial incentives for network information reporting?

Responding to this consultation

We welcome your responses to this consultation by **Tuesday 26 March 2013**. Around Easter 2013, we will publish a consultation on our approach to business planning for the next price review in 2014. Our decisions for the final methodology will be published in early summer 2013.

You can email your responses to stephen.beddoes@ofwat.gsi.gov.uk or post them to:

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If you wish to discuss any aspect of this consultation, please contact Stephen Beddoes on 0121 644 7759 or by email at stephen.beddoes@ofwat.gsi.gov.uk. We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

1. The overall framework

In 'Future price limits – statement of principles' (our 'FPL statement') we set out a principles-based framework to guide our approach to setting price controls in 2014 and beyond.

Our FPL statement set out a number of key changes to our approach, including:

- a greater focus on the outcomes customers want, and how well companies deliver for their customers;
- giving companies more ownership of, and accountability for, what they deliver; and
- targeting our price control regulation appropriately, in particular by setting separate controls for companies' wholesale and retail activities.

These principles are a central part of our approach to delivering our strategy of sustainable water. They are designed to improve the way we set prices, and the accountability of companies for delivery, to the benefit of customers throughout England and Wales.

After our FPL statement, we published the following consultations that explored how we might implement the principles when we set price controls in 2014.

- 'Consultation on retail price controls for the 2014 price review' (our 'retail consultation').

- 'Consultation on wholesale incentives for the 2014 price review' (our 'wholesale consultation').

Alongside these consultations, we have been engaging with stakeholders through workshops and one-to-one meetings. We have also tested a number of our proposals with our customer advisory panel (CAP), which we have appointed to advise on our approach to setting price controls.

At the end of December, we consulted on proposals to change companies' licences to allow us set separate retail and wholesale price controls, which is necessary to implement the methodology on which we are consulting. Our proposals would also commit companies to work with us to develop more targeted price controls in the future. All companies have accepted our proposals and we will amend their licences shortly.

This document continues our engagement on the methodology for the next price review. It confirms our direction of travel on key aspects of price controls for 2014, and sets out for consultation our preferred options on the packages of incentives we proposed in our retail and wholesale consultations.

We confirm our intention to set **two binding retail controls** for each company in 2014 – one for household customers and one for non-household customers.

We propose to tailor our approach to regulating non-household customers to reflect the different legislative and Government policy positions in England and Wales. We will set a single non-household control for each company, but the form of that control will be different for:

- companies that operate wholly or mainly in Wales (Dŵr Cymru and Dee Valley Water); and
- companies that operate wholly or mainly in England (all other appointed water and sewerage and water only companies).

We also propose to set **two binding wholesale controls** – one for water and one for wastewater. For both wholesale controls, we will continue to index price controls to the Retail Price Index (RPI), using an RPI ± K approach. We do not consider, however, that RPI indexation would be appropriate for the household or non-household retail controls.

These four binding controls make up the overall framework for setting the price and service package for all the appointed companies for each of the five years from 2015 to 2020. Together, these form one determination for each company. Within this framework, we propose to introduce new tools and incentives designed to improve the way our price determinations focus on:

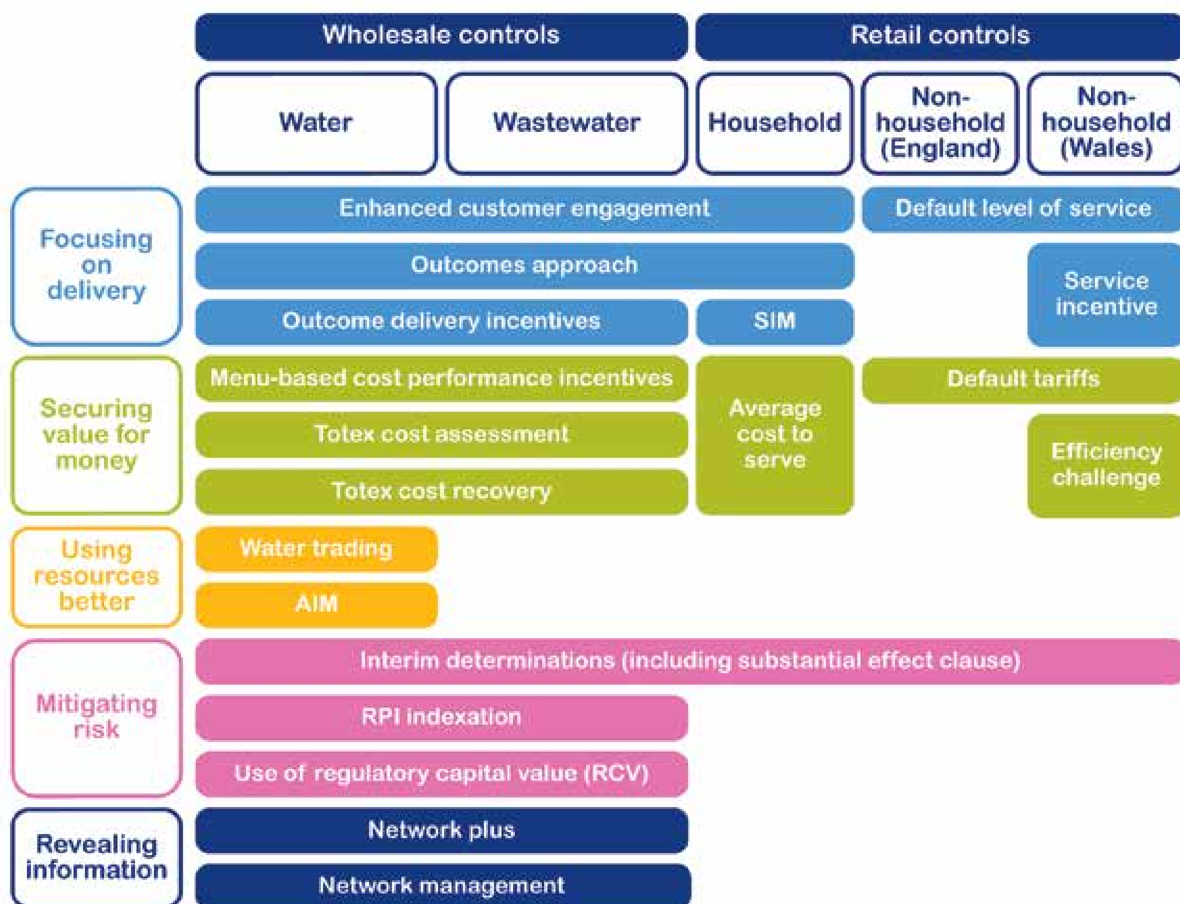
- **what companies deliver**; and
- securing **value for money**.

We also propose to introduce targeted incentives to encourage companies to make **better use of resources**. And, in line with our commitments in IN12/09, 'Update on the consultation on proposals to modify the conditions of appointment of all water and sewerage and water only companies' and our wholesale consultation, we propose to retain existing tools used to **mitigate risk** for them and their investors.

Finally, we want to take steps to improve the price control framework ahead of when we next set prices in 2019. So, we propose to introduce new tools to encourage companies to **reveal information** about their networks. We will develop these tools over the course of the next price control period (2015-20).

This package of tools and incentives makes up the core elements of our overall proposed framework for setting price controls in 2014 (see figure 1).

Figure 1 The overall proposed framework for setting price controls in 2014



Throughout this document, we set out some areas where we are confirming our direction following previous consultation, and some consultation proposals where we are seeking further responses before making our decision.

The overall framework – confirmed direction

We intend to set two binding retail controls in 2014:

- one covering each company's household customers; and
- one covering each company's non-household customers.

We propose to set two binding wholesale controls in 2014:

- one for the water service; and
- one for the wastewater service.

Each of these controls will cover the five-year period 2015-20.

1.1 Focusing on delivery

The first core element of our proposed overall price control package is the tools and incentives used to ensure companies focus on delivery for their customers.

In the past, we have made judgements on what companies should deliver. We want to change our approach so that companies:

- focus more on the outcomes customers want; and
- deliver for their customers in the long term.

We also want them to take more ownership of – and accountability for – what they deliver.

To do this, we have already embedded customer engagement in the business planning process. Each company and its Board now have a customer challenge group (CCG), which will challenge:

- the quality of their customer engagement; and
- how well their proposed outcomes and outcome delivery incentives reflect their customer engagement, and customers' views and priorities.

There are three broad stages to the process we are using to determine what companies should deliver.

- Company Boards will develop and propose outcomes and associated commitments and incentives that reflect their customers' views and priorities.

- The CCG will challenge the quality of companies' customer engagement and the extent to which the business plans put forward by their Boards reflect their customers' views, and provide an independent report to us at the same time as companies submit their business plans.

- We will make the final assessment of companies' outcome commitments as part of our risk-based challenge to companies' business plans and use the views of each CCG as a key input into this.

As well as ensuring companies' outcome commitments better reflect what their customers want and value, we also want to make sure they have the right incentives to deliver on those commitments.

In the past, our approach to this focused on requiring companies to deliver specific schemes, with penalties for non-delivery. We think this may have resulted in them adopting a risk-averse approach. It may have also reduced the scope for them to innovate and find better, more sustainable ways to deliver.

We propose to change this approach by introducing additional incentives to promote delivery of outcomes, based on the value of the outcomes delivered to customers. We are proposing to tailor our approach according to the nature of the outcomes being delivered. There will still be penalties for companies that fail to deliver, or where performance deteriorates. But where appropriate – and where justified by customers' willingness to pay – they will also be able to earn rewards for out-performance. In some circumstances, it may be appropriate to allow trade-offs between delivery incentives.

Rewards for out-performance will not be appropriate in all circumstances – for example, where customers do not value and are not willing to pay for out-performance. We expect companies to take account of:

- their customers' views;
- existing statutory standards; and
- the extent to which they can reliably measure performance in determining the incentives they propose.

In some situations, there will be benefits to using consistent incentives for delivery that would apply across all companies. In these cases, we could require them to use a particular incentive, or specify a 'minimum incentive'. This would give companies the option to adopt a more challenging incentive. Examples include:

- the service incentive mechanism (SIM), which has successfully driven improvements in customer service during 2010-15, and which we intend to continue to use for all household customers in England and Wales; and
- the abstraction incentive mechanism (AIM), which we intend to use as a minimum standard incentive to encourage more sustainable use of water.

Another area where we may set minimum standards is leakage targets. We intend to set out our proposals on leakage in a separate consultation.

We provide more detail on our outcomes-focused approach, and our approach to delivery incentives, in chapter 2.

1.1.1 Retail services for non-household customers

Customers that have the ability to choose their supplier will be able to choose the balance they want between service level and price. This creates a powerful incentive on companies to understand the needs of their customers, and to deliver services that meet those needs.

Currently, non-household customers in England that use at least five million litres – or megalitres (Ml) – of water a year and those in Wales that use at least 50Ml of water a year are allowed to change retail supplier. In the Draft Water Bill, the UK Government proposed to allow all non-household customers in England this choice.

As the competitive markets for retail services develop, we expect competitive pressures – both from new entrants and existing companies seeking a greater share of the market – to drive companies to provide the retail services their non-household customers want at competitive prices.

But the competitive market is not yet developed, and we will need to provide protection to customers in the short term. So, we propose to specify default tariffs – maximum prices for a minimum level of service (based on existing statutory standards) – that companies must offer to all non-household customers. As the market develops, we expect to be able to withdraw from regulating the provision of non-household retail services to customers, thus reducing the regulatory burden in this area.

Because most non-household customers in Wales will not have this choice, most of the pressure for improvements will not come from customers and entrants. So, we need to provide appropriate protection for these customers. We propose to do this through additional regulatory incentives to encourage companies operating in Wales to be more responsive to the needs of their non-household customers.

Focusing on delivery – confirmed direction and consultation proposals

Companies should develop and propose outcomes that reflect their customers' priorities and the value customers place on the outcome; company Boards are responsible for listening to their customers and for the proposals they submit to Ofwat

CCGs should challenge companies' proposals to ensure they reflect customer priorities and the value customers place on the outcome.

We will challenge companies' outcome and incentive proposals as part of our risk-based review of business plans – companies producing good plans that are well evidenced and reflect customers' priorities may receive a reduced level of scrutiny, but this will be a high hurdle reflecting the risks associated with this approach.

We are proposing to implement an incentives framework for outcome delivery that is:

- based on the value of benefits delivered to customers; and
- flexible depending on what companies propose; where appropriate – and where customer benefit is evidenced – companies may earn incentive rewards, as well as penalties, and trade-off penalties and rewards across outcomes.

We are proposing to use a modified version of the service incentive mechanism (SIM) for household customers in England and Wales.

We also propose to use incentives to encourage companies operating in Wales to improve the service they provide to non-household customers.

1.2 Securing value for money

The second core element of the overall price control is the tools and incentives used to secure value for money. These include the incentives created by the form of the wholesale and retail controls, as well as the specific tools and approaches illustrated in figure 1.

1.2.1 Wholesale controls

We will continue to set wholesale price controls that are indexed to the Retail Price Index (RPI), using an RPI ± K approach. This limits increases in companies' prices and (or) revenues to RPI ± K, where K is an annual adjustment factor we set in our price determinations. This will retain the stability and certainty that ensure the water and sewerage sectors can continue to attract low-cost financing in these parts of the value chain, which are relatively asset intensive. Within this familiar framework, we are making changes both to the way we calculate Ks, and to the revenue that is controlled by the RPI ± K limit.

These changes give more flexibility to companies in recovering the allowed revenues of the wholesale services concerned, and complement the ones we are making to how we regulate delivery for customers by:

- removing barriers on companies' ability to innovate and find new, sustainable solutions; and
- placing greater accountability with companies on **how** they chose to deliver for their customers.

For the water wholesale control, we propose to use an approach to controlling revenue that blends features of:

- a total revenue approach, which limits the total amount of revenue companies can collect from all customers; and
- a revenue yield approach, which limits the average revenue per unit of water delivered.

A key feature of this new approach is that it incorporates annual adjustment mechanisms, which adjust for differences in expected variable costs arising from differences between actual and expected demand and levels of metering. This removes the constraint on companies actively managing their revenue profiles (and hence customer bills) to deal with demand fluctuations within the five-year period, within the overall allowed revenue cap.

For the wastewater wholesale control, we propose to use a simple total revenue control.

This approach is the means by which we would ensure companies collect the appropriate amount of revenue needed to finance their activities. But we also need to decide what that appropriate amount of revenue is – we call this a company's **allowed revenue**.

When calculating allowed revenues for wholesale controls, we need to consider three key questions.

- Do the costs in companies' business plans represent the efficient costs of delivering the companies' commitments (**cost assessment**)?
- Where companies deliver their commitments for less (or more) than we assumed in price limits, how should those cost savings (or increases) be shared with customers in allowed revenues (**cost performance**)?
- How should the costs of longer-term spending commitments be shared between current and future customers (**cost recovery**)?

For 2015-20, we propose to make significant changes to the way we treat costs that will affect our approach to all three of these questions.

- We propose to use a total expenditure (totex) approach to cost assessment.
- We are consulting on using menus for cost performance in both water and wastewater.
- We propose that each company should propose the proportion of its expenditure to be recovered over the long term through its regulatory capital value (RCV). We will challenge companies' proposals, where required, through our risk-based review of business plans.

We provide more details on wholesale controls in chapters 3 and 4.

Wholesale controls – consultation proposals

We will continue to use the concept of the regulatory capital value (RCV) and an RPI ± K approach to setting wholesale controls.

We are proposing to adopt a new approach to revenue for the water and wastewater wholesale controls:

- a blend of 'total revenue' and 'revenue yield' controls for water; and
- a total revenue control for wastewater.

We are consulting on using a totex approach to cost assessment, and menus for incentivising cost out-performance in both wholesale controls.

We propose that each company should put forward how expenditure (and what proportion) should be added to its RCV taking into account the impact on its financeability. We will challenge these proposals, particularly for outliers beyond an acceptable sector range.

1.2.2 Retail controls

Our approach to setting retail controls differs fundamentally from our approach to wholesale controls; this reflects the different nature of the retail and wholesale businesses, and in particular the fact that retail activities use relatively few (and relatively short-lived) assets. That is why a price control based on a regulatory capital value (RCV) and index linked to RPI is not an appropriate form of control for these types of activities.

While we are making changes for the future, we confirmed in our FPL statement that we will allocate 100% of existing RCV – including all retail assets – to the wholesale control when we set price controls in 2014. This demonstrates our commitment to the stability and consistency of the regulatory framework.

We confirm our intention to set **two binding retail controls** for each company in 2014 – one for household customers, and one for non-household customers.

We propose to set retail controls that offer customers an appropriate level of protection on service and price, taking account of their ability to choose their supplier – both now and in the future. So, we are confirming our intention to use:

- an **average cost to serve** approach to set retail controls for all household customers in England and Wales; and
- a **default tariff** approach to set retail controls for non-household customers.

Our proposals for default tariffs in England assume that, in line with UK Government policy, non-household customers already have the ability to choose their retailer – or will have from 2017. Because of this, we do not think we need to introduce any additional price protection for these customers, and can reduce the burden of regulation.

We propose to adopt a different approach to setting default tariffs for non-household customers in Wales, most of which will not have a choice of retailer. So that we can continue to protect these customers, we intend to adopt additional safeguards for price and service.

We provide more details on retail controls in chapters 3, 5 and 6.

Retail controls – confirmed direction
We intend to use an average cost to serve approach to set retail controls for all household customers.
We intend to use a default tariffs approach to set retail controls for all non-household customers.
We will adapt the default tariffs approach to provide additional protection for non-household customers in Wales, which cannot choose their supplier.

1.2.3 Defining retail

We need to define clearly which activities and services are covered by the wholesale and retail controls. It is important to define retail activities so that costs are allocated properly both for:

- the purposes of setting appropriate retail and wholesale price controls; and
- to enable new entry into the contestable retail market.

Below, we set out our intentions on the activities and services that will be included in the retail business. The wholesale business is defined by exception – it includes all regulated activities and services that are not part of the retail business.

We provide more detail on the definition of wholesale and retail businesses in chapter 3.

Defining retail (and wholesale) services – confirmed direction

Define retail controls explicitly and wholesale controls by exception – all regulated services not in retail are in wholesale.

A consistent definition of retail activities and services across both retail controls.

Activities and services included in retail:

- billing;
- payment handling;
- all calls (non-network **and** network);
- debt management; and
- meter reading.

Activities and services split between wholesale and retail:

- meter installation, maintenance and repair included in wholesale, but with a role for the retailer in determining meter functionality and capability; and
- decisions on disconnection (and reconnection) included in retail, and the physical activity of disconnection in wholesale.

Activities and services excluded from retail (so included in wholesale):

- meter ownership; and
- trade effluent.

Potential role for third parties to carry out meter installations, meter maintenance and disconnections.

Defining retail (and wholesale) services – preferred options for consultation

Activities and services included in retail:

- demand-side water efficiency services; and
- customer-side leak repairs.

Activities and services split between wholesale and retail:

- developer services – customer-facing activities in retail, provision of connections in wholesale.

1.3 Using water resources better

We also confirm our intention to introduce new tools and incentives to encourage companies to make better use of water resources. The changes outlined here are aligned with and support clear UK and Welsh Government policies on sustainable use of natural resources.

As we explained in our wholesale consultation, the potential benefits of better resource use include:

- reduced costs;
- increased resilience of customers' water supplies; and
- reduced pressure on the environment caused by over-abstraction in water scarce areas.

To help deliver these benefits, we proposed to introduce incentives to:

- encourage efficient water trading; and
- reward or penalise companies depending on their levels of over-abstraction at the most environmentally sensitive sites (the abstraction incentive mechanism, or AIM).

In our wholesale consultation, we set out a range of options for implementing these incentives. Informed by consultation feedback, we have now decided to implement both water trading incentives and, on a phased basis, the AIM as part of the price control package for 2015-20.

We set out our preferred options for implementing the incentives below, and in more detail in chapter 7.

Using resources better – narrowing options and consultation proposals

We confirm our intention to introduce water trading incentives and the AIM as part of the price control package for 2015-20.

We propose to introduce water trading incentives for both buyers (importers) and sellers (exporters) of water.

We propose to introduce the AIM as part of the new price controls for 2015-20 (rewards and penalties do not take effect until 2016-17) in a simple form:

- covering abstraction sites where the risk of environmental damage from over-abstraction is greatest; and
- with rewards and penalties based on national data on the value of reducing abstractions.

1.4 Evaluating and mitigating risk

As we explained in our wholesale consultation, we also need to understand how all of the elements of the different price controls work together as an overall package. This will help us to make sure that incentives are properly balanced and calibrated, and that the overall balance of risk and reward that companies face is appropriate.

Our initial view is that, on balance, the changes we are introducing do not change significantly the overall balance of risk and reward that companies face – indeed, some enhance their ability to manage their own risks. This is because our proposals include new complementary tools designed to mitigate significant risks faced by companies.

We set out our preliminary assessment of risks in more detail in chapter 8. Our work in this area is ongoing and will continue throughout the price setting process.

Our approach to remunerating risk will depend on:

- the calibration of our overall incentive package;
- companies proposed commitments;
- choices of incentive rates through their business plans; and
- our use of menus.

We have a statutory duty to ensure that an efficient company can finance its functions. We interpret this duty as applying to the ring-fenced regulated activities of the appointee, and the approach we intend to take is to seek to ensure an efficient company can:

- earn a return at least equal to our allowed costs of capital – through net retail margins and wholesale returns relative to the WACC; and
- raise finance on reasonable terms.

We had already committed to allow companies to earn a return on their RCV as part of the wholesale controls, although we are thinking carefully about how we will do this. But our initial view is that a return on capital approach for setting allowed returns for retail controls is inappropriate. So, we propose to remunerate retail capital employed and risks through the margin associated with our price controls.

As well as reflecting returns in each price control, we propose to carry out key financeability tests and ratios using aggregations of the revenues, costs and cash flows associated with the regulated activities across price controls. We are carrying out further work on what we will expect companies to submit within their business plans.

Evaluating and mitigating risk – consultation proposals

Our preliminary view on the overall price control package is that there will not be a significant change to the overall balance of risk and reward.

We propose using a net retail margin to remunerate retail risks if appropriate and will continue to use a weighted average cost of capital (WACC) approach to remunerating wholesale risks.

We propose assessing financeability at the whole business level, targeting financial ratios that are consistent with a comfortable investment grade credit rating.

1.5 Assessing historic performance

We confirmed in our FPL statement that we intended to uphold commitments we made at the 2009 price review, and that position has not changed. When we set price controls in 2014, our main focus will be on companies' projections for 2015-20. But some decisions we made at the 2009 price review will also impact on our determinations for 2015-20. In particular, we will need to:

- reconcile companies' actual performance in 2010-15 with the projections we made at the 2009 price review; and
- apply incentive rewards or penalties arising from incentives we set out at the 2009 price review.

We also need to consider how best to reflect adjustments resulting from incentives set in 2009 (and performance in 2010-15) within the new framework of price controls for 2015-20.

We provide more detail on our approach to assessing (and adjusting for) historic performance in chapter 9.

Assessing historic performance – confirmed direction

We confirm our intention to implement commitments made at the 2009 price review.

We will make any decisions to spread adjustments across the price control period on a case-by-case basis.

1.6 Delivering price controls in 2014

As set out in more detail in chapter 10, this consultation is the first stage in developing the detail of the methodology for the 2014 price review. It sets out our preferred approach for setting price controls in 2014, confirming our direction of travel on key aspects of the controls. It provides companies with a platform for engagement with their stakeholders over their plans for 2015-20 and beyond.

This document does not try to set out our detailed approach to each of the tools and incentives in our proposed framework. We will continue to engage on implementation issues during this consultation; in particular, we will look to engage further on our approach to:

- cost assessment and cost performance;
- the assessment of companies' business plans;
- assessing the overall package and risks facing companies;
- the detailed design and calibration of water trading incentives and AIM; and
- network management information reporting.

We will consult further on these implementation issues, using a mix of working papers and workshops alongside a further consultation on the business planning process for the 2014 price review.

Responses to these consultations – as well as our ongoing stakeholder engagement – will help develop our final methodology, which we intend to publish in early summer 2013.

1.6.1 Reviewing business plans

In both our FPL statement and 'Delivering proportionate and targeted regulation', we committed to taking a risk-based, targeted and proportionate approach to reviewing companies' business plans in 2014.

This **risk-based review** process is intended to incentivise high-quality business plans, based on effective engagement with customers and the efficient costs of delivery. As part of that, we are committed to focusing our challenge where it really matters.

The risk-based review process will involve a limited number of assessment criteria, including comparisons between companies where appropriate. We think it is right for those that produce high-quality business plans to receive a reduced level of scrutiny of their proposals. But at the same time, we need to fulfil our statutory duties to customers and the environment. So, there will be an appropriately high bar before companies earn reduced scrutiny of their business plans.

We will consult separately on our expectations for companies' business plans and our approach to reviewing them.

Delivering price controls in 2014 – key next steps

This document sets out our framework for setting price controls in 2014. We will publish another consultation on business plan requirements around Easter 2013.

We expect to publish our final methodology in early summer 2013.

1.7 Building for future price controls

We have taken a measured approach to introducing changes for the 2014 price review. This reflects our view of the risks and practicality of implementing some of the options we proposed in our wholesale and retail consultations.

We expect the price control framework to evolve over time as our new approach beds in, as existing markets develop, and as the reforms proposed by the UK Government in the Draft Water Bill are implemented. For example, there may be scope:

- to reduce the extent of regulation as the competitive retail market develops; and
- for greater use of rewards for exceeding customers' expectations as companies' understanding of the value customers place on outcomes improves.

As well as these general improvements to the framework, in our wholesale consultation we also proposed the following tools designed to encourage companies to **reveal information** about their networks so that we can plan for the future improvements to regulation.

- The **network plus incentive** – designed to reveal information about costs and revenues related to companies' network and treatment activities.

- The **network management incentive** – designed to reveal information about companies' network management policies, practices and cost drivers.

We have decided use a phased approach to introduce these tools 2015-20. This decision reflects our view of the risks and practicality of implementing these tools.

We set out our preferred options in more detail in chapter 11.

Building for future price controls – consultation proposals

We propose introducing enhanced reporting for network plus during the next price control period (2015-20), by:

- enhancing accounting separation (through a requirement on companies to implement separated revenue accounting); and
- based on that, introducing reporting against non-binding sub-limits for both water and sewerage.

We propose to introduce enhanced reporting on network management for the next price control period (2015-20):

- covering water- and sludge-related activities;
- focused initially on companies providing information about their current practices and policies through responding to questions within the business plan; and
- evolving over the next price control period (2015-20) to support more consistent reporting on network management activities and cost drivers.

2. Delivering what matters – an outcomes-focused approach

2.1 Summary

In our FPL statement and wholesale consultation, we explained why we want to move away from our previous output-focused approach to delivery and towards an approach based on outcomes. The main advantages of an outcomes-focused approach are that it:

- focuses companies more on what their customers want and reduces dependency on the regulatory framework;
- encourages companies to focus on longer-term planning, which will help deliver better solutions to customers at lower whole-life cost;
- allows companies greater freedom to innovate and find more sustainable solutions; and
- reduces the regulatory burden.

Delivering this new outcomes-based approach involves changes to the process for determining companies' commitments – including a greater focus on what customers value and are willing to pay for – and giving companies more ownership of and more accountability for what they deliver. We also want to ensure companies face appropriate incentives to deliver on their commitments.

To give companies more ownership of what they deliver, we want them to develop and propose in their business plans outcomes and **outcome delivery incentives** that reflect their customers' views and priorities. We expect CCGs to challenge companies on the quality of their customer engagement, and how well their proposed outcomes and delivery incentives reflect the results of this and the value customers place on different outcomes.

In evaluating companies' business plans, we will need to take a view on their proposed outcomes – and the associated incentives – to ensure they deliver value for money and benefits for customers. This will be a key part of our risk-based review of business plans. We expect companies to provide clear evidence that their proposed package of outcomes and delivery incentives aligns with customer priorities, and to set out the benefits it should deliver for customers.

The CCGs' view of how well companies engaged with their customers, and how well plans reflect the results of this engagement, will form part of our assessment of each company's business plan. If the CCG tells us that a company's approach was poor, we are more likely to need to step in to scrutinise and challenge what that company proposed in greater detail.

We are proposing that companies' outcome delivery incentives should be value based. We think this would best incentivise them to deliver what matters most to their customers.

To help companies select the appropriate form of value-based outcome delivery incentive, we are consulting on a flexible framework that allows – where appropriate, and justified by benefits to customers:

- financial and non-financial incentives;
- incentive rewards, as well as penalties for non-delivery; and
- in certain circumstances, trade-offs between performance against different deliverables.

The onus is on companies – and ultimately each company's Board – to ensure they provide well-evidenced proposals that demonstrate the benefits to customers from their proposed package of outcomes and delivery incentives.

Below, we summarise the main elements of our proposals.

Determining outcomes and outcome delivery incentives – confirmed direction

Companies develop outcomes based on customer engagement, and propose a package of performance commitments in their business plans. company Boards are responsible for listening to their customers and for the proposals they submit to Ofwat

Companies also develop and propose a package of outcome delivery incentives.

CCGs challenge (and report to Ofwat on):

- the quality of companies' customer engagement; and
- how well companies' proposed outcomes and outcome delivery incentives reflect their customer engagement, and customers' views and priorities.

We will challenge companies' outcome (and incentive) proposals where required – this forms a key part of our risk-based review of business plans.

Framework for outcome delivery incentives – preferred options for consultation

Outcome delivery incentives should be based on the value customers place on the outcome.

A flexible framework for the form of outcome delivery incentives that allows, where justified by benefits to customers:

- financial and non-financial incentives;
- penalty only, and rewards and penalties; and
- trade-offs where benefits to customers are well evidenced.

Outcome delivery incentives that are binding over the 2015-20 price control period.

Some consistent incentives, or minimum performance levels (across all companies), will be part of companies' outcome packages.

2.2 Determining outcome delivery incentives

The process we are using both to determine companies' outcome commitments and outcome delivery incentives has three broad stages.

- In their business plans, companies will develop and propose a package of **outcome performance commitments** that reflects customers' views and priorities. They will also propose **outcome delivery incentives** alongside this.

- **CCGs** will challenge companies on their customer engagement, and provide an independent assessment report to us on the quality of that engagement.

- We will make the final assessment of companies' proposals as part of our risk-based challenge to companies' business plans and use the views of each CCG as a key input into this.

Our customer advisory panel (CAP) told us that we should be clear about the:

- process we will follow in assessing outcomes; and
- roles of all parties (including companies, CCGs and us) in that process.

We agree with this view. Below, we set out our preferred approach and our expectations for each stage of the process.

2.2.1 The role of companies

Companies' Boards are responsible for the content of their business plans. They will need to ensure that their proposals are robust, well evidenced and reflect customers' views and priorities. Business plans will need to set out:

- the proposed package of outcomes they will deliver;
- the measures they will use to demonstrate delivery of those outcomes – and the committed levels of performance they will deliver against those measures; and
- their proposed outcome delivery incentives.

Each company's proposed package should reflect their customers' views and priorities. Companies should be able to demonstrate that they understand the value their customers place on the delivery of particular outcomes. They should also be able to demonstrate that the outcomes package they are proposing balances price and service in a way that best delivers what their customers want.

We expect companies to have carried out willingness to pay surveys and collected other forms of evidence to back up their proposals, where appropriate. This could include studies of customers' actual behaviour (revealed preferences), as recommended in 'The use of revealed customer behaviour in future price limits'.

For each of their proposed outcomes, we expect companies to specify the measure (or measures) they will use to demonstrate delivery of that outcome. For each performance measure, they will also need to specify the level of performance they are committing to achieve – their **committed performance level**.

In determining their committed performance levels, companies should consider the related costs and benefits, building on the cost-benefit analysis carried out at the 2009 price review. And they should also consider recent developments in this area, such as UKWIR's 'Carrying out Willingness to Pay Surveys' and 'Review of Cost-Benefit Analysis and Benefit Valuation'.

Committed performance levels should be cost-beneficial – the expected marginal benefits of improved outcomes should be more than the marginal costs of delivery. Companies may commit up to a level of performance that represents the economic level of service (that is, where marginal benefits equal marginal costs), within an acceptable and affordable overall plan.

We expect companies to be able to demonstrate that their:

- proposed measures are appropriate to the outcome;
- committed performance levels provide the best value for customers – this will include providing appropriate information on both marginal costs and benefits to justify their proposals; and
- proposed outcome delivery incentives align with the framework we set out in more detail below.

Companies' outcome delivery incentives will also need to reflect our approach of setting separate price controls for wholesale and retail activities. This is particularly the case for any financial incentives proposed by companies – where they will need to propose whether the incentive will be applied through the water wholesale, wastewater wholesale or the household retail control.

There may be situations where customers would benefit by companies proposing outcome commitments that depend on activities undertaken by third parties or governed by different price controls. We expect companies to propose that the incentive is applied through one control, and make contractual or other arrangements between the wholesale and retail areas, or with a third party, to deliver on the outcome commitment.

We discuss the need for agreed arrangements between the management of wholesale and retail activities further in chapter 4.

2.2.2 The role of CCGs

We expect CCGs to challenge companies on the quality of their customer engagement, and how well that engagement has led to customers' views and priorities being reflected in their business plans. In particular, we expect CCGs to focus on challenging whether companies' proposed outcomes and incentives:

- are an appropriate response to their customers' views, reflecting their priorities and the value they place on the different aspects of service they receive;
- strike a reasonable balance between the views of different customers and stakeholders; and
- are part of an overall final business plan that appears likely to be acceptable to most customers.

CCGs will submit a report to us alongside companies' business plans. In the report, each CCG should set out their views on companies' plans, including how they have responded to any challenges the CCG raised on the quality of the company's engagement with customers and highlighting any outstanding concerns.

CGGs will also then have important roles to play in challenging any revisions to companies' proposals once we have published our draft determination for each company. We discuss this in more detail in chapter 10.

2.2.3 Our role

The first stage of our risk-based review of companies' business plans is to examine their proposed outcomes and outcome delivery incentives. We discuss our approach to business plans in more detail in chapter 10.

The views of each CCG will be a key input into this assessment. But we will also need to consider how well companies' proposals reflect value for money for customers. Where appropriate, we will make use of comparisons between companies in reaching our view.

If companies provide robust and well-evidenced plans, we are more likely to accept their proposed outcomes and delivery incentives without in-depth challenge. But where necessary, we will ask them to provide further justification for their proposals, or make changes to them.

We also think there are some situations where there are benefits to using consistent incentives for delivery that would apply across all companies. In such cases, we propose that we could require companies to use a particular incentive, or specify a minimum standard of incentive. This would give them the option to adopt more stringent incentives.

We are currently proposing to use consistent incentives for delivery in the form of the:

- **service incentive mechanism (SIM)**, which we intend to continue for all household customers in England and Wales; and
- **abstraction incentive mechanism (AIM)**, where we consider it is appropriate to apply a minimum standard incentive that we can use to compare companies' performance.

We set out our proposals on the use of the SIM (and other retail incentives) in chapter 5 and on AIM in chapter 7.

Another area where we may set minimum standards consistently in the sector is for leakage targets. We intend to set out our proposals on leakage in a separate policy consultation later this year.

2.3 Framework for outcome delivery incentives

When taking decisions on the appropriate outcome delivery incentives, it is necessary to consider the:

- **strength** of the incentives – including how any financial incentives should be calculated;
- appropriate **form** of the incentives – including whether (and, if so, when) there should be financial consequences for over- or under-delivery; and
- **duration** of incentives – including whether they could span more than one price control period.

In our review of companies' proposed outcome delivery incentives, we will look at these aspects of their proposals. The rest of this section sets out the high-level principles we expect companies to follow in developing their proposals.

2.3.1 Strength of incentives

A key consideration in setting the strength of financial outcome delivery incentives is whether to base them on value or cost.

In our wholesale consultation, we said that a value-based approach was our preferred basis for any financial delivery incentives companies propose. Outcomes are about delivering what is important to customers and value-based incentives focus their efforts where they matter most to customers. And when combined with cost performance incentives, they incentivise companies to deliver the most value to customers at the lowest cost.

Respondents to the consultation were split on the use of value-based incentives – raising questions about both the suitability of value-based incentives compared with cost-based ones and the feasibility of applying value estimates to outcomes. The CAP agreed with our preferred approach, noting that willingness to pay should inform the value of future rewards and penalties.

Our view remains that companies should be incentivised to deliver what matters most to customers. This is best done through a value-based incentive. Some stakeholders were concerned about the feasibility of value based incentives. But we consider that companies have sufficient experience and understanding to make our preferred approach work. Companies can build on the cost-benefit analysis undertaken at the 2009 price review and recent developments in this area, such as UKWIR's 'Carrying out Willingness to Pay Surveys' and 'Review of Cost-Benefit Analysis and Benefit Valuation'.

Outcome delivery incentives will need to be carefully calibrated with other incentives in the overall package – including, in particular, any incentives to reduce costs. This calibration is necessary to ensure that customers are fully recompensed for under-delivery and companies are not penalised – or rewarded – twice.

We set out our proposed approach to cost performance incentives in more detail in section 4.4.2.

Calibrating proposed delivery incentives should also take into account the incentives that other regulators, such as the Environment Agency or the Drinking Water Inspectorate, have put in place for statutory requirements the companies should meet. We do not intend that their proposed outcome delivery incentives should add

additional penalties, or rewards, where existing incentives already adequately address the value lost, or gained, from under- or over-delivery.

2.3.2 Form of incentives

In our wholesale consultation, we set out a range of possible options for the form of outcome delivery incentives, based around different combinations of:

- financial and non-financial incentives;
- incentives with rewards and penalties, as well as penalties only; and
- allowing (or dis-allowing) trade-offs between performance on different outcomes.

In response, some stakeholders said they had a preference for one of the options, but others said that we should use the best approach to suit the circumstances of any particular outcome, and any single option would not be appropriate for all outcomes.

The CAP noted that proper design of delivery incentives was central to protecting customers, and that our incentives should not discourage companies from adopting ambitious goals.

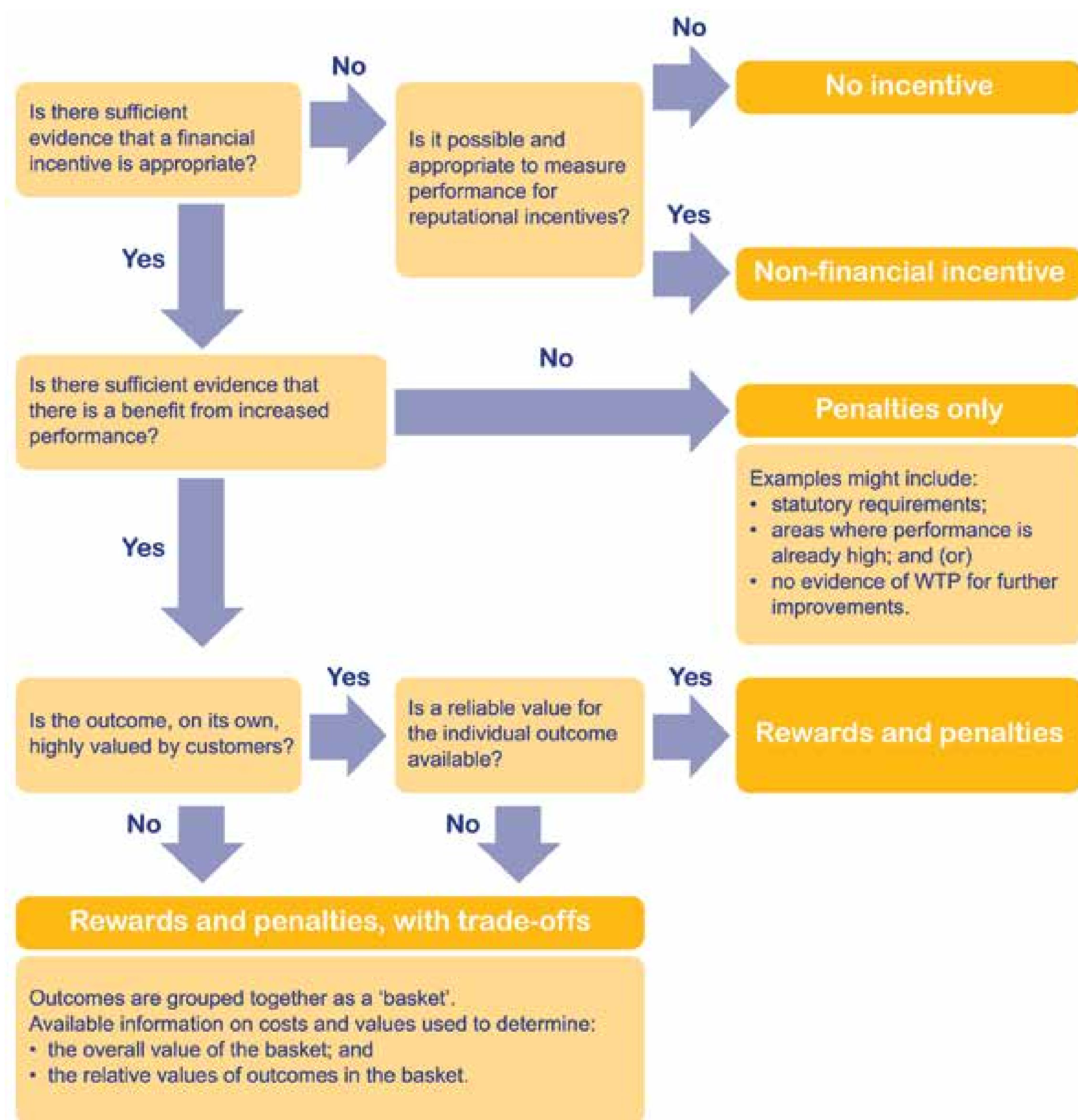
We have listened to stakeholders' views, and agree that it may not be appropriate to adopt a 'one size fits all' approach to the form of outcome delivery incentives. Instead, we propose to adopt a flexible approach that permits companies to put forward a mix of different forms of incentives that reflect the particular characteristics of the outcomes they are proposing to deliver.

When deciding on the most appropriate incentive to propose for an outcome, companies should consider:

- how important the outcome is to customers;
- the quality of data on the costs and benefits associated with the outcome and the value customers place on the outcome;
- how clearly the costs, benefit and value can be identified as belonging to just that outcome; and
- how accurately the company can measure successful delivery of the outcome.

Figure 2 below summarises the approach we expect companies to follow when selecting the appropriate incentives for their outcomes.

Figure 2 Framework for outcome incentives



We expect companies to explain clearly their decisions around the forms of incentive they propose and the reasons for their decisions. We also expect them to demonstrate:

- how their proposals will benefit customers; and
- why their proposed incentives are the best way to secure delivery of their outcomes and value for money for customers.

We explain some of the key issues companies will need to address for each type of outcome delivery incentive in table 1 below.

Table 1 Forms of outcome delivery incentives – summary

Form of incentive	Our expectations
Non-financial incentive	Companies should propose using non-financial delivery incentives where it is not practical to measure outcome delivery or the necessary data to set a financial incentive is not available.
Penalties only	Companies should propose penalty-only incentives where customers are unwilling to pay for improvements beyond the committed performance level, for example where: · statutory requirements are set at or beyond the level that customers are willing to pay; or · the customer value of delivering the committed level is significant but reduces rapidly beyond that level. Companies should set out the value that customers would lose at different measureable steps below the committed performance level, and will need to demonstrate how their proposed incentive will work to ensure that the value lost is returned to customers.
Rewards and penalties	Companies should consider proposing incentives that allow for both penalties and also for rewards where they can demonstrate that customers are willing to pay for a company to go beyond its committed performance level. An example might be where customers are willing to pay for a higher level of service than a company's committed performance level, but at the time of developing its business plan the company does not consider it can deliver the desired improvements cost effectively. If the company finds a more cost-effective way to deliver improvements during the price control period, a reward would incentivise a company to go beyond its committed level, to the benefit of customers. Companies will need to demonstrate that their proposed rewards for over-delivery (and penalties for under-delivery) reflect the value that customers place on the higher (and lower) levels of service.

Rewards and penalties, with trade-offs	Trade-offs group together a set of outcomes, allowing companies to avoid a penalty for under-delivery on one outcome within the set by over-delivering on a different one. We recognise that trade-offs might allow companies to adopt better, more innovative approaches to delivering some outcomes, but they can also weaken the incentives on companies to deliver. We expect it to be acceptable for companies to propose trade-offs where: ▪ there is a single, inseparable willingness to pay for a group of outcomes or measures of success for a given overall outcome; ▪ different outcomes are delivered by a high proportion of shared activities and so there are significant joint costs; or ▪ there are multiple interdependent milestones relevant to delivering against different outcomes. Companies will need to demonstrate that they have clear and robust support from customers for their trade-off proposals and that any weighting of outcomes within the set reflects the relative value customers place on the different outcomes. We do not expect companies to propose trade-offs: ▪ where customers highly value a particular outcome in its own right and the incremental costs and data associated with the outcome are robust; or ▪ for outcomes related to statutory requirements.

As part of our risk-based review of companies' business plans, we will need to take a view on the appropriateness of their proposed commitments and incentives. As well as looking at whether the commitments interact with the incentives in an appropriate way, we will be particularly alert to:

- companies proposing non-financial delivery incentives where a penalty-only incentive might be more appropriate – for example, where an outcome is important to customers;
- companies proposing incentive rewards where there is insufficient evidence that customers value over-delivery; and
- inappropriate use of trade-offs to limit companies' exposure to particular outcomes.

2.3.3 Duration of incentives

We want to provide an overall price control framework that encourages long-term sustainable planning. But to do this effectively we need to consider the framework as a whole, and not simply look at the individual tools and incentives within the framework in isolation.

A number of other elements of the price control framework are designed to help encourage this long-term focus. These include:

- our continued commitment to regulatory mechanisms to mitigate risk – for example, interim determinations, indexing wholesale price controls by RPI and managing demand risk through the form of wholesale controls;
- our commitment to remunerate the right, efficient investment to provide companies with certainty to plan for the future and respond to changing circumstances;
- encouraging companies to engage better with their customers – an important part of this process is testing how to balance long-term needs against short-term priorities; and
- balancing incentives – for example, through our changes to the way we treat wholesale costs and our proposed new targeted environmental incentives.

This will encourage companies to think about the full range of solutions, rather than those with the best short-term payback within the regulatory rules.

Other processes that are not part of our price control framework, including statutory frameworks such as Water Resource Management Plans and industry best practice such as asset management frameworks, also encourage long-term thinking.

The outcomes-focused approach is another part of the overall framework that contributes to encouraging a long-term focus. In particular, an outcomes-focused approach gives companies more flexibility to determine how they deliver their commitments. Flexible use of incentive rewards should also encourage them to make more progress towards long-term performance goals, where those goals are in line with customers' priorities.

We also considered a number of different ways in which we could commit explicitly to outcomes and associated milestones and incentives across multiple price control periods (see table 2 below).

Table 2 Options for long-term outcome delivery incentive commitments

Option	Description
Option 1 – regular short-term incentives	Assess delivery when companies reach each outcome milestone and apply incentives that reflect their performance over the period defined by the milestone. Companies would receive either a reward or penalty when they reach each milestone. When the end of the outcome delivery period is reached, we would apply an incentive that reflects performance over the period since the most recent milestone (that is, there would be no overall incentive applied to the achievement of the outcome).
Option 2 – one-off assessment at end of agreed timescale for outcome delivery	Only assess delivery and apply an incentive at the end of the agreed timescale for outcome delivery. We would not apply any interim incentives; any milestones the company sets would only be for the monitoring of delivery. Alternatively, we might apply non-financial incentives at interim milestones, but financial incentives only at the end of the agreed outcome timescale.
Option 3 – short-term incentives with end of outcome true-up	Assess delivery when companies reach each milestone and apply incentives that reflect performance over the period defined by the milestone as option 1. We would, however, also assess delivery at the end of the agreed period for achieving the outcome as option 2 and apply an incentive that reflects performance over the entire period. This final, long-term incentive would be adjusted (trued-up) to account for any over- or under-delivery earlier in the outcome period.

Setting regulatory commitments to delivery incentives that apply to companies' commitments across multiple price control periods (using either option 2 or 3, assuming there are shorter-term milestones available in option 1) would require:

- companies to provide good-quality business planning data that is likely to remain relevant over a long period of time in the future; and
- delivery incentive mechanisms that allow for changes – for example, where outcome commitments become irrelevant or impossible to achieve, customer priorities change, or there are significant changes in legislation or technology that impact on delivery.

We think it is unlikely that either of these requirements can be delivered before we set price controls in 2014.

As a result, our preferred approach is to use outcome delivery incentives that are binding for the 2015-20 period only. We think that the other measures within the overall control framework will be sufficient to encourage long-term planning.

That said, we do not want to rule out using approaches based on options 2 and 3 in the future. We welcome views on these options, and the feasibility of adopting them for the 2015-20 period and beyond.

Companies may, however, wish to propose outcome commitments with a measure of performance for delivery over more than one price control period, consistent with their own longer-term planning horizons. We are willing to work with them to pilot such longer-term targets. This is because they could provide useful data and experience to support decisions on introducing longer-term incentives from 2020.

2.4 Consultation questions

Delivering what matters

Q1 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)?

Q2 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?

Q3 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?

3. Defining retail (and wholesale) services

3.1 Summary

In our FPL statement, and our wholesale and retail consultations, we explained why we wanted to better target our price controls – in particular, by setting separate controls for companies' wholesale and retail activities.

The advantages of setting separate controls are:

- better, more effective incentives for retail businesses that are distinct from those that apply to the much larger wholesale businesses;
- an increased likelihood that retailers will place efficiency pressures on wholesale businesses; and
- that they support and facilitate the development of the proposed competitive market for retail services to non-household customers.

In chapter 4, we explain that we propose to set separate wholesale controls for water and wastewater. In chapters 5 and 6, we explain that we propose to set two retail controls:

- one covering each company's household customers, using an average cost to serve approach; and
- one covering each company's non-household customers, using a default tariffs approach.

Before we discuss these controls in more detail, this chapter first sets out our proposals on the definition of retail services (and by exception, wholesale services).

We are confirming the proposals set out in our retail consultation to define:

- the activities and services associated with retail controls explicitly; and
- wholesale activities and services by exception – all regulated activities and services that are not part of retail are defined as being part of wholesale.

We have decided to adopt a consistent definition of retail activities and services across both retail controls. We think this will reduce complexity and the potential for inappropriate discrimination and may also realise spill over benefits from the contestable market to customers without choice.

We set out our rationale for each allocation in section 3.2.

Below, we summarise the main elements of our proposals.

Defining retail (and wholesale) services – confirmed direction

Activities and services included in retail:

- billing;
- payment handling;
- all calls (non-network **and** network);
- debt management; and
- meter reading.

Activities and services split between wholesale and retail:

- meter installation, maintenance and repair included in wholesale, but with a role for the retailer in determining meter functionality and capability; and
- decisions on disconnection (and reconnection) included in retail, and the physical activity of disconnection in wholesale.

Activities and services excluded from retail (so included in wholesale):

- meter ownership; and
- trade effluent.

Potential role for third parties to carry out meter installations, meter maintenance and disconnections.

Defining retail (and wholesale) services – preferred options for consultation

Activities and services included in retail:

- demand-side water efficiency services; and
- customer-side leak repairs.

Activities and services split between wholesale and retail:

- developer services – customer-facing activities in retail, provision of connections in wholesale.

3.2 Defining retail (and wholesale) services

In our retail consultation, we explained why we wanted to define retail activities and services explicitly, and that it was sensible and pragmatic to define wholesale activities and services by exception (with all activities and services not included in retail being part of wholesale unless explicitly excluded by the licence). Respondents supported this approach, and so we are confirming this proposal.

We also sought views on whether we should use different definitions of retail for each of our two proposed retail controls. We explained that there were arguments against adopting separate definitions of retail for each of our two proposed retail controls – complexity, potential for inappropriate discrimination, and the impact on 'spill over' benefits.

In our retail consultation, we provisionally concluded that it would be more appropriate to adopt a consistent definition across both retail controls. The responses we received have not caused us to change our view. So, we have now decided to adopt this proposal. We consider this will reduce complexity and the potential for discrimination. For example, it will eliminate the potential for different wholesale charging arrangements for the contestable and non-contestable elements of the retail business. It may also realise spill over benefits from the contestable market to those customers that cannot choose their supplier.

The definitions of wholesale and retail services we now propose would apply at the start of the 2015-20 period. But the way in which retail competition has developed in the water sector in Scotland suggests that, over time, we may need to make changes to the services included in retail to deliver the best outcome for customers.

We intend to keep under review how well the proposed definitions are working. If we decide that we need to make changes to the definition of retail activities and services, we will need to ensure that any changes do not disadvantage companies by adjusting for any change in costs covered by the retail and wholesale controls.

In our retail consultation, we also set out a range of activities and services that could be included as part of retail. Below, we explain where we have come to a final position on these activities and services – and where we are still consulting on preferred options.

3.2.1 Activities and services confirmed as included in retail

We consulted on our provisional view that the following activities and services – all of which involve a high level of direct interaction with the customer – should be included in retail:

- billing – calculating, processing, printing and dispatching bills;
- payment handling – processing all payment types;
- non-network calls – receiving customer contacts for issues such as tariffs, charging and bills;
- debt management – the recovery of debt owed by customers; and
- meter reading.

All respondents that expressed a view supported including these activities and services in retail. So, we are now confirming our provisional view for the reasons given in our retail consultation: all these activities and services will be included in retail.

We also sought views from stakeholders on whether we should include **network calls** – that is, contacts from a customer regarding a network issue, including things like low pressure, discoloured water or sewer flooding – in retail. Stakeholders expressed a range of views. For example:

- most companies favoured including network calls in wholesale. Reasons for this varied, but included allowing wholesalers to understand customers' network issues directly, and the potential risk of discouraging retailer entry; and
- the resounding view of customers – including the CAP and the business customer forum – is that they want a single point of contact for all queries.

There are benefits – and potential problems – arising from including network calls in either retail or wholesale. On balance, we think that the benefits to customers of a single point of contact outweigh the risks, complexity and costs associated with including network calls in retail. So, we have decided to include network calls in retail.

3.2.2 Activities and services confirmed as excluded from retail

We consulted on our provisional view that monitoring trade effluent compliance should be excluded from retail. We considered that this is an activity that the wholesale business is likely to be primarily concerned with since it will bear the risk of customers not meeting their trade effluent requirements.

A significant majority of respondents supported this approach. We have decided to confirm our provisional view for the reasons give above monitoring of trade effluent compliance will **not** be included in retail, so it will be included in wholesale.

3.2.3 Activities and services confirmed as split between wholesale and retail

In our retail consultation, we sought views from stakeholders on the appropriate approach to:

- disconnection services, which includes two distinct activities – the decision to disconnect (and reconnect) most non-household customers, and the physical activity of disconnection; and
- metering services, which includes both the ownership of meters as an asset, and services to install, maintain or repair meters.

For disconnection services, most respondents that expressed views thought that the decision to make a disconnection should be a retail activity, and that responsibility for the act of disconnection should lie with the wholesaler. Some respondents also agreed that if we adopted this split, there could be a degree of contestability for some aspects of disconnection services. And that there could be a role for third parties in carrying out the physical disconnection services.

Taking into account these views, we have decided that:

- the decision to disconnect – and reconnect – customers will be included in retail; and
- the physical activity of disconnection will be included in wholesale, but with potential provision by third parties.

This allocates the activities to those best placed to carry them out. It places the decision to disconnect with the retail business, which bears the risk of debt, and allocates the network activity to the wholesaler, which is best able to manage that activity. It also provides some scope for competition.

For metering services, most respondents that expressed views supported allocating meter services to wholesale. Some also suggested choice over who installs and maintains meters could be beneficial – pointing to the approach used in Scotland, where third parties can also provide installation and maintenance services.

Our view is that there is a case for this price review for excluding meter ownership from retail controls (and therefore including it in wholesale controls). This seems to be an appropriate allocation because metering is an important tool for balancing supply and demand, which will primarily be the responsibility of those providing wholesale activities. We also propose to exclude from retail meter installation,

maintenance and repair. This ensures a consistent allocation of all metering activities apart from meter reading to those providing wholesale activities.

We are aware that in the Scottish market specific arrangements have been developed that enable non-household retailers to choose who installs, maintains or repairs meters on behalf of their customers from a list of approved third party suppliers.

We also think that there could be benefits to retailers – and, ultimately, end customers – by allowing third parties to provide installation and maintenance services.

So, we have concluded that:

- meter ownership should not be included in retail;
- meter installation, maintenance and repair should not be included in retail, but retailers should have a role in decisions on meter functionality and capability; and
- there should also be scope for third parties to carry out these activities.

3.2.4 Activities and services – preferred options for consultation

There are three areas where we consider it would be useful to receive further comments before reaching a final conclusion on the appropriate approach we should adopt. These are:

- demand-side water efficiency services – services to help reduce customers' consumption of water (such as promoting water saving initiatives, retro-fitting of water saving devices, and providing water efficiency audits);
- customer-side leaks – work carried out to repair leaks on pipework for which customers are responsible; and
- developer services – which includes both managing relationships with developers and providing connections.

We are now consulting on our preferred approach to each of these services (see table 3).

Table 3 Retail definition – preferred options for consultation

Activity/service	Rationale	Preferred option for consultation
Demand-side water efficiency services	Responses to the consultation were mixed, but broadly supported including these services in retail. For non-households, our view (which is supported by the CAP) is that including demand-side water efficiency services in retail maximises the incentive to provide these services as part of competitive offerings. For households, we think that those in companies responsible for providing retail services are best placed to provide demand-side efficiency services (as they are customer facing). But we think that those managing wholesale activities are best placed to decide on the efficient level of activity as part of water resources management planning.	Services included in retail.
Customer-side leaks	As with demand-side water efficiency services, responses to the consultation were mixed, but broadly supported including these services in retail. As with our approach to demand-side water efficiency services: · for non-households, including customer-side leak repairs in retail maximises the incentive to provide these services as part of competitive offerings; · we think that those managing retail activities are best placed to provide services to households; and · those managing wholesale activities are best placed to decide on the efficient level of repairs as part of their water resources management planning.	Services included in retail.

Developer services	Our initial view (as set out in the retail consultation) was that these services should be excluded from retail. Most respondents supported this initial view, but some companies identified issues with this proposal, noting that developer services involve significant customer interaction. As a result of this feedback, our preferred option is now to split developer services between retail and wholesale. In particular, we think that the customer-facing aspects of developer services should be included in retail. These activities include providing developers with information about new connections and responding to questions about changes in infrastructure. We think that this activity would benefit from the more customer-centric approach that a retailer would provide. The actual provision of connections involves a physical interaction with the network, so we think wholesalers are better placed to undertake this activity. This is consistent with our treatment of disconnections and metering.	Customer-facing activities included in retail. Provision of connections not included in retail (and therefore included in wholesale).

3.3 Consultation question

Defining retail (and wholesale) services
Q4 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?

4. Setting wholesale controls

4.1 Summary

We have explained that we intend to set separate controls for retail and wholesale services because this will help deliver improved services and promote greater efficiency.

In our FPL statement and wholesale consultation, we proposed to set a single wholesale control, covering all water and wastewater wholesale services. We have since developed our thinking further because of the benefits of distinct cost and delivery incentives between water and wastewater.

So, it seems appropriate to set separate binding wholesale controls for water and wastewater building on the indicative controls at previous controls – this is now our preferred option.

For the wholesale controls, we do not propose to change the RPI ± K approach used previously. So, water and sewerage companies would have two separate wholesale Ks – one for water and one for wastewater.

We propose that the wholesale controls should cover revenue collected from **connection charges** – including infrastructure charges – and **wholesale charges**.

To protect customers we think it is appropriate for the scope of the new wholesale control to include connection charges, as well as wholesale charges. This will align to the proposed scope of the relevant cost performance and outcome delivery incentives over the whole control period. This will help to provide customers and companies with regulatory consistency and stability during the control period.

We want to give companies more responsibility and accountability for the charges they set. So, we are proposing to set controls that limit each company's total wholesale revenues, rather than charges, and companies may be required to publish their **wholesale charges**.

In order to determine companies' allowed wholesale revenues, we need to reach a view of the costs companies are likely to incur.

Our preferred approach to **cost assessment** is to move away from our traditional approach based around separate opex and capex assessments to a total expenditure, or totex, approach. This has the advantage that associated **cost performance** incentives are focused on total expenditure rather than treating opex and capex differently

We want to improve the incentives for companies to prepare high-quality business plans. So, we want to implement menus, incentivising companies to set out their best forecasts of the total costs they will need in order to deliver the outcomes to which they have committed. But before we confirm our intention to do this, we want to talk to the companies about the challenging timescale this would involve for both us and them.

Since a significant proportion of wholesale costs derive from investments in long-lived water and sewerage networks, we need to take account of the fact that many of the costs companies incur in delivering wholesale services bring benefits to both current and future customers. Our **cost recovery** proposals allow companies to propose how they think costs should be split between current and future customers, subject to our review of those proposals. We will challenge these proposals where necessary as part of our risk-based review of business plans.

Below, we summarise the main elements of our proposals.

Setting wholesale controls – preferred option for consultation

Separate wholesale controls for water and wastewater.

RPI+K as a limit to the increase in revenue from the previous year – rather than as a limit to the increase in average charges.

Wholesale controls limit revenue collected from:

- connection charges (including infrastructure charges); and
- wholesale charges (including relevant charges for large users using more than 50Ml of water a year).

Controlling wholesale revenues – preferred option for consultation

Total revenue control for water wholesale services that incorporates adjustment mechanisms for changes in:

- volumes of water supplied; and
- the number of new metered connections.

Simpler total revenue control for wastewater wholesale services.

Set allowed wholesale revenues, rather than absolute limits on changes in charges.

Companies to publish wholesale charges

Companies have flexibility to adjust charges in period to account for differences between actual and allowed revenues from previous years.

Determining companies' allowed wholesale costs – preferred options for consultation

Totex approach for assessing and determining companies' allowed wholesale costs.

Two totex menus (one for water, one for wastewater) to allow companies choice over their:

- allowed wholesale cost levels; and
- associated cost incentive rates.

A combination of new, more sophisticated econometric models and approaches used in previous price controls to set Ofwat's estimated baseline costs.

Determining allowed wholesale revenues – preferred options for consultation

Companies propose how they should recover totex from:

- current customers – that is, on a 'pay as you go' (PAYG) basis; and
- future customers – that is, by adding expenditure to the regulatory capital value (RCV).

We will review, and challenge if appropriate, these proposals as part of our risk-based review of business plans.

4.2 Scope of the wholesale controls

At all previous price reviews, we have set a single retail price control for the whole business – but with non-binding separate water and wastewater controls. In this price review, we will be setting separate price controls for:

- retail services to household and non-household customers; and
- wholesale water and wastewater services.

The scope of the wholesale controls will be defined by reference to our definition of retail services for price control purposes (discussed in chapter 3).

In previous price controls, not all of the regulated activities were subject to the general retail price cap mechanism. This is because we took account of the fact that

- some of the companies' charges, such as connection charges, were regulated through other means, which are governed by separate provisions in the Water Industry Act 1991; and
- large customers using more than 50Ml of water a year could opt to change either their retail supplier or a new vertically-integrated supplier.

So, we excluded revenue from connection charges and large customers from the scope of our standard retail price controls.

We propose that the new water and wastewater wholesale controls should cover revenue collected from **connection charges**, including infrastructure charges, as well as **wholesale charges**. This will allow us to continue to oversee both connection charges and wholesale charges – and, if required, the balance between them – on a consistent basis throughout the next control period.

Although connection charges are currently governed by the provisions in the Water Industry Act 1991, in its Draft Water Bill the UK Government proposed to make changes to these arrangements. These changes could mean that the balance between connection and wholesale charges changes within the next price control period. So our proposal to include revenue from connection charges within the new wholesale control will also serve to protect customers and provide overall stability in the control period.

Our view is that controlled revenue from wholesale charges should include that arising from charges for all relevant wholesale services provided to all customers, including those large customers that use more than 50Ml of water a year. Although it is possible for large users to change their wholesale supplier through the new appointments and variations framework, we do not think this provides a sufficient competitive constraint on wholesalers to justify excluding wholesale services to particular customers from the scope of the overall wholesale revenue controls.

We also propose that companies should set wholesale charges to comply with the allowed overall revenues for each year, for the purposes of separate price controls. Our proposed form of control will allow companies the flexibility to adjust individual charges in the light of developing circumstances, subject to regulatory oversight. We will consult further on the details of our oversight of companies' wholesale charges later in 2013, following our decisions on the overall form of revenue control.

4.3 Controlling wholesale revenues

Consistent with the approach set out in 'Delivering proportionate and targeted regulation', we want to give companies more responsibility and accountability for the charges they set. We also think that companies are better placed to manage some of the risks associated with setting charges.

So, we propose to move away from our current approach, which imposes an absolute limit on average charge increases. Instead, we propose to set controls that limit each company's total wholesale revenues. These wholesale controls would be based on the assessed efficient costs of delivering the relevant outcome commitments, which – among other things – will reflect companies' predictions about demand during the period.

But we recognise that, in practice, actual demand is likely to differ from the predictions used to set wholesale controls. This means that companies' actual wholesale revenues will differ from both their predictions and their allowed wholesale revenues. This issue exists within the 2010-15 retail price controls. To deal with it, we currently reconcile companies' actual revenues with their allowed revenues at the end of the price control period using the revenue correction mechanism (RCM); any variation from the allowed revenue is then recovered in the following period. We discuss how this adjustment will be applied in chapter 9.

In future, we propose to use a mechanism that adjusts companies' allowed revenues each year to take into account any differences between actual and projected demand from previous years. This will give them more scope to smooth changes from unexpectedly high or low demand years over time, with less reliance on the regulatory decisions made at the price review. It also supports the expected evolutionary development of markets for retail non-household customers.

This approach means that wholesale charges should fluctuate less with demand over the longer term. If companies manage their charges well, they should also be able to minimise any adjustments at the end of the price control period – although we will still roll forward any such residual variations into the following period. This shares the risks with current customers more effectively, rather than transferring all forecasting risk to future customers, as under the RCM.

We also propose that companies should be able to recover the costs of providing additional water and serving additional metered connections. And conversely, they will no longer be able to over-recover revenue automatically and make short -term windfall gains, which happened under our previous price controls. This should help to reduce the incentives for regulatory gaming and smooth prices over the longer term.

To do this, we propose to adjust allowed water wholesale revenues for differences between actual and predicted volumes of water supplied, as well as changes in the number of new metered connections.

Both these adjustments to the allowed revenue will be **symmetric**. So, for example, the form of control would lead to an increase in allowed revenue if there is higher demand than expected, but a decrease if there is lower demand than expected.

Although this type of approach may also apply to the wholesale wastewater control in principle, at this stage we do not think there is sufficient evidence to support a view that the variable elements of wastewater costs are material or predictable enough to warrant this type of general adjustment, although we would welcome views and supporting evidence on this issue.

The extra flexibility we are giving companies to set wholesale charges and manage emerging demand changes gives them more freedom. But it also makes them more accountable for their approach to wholesale charging. We expect companies to set charges responsibly, and we will be alert to suggestions that this flexibility is being used to generate additional revenue unfairly in the earlier years of a price review period.

If companies do not use this new flexibility in a responsible way, there are measures we could introduce to protect customers. For example, we could:

- use adjustment mechanisms such as caps or tapers to constrain how much revenue can be transferred between years;
- challenge companies to demonstrate why their predictions have changed, require them to submit an assurance statement each year, or require them to have their updated predictions audited; or
- use a residual revenue correction mechanism at the end of the control period.

The need for measures of this type should be reduced if companies manage their revenue predictions effectively each year. We invite views on the appropriate regulatory response companies should face if they do not use the proposed flexibility over charges responsibly.

4.3.1 Monitoring wholesale charges

Companies may be required to publish their **wholesale charges**, in addition to the existing legal requirement for them to publish a retail charges scheme.

Given their predictions about demand for the year ahead, companies may be required to demonstrate that these wholesale charges will recover no more than their allowed wholesale revenues. We will also expect the charges to reflect the costs of providing the relevant wholesale services to each group of customers.

We will consult on more detailed and specific guidance on setting separate wholesale and retail charges for the price controls, later in 2013.

4.3.2 Form of the wholesale controls

Our proposed approach to controlling wholesale revenues leads to the following equations for calculating allowed water and wastewater revenues in a given year (where RPI is the Retail Price Index, and may be positive or negative):

Allowed water revenue = (previous year's water revenue + change factor) × (1 + RPI ± K for water wholesale)

Allowed wastewater revenue = (previous year's wastewater revenue) × (1 + RPI ± K for wastewater wholesale)

The **change factor** in the equation for the allowed water revenue is the impact of the differences between actual and planned metered water connections and the volume of water supplied. It can be thought of arithmetically as:

change factor = aM + bV

The terms are defined in table 4 below.

Table 4 Terms used to calculate the change factor

Term	Definition
a	Unit cost allowance for metered connections.
b	Unit cost allowance for volume delivered.
M	Annual change in the difference between actual and planned metered water connections.
V	Annual change in the difference between actual and planned volume of water supplied.

When we set wholesale controls for 2015-20, we will need to determine **K for water wholesale**, **a** and **b** – as well as **K for wastewater wholesale** for water and sewerage companies – for each company, and for each year of the price control period:

- **K for water wholesale** and **K for wastewater wholesale** – from 2016-17, we propose to set both as percentage changes in allowed wholesale revenue for each of the water and wastewater wholesale controls;
- for 2015-16, where there will be no previous year's wholesale revenue, we will not set values for **K** – instead, we will set allowed wholesale revenues for water and wastewater directly;

- **a** – we propose to set this term at an estimate of the average annual relevant cost of providing an additional metered connection (that is, the relevant local distribution costs plus meter ownership, installation and maintenance). This could be set separately for each year in the control period; and
- **b** – we propose to set this term at an estimate of the incremental relevant costs of supplying an additional unit of water. Again, this term could be set for each year in the control period.

M and **V** would be calculated each year, based on actual and projected demands. It is important to note that both are **changes** in the difference between actual and expected demand – we show how we would calculate **V** in table 5 below.

Table 5 Calculating 'V' (all values in Ml/day)

	Year 1	Year 2	Year 3	Year 4	Year 5
Assumed volume	400	400	410	420	440
Actual volume	400	420	420	440	480
Difference (actual – assumed)	0	20	10	20	40
V	**0**	**20**	**-10**	**10**	**20**

4.4 Determining companies' allowed wholesale costs

At previous price reviews, we have taken different approaches to setting companies' allowed costs for:

- operating expenditures (opex) – these are day-to-day running costs such as employment and power costs; and
- capital expenditures (capex) – these reflect investments in assets such as networks and treatment facilities, and include the expenditures on both building new assets and replacing or maintaining existing assets.

This different regulatory treatment of different types of costs makes the process for determining allowed costs complex. It has also led to different incentives for companies to deliver opex and capex efficiency savings. And it may have distorted companies' investment decisions, which is an issue we explored in more detail in 'Capex bias in the water and sewerage sectors in England and Wales – substance, perception or myth?', which we published in May 2011.

To address the limitations of our existing approach, we have been exploring two key changes we might make to our approach to determining allowed wholesale costs. These are to:

- move towards a **total expenditure** (or totex) approach to costs, which removes the current distinction between opex and capex; and
- make greater use of **menu regulation**.

In traditional price control regulation, the regulator determines both companies' allowed costs and the strength of the incentives companies face to deliver actual costs below their allowed costs.

Under a menu regulation approach, we would instead form a view on the efficient costs each company needs to deliver its outcomes (the **baseline**). Companies then choose from a **menu** of options – each of which combines a different level of allowed expenditure relative to our baseline with a matching cost incentive rate.

Those that opt to spend less than our baseline and select a more demanding efficiency challenge can earn higher returns on any cost savings they then make; conversely, higher expenditure choices lead to lower returns on cost savings. We used a form of menus for capital expenditure at the last price review – the capital expenditure incentive scheme (CIS).

The way we design and implement menus can create incentives on companies to:

- provide their best, unbiased forecast of the expenditure they need to deliver their outcomes when they make their menu choice; and
- deliver their outcomes for less than their forecast expenditures.

In our wholesale consultation, we set out three options we considered viable for the 2014 price review that differed in the extent to which they would implement a totex approach to cost assessment – and, as a result, the number of menus that would be required.

Most respondents supported an approach that fully implemented totex cost assessments for water and wastewater, and used separate water and wastewater menus. We agree with this view, and our preferred option is to use two separate menus – one each for water and wastewater. We consider this approach has a key advantage over the other two options we set out in our wholesale consultation – it uses fewer cost types. Because we will need to take different approaches to

assessing each different cost type, more cost types carries a greater risk of distorting company investment decisions by creating biases between the different cost types. The more integrated cost assessment we propose may also be simpler to carry out and less data intensive.

But using a fully integrated totex cost assessment and water and wastewater menus is not without implementation risks. It involves the most significant changes from our current approach, in particular:

- we would need to set sufficiently robust baseline expenditures and calibrate cost incentive rates appropriately – so, we would need to use new cost assessment tools to allow us to **set totex baseline expenditure**; and
- we need a process that **makes menus work well**, where companies can challenge the assumptions underpinning our assessment of baseline expenditures and make real, effective menu choices.

4.4.1 Cost assessment – setting totex baselines

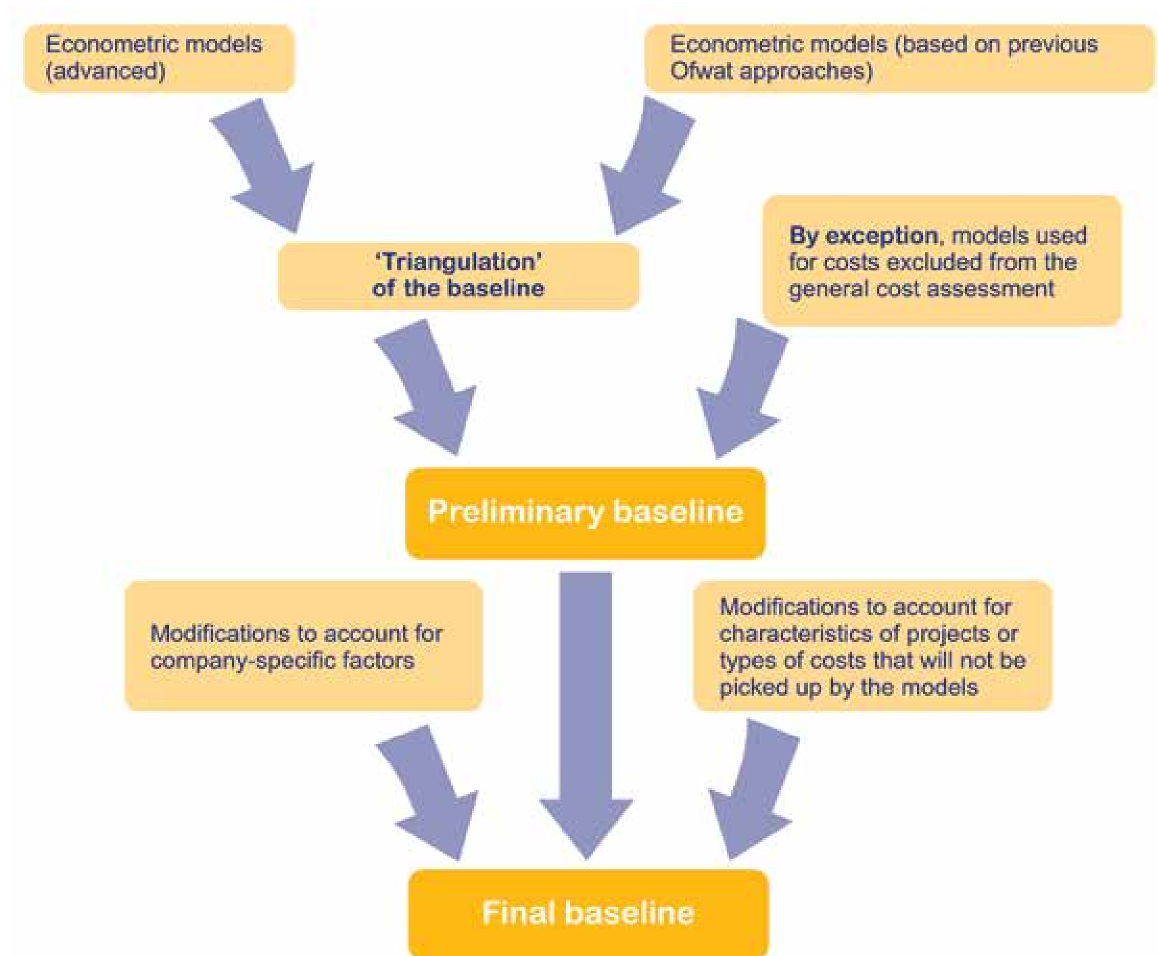
We commissioned Cambridge Economic Policy Associates (CEPA) to develop new econometric models to help us set baselines for water and wastewater.

For water, these models are more sophisticated than those we have used previously to assess efficient costs. The different models offer alternative bases on which to estimate the costs concerned. This is because we have access to historic information for a significant number of companies for a range of relevant explanatory variables (cost drivers).

For the sewerage network, more developed econometric models have also been developed to assess efficient base expenditure. But in other areas of wastewater expenditure, the available information is likely to constrain us to continue to use simpler cost assessment approaches – similar to those we have adopted previously. Further details are set out in CEPA's report, 'Cost Assessment', which we have published alongside this consultation.

We currently propose to use a combination of these more advanced econometric models and modified versions of our historic models to set baselines. The process we propose to use is illustrated in figure 3.

Figure 3 Draft process for developing baselines



We propose to set a preliminary baseline using a **triangulation** approach. This involves using a main model – or suite of models – to calculate the baseline in the first instance, and then a further model (or suite of models) as a cross-check. All these models will use a combination of historic cost data and forward-looking projections from companies' business plans.

We may need to take different approaches to triangulation for water and wastewater. We propose to use totex econometric models as the main model for setting the water baseline. But we do not propose to use econometric models as the main cost assessment tool for all of wastewater expenditure – as CEPA's report explains, econometric models for wastewater are less precise, particularly when estimating capex spent on both new sewerage assets, and on maintaining and enhancing sewage treatment assets.

We are developing alternative, simpler, approaches for estimating wastewater costs in these areas to deal with the fact that the available data are more limited. These models are similar to the methods we used in previous price reviews. They are based on volume parameters and take into account forward-looking predictions of those volumes that align to companies' investment programmes. Our initial development work demonstrates that these models continue to provide a satisfactory and suitable alternative to the more sophisticated forms of econometric models for baseline setting in these cost areas. But further work is required to refine our approach.

We want companies to focus on engaging on the key issues and the best way to deliver a plan that reflects what customers want and value, rather than being driven by the regulatory framework and second-guessing our cost assessment models and other tools for risk-based review. We do not propose sharing details of the models at this stage.

In calculating the preliminary baseline, we recognise that we may need to exclude certain costs from the approach used in the general cost assessment. For example, Where costs are uncertain or less controllable, it may also be appropriate to exclude them from the scope of all or some cost incentives, and from the cost assessment, cost performance and cost recovery framework – that is, a menu supported by a baseline.

In making our decisions on whether we should exclude costs from the general cost incentive framework, we will consider:

- cost uncertainty;
- timing uncertainty;
- output uncertainty;
- degree of controllability; and
- materiality.

At this stage, we do not have evidence to suggest there would be many costs that would be sufficiently uncertain, uncontrollable and material to warrant their exclusion from the general cost performance incentives. It would be helpful if any views that there are any such significant costs are accompanied by supporting evidence and examples.

We may also need to adjust our assessment of the baseline to account for any company-specific factors – and for characteristics of projects or costs that will not otherwise be captured by our cost models, usually because past costs will not be a good predictor of future costs. We will provide more details of our proposed approach later this year.

4.4.2 Cost performance – making menus work

Implemented effectively, menus would allow companies to choose their own balance of cost performance risk and reward. They also encourage them to provide their best, unbiased expenditure forecasts when they make their menu choice.

To deliver these benefits, we need a process that makes sure that companies:

- have an opportunity to challenge the assumptions underpinning our baseline; and
- can make real, effective menu choices.

The challenge in delivering this process is one of timing. We will not be able to set robust baselines until we have a clear view of the outcomes companies intend to deliver following their engagement with customers over their business plans. Since they will provide this information in their business plans, the earliest we will be able to set baselines is as part of our draft determinations.

In between draft and final determinations, we will then need to:

- allow companies to make representations on our baselines, and (or) make other changes to their business plans – after consulting with their stakeholders, including their CCGs;
- allow companies to make their menu choice consistent with their business plans – and proposed outcome commitments and delivery incentives – following any such adjustments; and
- revise our draft determinations where necessary in the light of companies' representations and associated menu choices.

This means that both the companies and Ofwat would have to work to a challenging timetable in the period between our draft and final determinations.

We have considered an alternative approach – not using menus, but relying on a more traditional business plan challenge process. But this alternative approach also involves similar risks and greater regulatory intrusion – including comparable risks to delivery that would arise because we will need to carry out more detailed assessments of companies' business plans.

Our preferred option is to proceed with a menus approach. It is more consistent with a risk-based review of plans and providing companies with greater accountability for their commitments to customers as set out in our future price limits framework. Since this approach would involve us and the companies working together to a challenging timetable, we will use workshops with them to explore the benefits of menus and the challenges of the timetable before making a final decision on whether or not to implement menus. We expect to hold these workshops during the consultation period for this document.

Under our preferred approach, a company's allowed wholesale expenditure would be determined by its menu choice relative to our baseline – allowed wholesale costs are set partway between our baseline and the company's menu choice.

4.5 Cost recovery – determining allowed wholesale revenues

Having determined companies' allowed wholesale expenditure, we would use that allowed expenditure as inputs to determine allowed wholesale revenue. An efficient company should be allowed to recover its efficient operating and capital costs.

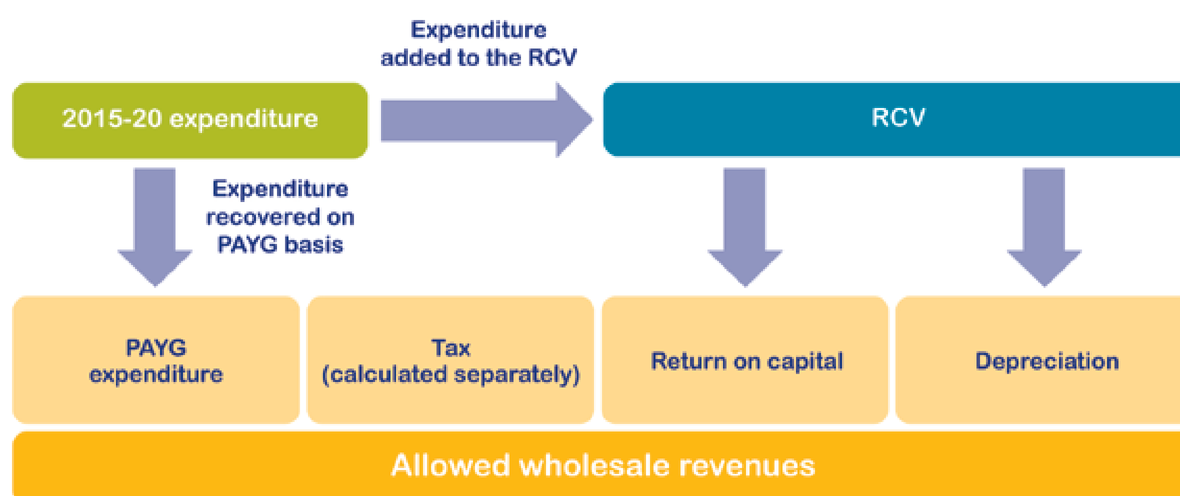
There are a number of ways that this can be achieved. The key consideration here is how best to ensure that the funding of wholesale expenditure is shared fairly between current and future customers, in line with the benefits that those customers receive.

One element of cost recovery is the approach taken to spreading the costs of long-lived investment over time. To do this, we have used the regulatory capital value (RCV). This can be thought of as a regulatory mortgage, which companies take out to invest in assets, and customers then pay back over a period of time.

All water and sewerage and water only companies have an existing RCV, which reflects the value both of the assets acquired at privatisation and subsequent investments in new and replacement assets. As we explained in our wholesale consultation, we are allocating all of the RCV as at 1 April 2015 (the **2015 RCV**) to the wholesale control.

We will continue to use an RCV-based approach, but for expenditure for 2015-20 we will do so as part of a totex approach to cost recovery. Instead of considering capex in isolation, we will look at the recovery of totex as a whole. Companies will decide how much of this will be recovered in the year the costs are incurred. This is known as '**pay-as-you-go**' or **PAYG** expenditure. The remaining totex will then be added to the RCV (see figure 4 below).

Figure 4 'Building blocks' for allowed wholesale revenues



PAYG expenditure, depreciation – which can be thought of as repayments of the amount borrowed on the regulatory mortgage for the consumption of assets – and return on capital – which can be thought of as payments to the providers of finance on the regulatory mortgage – make up three of the four 'building blocks' of companies' allowed wholesale revenues. The fourth is the **tax** that the companies pay.

In the following sections, we explain our approach to determining each of these building blocks when we set wholesale controls for 2015-20. We also discuss how this approach differs from the one we used for the 2009 price review.

4.5.1 Dealing with expenditure in 2015-20

For the 2009 price review, our treatment of expenditure depended on how it was categorised. We used five different expenditure categories, which we explain in more detail in table 6.

Table 6 Treatment of expenditure categories for the 2009 price review

Expenditure category		Approach
Capital expenditure on enhancements (additions to the asset base)	Above-ground assets	Expenditure added to the RCV, then depreciated.
	Below-ground assets	Expenditure added to the RCV, but **not** depreciated.
Capital expenditure on maintenance (for example, replacing existing assets)	Above-ground assets	Expenditure added to the RCV, then depreciated.
	Below-ground assets	Expenditure recovered on PAYG basis, in line with average expenditure over 15 years.
Operating expenditure		Expenditure recovered on PAYG basis.

As for cost assessment, we think this different regulatory treatment of different types of expenditure for cost recovery purposes carries a risk that it distorts companies' investment decisions – in particular, leading to a bias towards capital expenditure.

In our wholesale consultation, we proposed to adopt a totex-based approach to cost recovery. We explained that this would simplify our approach to cost recovery by adopting the same treatment for all types of expenditure, and removing the distinction between different expenditure categories. Respondents broadly supported this proposed approach, and did not raise any issues that cause us to change our view.

So, our preferred option is to use a totex approach to cost recovery for 2015-20. Under this approach, companies would recover a fixed percentage, which we call the **PAYG ratio**, of total expenditure on a PAYG basis, with the remaining expenditure added to the RCV. The PAYG ratio can vary from company to company, and between water and wastewater costs.

We also propose two options for setting the percentage of expenditure added to the RCV. Either:

- we set a single percentage that applies across all companies; or
- companies set out their view of the appropriate percentage in their business plans – which we could challenge (or accept) as part of our risk-based review of their business plans.

Because it is more consistent with our future price limits principle of 'ownership, accountability and innovation', we propose to adopt the second approach. Companies will be able to propose PAYG ratios in their business plans.

These proposed ratios will be one of the key metrics we examine as part of our risk-based review of business plans – and one of the areas where we intend to make use of comparisons between companies. We will compare the PAYG ratios that companies propose (making separate comparisons for water and wastewater) to identify outliers.

Where our analysis indicates that a company's proposed PAYG ratio is an outlier, as part of our risk-based review, we could ask that company to provide further justification for its proposals. We would then need to take a decision on whether to accept the company's proposals, or adjust its proposed PAYG ratio. Our decision will take a number of factors into account, such as whether there might be an impact on customers' bills.

4.5.2 Return on capital

For the 2009 price review, we calculated the return on capital as a fixed percentage of companies' RCVs. This percentage was given by the weighted average cost of capital (WACC). We used the same rate of return for both the existing RCV (as at 1 April 2010), and any additions to the RCV during 2010-15.

We set out our proposals on the return on capital for the 2014 price review in chapter 8.

4.5.3 Depreciation

The price controls we set at the 2009 price review included:

- a current cost depreciation charge for above-ground assets, such as treatment works; and
- an infrastructure renewals charge for below-ground assets, such as pipes (which form part of either the water or sewerage networks).

We also set out detailed guidance for companies to follow when calculating these charges.

For 2015-20, we propose to simplify our approach to cost recovery for expenditure from April 2015 onwards using a totex approach. This change means we need to adopt a different approach to depreciation. Totex menus expenditure is not identified separately and so we cannot calculate separate charges for above- and below-ground assets. We propose to have different calculations for pre- and post-2015 expenditure instead (see table 7).

Table 7 Approach to depreciation for 2015-20

Component of the RCV	Approach to depreciation charge
Capital expenditure added to the RCV up to 31 March 2015.	Depreciation charge calculated as a fixed percentage (the 'run-off rate') of the 2015 RCV.
Totex additions to the RCV after 1 April 2015.	Depreciation charge calculated based on notional asset life of additions.

We propose to ask companies to specify an average asset life for totex additions to the RCV for 2015-20. We will use the asset life to calculate depreciation for the new totex additions to the RCV.

In past price reviews, we have assessed the reasonableness of companies' projections of depreciation by comparing the mix of assets by asset category and the relevant asset lives of each category with companies' asset inventory submissions. Given the change in nature of the additions to the RCV after 2015 – that is, as a proportion of totex – we consider that it is appropriate to simplify the way depreciation is calculated for assets in the 2015 RCV. We propose that companies mirror the approach for totex additions to the RCV by using a simple percentage run-off rate to depreciate the 2015 RCV.

In setting these variables – the run-off rate in particular – companies will have to balance both affordability for customers (effectively how much expenditure is paid for by current customers and how much by future customers) and financeability. Consideration of companies' proposed run-off rates will form part of our risk-based review of business plans and may use comparisons with the approach taken by other companies. Depending on what they propose and the supporting evidence in the business plans, we may:

- ask them to provide further justification of their proposed approach to depreciation; and (or)
- make adjustments to their proposed run-off rate and (or) notional asset life if they do not provide adequate justification.

4.5.4 Separating water and wastewater

To set separate wholesale controls for water and wastewater, we will need to calculate a separate return on capital and separate depreciation charges for water and wastewater. So, companies will need to consider asset lives separately for water and wastewater additions.

In particular, we need to determine the appropriate way to allocate the returns and depreciation arising from the 2015 RCV between water and wastewater. Because we have at previous price reviews set indicative water and wastewater price limits, the need to split the RCV in this way is not new.

We intend to split the 2015 RCV on a basis that utilises the 2009 modern equivalent asset (MEA) revaluation, which has a value for water and wastewater assets. We could do this by using:

- the revalued current cost fixed asset net book values in the reported regulatory accounts for 1 April 2010; or
- that value updated for subsequent additions and depreciation – for example, the net book value at 31 March 2013.

We invite views on which date companies feel is most appropriate to use as a basis for the split for 2015.

4.5.5 Tax

The final component of companies' allowed wholesale revenues is the tax they must pay. Like other businesses, water and sewerage companies pay corporation tax on the profits they make, and can also claim tax relief for:

- interest payments on debt used to finance their activities; and
- investments in certain types of assets (**capital allowances**).

So, the overall level of tax that the companies pay depends not only on their profits, but also on the extent to which they actually finance their activities using debt rather than equity, and their capital allowances.

For the 2009 price review, we calculated tax based on a notional proportion of debt financing – or, where higher, companies' actual proportion of debt financing. This preserved incentives for companies to adopt efficient financing structures, while also ensuring customers shared any tax efficiencies that companies with higher levels of debt funding delivered.

We also required companies to allocate their capital expenditure projections into 12 categories, depending on how they would be treated for tax purposes, accompanied by detailed commentary. This enabled us to replicate their calculations fully, so we could amend them to reflect any changes in the projected capital programmes. This approach was very data intensive. And in most cases, it produced a tax charge that was similar to what companies had proposed in their business plans.

For 2015-20, we propose to continue with the same high-level approach to tax, taking account of levels of debt financing and allowances available for capital expenditure in our calculations. But we think there is scope to simplify the approach we take to calculating capital allowances. Rather than replicating separate tax pools, we propose that companies should submit average capital allowance writing down rates. We will need separate writing down rates for:

- expenditure brought forward from previous price controls (water and sewerage companies will need to propose two – one each for water and wastewater); and
- expected expenditure in 2015-20 (again, water and sewerage companies will need to propose two – one each for water and wastewater).

We would use these writing down rates to project tax allowances for capital expenditure. For expected expenditure in 2015-20, we would apply the writing down rates to the expected capital expenditure, not the expected amount added to the RCV. We would continue to look at the percentage of expenditure to maintain below-ground assets that is tax-deductible on a company-by-company basis.

This simpler approach would result in a significantly reduced data burden on companies. It is less precise than the one we used in 2009, but we do not expect any differences to be material. This is because tax only makes up about 3% of companies' total allowed wholesale revenues. But we could amend our approach if a company could demonstrate a material impact in its particular circumstances.

4.6 Consultation questions

Setting wholesale controls

For controlling wholesale revenues

Q5 Do you agree with our proposed scope for the wholesale water and wastewater controls, given the proposed scope of the retail business we have defined in chapter 3?
Are there any revenues of the regulated wholesale business you think should be excluded from this scope – if so, please give your reasons?

Q6 Do you agree with our proposal for a mixed revenue and revenue yield form of water wholesale control, including our proposed adjustment mechanisms to smooth allowed revenues within the control period? Are there any adjustments you would suggest?

Q7 Do you agree with our proposed simple revenue control for wastewater wholesale services? Do you have any evidence that suggests a revenue yield element should also be included?

Q8 How do you suggest we incentivise companies to prepare and update accurate demand assumptions to apply our proposed forms of wholesale control?

For cost assessment

Q9 Do you agree with our draft process for developing baselines? If not, how might it be improved?

Q10 What areas of expenditure do you consider we should exclude from the general cost assessment methodology (that is, advanced econometric models and econometric models)? How should we assess these costs?

Q11 What special factors should we consider for your company as part of our cost assessment? What criteria should we use to assess whether we need to take account of these in our view of your costs?

For cost performance incentives

Q12 Do you agree with our criteria for excluding costs from the general cost performance incentive framework? What types of costs should we exclude from the general framework? Please explain how these meet the cost exclusion criteria and how we should incentivise cost performance for these costs.

For cost recovery

Q13 At what point should we take the MEA values to split the 2015 RCV in order to set water and wastewater price controls?

Q14 Do you agree that it is possible to simplify our approach to calculating tax?

5. Retail controls for household customers

5.1 Summary

In our retail consultation, we explained that our preferred approach was to set two retail controls:

- one for retail customers without choice, using an average cost to serve (ACTS) approach; and
- one for retail customers with choice, using a default tariffs approach.

Our reason for distinguishing between customers with and without choice is because market forces will protect those customers that will, or may in the future, have choice. But for those without it, price controls are necessary to protect them from monopoly companies charging more than they need.

In the light of the UK Government's proposals to extend retail competition to all non-household customers in England by 2017, we have looked again at our preferred approach to retail controls. Our view remains that having separate controls for customers with and without choice remains appropriate.

Our proposals for default tariffs to protect non-household customers is discussed in chapter 6. This chapter sets out how we intend to implement ACTS when we set price controls in 2014 and how we will incentivise good customer service and efficiency improvements.

To set an ACTS control, we need to decide:

- how we are going to **calculate** the ACTS;
- how we are going to **apply** the ACTS to set revenue limits; and
- what **form** of retail control these revenue limits will take.

In calculating **individual company ACTS** our preferred option is to use a measure of unique customers – we think this best reflects the cost drivers of providing retail services to customers.

We think that an un-weighted average should be used to calculate the **industry ACTS** because this avoids reflecting the current scale of companies in the price control – and so there is a better chance that the efficient scale of future retail activities will be determined by market forces, rather than the regulator.

We leave open, for consultation, the question of whether the ACTS should be calculated based on forecast or historic costs. Both approaches have advantages, which we explore in this chapter.

We propose three criteria that must be met before we would adjust the calculation of the ACTS to account for costs beyond companies' control. We think costs relating to metering meet these criteria. But it is less clear at this time that costs associated with doubtful debt would do so.

To **apply** the ACTS, we are consulting on whether companies should be allowed to recover the ACTS or the lower of the ACTS and their actual costs. We recognise that there is a trade-off between providing incentives for companies below the ACTS to lower their costs and protecting customers by not allowing companies to recover more than their relevant costs. Our preferred approach is to use a **glide path** to provide stronger cost-cutting incentives to companies, but at the same time giving them time to adjust to the new control.

Applying a **net margin** to the ACTS would be partly intended to allow for the remuneration of the capital required to provide household retail services. We propose either a single margin rule, or to make an adjustment through the wholesale margin – or some combination of the two to avoid companies recovering these margins twice.

We highlight the need for those providing wholesale and retail activities to work together to define what **payment terms** between wholesalers and retailers might be sensible after market opening.

We want to give companies more responsibility and accountability for the household retail charges they set. So, in line with our approach to wholesale controls, we propose a **form** of retail control that limits total household retail revenues. We then set out how we propose to convert these allowed revenues into a revenue control for companies.

Our preferred approach to incentivise good service is to continue to use the **service incentive mechanism (SIM)**. But we propose to apply it to the retail control only while ensuring that the overall scale of rewards and penalties are similar in scale to what they have been in the past.

Below, we summarise the main elements of our proposals.

Household retail controls – confirmed direction
An average cost to serve (ACTS) approach for all household customers in England and Wales.
Household retail controls – preferred options for consultation
RPI indexation would not be appropriate for the household retail control. **Retain the SIM as an incentive for the retail household control.**
Calculating the ACTS – preferred options for consultation
Use a unique customer measure to calculate company ACTS. **Use an un-weighted average approach to calculating industry ACTS.** **We leave open, for consultation, the question of whether we should use historic or forecast costs.** **Companies will be able to propose adjustments to allowed ACTS for any factor that can be shown to meet three criteria.** **Strip out the costs of metering before calculating the ACTS, and give companies a cost allowance for metering based on their level of metering penetration.**
Applying the ACTS – preferred options for consultation
Phase in the efficiency challenge using a glide path. **We leave open, for consultation, the question of whether we should set a net retail and whether we should use a single margin rule or another approach.**
Form of control – preferred options for consultation
Household retail controls that limit companies' total household retail revenues. **An annual adjustment to account for the fact a company's allowed household retail revenues will differ from the actual revenues they collect.**

5.2 Calculating the household retail control

There are two stages to calculating the ACTS.

- First, companies calculate their own **individual company ACTS**.
- Second, we then calculate an overall **industry ACTS**, based on companies' individual ACTS.

5.2.1 Calculating companies' individual ACTS

Calculating a company's ACTS is straightforward – it involves dividing the company's retail costs by the number of customers it serves:

$$\mathbf{ACTS_{company}} = \frac{\textbf{Total retail costs}}{\textbf{Number of retail customers}}$$

But to ensure consistent and fair calculations of the ACTS across all companies, both retail costs, and the number of retail customers, need to be defined carefully.

Retail costs are defined as the costs associated with the retail activities and services – as we set out in chapter 3.

Some respondents to our retail consultation put forward an option for defining customer numbers that we had not considered in our consultation – using the number of **unique customers** or the total number of household properties served by a retailer.

The number of unique customers is the sum of:

- households billed for water and wastewater; and
- households billed for water only; and
- households billed for wastewater only.

We think this way of defining customer numbers is the most appropriate because it takes account of the number of individual customers served – whether for water only, wastewater only, or both.

Using a measure of unique customers includes in the calculation every household that receives any service, or combination of services, requiring retail activities. If we used a measure based only on the number of water customers instead, this would disadvantage companies with a higher proportion of wastewater only customers.

Some respondents argued we should use a billed services measure – households billed for **water** plus households billed for wastewater – and that this measure could be used in conjunction with an adjustment for economies of scope. A billed services measure would give a greater weight to dual service water and wastewater customers when calculating the ACTS as they would be counted as '2' rather than '1' under a unique customer measure. But some respondents said that the incremental cost associated with providing the additional retail service is marginal. So, our preferred option is to use the unique customer measure.

5.2.2 Determining the industry ACTS

Using the individual company values of ACTS, we then work out an overall **industry ACTS**.

In our retail consultation, we explained that we could either use a weighted or un-weighted average to determine the industry ACTS. Respondents expressed strong support for an **un-weighted average approach**.

After taking account of views, our preferred option is to use an un-weighted average of companies' ACTS. This is because it places an equal weight on each company's management performance, regardless of the size of the company. By not reflecting the current structure of the industry in the measure, there is more scope for market forces to determine the efficient scale of retail businesses.

5.2.3 Use of actual or projected costs

We also need to decide which costs should be used in calculating the ACTS. In the past, we have used forward-looking cost projections to set allowed revenues. But we could choose to use actual – historic – costs.

ACTS rewards companies based on their performance relative to their peers, so using historic costs would allow comparisons based on actual relative performance, rather than forecast performance.

Basing allowed revenue on actual costs may also reduce the scope for regulatory gaming in forecasting. This is because companies would only profit from the ACTS if they reduce their actual costs – as opposed to bidding up forecast costs.

We recognise that, if we use historic costs, companies might have an incentive to artificially inflate their retail costs ahead of 2015, to gain less stretching efficiency targets when we introduce controls based on ACTS. But they face stiff penalties for mis-reporting that would counter this incentive. We are also conducting a horizontal audit of cost reporting that should reduce the scope for inconsistencies and inaccuracies in the reporting of actual costs.

Using forecast data also has a number of benefits. It is consistent with our proposed approach for wholesale costs. It would also reduce the dependence on projections based on separated retail cost data, which are relatively new.

We have not previously consulted on which costs should be used to calculate the ACTS. We invite views from stakeholders on the appropriate approach.

5.2.4 Adjustments

In our retail consultation, we explored whether we should consider making adjustments to the ACTS to reflect company-specific factors beyond companies' control.

Our view is that such adjustments to the ACTS would risk adding complexity to our approach and adjustments should be kept to a minimum.

In our retail consultation, we proposed using two principles when deciding whether or not to make such adjustments to the **allowed average cost to serve** to account for external factors. These were that the:

- impact of the factor must be material; and
- factor must be outside of a company's control.

In our consultation, we explained that these principles would ensure that we do not make adjustments for differences as a result of inefficiency and only for factors that are beyond the control of a company's management. It may be difficult to assess whether some factors are outside of a company's control, or the result of that company's approach – for example, efficient recovery of bad debt. As at previous price reviews, it would be up to companies to provide compelling evidence that they have met the criteria.

We also explained that where we do make adjustments, we consider that there is a strong case that these should be made on the basis of efficient costs. This would imply that any adjustment factor should be calculated on the basis of an industry-wide assessment rather than the assessment of individual companies.

These principles are also consistent with those set out for assessing which costs may be excluded from the scope of the general cost assessment when setting the wholesale price controls – see section 4.4.1.

Respondents broadly supported our preferred approach. But they also suggested other principles – in particular, that adjustments should only be made if the factor affects different companies in different ways.

Factors that affect all companies within the sector in the same way would already be reflected in the calculation of the industry ACTS, and so will not warrant an adjustment to the ACTS allowed for any specific company. So, we propose a third principle, which is that companies must also be able to show that the factor affects it in a way that is materially different to other companies.

Our preferred approach is that in their business plans, companies will be able to propose adjustments to the ACTS for any factor that can be shown to:

- have a material impact on their costs;
- be beyond management control; and
- impact the company in a materially different way to other companies.

We intend to consider only making adjustments to the ACTS, based on an assessment of efficient costs, where companies can provide compelling evidence that all three criteria have been met.

In response to our retail consultation, stakeholders suggested two factors that might meet the criteria we proposed. These are:

- levels of metering; and
- drivers of doubtful debt outside management control.

5.2.5 Adjustments for levels of metering

We think there is a strong case for making an adjustment to the ACTS for levels of metering as it seems that our three criteria, discussed above, are met.

The additional costs of providing a retail service to metered customers are material – making up between 7% and 30% of total retail costs – and so this meets the first criteria of significance.

In line with the definition of retail services set out in section 3.2.1, while those responsible for retail activities will have a role in deciding on the functionality and capabilities of meters, the ultimate decision on the level of meter roll out will be made by companies providing wholesale services as part of an assessment of different options for maintaining a robust supply/demand balance. So our second criteria – outside companies' control – is also met.

Differences in efficient costs of metering between companies are driven by the level of meter penetration – so companies with high meter penetration will be affected more than those with low meter penetration. So our third criteria is met.

Our preferred option is to make an adjustment by stripping out the costs of metering before calculating the ACTS. Companies will have an allowance for metering based on the average cost of providing retail metering services and their level of metering penetration. This aligns with our proposed wholesale form of control, which will also remunerate companies for different levels of relevant wholesale metering costs. We propose that metered water only, metered wastewater only and dual service retail metering costs will be calculated separately. We invite views on this approach.

5.2.6 Adjustments for drivers of doubtful debts

Compared with metering, the case for making an adjustment for drivers of doubtful debt outside of companies' control is less clear. But we recognise that there are factors over which companies have limited or no control – such as levels of income deprivation relative to the size of customer bills. But we do not have evidence to convince us that such an adjustment would meet our three criteria.

We continue to work on analysing whether our criteria might be met for different drivers of doubtful debts. We need to collect more information on these drivers and how they vary across companies. So we can assess any applications for adjustments for doubtful debt in setting allowed revenues, we will complete this analysis before companies' submit their business plans.

We recognise that there is a trade-off between collecting all the information we might want for this analysis, and putting a burden on companies. We welcome views on how best to go about this work.

5.2.7 Impact of ACTS on the provision of services

Some respondents to our retail consultation said that our approach to setting household retail controls might discourage companies from providing some services. In particular, our approach might discourage:

- the provision of demand-side water efficiency services and customer-side leak repairs; and
- metering.

5.2.8 Water efficiency and customer-side leaks

We heard mixed view about how our ACTS approach may impact on incentives to provide water efficiency services and customer-side leak repairs. About half the respondents to our retail consultation said they had concerns about discouraging the provision of these services, while others thought it would not be a problem. We summarise the main arguments in table 8.

Table 8 Does the ACTS impact on incentives for water efficiency and customer-side leaks?

Arguments which suggest ACTS would reduce services	Arguments which suggest ACTS would not reduce services
The ACTS provides strong, targeted incentives for companies to reduce retail costs by reducing services, particularly if their current costs are above the ACTS.	Companies already face strong incentives to reduce costs under the current integrated price controls.
Water efficiency and customer-side leak repairs are discretionary services and could be scaled back easily.	Scaling back water efficiency and customer-side leak repairs would only generate modest cost savings (up to a maximum of 8% of retail costs).
Companies would not be funded to provide higher levels of service in the future.	Companies could propose outcome delivery incentives providing incentive rewards for delivering higher levels of service.
	Companies' existing obligations to balance supply and demand will not change – and water efficiency and customer-side leak repairs are important tools for companies.

On balance, we do not think that our ACTS approach means that there will be a strong negative impact on incentives to continue providing **existing** services. Other changes to the price control package – such as adopting a totex approach, the remuneration of additional wholesale and retail metering costs and outcome delivery incentives – may **increase** companies' incentives to use demand-side measures, including water efficiency and customer-side leak repairs.

But because companies would not receive more funding for additional complementary retail services through the ACTS automatically, there is a risk that they will be discouraged from adopting additional demand-side solutions. But offsetting this risk, as we explain in the context of outcome incentives, is that those committing to outcomes and proposing performance incentives would need to secure the inputs they needed from others.

5.2.9 Metering

Some respondents to our consultation argued that because metered customers cost more to serve than unmetered customers, the ACTS approach could discourage companies from further roll-out of metering.

These concerns would be addressed by our proposals to adjust the ACTS to account for levels of metering. Adjusting the ACTS in this way should remove any disincentive to incur costs for further meter roll-out.

5.3 Applying the household retail control

Having established an **allowed ACTS** for each company, we then need to decide how to apply an efficiency challenge. We said in our retail consultation that we could set all companies' allowed costs (as the basis for allowed) revenues based on the:

- industry ACTS;
- lower of the industry ACTS or a company's own retail costs; or
- most efficient company – that is, the lowest ACTS.

Most respondents – including the CAP – supported using the lower of the industry ACTS and a company's actual costs. A number of respondents also said they supported a glide path, which would provide for a more gradual efficiency challenge for those above the industry average. And five respondents said they supported applying the industry ACTS symmetrically – that is, allowing those with costs below the industry average to price up to the average. These respondents argued that this would provide an incentive for companies below the allowed ACTS to further reduce costs to maximise their returns.

The responses to the consultation raised an important point – how do we set a forward-looking challenge for those companies below the average?

As we noted in our retail consultation, the efficiency challenge associated with using the lowest cost to serve might be too strong for 2015 but might be more suitable in the future – for example, from 2020.

We could apply the industry ACTS symmetrically. But one drawback with this is that it would provide a future windfall benefit to those companies below the industry ACTS without any change in the service they provide.

We are minded to conclude that, unless the efficiency challenge is attainable from the start of the control period, it needs to be phased in using a glide path.

We invite views from stakeholders on the appropriate approach.

5.3.1 Setting a net margin for the household retail control

Having considered both how we calculate the allowed ACTS for each company, and how we might apply it, we now need to consider whether we should include a net margin in the allowed revenue for the household retail control.

The purpose of including a net margin in the household retail control would be to:

- provide a return on the finance required for working capital and retail assets invested during the control period; and
- remunerate the associated risk incurred by providing these retail services.

As we explained in chapter 4, we have committed to allocating 100% of companies' existing RCV to wholesale. So, for 2015-20, companies will continue to earn a return on any household retail assets in the existing RCV through the wholesale controls (referred to in the diagram below as 'return in wholesale').

But most retail assets – which include assets such as IT systems for billing and customer records management – have short asset lives, that is, we expect most existing household retail assets to be fully depreciated by 2020. So, companies will require remuneration if they are to invest in new and replacement household retail assets during 2015-20 and beyond.

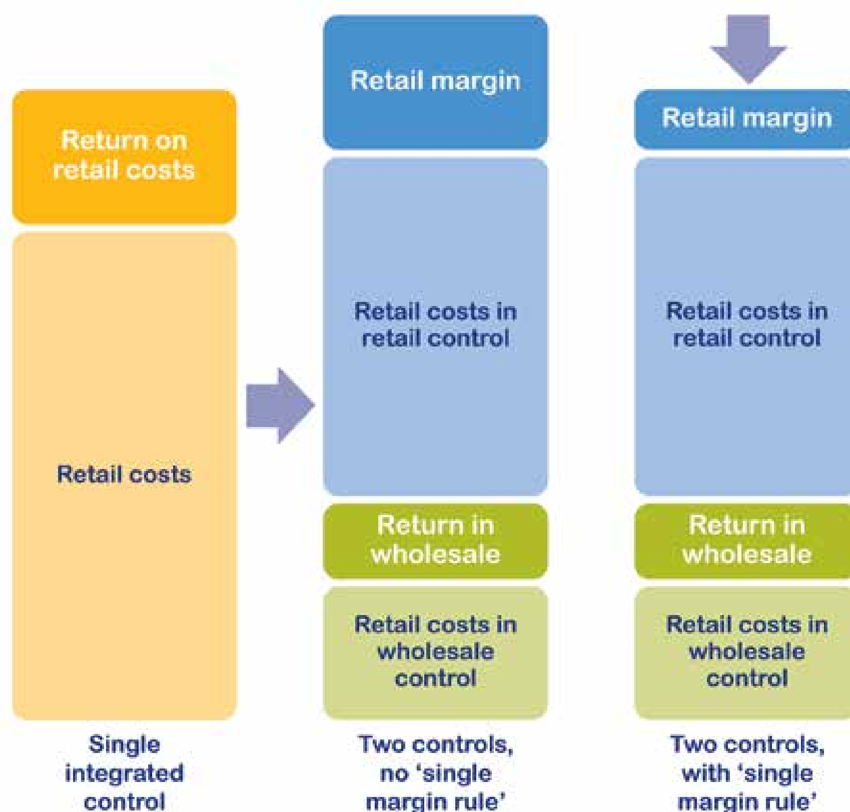
We could set a net retail margin to remunerate the risks to capital required to provide household retail services, but adjusted for the return on existing retail assets remunerated in the wholesale controls by using a **single margin rule**.

Using this approach, we would adjust the return for either the wholesale or retail business to ensure the overall return earned by the company is the same as it would have been had we set a single price control.

Figure 5 provides an illustration of the adjustment made wholly through the retail margin. This implies retail activities contribute to the remuneration of invested retail assets through wholesale charges. But we could make the adjustment through the wholesale margin, or some combination between the two.

We have not yet decided what the appropriate approach should be and we invite views on this.

Figure 5 Illustration of impact of the single margin rule



We have also considered two alternatives to this single margin rule. We could:

- set zero net household retail margin for the period to 2020; or
- allow full recovery of net margins for the retail household price control, without taking account of recovery of retail assets in the wholesale control.

The first of these is inconsistent with our objective of developing the efficient provision of retail services as distinct activities from wholesale because it would tie part of the retail return into the wholesale price control. This could result in under-funding of retail activities.

The second option would avoid the issue of under-financing of retail activities, but would instead risk introducing a double return on retail assets until all existing retail assets included in the RCV had been fully depreciated.

We invite views from stakeholders on what is the appropriate approach to setting margins for retail household services consistent with ensuring a reasonable return and protecting consumers from over-recovery.

In particular, we invite views on whether or not a margin should be included and, if so, whether it should be adjusted to avoid over-recovery of returns through a single margin rule.

5.3.2 Payment terms

When deciding on the appropriate approach to setting any net retail margins, we need to think about whether we should assume providers of retail services should make payments to the providers of wholesale services in advance or in arrears.

This assumption is important because the approach to payment terms affects the cash flow and hence the costs of working capital of both the wholesale and retail business activities.

The payment terms between wholesale and retail activity areas is a particularly important issue for the (contestable) non-household retail segment. The terms are also likely to be an issue both for incumbents, which may prefer arrangements that offer greater protection to the wholesale business, as well as new entrant retailers, which may prefer arrangements that do not require them to carry and finance substantial working capital.

But for simplicity, we think that it would be appropriate to adopt a consistent approach across contestable and non-contestable retail services. This would be in line with our proposals on the definition of retail services, as set out in chapter 3.

We think that it would be most appropriate for the assumption about payment terms to be driven by the market reform process, but reflected consistently across all price controls.

Ideally, when we set price controls, we would use the terms in industry codes set by market participants, and approved by us, following discussions between wholesalers and retailers, including entrant retailers. But we recognise that participants might not decide on their preferred approach. So, if we need to make an assumption about payment terms, we invite views on what this should be.

5.3.3 Dealing with any uncontrollable input price risk

In the previous controls, we have addressed input price risk by allowing companies to increase prices automatically every year by the change in the Retail Price Index (RPI) with an adjustment for expected efficiency (the K factor). This reflected our view that RPI was a good proxy for the uncertain input price risks faced by a vertically-integrated water company, taking account of the significant proportion of capital costs and the need to ensure recovery of the costs of long-lived assets in future time periods.

But retail services alone require a very different mix of costs compared with wholesale, a much lower proportion of capital costs. They also have assets with much shorter lives and existing retail assets in the RCV have been allocated to the wholesale price control, which will continue to have RPI indexation. So, we do not consider that RPI indexation would be appropriate for the household retail control – and note that this would be in line with the experiences of most retail businesses, across the economy

We expect retailers to manage emerging cost pressures actively by seeking lower costs and optimising their mix of retail inputs, as all retail business in other sectors would. For example, IT systems tend to both fall in cost over time and increase in capability allowing retailers to maintain or improve service at lower cost. We note that some water companies make use of outsourcing and this model is also extensively used to provide retail services in other sectors. We would expect efficient retailers to innovate and actively consider alternative means of providing retail services and so identify scope to reduce costs and (or) improve services.

If stakeholders consider that the household retail price control does need to allow for uncontrollable input price pressures, then we would welcome evidence from them about what these costs are and how they meet the three criteria set out in section 5.2.4. If we were to provide a mechanism to make such allowances, then there are a number of approaches we could take that did not involve indexation by RPI and these various approaches are set out in section 6.5.

5.4 The form of the household retail control

We want to give companies more responsibility and accountability for their household retail charges. This is because they are better placed to manage some of the risks associated with setting charges – provided they have appropriate tools to manage those risks.

So, in line with our approach to wholesale controls, we propose to set household retail controls that limit companies' total household retail revenues.

To set these controls, we need to determine companies' **allowed household retail revenues** for each year of the price control period. To ensure these allowed revenues reflect the different costs associated with serving metered and unmetered customers, we propose to set four unit costs for each company as the basis for deriving the total allowed revenues (see table 9).

Table 9 Unit costs for household retail control

Unit cost	Definition
Customer ('U')	Cost set for each unmetered customer.
Metering – water ('M_W')	Incremental cost set for serving a metered water only customer.
Metering – wastewater ('M_S')	Incremental cost set for serving a metered wastewater only customer.
Metering – water and wastewater ('M_{WS}')	Incremental cost set for serving a metered water and wastewater customer.

We would set the **customer allowance** for each company – and for each year of the price control period – based on the industry average unmetered ACTS, with adjustments to reflect any further industry-wide or company-specific adjustments to the ACTS, as well as our approach to the efficiency challenge.

We would determine the metering unit costs based on our assessment of efficient costs. Again, these costs could vary for different companies – and for different years of the price control period, depending on our approach to the ACTS efficiency challenge.

Companies' total allowed household retail revenues would then be based on these four unit costs shown in table 10.

Table 10 Companies' annual allowed household retail revenue

Annual allowed household retail revenue =			
	Number of unique customers	x	Customer ('U')
+	Number of metered water only customers	x	Metering – water ('M_W')
+	Number of metered wastewater only customers	x	Metering – wastewater ('M_S')
+	Number of metered water and wastewater customers	x	Metering– water and wastewater ('M_{WS}')
… plus any net margin included in the household retail control			

When we set price controls in 2014, we propose to use companies' projected customer numbers – and levels of meter penetration – to set a **base annual allowed household retail revenue ('R_H')** in line with this formula for each company, and for each year of the price control period.

As with the wholesale control, we want to take account of the fact that actual customer numbers and meter penetration will differ from companies' projections. So, companies' allowed household retail revenues will differ from the actual revenues they collect. We propose to do this using an annual adjustment mechanism, so that actual annual household retail revenues from 2016-17 will be given by:

Actual annual allowed household retail revenue =

$$R_H + (N_U \times U) + (N_W \times M_W) + (N_S \times M_S) + (N_{WS} \times M_{WS})$$

The terms in this equation are defined in table 11 below.

Table 11 Terms in equation for allowed household retail revenue

Term	Definition
R_H	Base allowed household revenue (current year).
N_U	Difference between actual and projected number of unique customers (prior year).
N_W	Difference between actual and projected number of metered water only customers (prior year).
N_S	Difference between actual and projected number of metered wastewater only customers (prior year).
N_{WS}	Difference between actual and projected number of metered water and wastewater customers (prior year).
U	Customer (current year).
M_W	Metering – water (current year).
M_S	Metering – wastewater (current year).
M_{WS}	Metering – water and wastewater (current year).

Depending on our approach to any adjustments for uncontrollable and uncertain input price risk, we may also need to incorporate an annual adjustment for such relevant changes in input prices.

5.4.1 Monitoring household retail charges

Under the expected legal framework, companies will continue to be required to publish a retail scheme of charges.

As with the wholesale controls, we expect them to demonstrate that the retail charges will recover their allowed retail household revenues.

As explained in section 4.3.1 above, we have not set out the details of how future charging governance will work in this consultation. Once we have published our methodology statement, we will consider the need for more detailed and specific guidance on setting separate wholesale and retail charges for the price controls.

5.4.2 Providing services to household customers

Our proposed approach to setting the household retail control will place incentives on companies to manage their costs. Since household customers cannot choose their supplier, we also need to ensure that the level of service they receive is protected and that companies have incentives to improve this service.

The SIM, which we introduced in 2010, has proved to be an effective tool at protecting customers and incentivising companies to improve the overall service they provide. Since 2010, customer complaints have decreased and customer satisfaction with the service provided has improved.

The CAP supported retaining the SIM as a national comparative incentive for companies. In line with this view, we propose to retain the SIM as an incentive for the retail household control. We will retain the overall design of the SIM. So for 2015-20, we will continue to compare companies' customer service levels, rewarding those that perform better than their peers – and penalising those that perform worse.

For the 2015-20 control period, we propose to apply the performance indicators that make up the SIM for only household customers. These indicators currently cover the service provided to both household and non-household customers. We propose to apply the financial incentive to household retail prices to deliver a similar financial outcome to the current SIM.

5.5 Consultation questions

Setting retail controls for household customers
Q15 Should the ACTS be calculated on the basis of historic cost data or forecast cost data?
Q16 Do you agree with our proposed criteria for assessing other adjustments to the ACTS? Are there other factors we should take into account, and (if so) how?
Q17 Do you agree with our preferred option of applying an industry-wide adjustment to the ACTS for levels of metering?
Q18 How do you think we should apply the ACTS for those above the industry ACTS? Do you think that we should use a glide path and (if so) of what form?
Q19 How should we set a forward-looking efficiency challenge for those companies below the industry ACTS?
Q20 Do you think we should use a net margin to remunerate household retail invested capital and risk over the period 2015-20? How can we avoid over-recovery of returns and take into account any implicit margin that exists in the difference between efficient retail costs and the retail price?
Q21 Do you agree that we should retain the service incentive mechanism (SIM), in a modified form, to encourage good customer service for households?
Q22 Do you agree with our preferred option of funding additional water efficiency services and customer-side leaks through the wholesale control?

6. Retail controls for non-household customers

6.1 Summary

In our retail consultation, we explained that our preferred approach was to set two retail controls:

- one for retail customers without choice, using an average cost to serve approach; and
- one for retail customers with choice, using a default tariffs approach.

In this document, we refer to:

- **non-household customers in England** to mean all non-household customers of companies operating wholly or mainly in England, including non-household customers of Severn Trent Water in Wales; and
- **non-household customers in Wales** to mean all non-household customers of companies operating wholly or mainly in Wales, including non-household customers of Dŵr Cymru and Dee Valley Water in England.

Non-household customers in England will not have choice in 2015, but are likely to from 2017. Our view is that, from 2015, these customers will receive a degree of protection because companies will begin taking active steps to retain customers that might leave in 2017. Indeed, we see evidence of this happening already with many companies making organisational changes that would enable them to better compete in the retail market – for example, by appointing retail specialists to their Boards and other key positions.

So, we propose to use a default tariffs approach for all non-household customers in England – including those that will be part of a contestable segment from 2017. Adopting a consistent regulatory approach to all non-household customers across England and Wales will be simpler, and could encourage spill over benefits from the contestable market in England. So we also propose to use a default tariffs approach for non-household customers in Wales. But, to reflect the reduced protection from competitive pressures, we also propose to adopt additional safeguards to secure value for money and service for non-household customers in Wales.

Chapter 5 sets out our approach to the ACTS. This chapter sets out our approach to setting default tariffs.

Non-household customers will be put on default tariffs, with an associated minimum level of service, automatically – unless they have an existing individual agreement or choose or have already chosen to switch to an alternative.

We propose to set a **separate default tariff structure for each company** by allowing companies to roll over existing tariff structures. We think this is the best approach because it minimises incidence effects.

We propose setting the default tariffs as a **gross margin per customer**. By this, we mean that the tariffs will set an allowed retail charge that will be added to the wholesale charge to arrive at total customer charges. We think using a gross margin approach would simplify the regulation of default tariffs as the default tariffs would not need to be re-specified if the wholesale elements change.

We intend that companies will propose tariff levels that recover their relevant retail costs, including a **net margin**.

We consider that the Guaranteed Standards Scheme (GSS) would provide sufficient back-stop protection for customer service levels for those customers likely to benefit from retail competition. So, for companies operating mainly in England, we do not propose for the default tariff to include any efficiency challenge, or to specify additional service delivery incentives to the GSS. But we may revisit this proposal if market opening in England were to be postponed beyond the 2017 date currently envisaged for the implementation of the Draft Water Bill.

We do not expect non-household customers of companies mainly operating in Wales that use less than 50Ml of water a year to be able to choose their supplier. So, we intend to provide them with additional regulatory protection. For these customers, the default tariff will set a tighter cap on the absolute price paid. Because of this, we will apply an efficiency challenge to the Welsh companies' default tariffs to replace the incentive to drive down costs, and hence prices, that a market would provide. We will also propose to set a regulatory service incentive for these customers, to protect the level of service customers receive.

Below, we summarise the main elements of our proposals.

Default tariff structure – confirmed direction
We intend to use a default tariffs approach to set retail controls for non-household customers. **We will adapt the default tariffs approach to provide additional protection for non-household customers in Wales, which cannot choose their supplier.**
Default tariff structure – preferred options for consultation
Separate default tariff structure for each company – by allowing companies to roll over existing tariff structures (but not levels). **Set default tariffs on the basis of a gross margin.** **Use GSS as default level of service.**
Default tariff structure – options for consultation
In determining allowed non-household revenue: ▪ whether we use our own assessment of operating costs or companies'; ▪ whether and how we include a net margin; and ▪ how to deal with any uncertain and uncontrollable input price risk. **In Wales**: ▪ how we apply an efficiency challenge; and ▪ how we should incentivise customer service.

6.2 Default tariff structure

There are three key questions in setting the default tariff structure.

- Should we set a **tariff structure** on an industry-wide or company-specific basis?
- How many **tariff bands** should we set for such a structure?
- Should controls on tariffs be set as a **gross margin or a total tariff**?

6.2.1 Industry-wide or company-specific tariff structures

In our retail consultation, we set out three options for default tariff structures. We said we could set a:

- single tariff structure that applies to all non-household customers across England and Wales;
- separate default tariff structure for each company, with bands matching the company's existing tariffs; or
- number of different default structures, and allow companies to choose between them.

Our view is that setting default tariffs on a company-specific basis reflecting existing structures is preferable. This is because setting default tariffs on this basis will help to avoid incidence effects that would arise from forcing customers to move from one existing tariff banding structure to another. A significant majority of the respondents to our retail consultation supported this option.

6.2.2 How many tariff bands should we set?

The same logic as for an industry-wide or company-specific tariff structure applies to the number of tariff bands that we should ask companies to set. The existing range of tariffs that companies offer has been developed to be appropriate to their customers. So, our view is that keeping regionally-specific tariffs by allowing companies to roll over their existing tariff structures is the best way of retaining the benefits that companies have sought to achieve. Rolling over tariffs has three key advantages.

- It minimises the scope for incidence effects from the introduction of competition, by ensuring that no existing customers are compelled to change tariff band.

- Companies are more accountable for their default tariffs.

- It minimises the regulatory burden associated with introducing default tariffs.

So, our preferred option is to set a separate default tariff structure for each company, based on their tariff proposals and their existing tariff structures.

6.2.3 Should default tariffs be set as a gross margin or a total tariff?

Setting default tariffs as a gross margin means specifying the retail element of tariffs as one part of the bill, with the wholesale element making up the other part. This approach has the advantage that the retail element can be specified separately from the wholesale element, which simplifies regulation. If the wholesale element were to change, then the default tariff would not need to be re-specified under this approach. This approach also makes these two elements of charges transparent.

Conversely, setting the default tariff as a total tariff – that included both the wholesale and retail elements – would require the tariff to be re-specified if the wholesale element were to change.

So, our preference is to control default tariffs as a gross margin. These will be set on a per company basis, using the same tariff structures as existing tariffs.

6.3 Setting the default level of service

The default level of service is the minimum level of service that companies must offer in association with the default tariff.

In our retail consultation, we set out two broad options for setting the default level of service. We could use the existing GSS or develop new service standards that reflect the service levels offered to customers under existing tariffs. We also explained why our preferred approach was to use the existing regulated standards because it would be the simplest and most consistent way to set the default level of service. All respondents, and the CAP, also supported basing the default level of service on the GSS.

Our preferred option is to set the default level of service using the GSS for the reasons given above.

We do not propose to set any specific service incentives for non-household customers in England. Where customers have the ability to choose their supplier, they can seek a better or different service. This creates a powerful incentive on companies to understand the needs of their customers, and to deliver more bespoke services that meet those needs better than regulated standards.

As the competitive market for retail services to non-household customers develops, we expect competitive pressures – both from new entrants and existing companies seeking a greater share of the market – to drive companies to focus on delivering better retail services for non-household customers. If competition did not develop as expected, we would consider whether customers needed additional regulation to protect them. But we want to allow competition to develop as we think that an effective market would deliver a higher level of protection to customers than regulatory measures.

But we recognise that we need to provide appropriate protection for non-household customers in Wales, where non-household customers are unlikely to be able to choose their supplier. As well as specifying the default service level in line with the GSS, we also propose to introduce a service incentive to encourage companies operating in Wales to be more responsive to the needs of their non-household customers.

We want this service incentive to target aspects of service that are important to non-household customers in Wales.

For this purpose, we could use measures similar to those in the SIM. Alternatively, we could develop an incentive that promotes service improvements in Wales in line with those being delivered by the non-household retail market in England to ensure that we capture and reflect in regulatory requirements the spill over benefits for Welsh customers. We would need to consider how information on the level of service would be measured so that we do not burden companies or customers in England.

We do not have a preferred approach to this non-household service incentive for the two companies operating mainly in Wales. We welcome views from stakeholders on the aspects of service we may want to target through this incentive.

6.4 Setting default tariffs

We need to establish the total amount of revenue that each company will need to provide its expected levels of non-household retail services. This will be important to enable them to split the projected costs and revenues from the different controls in their business plans. So, it will provide a key building block for the setting of default tariffs by companies. Identifying the expected overall non-household revenue as a component of integrated companies' business plans will also be important for

assessing financeability as we discuss in chapter 8, and ensuring that default tariffs are sufficient to allow retail competition to develop in England.

In this respect, we must also take account of the fact that a significant number of non-household customers in England may switch retail suppliers as the market develops. Any predictions about the likely levels of switching, underpinning cost and revenue projections, are inherently uncertain. In turn, this means that it will be difficult for us – or the companies – to predict likely future customer numbers.

As with the household retail controls, customer numbers will be one of the key drivers of non-household retail costs, and hence expected revenues. Without robust projections for customer numbers, it is difficult to set non-household controls based on an expectation of total revenues and attendant risks. This makes it difficult to set a control based on revenue from these retail services.

A further potential problem with a total revenue control is that unanticipated customer switching could then lead to significant changes in customer bills – with bills rising as customer numbers fall, and falling as customer numbers increase. While this could be managed by adjusting allowed revenues to account for changes in customer numbers, such adjustments could be complex and increase regulatory burden – particularly for a control that is intended mainly to provide back-stop assurance over tariff and service levels.

So, our preferred approach to the non-household retail control is to use average revenue controls – this will limit the average retail revenue (per customer by customer type) that companies can recover through the default tariffs. These controls would be set at the start of the price control period and would not then need to change to reflect differences between actual and projected customer numbers.

But we recognise that the risks posed by the potential churn of customers could remain a concern for non-household retailers, and so we invite views on this approach.

To set these average revenue controls, we propose to ask companies to:

- estimate the total non-household revenue they each will need for 2015-16, based on each company's proposed **operating costs** and a net **margin** designed to secure efficient finance capital employed in service provision (including working capital), encourage entry and remunerate operating and commercial risk; and

- consistent with these revenue estimates, and companies' customer numbers, to then determine default tariff levels for each of their tariff bands, consistent with the 'tariff corridors' we propose to set out in our methodology statement.

6.4.1 Operating costs

We have considered two approaches that could be used to determine the amount of non-household revenue needed to cover companies' operating costs. We could determine this revenue based on:

- our own assessment of the cost to serve non-household customers, which we would then apply nationally, regardless of companies' current non-household retail costs. For example, we could use our assessment of efficient, average or the highest non-household retail costs; or
- companies' current non-household retail costs.

If we use our preferred approach of allowing companies to roll over existing tariffs, then it makes sense to use each company's current costs as the basis – although there may be a case for adjusting these for expected material changes to the cost base. Default tariffs will then broadly reflect current levels of tariffs, as well as their current structures. So, our preferred approach is to use companies' current costs as the basis for calculating cost allowances, but we invite stakeholders' views on this.

6.4.2 Setting a net margin

As with the household retail control, we need to consider whether we should include a net margin in the determination of the gross retail margins proposed for the non-household retail control. The purpose of including a net margin in the control is to:

- secure efficient finance for capital employed;
- encourage entry; and
- remunerate risk.

The key issue is whether non-household retail costs are likely to be sufficiently above the efficient level to provide a net margin for new entrant retailers. If they are, then default tariffs based on these costs would already include an implicit net margin for efficient suppliers of these retail services. Introducing a net margin in the default tariff could then be postponed until existing suppliers' costs were closer to efficient levels. But if current costs are already relatively close to efficient levels, then an

explicit net margin allowance should be added to the relevant operating costs to provide a sufficient return for an efficient stand-alone retailer.

We are considering two approaches to net margins in the non-household retail control reflecting these alternative propositions. We could either:

- postpone introducing net margins for non-household retail controls for a period of time – which would be appropriate if there is already sufficient effective net margin in the existing retail costs as a result of inefficiency; or
- include a net margin that is set by reference to:
  - the net retail margins in other sectors, such as the water retail market in Scotland and in the energy sector; and
  - an assessment of the amount of revenue that a stand-alone efficient retailer would require to be independently financeable.

If a net margin was required, we would not consider a single margin option for the non-household control as only incumbent retailers will benefit from returns on retail assets in the RCV.

As with household retail controls, a particularly important consideration in determining our approach to net retail margins is our assumption about the payment terms between retailers and wholesalers (see section 5.3.2).

If we were to include a net margin for non-household retail price controls, it would be specified as part of the gross margin default tariff. But it would be set by reference to the costs of both the retail services and those incurred from wholesale charges, as the relevant working capital requirements are driven by both elements of overall gross retail costs and revenues.

We do not have a preferred approach to net margins for non-household controls, and invite views from stakeholders on which of the options is the most appropriate.

6.4.3 Determining the level of default tariffs

Once the allowed costs and any net margin have been determined, they will need to be translated into actual gross retail margins to set default tariffs. We have identified a range of options to carry out this step, reflecting different degrees of regulatory burden.

- We set the gross margin level for each company's rolled over tariff bands.

- We set out corridors for tariff bands based on the tariff bands of company charges that contain minimum and maximum gross retail margins for that band of customer. Companies would then be required to set the tariff levels that conformed to these tariff bands.

- Companies set their own default tariffs on the basis of the allowed recoverable costs and any net margin, consistent with our approach to wholesale and household retail charges, with no direct guidance from Ofwat.

A key consideration when assessing these options is ensuring that we do not impede the development of competition. In particular, we recognise that companies have an incentive to design their actual tariffs so that they can adapt flexibly to developing competition. For example, they may wish to offer lower prices to customers with a higher propensity to switch, while maximising their revenue from customers that are less likely to switch.

In this context, we recognise that companies are best placed to understand their customers and design tariffs – and we do not want to impose any unnecessary regulatory burden. Although consistent with the overall purpose of the default tariffs, we wish to provide the affected customers with a back-stop level of regulatory protection.

We do not have a preferred approach and invite views from stakeholders on which of the options is the most appropriate.

6.5 Dealing with uncontrollable input cost pressures

As for the household retail control, we do not consider that RPI indexation would be an appropriate mechanism for reflecting uncertain and uncontrollable input price risks in default tariffs. This is because retail costs are primarily operating costs with a high level of controllability by management and do not involve significant long-lived assets, which means they do not require the same approach as wholesale services.

In many respects, the issues we need to consider in relation to uncertain cost inflation are similar across the two retail controls. One key difference is the impact of competition – companies will have a stronger incentive to minimise the cost that is

passed onto customers. We consider there are three options to address uncertain and uncontrollable price pressures within the non-household control. These are:

- no explicit allowance for input price inflation, based on an assumption that companies can control and manage all the relevant risks;
- to ensure that the non-household retail control over the period 2015-20 has sufficient net margin to cover the risks of unexpected uncontrollable changes in input prices; and
- a pre-set measure that reflects the future changes in relevant efficient costs of a retailer providing non-household services.

We would not expect to include an allowance for input price increases unless we were provided with evidence that these were uncontrollable. We invite views from stakeholders on this.

6.6 Setting an efficiency challenge for non-contestable non-household customers in Wales

We explained in chapter 3 that only the very largest non-household customers in Wales – that is, those that use more than 50Ml of water a year – are likely to be eligible to choose their retailer, and there are currently no plans to change this. So, in the absence of a competitive market, we want to provide non-household customers of the two companies operating mainly in Wales with additional protection. For example, we may include an efficiency challenge when we set retail controls for these non-household customers.

We are considering two options for setting that efficiency challenge. We could apply:

- the efficiency challenge faced by household retailers (under the ACTS) to the non-household retail control; or
- an alternative efficiency challenge, based on the cost performance of non-household retailers in England (which are expected to face increased levels of competition).

Applying an efficiency challenge based on the performance of non-household retailers in England would have the advantage of providing some of the benefits of competition in England to customers in Wales. But it may also impose a cost on customers in England by requiring companies in England to collect and provide

information. As this would only benefit customers of companies operating mainly in Wales, we would need to consider how this cost was met.

We have not yet reached a view on how we should provide an efficiency challenge to companies in Wales, and so invite stakeholders' views.

6.7 Consultation questions

Setting retail controls for non-household customers

Q23 Do you agree with our preferred option of rolling over existing tariff structures to form default tariffs?

Q24 What are your views on our approach to customer churn under the proposed form of control for default tariffs?

Q25 What approach should we take to determine the aggregate level of operating costs to include in the non-household retail control? For example, should we use historic costs or forward-looking costs?

Q26 Do you think we should use a net margin to remunerate non-household retail capital employed and risk over the period 2015-20? How can we avoid over-recovery of returns and take into account any implicit margin that could exist in the difference between efficient retail costs and those used to set default tariffs?

Q27 What constraints, if any, should we place on companies' ability to set the gross margin levels for individual default tariffs for non-household customers?

Q28 Is there evidence that demonstrates that the costs of providing retail services to non-household customers are driven by uncontrollable changes in input prices? Are these difficult to predict? Given this, what is the appropriate approach in non-household retail controls for 2015-20 for uncontrollable changes in input prices?

Q29 Do you agree with our preferred option of setting the default tariff minimum service level using the existing GSS standards?

Q30 What aspects of service should we target in setting a service incentive for non-household customers in Wales?

Q31 Are there other options for setting an efficiency challenge for non-household retailers in Wales we have not considered? If so, what are they? Which approach do you think best meets our objectives?

7. Making better use of water resources

7.1 Summary

In our wholesale consultation, we explained that there is scope for significant benefits to customers and the environment if companies make better use of water resources. These include:

- reduced costs;
- increased resilience of customers' water supplies; and
- reduced pressure on the environment caused by abstraction in water scarce areas.

To help encourage better use of water resources, we proposed introducing new targeted incentives to encourage efficient **water trading**, alongside the **abstraction incentive mechanism (AIM)**, which is designed to reward or penalise companies depending on their levels of over-abstraction.

These incentives are also designed to complement and facilitate the longer-term reforms set out by the UK Government in the Water White Paper and Draft Water Bill. Our proposals are an important first step in realising the benefits of longer-term reforms, but also deliver benefits to customers and the environment in the shorter term. But more fundamental reform to the abstraction regime is needed to secure long-term benefits to customers and the environment.

Our preferred approach to water trading is to provide incentives for both exporters (sellers) and importers (buyers) of water. In the short term, these incentives – alongside other changes to our regulatory framework, such as the use of a totex approach to wholesale costs – should help to address some of the barriers to efficient water trading.

For the AIM, our preferred approach is to use a simple incentive that targets the most damaging over-abstractions. As we explained in chapter 2, the AIM is one of the minimum standard delivery incentives we want to use for all companies – and we are proposing to use a consistent, national incentive rate for all companies. To ensure it is targeted appropriately, we propose to trial the AIM in 2015-16, with financial rewards and penalties taking effect from 2016-17 onwards.

Below, we summarise the main elements of our proposals.

Water trading incentives – preferred options for consultation
Incentives for both exporters (sellers) and importers (buyers) of water, both introduced as part of the new price controls for 2015-20.
Incentives for exporters will increase the proportion of profits from trades retained by companies.
Incentives for importers use a simple cost over-recovery approach based on a fixed percentage of import costs.
Set a cap on the total incentive rewards for imports (to ensure customers do not pay more under the incentive than is needed to encourage efficient trading).
Abstraction incentive mechanism – preferred options for consultation
Introduce the AIM as part of the new price controls for 2015-20 (rewards and penalties do not take effect until 2016-17).
Use a simple version that has a single flow threshold, and a uniform effective outcome incentive rate per Ml abstracted.
Scope limited to Water Framework Directive 'Band 3' sites.
Incentive rewards and penalties based on national data on the value of reducing abstraction (provided by the Environment Agency).

7.2 Water trading incentives

In our wholesale consultation, we explained that there are significant barriers to water trading – and that these barriers mean that companies do not always trade water where it would be beneficial for them to do so.

In the long term, the proposals in the UK Government's Draft Water Bill should encourage the development of markets in water resources, and – potentially – enable new entry.

In the meantime, we want to introduce targeted incentives to encourage water trading. This should help realise the benefits of increased water trading more quickly than relying only on longer-term reforms.

In our wholesale consultation, we set out two primary options for implementing water trading incentives, which were:

- targeted incentives for exporters (sellers) of water only; and
- targeted incentives for both exporter (sellers) and importers (buyers) of water.

Most respondents supported water trading incentives, and the majority of these expressed a clear preference for both import and export incentives.

Stakeholders' responses support our preliminary view (set out in the wholesale consultation) that there is a strong case for introducing targeted water trading incentives for exporters for 2015-20 – and this remains our preferred option. But we also need to consider the case for introducing targeted incentives for importers.

Our view is that there are barriers to importing water that might not be fully addressed by other changes we are making to the price control framework. Existing cultural and behavioural biases mean that companies are likely to continue to retain a preference for ownership and direct control of water resource assets. Companies also have limited experience in designing and using effective contracts for water trading, so there may be some additional costs associated with them establishing appropriate processes to manage trading. So, our preferred option is to also introduce targeted incentives for importers for 2015-20.

But we also think that the barriers to importing – and the associated costs – are likely to reduce over time as companies gain experience of water trading. So, we consider that the main purpose of an import incentive is to act as a stimulus to change cultural and behavioural biases and, therefore, once those biases have been addressed there may no longer be a strong case for an import incentive.

So, we will need to keep our use of targeted water trading incentives – and import incentives in particular – under review as new evidence emerges and longer-term reforms bed in.

We now consider in more detail how we might design incentives for exporters and importers, as well as approaches to ensure trades are efficient.

7.2.1 Designing incentives for exporters (sellers) of water

Stakeholders have consistently told us that a key barrier to companies selling water is the limited returns available to exporters. Under our current approach, companies keep profits from water exports until the next price control, when profits are passed on to customers through reduced bills. This is broadly equivalent to companies keeping (on average) about 30% of the profits earned over the lifetime of a water trading project.

We want to tackle this barrier to trading directly, by increasing the proportion of lifetime profits companies keep from exporting water. Our preliminary work indicates that companies retaining about 50% of lifetime profits from exporting water could deliver the maximum benefits to customers (as lower returns for companies reduce the volume of trades, and higher returns for companies reduces customers' share of total benefits).

In practice – given our new approach to wholesale costs outlined in chapter 4 – this is likely to be achieved through a combination of adjustments to companies' cost performance rates specifically for water export expenditure and (or) allowing companies to retain revenues from exports for more than one price control period. We will engage further on the detail ahead of our final methodology statement.

We welcome stakeholders' views on our proposed broad approach to export incentives.

7.2.2 Designing incentives for importers (buyers) of water

The purpose of incentives for importers is to encourage companies to choose to buy water from another company where that is likely to be the most efficient source of supply.

We have considered two potential approaches to setting the level of import incentives:

- a case-by-case assessment of the difference in costs between the import and the next best alternative project; or
- a fixed percentage of the total costs of the import.

Both approaches have strengths and weaknesses. Using a fixed percentage of import costs is simpler to implement, but does not distinguish trades by their efficiency.

A case-by-case next best alternative approach may better reflect the benefits to the importing company delivered by water trading. But it is more complex and challenging to implement, and could significantly increase the regulatory burden – we would need to scrutinise each individual trade, and companies would need to provide us with detailed information about the costs of alternative projects for each proposed new trade.

Our preference is to use an approach based on a fixed percentage of import costs, because it is likely to be disproportionate for us to conduct a detailed assessment of the costs of alternative resources for each potential trade.

We propose to allow companies to recover a fixed percentage of import costs as an incentive reward. Calibrating the importer incentive is not straightforward. We want to protect customers against paying too much – but at the same time the incentive reward needs to be sufficient to overcome existing behavioural and cultural barriers and any short-term costs associated with increased levels of water trading.

We invite views and evidence from stakeholders on the factors we should take into account in setting incentive rates, and on the appropriate incentive rate to allow.

7.2.3 Securing efficient trades

Water trading benefits customers where it is the most efficient solution, taking into account resilience benefits from any increased interconnection.

- Customers of the importing company benefit when the cost of buying water is less than the cost of alternative approaches to balancing supply and demand.

- Customers of the exporting company benefit when the increased profits earned from selling water are shared with customers through lower bills.

When setting incentives to encourage water trading, we want to ensure that the incentivised trades will be beneficial overall – so that both sets of customers affected by such trades will benefit from them.

To secure this, the importer's incentive reward could be matched by a corresponding decrease in the exporter's allowed income (see figure 6). So, if the exporter's expected profits were less than the import incentive, the exporter would not choose to proceed, and the import incentive would not have brought forward an overall inefficient trade.

Figure 6 Offsetting water trading incentives

Thus, this approach should help ensure that the import incentive does not result in inefficient trades.

We also want to ensure that customers do not pay more under the incentives than is needed to encourage efficient trading. So, we are considering two approaches, which are to:

- set a cap on total incentive rewards for imports; and
- require each company to establish and report against a trading and procurement code covering water resources.

A cap on total export incentive rewards is undesirable because it could reduce the financial and other benefits available to customers of the exporting company. But we think that a cap on rewards for imports is desirable, because the import incentive is intended to act only as an initial stimulus to trading, addressing temporary barriers. While the quantity of new imports that each company could feasibly deliver in 2015-20 already restricts the rewards available under the import incentive, we are considering also setting a cap on import incentive rewards as a proportion of a company's total water revenues.

Requiring each company to establish and report against a trading and procurement code covering water resources would help ensure that rewards under the export and import water trading incentives were being earned only for efficient trading. We are also considering a de minimis criterion for a trade qualifying for a water trading incentive.

We welcome stakeholders' views on our proposed approaches to securing efficient water trades and protecting customers' interests.

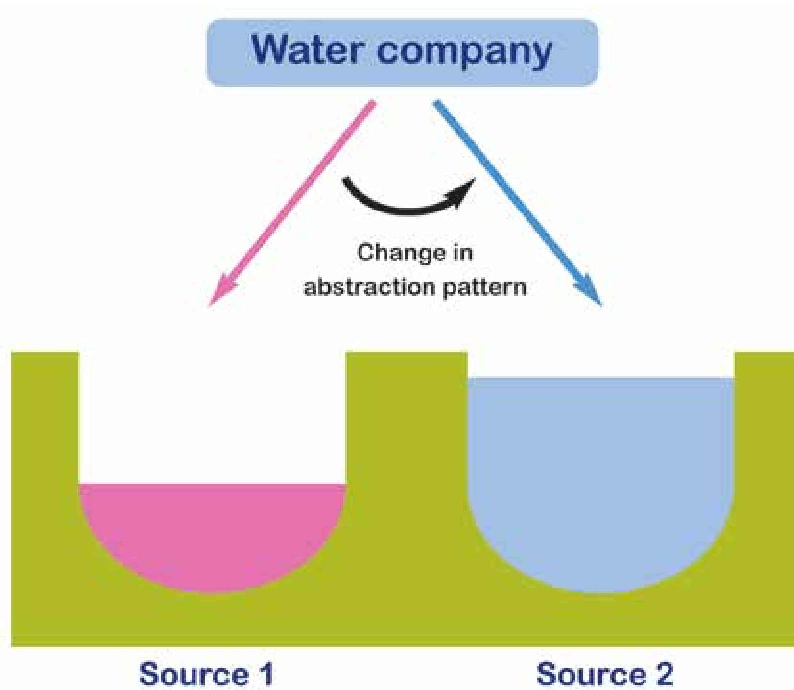
7.3 The abstraction incentive mechanism (AIM)

The AIM is a proposed compulsory minimum outcome incentive targeting the level of over-abstraction with a high risk of damaging the environment. Under the AIM, a company receives a symmetric reward or penalty depending on how far its actual over-abstraction is less than or greater than its baseline historic level. The AIM is not intended to prevent companies proposing their own outcomes related to over-abstraction. But any associated outcome incentive rates would need to be consistent with the AIM incentive rate.

The scope of over-abstraction that the AIM targets is defined by the most environmentally sensitive sites, and abstraction at those sites when the flows are below a given level.

The AIM ensures that companies take into account both environmental and financial costs in their day-to-day decisions on abstraction. It encourages them to reduce and – where they have a choice – to change abstraction patterns to avoid abstracting from sources at the highest risk of damaging the environment.

Figure 7 The AIM in practice



Ultimately, the UK Government's proposed reforms to abstraction licensing set out in the Water White Paper and Draft Water Bill are expected to deal with over-abstraction and the long-term environmental pressures caused by climate change and population growth. But these reforms will take time, and in the short term we think the AIM can help to reduce the pressure on the most environmentally sensitive sites.

7.3.1 Simplifying the AIM

Our consultant, CFOnstream, developed and reported on a trial version of the AIM, which we tested with several water companies. CFOnstream's report, 'Application of testing of prototype design and the abstraction incentive mechanism (AIM)' is available on our website.

The trial successfully tested the efficacy of pricing environmentally sensitive abstractions. The trial also highlighted the range of different parameters that could go into the design of the AIM. Companies and other stakeholders raised concerns about the complexity of including all of these parameters. For example, the trial version of the AIM allowed for the possibility of setting different weightings for:

- abstractions from sites with differing levels of sensitivity to over-abstraction; and
- abstractions at different levels of flow – that is, abstractions at very low flows would result in a higher AIM penalty than abstractions at merely low flows.

In our wholesale consultation, we committed to looking into a more simple version of the AIM. Feedback from stakeholders, including the CAP, and responses to the wholesale consultation strongly supported simplifying the AIM. So, we have decided to adopt a significantly simpler version of the AIM that uses:

- a single weighting across all sites where the AIM applies; and
- a single flow threshold below which abstraction volume scores within the AIM and above which it does not.

In other words, every megalitre of over-abstraction targeted by AIM will have the same weighting, and so there will be a single outcome incentive rate (in £/Ml) applicable to the AIM. The single outcome incentive rate would take account of interactions with our decisions on companies' cost performance incentives.

These simplifications reflect the lack of robust data to support a more fine-tuned calibration of the AIM. They will help reduce the administrative burden associated with it, while at the same time retaining its key function of discouraging the most environmentally damaging abstractions.

7.3.2 Implementing the AIM

In our wholesale consultation, we set out two primary options for implementing the AIM, having provisionally ruled out four further options for 2015-20.

- One proposed financial incentives that were based on local data about the value of reducing abstraction and were limited to the worst sites.

- The second proposed financial incentives based on national data about the value of reducing abstraction, with adjustments for external factors made in advance.

These two primary consultation options differed in two important respects:

- the **scope of the incentive** – the first option places more explicit limits on the number of sites included in the incentive; and
- the **approach we take to valuing the environmental benefits of reduced abstraction** – the use of local or national data.

In their responses to our wholesale consultation, all stakeholders that expressed a preference for the scope of the AIM suggested it should be limited in scope. Some thought it should be limited to the worst ~50 sites across England and Wales. Others suggested it should cover sites designated by the Environment Agency as Water Framework Directive 'Band 3' sites. These are sites where the Environment Agency has 'high confidence' that flows are not supporting Good Ecological Status.

Views on the approach to valuing environmental benefits were mixed, with some respondents preferring to use national data, and others suggesting that it might be more appropriate to use local, more site-specific data.

The CAP suggested we give further thought to using a 'shadow' AIM, which collates and publishes AIM scores but does not apply financial rewards and penalties, while we develop our approach.

We agree with stakeholders on the need to avoid an excessive regulatory burden. We also recognise the scientific uncertainty at many sites about the relationship between flow levels and environmental damage. The AIM needs to be targeted at those sites where there is the greatest confidence about the environmental damage from over-abstraction, or it risks incentivising inefficient and even environmentally worse outcomes.

So, we think that it is most appropriate to limit the scope of the AIM to no wider than those abstractions impacting Water Framework Directive 'Band 3' water bodies. This includes both surface water and groundwater abstraction sites. We are continuing to engage with the Environment Agency to understand whether or not it may be appropriate to use a subset of 'Band 3' sites.

We also think that it is more appropriate to use national data (on willingness to pay for improvements to ecological status, taken from the Environment Agency's 'National Water Environment Benefit Survey') to inform our judgements on the value of reducing over-abstraction and calibration of the AIM outcome incentive rate. This is because we want to ensure consistent application of the AIM across companies, which is particularly important in the context of potential increases in water trading resulting from our changes to incentives.

In implementing the AIM flow threshold, we think it is appropriate to establish this as percentage of the Environment Agency's Environmental Flow Indicator (EFI) at the relevant site.

In calibrating the AIM, we will need to finalise the flow threshold, as well as the outcome incentive rate and the sites to be included. We will also need to establish a baseline (historic) level of targeted over-abstraction for each company.

This will not be straightforward, particularly because baseline levels of over-abstraction will need to properly reflect historic average levels and – potentially – take into account the impact of events outside the companies' control, such as rainfall effects. In carrying out overall calibration, we will need to ensure that neither customers nor companies carry inappropriate levels of risk. Table 12 summarises the main elements of the AIM that we will need to set.

Table 12 Key elements of the AIM we need to set

Element	Our proposed approach
Scope	We expect the AIM to apply to abstraction sites no wider than those water company abstractions impacting Water Framework Directive 'Band 3' water bodies.
Incentive rate	The incentive rate would be informed by the data on willingness to pay from the National Water Environment Benefit Survey, and would take into account interactions with cost performance incentives.
Threshold	The AIM threshold, below which the AIM applies, would be a percentage of the EFI relevant to each site – for example, 50% of the EFI.
Baseline	The baseline could reflect historic average abstractions below the AIM flows threshold. We might also have a process to make adjustments to the baseline to take into account the impact of events outside the companies' control, such as rainfall effects.

We also recognise that the scientific evidence underpinning EFIs has not been fully tested at many sites. So, we consider there is a case for allowing extra time for scientific investigation (where appropriate), and any consequential adjustments to companies' baseline (historic) level of over-abstraction, before financial incentives come into force, in line with the suggestion of the CAP.

As a result, our preferred option is to implement the AIM in two stages.

For 2015-16, we intend to adopt the CAP's suggestion of running a shadow AIM, and will not apply incentive rewards and penalties. Instead, we will publish companies' AIM performance, and the incentive rewards and penalties they would have incurred. This will help companies and other stakeholders understand performance. At the end of this first phase, we will make adjustments to companies' baselines to reflect any improved information on EFIs.

From 2016-17 onwards, companies would incur financial AIM rewards and penalties.

We intend to engage further on our approach to scope, calibration and baseline setting in early 2013, taking into account work currently being carried out for UKWIR. As with other incentives, we will provide more detail on calibration in our final methodology statement.

7.4 Consultation questions

Making better use of water resources

Q32 Do you agree with our preferred option for implementing water trading incentives?

Q33 What are your views on the sharing of export profits that the incentive should aim to deliver? Please provide your reasons and supporting evidence where possible.

Q34 What evidence should we take into account in setting incentive rates for importers (buyers) of water?

Q35 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.

Q36 Do you agree with our preferred option for implementing the AIM?

Q37 Do you agree with our preferred limit to the scope of the AIM?

Q38 What evidence should we take into account in calibrating the AIM?

Q39 What are your views on our proposed phased implementation of the AIM?

8. Overall incentives, risk and financeability

8.1 Summary

In chapters 2–7, we have explained the key features of our approach to setting price controls for 2015-20. These include:

- incentives for delivery;
- incentives to reduce wholesale and retail costs; and
- targeted incentives to encourage better use of water resources.

As we explained in our wholesale and retail consultations – and the wholesale consultation in particular – all of these incentives need to work together as a coherent integrated package in order to deliver on our regulatory objectives.
In our wholesale consultation, we illustrated potential packages of new wholesale incentives and sought views on both:

- our approach to wholesale incentive packages; and
- on issues associated with overall packages of incentives across wholesale and retail.

Respondents provided little direct feedback to these questions. But our wider engagement has confirmed that stakeholders are considering the combined effects of our different proposals. In particular, we have had inputs from Indepen (sponsored and guided by a number of companies) and Severn Trent Water, which have published the following reports on incentive interactions.

- 'Behavioural Modelling of incentives in Ofwat's wholesale price limits consultation'.

- 'Designing incentive packages – Balancing incentives to drive the right behaviour'.

We have also been exploring further how incentives work together – in particular, by considering the potential impacts of the incentives on different stakeholders under different conditions. This work is taking place in two phases: an initial qualitative assessment, followed by a more quantitative assessment of potential impacts on financial risks under different scenarios.

Our initial qualitative work has focused on the main tools and incentives we propose to implement as part of the 2014 price review (as outlined in chapters 2–7), as we expect these to bring the most significant benefits during 2015-20.

This initial work has helped to validate our view that, in principle, our proposals should work together as a coherent package. Our preliminary view is that – subject to calibration – our proposed overall package of incentives should encourage company behaviours that are consistent with our regulatory objectives – including, in particular, protecting customers' interests – under a variety of possible circumstances. The quantitative modelling work carried out by Severn Trent, and by Indepen on behalf of companies, generally supports this preliminary view, although it highlights issues for more detailed consideration.

Our assessment of overall incentives is ongoing, and will be supported by the second phase of more quantitative analysis as we develop our proposals for our final methodology statement. This further quantitative work will help us identify in more detail the risks of perverse incentives and unintended consequences, under different incentive design and calibration assumptions, and under different scenarios.

This quantitative analysis will be informed by our modelling of incentive interactions, and will feed into our approach to:

- calibrating the overall incentive package to secure efficient financial risk allocation, so that risks are allocated to those best able to manage them;
- based on this, determining the appropriate overall level of risk to be borne by efficient companies, and given the appropriate approach to **remunerating risk**; and
- assessing efficient companies' **financeability** based on our approach to incentives and remunerating risk.

Getting our approach right in these areas supports delivery of our statutory duties to ensure efficient companies can finance their functions while protecting customers by ensuring they pay no more than is sufficient to reward these efficient companies and their investors for the risks they bear in delivering the outcomes they have committed to.

Below, we summarise the main elements of our proposals.

Securing efficient financial risk allocation – preferred options for consultation

Quantitative analysis will inform approach to incentive calibration, remunerating risk and financeability.

Use a net retail margin to remunerate retail risks if appropriate.

Continue to use a weighted average cost of capital (WACC) approach to remunerating wholesale risks.

Assess financeability at the whole business level, targeting financial ratios that are consistent with a comfortable investment grade credit rating.

8.2 Analysing impacts on financial risk

We need to understand the way our proposed changes to the way we set price controls could affect the overall balance of risks between companies and their customers.

Some changes to the risks faced by customers and companies during the price control period will occur even if we had not made changes to our approach to setting price controls. We will take these into account as required.

The main areas where our proposed changes to price controls might affect the overall balance of risk and its allocation between customers and companies are:

- the existing approach to efficiency and linking of price limits to RPI will no longer apply to retail activities – instead, we will use alternative efficiency challenges based on, for example, on the ACTS;
- there will be no specific efficiency target for retail activity costs incurred to serve contestable non-household customers of English companies that should benefit from increasing competition;
- there will be no distinct and separate efficiency targets for capex and opex for most of the value chain – instead, we propose more integrated cost performance incentives for the bulk of the wholesale value chain, which should improve the opportunities for companies to deliver value for money for customers over the longer term;
- companies will face higher-level outcome incentives for delivery, with the potential for greater non-controllable risks but greater opportunity to mitigate the impacts on customers when they arise;

- companies will face more targeted water resource efficiency incentives but greater opportunities to retain more profits from water trading;
- companies will face lower risks from unanticipated demand changes within the period, as the value of allowed revenue and associated cash will be automatically adjusted in line with relevant marginal wholesale and retail costs;
- companies will have greater flexibility to determine appropriate cost recovery rates for their own circumstances – including separate rates for water and wastewater expenditure and outcome commitments – and hence have greater ability to manage financeability; and
- companies will be required to provide greater transparency over the relative values of components of their value chain, which could increase entry risks and opportunities for more effective competition.

In most cases, our proposed changes should result in an enhanced ability for companies to manage risks effectively – and this should help to reduce the companies' overall level of risk and lead to better outcomes for customers. But in some small areas of expenditure they may increase risk. We will need to consider all potential changes in risk in the context of the steps an efficient and prudent company could take to manage these risks.

Our wider engagement with companies on the wholesale and retail consultations has revealed their preliminary views on the financial risks associated with our proposals. These views, together with our own analysis, have yielded initial estimates of the relative impacts of the main incentives in our price control package – which are broadly consistent with those set out in the recent Severn Trent report.

In practice, any change in the overall balance of risk will depend on the calibration of the individual incentives – including those where we will be defining the main incentive rates, such as:

- our approach to cost assessment (including incentive rates within any menus);
- water trading incentives; and
- any limits to minimum required incentives for delivery of outcomes (including the SIM and AIM), and any restrictions we place on companies' ability to trade-off delivery.

Our second phase quantitative analysis of financial risks will support incentive calibration, and the development of our final methodology, using a range of scenarios for modelling the financial risk impact of the proposed incentive package. This modelling will examine potential impacts for representative notional companies using capital structure assumptions consistent with our allowed returns at the last price review.

A key metric we propose to use in this analysis is return on regulatory equity (RORE) – this is a regulatory metric developed by Ofgem to understand the returns available to shareholders in regulated networks. Ofgem includes the effects of all material incentives, drivers and true-ups, even where adjustments take place in a subsequent price control period.

This focus on risks to equity is driven by the assumption that equity investors will bear most of the risks and rewards of up-front regulatory incentives. This is because, in order to sustain investment grade ratings, efficiently financed companies should not expect debt investors to be exposed significantly to business performance risks within the ranges expected for such an ex ante regulatory incentive framework. Accordingly, our view is that the overall envelope of expected ex ante incentive risk should be related to the equity risk premium.

We intend that our work on financial risk impacts will have two main components. First, we will develop a range of scenarios and explore risk impacts for each scenario individually. Then we will assess the relative probabilities of each scenario occurring, in order to arrive at an average overall risk impact.

For the first component of our analysis, the key issues we will need to consider include:

- whether risks are systematic – and so relevant to allowed remuneration in price controls;
- whether risks to companies are asymmetric – taking into account the proposed form of our regulatory incentives and companies' available mitigations, including their ability to develop appropriate forms of outcome delivery incentive;
- what proportions of the risks will be borne by companies and customers under our incentive proposals – bearing in mind our ability to adjust this during incentive calibration, and companies' ability to propose this, both in business planning and final menu/delivery incentive choices – after our draft determinations; and

- what time profiles are attached to risks and rewards by the regulatory framework, and their impact on companies' cash flow – including the relative impacts of in-period changes in allowed revenues and actual expenditures, and five-yearly changes to allowed revenues when incentive rewards and penalties are calculated at subsequent price reviews.

For the second stage of our analysis, we will need to evaluate the relative likelihood of different scenarios; this will allow us to understand the combined probabilities associated with different risks, and the overall balance of risks to RORE.

Our analysis might identify a spectrum of possible impacts.

At one end of the spectrum are incentive risks that give rise to limited and balanced deviations in RORE from the assumptions traditionally used in setting efficient companies' allowed returns – the WACC and assumed retail operating margins. Risks of this type are unlikely to affect investors' actual costs of capital, and are inherent in existing regulatory frameworks.

At the other end of the spectrum are incentives that give rise to a significant asymmetry in overall risk to RORE – particularly where impacts are skewed towards the downside. In these cases, the actual future cost of equity may be different to the level derived from historic information, such as that reflected in the capital asset pricing model (CAPM), and using cross-checks, such as the dividend growth model.

We will use this analysis to inform decisions on incentive rates that we set out for the industry as a whole in our methodology statement. But we will then need to carry out further analysis of incentives and risks for individual companies as part of our risk-based review of their specific business plan proposals, to inform our draft and final determinations.

The nature and extent of the overall risk impacts we identify will inform our approach to remunerating risk and financeability. Accordingly, we will set also out our decisions on our general approach to remuneration and financeability in our methodology statement, and then apply this approach in our draft and final determinations.

8.2.1 Remunerating risk

The application of our approach to remunerating risk – including the returns we allow companies to reflect that risk – will depend both on the calibration of our overall incentive package, and companies' choices of incentive rates through their business plans and our use of menus.

At this stage, we set out our intended approach to remunerating risk in high-level, qualitative terms – both for retail and wholesale controls.

8.2.2 Remunerating risk in retail controls

We have set out our proposals on the scope of retail services and activities in chapter 3. As a consequence of these, there would be relatively limited capital investment associated with the expenditures covered by the retail controls, particularly because the whole of the 2015 RCV will be allocated to the wholesale controls. This is in line with our commitments in our FPL statement.

In these circumstances, a return on capital approach for setting allowed returns for these controls is inappropriate. So, we propose to remunerate retail capital employed and risks through the margin associated with our price controls.

We discussed the broad options for retail net margins in chapters 5 and 6.

8.2.3 Remunerating risk in wholesale controls

In our FPL statement, we committed to continuing to allow companies to earn a regulated return on their RCV as part of their wholesale controls. We are thinking carefully about how we will do this, and what we will expect companies to submit within their business plans. As we set out in section 4.5 above, we will continue to do this using a WACC approach.

We will continue to derive the WACC in real terms, and use it for the whole control period, as the RCV and allowed revenues will be indexed by RPI. To derive the WACC, we need to estimate:

- the cost of debt finance;
- the cost of equity finance; and
- gearing – that is, the proportions of finance provided by debt and equity.

We set out our proposed approach to estimating all three of these factors in table 13.

Table 13 Proposed approach to estimating components of the WACC

Option	Approach
Cost of debt	We propose to continue using the approach taken in previous price reviews, combining direct observations from companies' existing debt portfolios and forward-looking projections. We propose using market evidence to determine whether a small company premium for water only companies is justified.
Cost of equity	Our initial view is that the capital asset pricing model (CAPM) is likely to have a role to play but with cross-checks to other approaches such as the dividend growth model, and informed by our analysis of the impact of our proposed incentive package on RORE. Again, we propose using market evidence to determine whether a small company premium for water only companies is justified.
Gearing	We propose to continue using a notional industry-level assumption for the mix of debt and equity (gearing). We will need clear market evidence to justify an assumption that any of the water only companies should have a different capital structure to the water and sewerage companies.

For previous price reviews, we have assumed notional levels of gearing in the 50–60% range. We will need to confirm whether this remains the right basis for setting price controls for 2014.

In practice, we note a number of companies have adopted actual gearing levels that are significantly in excess of this assumed range. Actual capital structures are a matter for companies to determine, given their commercial and financial structures. Where companies identify innovative approaches to outperform the regulatory assumptions on capital financing costs, we can share the benefits of this outperformance with customers when we set prices.

But we also note that in developing its proposals for reforms, the UK Government has identified the potential for increases in systemic risks facing the water and sewerage sectors. So, we will need to consider carefully any proposals for allowing actual capital structures to adapt to new risk profiles, to ensure financeability and efficient financing costs over time.

In any event, we propose to continue basing our assessments of tax on companies' actual gearing levels. This approach, which we have used in previous price reviews, removes the incentive for a company to out-perform regulatory tax assumptions by increasing its gearing.

8.3 Assessing financeability

As set out in section 2 of the Water Industry Act 1991, we have a statutory duty to ensure that an efficient company can finance its functions. We interpret this duty as applying to the ring-fenced regulated activities of the appointee, and the approach we intend to take is to seek to ensure an efficient company can:

- earn a return at least equal to our allowed costs of capital – through net retail margins and wholesale returns relative to the WACC; and
- raise finance on reasonable terms.

So, we propose to carry out our key financeability tests and ratios using aggregations of the revenues, costs and cash flows associated with the regulated activities across price controls, with:

- a single associated balance sheet that assumes the notional capital structure represented in the derivation of the WACC and allowed retail margins; and
- the allowed cost recovery and depreciation rates for water and wastewater wholesale services determining the evolution of the RCV over the price review period.

Using these assumptions, we will check that the projected financial ratios for companies are at levels consistent with a comfortable investment grade credit rating. But we will also assess whether the activities covered by the retail price controls are financeable in their own right, given our assumptions over relevant risks and our allowed remuneration for these risks, as discussed in chapters 5 and 6.

Where the financial ratios indicate that an individual company's actual capital structure may put at risk a comfortable investment grade rating with the allowed revenues, we will examine capital structure solutions in the first instance – as we did at the 2009 price review.

Then, three companies were in such a position and we assumed that they would raise new equity to address the situation. We included the associated transaction costs in their price controls, which we committed to claw back if not required.

If a similar approach is required in the next price review, it is likely that any funding would be recovered from allowed wholesale revenues, as wholesale controls reflect these company-specific costs more closely than the retail controls.

8.4 Consultation questions

Overall incentives, risk and financeability

Q40 Do you agree we should develop the balance of our proposed incentives using initial quantitative analysis of notional companies, and refine the calibration of incentives to reflect individual companies' business plan proposals?

Q41 Do you agree that we should evaluate the overall risks relevant to each price control in assessing the allowed returns?

Q42 Do you agree with our broad approach to setting the WACC for wholesale services, given our proposals for the remuneration of retail services in chapters 5 and 6?

Q43 In setting the WACC are there specific considerations we should bear in mind taking account of the profile of relevant risks to wholesale service provision?

Q44 Do you agree with our broad approach to assessing financeability? Are there specific factors we should take account of in the next price control review?

9. Assessing performance during 2010-15

9.1 Summary

When we set price limits for 2010-15 at the 2009 review, we included a number of mechanisms (legacy tools) to:

- manage risks to customers and companies from uncertainty in costs and changes in the outputs companies must deliver; and
- provide incentives to encourage outperformance and penalise companies that perform poorly.

We committed to assessing the final outcome of the legacy tools in the light of outturn costs and benefits when we set price limits for 2015-20 and, where appropriate, to make adjustments to allowed revenue. We reaffirmed this commitment in our FPL statement, and that position has not changed.

Table 14 sets out the key legacy tools we will need to reconcile when we set prices for 2015-20.

Table 14 Legacy tools

Tool	Purpose
Service incentive mechanism (SIM)	Incentive to reward good customer service performance.
Revenue correction mechanism (RCM)	Tool to deal with differences between actual revenue collected and our assumptions at the 2009 price review.
Opex incentive allowance	Balancing incentive for savings in operating expenditure designed to counter effect of five-year price controls.
Capital expenditure incentive scheme (CIS)	Incentive used for capital expenditure, designed to reward both cost out-performance and accurate business plans.
Change protocol (logging up and down, shortfalls, overlap programme)	Tools used to deal with material changes in delivery from our assumptions at the 2009 price review.

For all of these legacy tools, we will need to:

- compare actual performance, costs and revenues against the assumptions we made at the 2009 price review; and
- based on actual performance, costs and revenues, determine and apply any adjustments to companies' allowed revenues (and price controls) for 2015-20.

We will also need to make adjustments to:

- account for differences between the RCV projections we made in 2009 with the companies' outturn positions;
- recover any assumed costs of issuing new equity during 2015-20 where these costs did not materialise (this only applies to the small number of companies we assumed would need to issue new equity); and
- recover any tax benefits arising from in-period changes in capital structures.

Below, we summarise the main elements of our proposals.

Adjusting price controls for 2015-20 – preferred options for consultation
All adjustments as a result of legacy tools made through wholesale controls.
Decisions to spread adjustments across the price control period made on a case-by-case basis.

9.2 Adjusting price controls for 2015-20

When making adjustments to price controls for 2015-20, we need to consider:

- which control we should adjust; and
- over what period we should apply any adjustments.

9.2.1 Choosing controls to adjust

At the 2009 review, we set price limits on the basis of a single price control covering all activities within the company. When we come to make adjustments for legacy tools, we will need to decide how we allocate any adjustment between the retail and wholesale controls.

Our initial view is that we should make all adjustments to the wholesale control. Most of the legacy tools map to activities within the wholesale control. The principal exception to this is the SIM, which is a customer-facing incentive. We could seek to apportion adjustments to the different retail controls or across retail and wholesale controls. But because in the current period SIM applies to most non-household customers as well as household customers, we think it is more appropriate to make the adjustment to the wholesale control.

9.2.2 Time period for adjustments

The size and nature of the adjustments we need to make will vary across companies, depending on each company's performance and the extent to which its circumstances and investment programme has changed since we set price limits in 2009. Some adjustments need to be made in each year of the control – for example, the opex roller allowance – but others could be made either in a single year or across more than one year.

As a result, when we make adjustments we will consider whether to ensure the impact is felt in full in the first year of new price controls or spread across a number of years. Any decision would be revenue neutral and will depend on the individual circumstances of the company at that time and having regard to customer impacts.

9.3 Use of legacy tools beyond 2014

We have also considered whether – and, if so, how – we will continue to use these legacy tools in the future.

Some of the legacy tools will no longer be needed, because their function is being delivered through elements of the overall incentive package for 2015-20. So:

- our proposed approach to water wholesale revenues directly incorporates adjustment mechanisms that perform similar functions to the RCM (see section 4.3);
- our proposed cost performance incentives (section 4.4) will deliver the functions of both the opex incentive allowance and the CIS; and
- our proposed outcome delivery incentives (section 2.3) will address many of the issues covered by the change protocol.

We will continue to use the remaining tools, but – in some cases – will need to adapt them to reflect the wider changes we are making to the overall incentive package and the price control framework.

We summarise our approach to legacy tools beyond 2014 in table 15.

Table 15 Use of legacy tools beyond 2014

Tool	Use beyond 2014
Service incentive mechanism (SIM)	Continue to use, but adapt to align with new price control structure and wider delivery incentives.
Revenue correction mechanism (RCM)	Not needed – addressed by our proposed approach to wholesale revenues.
Opex incentive allowance	Not needed – addressed by proposed cost performance incentives.
Capital expenditure incentive scheme (CIS)	Not needed – addressed by proposed cost performance incentives.

We consider that our proposed framework should improve the incentives on companies to manage investment across the transition between 2010-15 and 2015-20 price reviews. In chapter 2, we described how our overall framework will reduce biases in favour of capital solutions through our approach to wholesale costs, and give companies greater flexibility around how they deliver through the outcomes approach. And Infrastructure UK recently described a number of measures companies themselves could take to help manage this issue.

The changes we are making to our proposed framework will give companies both the flexibility and incentives to invest for the longer term, and to respond to changing circumstances and customer priorities.

At the same time, we will retain mechanisms that mitigate risk and provide companies with certainty that, in specific circumstances, efficient investment will be remunerated. Taken together, these will provide the right framework to allow companies to take decisions and manage the way they procure and deliver their proposed work programmes.

We have attempted to address the stop-start nature of investment across price review transitions in the past through specific mechanisms such as the early start and overlap programmes. But we found that these did not deliver the hoped-for improvements in companies' management of their investment cycles.

We think that without compelling evidence to the contrary, the our proposed changes – and the mechanisms we are retaining – will be sufficient for companies to manage the investment cycle. We do not propose to introduce specific, new and potentially burdensome mechanisms for the 2014 price review.

We will reconcile any investment undertaken within the overlap programme in line with our commitments at the last price review.

9.4 Consultation questions

Assessing performance during 2010-15
Q45 Do you agree with our preferred option of implementing adjustments for legacy tools through wholesale controls?
Q46 What factors should we take into account when determining whether to spread adjustments over the price control period?

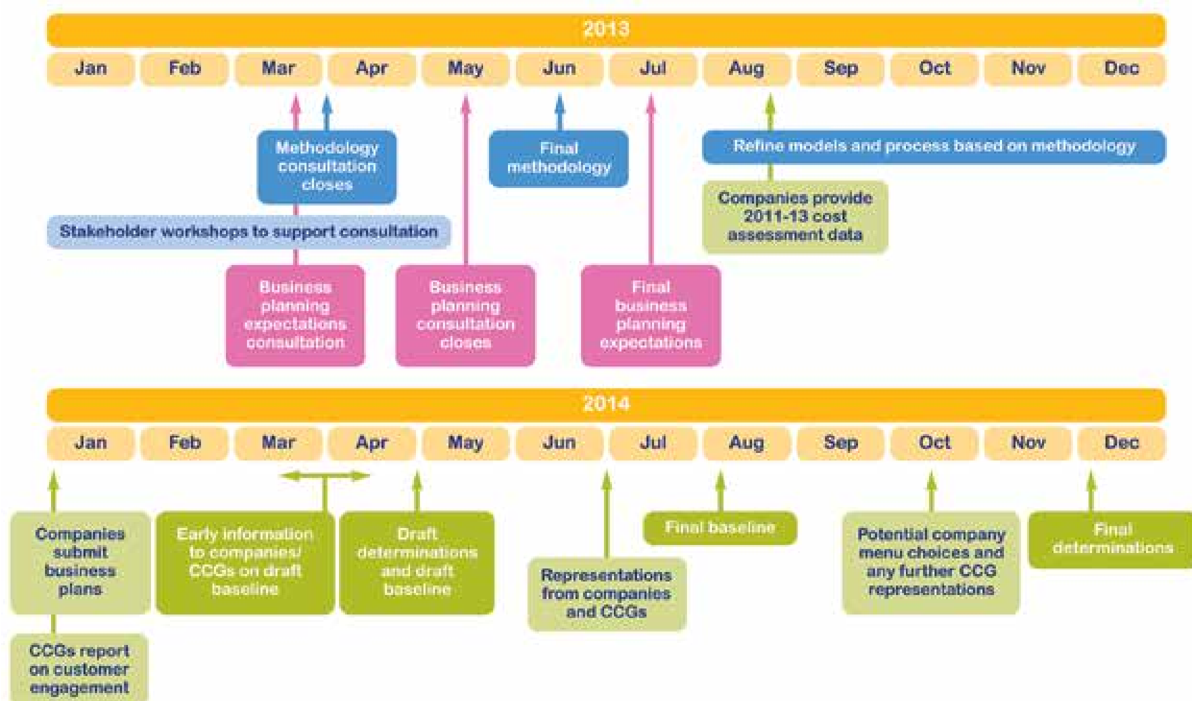
10. Delivering price controls in 2014

To deliver price controls in 2014, there are three main phases of work we need to complete, which involve:

- **developing our final methodology**;
- in parallel, **developing our business planning expectations**; and
- **delivering our determinations** – assessing companies' business plans and setting draft and final determinations.

We illustrate these three phases of work, with indicative timescales, and assuming menus are implemented, in figure 8.

Figure 8 Phases of work for delivering 2014 price controls



10.1 Developing our final methodology

The first phase of work we need to complete is the development of our final methodology for setting price controls in 2014.

This consultation closes on 26 March 2013. We will use responses to this consultation to inform decisions on our final methodology, which we intend to publish in early summer 2013.

During and after the formal consultation period, we intend to continue engaging with stakeholders on implementation issues, through a series of targeted workshops and other forms of consultation. As our proposals become more detailed, it may help both us and the companies to engage in consultation through other means than large, formal written documents.

10.2 Developing our business planning expectations

The second phase of work we need to complete is the development of our business planning expectations for 2014.

The responsibility for the business plan and its contents rests solely with the Board of each company. The CCGs have an important role to play in ensuring companies engage properly and reflect customer views. But it is the company that makes the final decision about its plan and has to present a well-evidenced case to demonstrate its proposals:

- are proportionate;
- reflect customers' views; and
- are robust.

We will publish our business planning expectations for consultation around Easter 2013. Having taken account of responses to the consultation, we intend to publish our final business planning expectations in summer 2013.

As part of the business planning consultation, we intend to set out the approach we will take to assessing companies' business plans – our **risk-based review**. This is a key part of making sure our approach to setting price controls aligns with the principles we set out in 'Delivering proportionate and targeted regulation'.

The risk-based review process is intended to incentivise high-quality and truthful business plans, based on effective engagement with customers and the efficient costs of delivery. Each company will need to set out clear plans for the separate retail and wholesale controls, and demonstrate how these form a coherent and financeable set of proposals.

We think it is right for companies that produce high-quality business plans to receive a reduced level of scrutiny of their proposals. But at the same time, we need to fulfil our statutory duties to customers and the environment. So, there will be an appropriately high bar before companies earn reduced scrutiny of their business plans.

Our emerging view is that we are likely to follow a four-stage process for our initial risk-based assessment of companies' business plans.

- First, we will assess companies' proposed outcome commitments and the associated delivery incentives.

- Second, we will assess companies' proposed costs associated with these proposed commitments.

- Third, we will assess companies' approach to risk and reward – including proposed charges and outcome delivery incentives – based on the approach in our methodology statement.

- Finally, we will assess companies' associated plans for financeability.

Each of these stages will involve a limited number of assessment criteria, including – where appropriate – comparisons between companies.

We intend to consult on the criteria we will use as part of the business planning consultation. But example criteria could include:

- whether the CCG has made a positive, and well-evidenced, assessment of how customers' preferences have fed into the company's business plan;
- whether the proposed package of outcome commitments and outcome incentives meets the methodology's minimum requirements;
- whether the overall ambition of the proposed outcome commitments is consistent with the company's track record of delivery;
- whether the business plan's costs fall within cost corridors identified by our cost assessment models;
- whether the companies' approach to cost recovery – including its PAYG ratio – is within reasonable bounds; and
- whether the company's plans meet financeability tests.

We want companies to focus on the best way to deliver a plan that reflects what customers want and value, rather than being driven by the regulatory framework and second-guessing our cost assessment models and other tools for risk-based review. As a result, we will not reveal precise thresholds for an 'acceptable' plan.

Following the initial risk-based review, we will focus our detailed scrutiny and challenge on those business plans, and parts of business plans, that did not meet the relevant criteria under the risk-based review.

The process we will follow will aim to be fair to all companies and take account of relevant differences between them. There will be opportunities – both in the business plan and later in the process – for companies to provide supporting evidence if elements of their business plan are likely to sit outside the relevant thresholds we set for our assessment criteria.

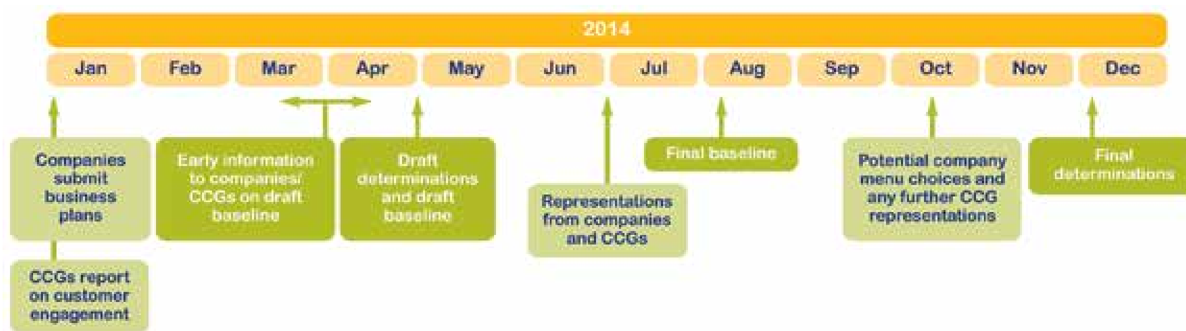
We think that our risk-based approach to assessing business plans will create strong procedural incentives on companies to submit high-quality business plans – as this will result in less onerous scrutiny of, and less challenge to, their proposals. These procedural incentives will complement the incentives for high-quality and truthful business plans that would arise from our use of menu regulation in setting wholesale controls.

Taken together, we think these procedural and financial incentives should be sufficient to encourage companies to submit robust, high-quality plans. So, we are not considering using additional direct financial rewards for companies that submit good business plans.

10.3 Delivering our determinations

The final phase of work is the delivery of the price control process itself, again assuming we implement menus (see figure 9).

Figure 9 Delivering determinations in 2014



We recognise that this proposed timetable for delivering our determinations in 2014 is challenging. In particular, there are relatively short periods of time between:

- the submission of business plans and the CCGs' reports in early January and our draft determinations in late April; and
- our draft determinations and when companies and CCGs must submit representations in June 2014.

But these short timescales are necessary to deliver the improvements to our price setting process that companies have told us they want, and that we consider will bring significant benefits to customers. In particular, they are essential to ensure robust baselines that incentivise companies to reveal the efficient costs of delivery by making menu choices, and that are properly informed by dialogue with CCGs.

We want to work with companies to deliver against this demanding timetable – this will be a key focus of our coming workshops. We will not make a final decision on the implementation of menus until after we have gathered feedback through these workshops.

We also welcome suggestions from stakeholders about how we could improve this proposed timetable, and any proposed alternative timetables that might address some of the timing constraints we have identified.

10.3.1 Role of the CCGs

The CCGs have an important role to play in helping us deliver our determinations – particularly in challenging companies' proposals once we have published our draft determinations. These will provide the CCGs with information on our scrutiny of different companies' costs and plans. This will enable them to take a more informed

view of the truthfulness of companies' costs and to challenge the scope and scale of their own company's package based on comparisons with those of other companies. CCGs' responses to our draft determinations will be a key input to our final determinations.

We and the companies will support the CCGs in carrying out their role by providing them with appropriate information. For example, we would expect companies to provide CCGs with information:

- on their proposed customer engagement plans, and the material used in that engagement;
- on their current performance against the delivery package set out in our 2009 final determinations;
- about other regulatory requirements and plans, such as drinking water quality requirements and WRMPs; and
- that allows them to challenge proposed company choices on outcomes and bill impacts.

And at appropriate points, we will look to provide CCGs with comparative information on companies' delivery performance – including on SIM, bad debt and leakage – and their financial performance.

Of course, CCGs may also arrange to share between themselves non-confidential information such as companies' engagement processes, emerging customer preferences and willingness to pay results.

10.4 Consultation questions

Delivering price controls in 2014
Q47 What are your views on our emerging criteria for identifying high-quality business plans? Are there other criteria we need to consider?
Q48 What factors should we take into account in further developing our process for a risk-based review?
Q49 Is the timetable we propose for introducing menus feasible? How could we improve it? What can we and the companies do to address the challenges of the timetable to allow companies to make a real effective menu choice?

11. Building for price reviews in 2019 and beyond

11.1 Summary

We have outlined a package of significant changes to the way we set price controls for 2014. For future price reviews, we expect to continue to evolve our approach to price setting to take account of ongoing changes in the water and sewerage sectors, including:

- implementing proposals in the Draft Water Bill – in particular, changes to enable greater use of markets, and changes to charging governance such as adopting new charging rules;
- the development of markets in different parts of the value chain; and
- improvements in the quality of information about companies' costs, and the value that customers place on different aspects of the services companies provide.

We will need to consider carefully how best to adapt our approach in response to these or other changes. Examples of the way we might change our approach include:

- more use of incentive rewards for delivery and trade-offs between outcomes as information about the value and specific costs of outcomes improves; and
- target regulation across different areas of the value chain to reflect different economic characteristics and where appropriate – and within the scope of relevant enabling legislation – consider deregulation.

We also want to take steps in the next price control period to improve the way we regulate companies' monopoly network activities when we next set prices in 2019. In our wholesale consultation, we proposed two new tools to help achieve this:

- **network plus** – designed to reveal information about costs and revenues related to companies' network and treatment activities; and
- **network management** – designed to reveal information about companies' network management policies, practices and cost drivers.

Our wholesale consultation also explained how we had developed a range of options for implementing these tools, and set out our initial evaluation of those options.

Below, we summarise the main elements of our proposals.

Network plus – preferred options for consultation
Two non-binding sub-limits: · one for water, covering raw water distribution, water treatment and treated water distribution, but not water resources; and · one for sewerage, covering sewage collection and sewage treatment, but not sludge treatment, recycling and disposal. **Both sub-limits implemented by a target date during 2015-20, with both separated revenue accounting and non-binding limits by 2017-18.**
Network management – preferred options for consultation
Network management incentive covers reporting on water networks and sludge. **Reporting evolves from open questions about network management practices that companies respond to in business plans to specific, consistent reporting (including cost drivers) over the course of 2015-20.** **Option to set a trial, non-binding incentive for efficient network management before the end of the price control period.** **Include an allowance for the costs of high-quality reporting by companies in the wholesale controls, subject to clawback if reporting is not sufficiently high quality.**

11.2 Network plus

The network plus tool works by setting indicative, non-binding sub-limits for companies' network plus – that is, their network and treatment – activities. A key purpose of such sub-limits is to delineate the charges and revenues associated with parts of the value chain that are likely to have different regulatory approaches in future.

In our wholesale consultation, we set out four options for implementing network plus, having provisionally ruled out two options for 2015-20. The four consultation options covered combinations with the following characteristics.

- The **scope of sub-limits** – water only, or both water and wastewater.

- The **timing of implementation** – as part of 2014 price review, or during the period 2015-20.

- The **approach to implementation** – including whether non-binding sub-limits are set by us or by companies, and the extent to which implementation is phased).

We have used responses to our wholesale consultation, alongside Thames Water's report on network plus and wider feedback from stakeholders, to take decisions on our preferred approach to network plus.

Half of the companies that responded on this issue questioned the need for an indicative network plus sub-limit. In particular, they noted the increased costs for customers of implementing it. Almost all respondents expressed a preference for the option based on enhanced reporting, followed by sub-limits later in the period.

We remain of the view that implementing an indicative network plus sub-limit during 2015-20 will create greater transparency around the costs and revenues associated with network activities. This increased transparency will enable:

- improvements in the way we regulate companies' network activities for the 2019 price review and beyond; and
- market forces to improve activities such as efficient water trading and more sustainable use of networks, as existing and new players have better information on which to base their decisions.

There will be some costs to customers in the short term from companies implementing network plus, as well as to those required for companies to implement the necessary enhanced accounting separation for regulatory financial reporting purposes. But we have no evidence these costs will be significant if the implementation is managed effectively, while in the longer term these improvements are likely to bring significant benefits to customers.

We accept some of the concerns that stakeholders raised about the feasibility of implementing indicative network plus sub-limits as part of our 2014 price review, given the current ability of companies to furnish sufficient information during the business planning process. So, we have decided to take a more measured approach to introducing non-binding sub-limits during 2015-20.

There are two key issues we need to consider for this purpose: scope, and our approach to implementation.

11.2.1 Scope of indicative network plus sub-limits

As we explained in our wholesale consultation, we want to use a non-binding sub-limit within the water service, to help harness market forces in water resources – encouraging new entrants and more efficient water trading.

In determining the appropriate scope for network plus, there are two further questions we need to answer.

- Should we also implement a sub-limit within the sewerage service?
- Which activities should the sub-limit(s) cover?

Alongside water resources and retail, sludge is also a key part of the value chain where there is potential to make more use of market mechanisms to deliver benefits for customers (as the Office of Fair Trading's 2011 organic waste market study highlighted). One important way we could promote development of the sludge market is by helping ensure there is no cross-subsidy between monopoly sewerage and potentially contestable sludge activities. Another is by tailoring the way we regulate sludge, in future after 2019, relative to other monopoly sewerage activities.

Our view is that developing an indicative sub-limit in the next control period covering sewage collection, transport and treatment – but excluding sludge treatment, transport and disposal – would help achieve these aims, by developing and improving the scrutiny of the regulatory boundary between sludge and sewerage assets.

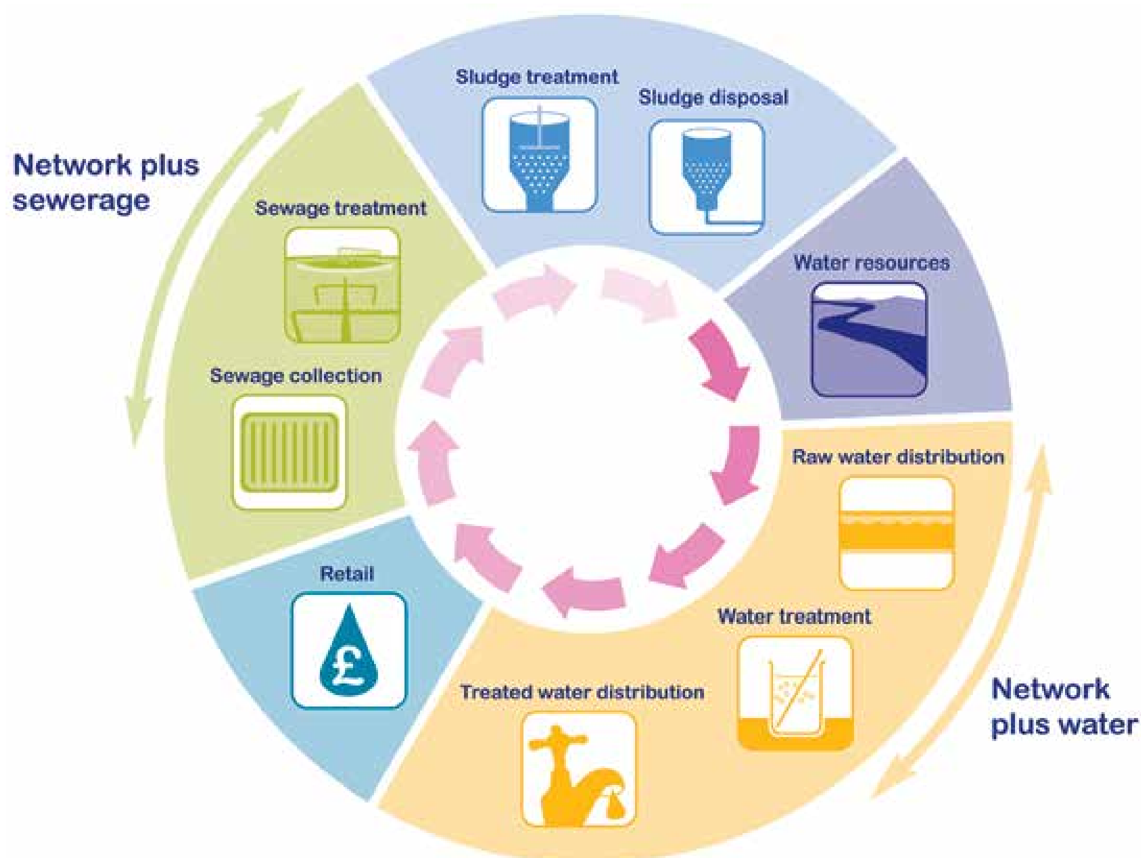
So, we are proposing to implement non-binding sub-limits in both water and sewerage during 2015-20.

We also need to propose which specific activities should be included within the two sub-limits.

In our wholesale consultation, we explained that we could define both proposed sub-limits by reference to the nine business units developed as part of our work on accounting separation (see figure 10). We invited views from stakeholders on this.

A key concern that stakeholders raised in response to our wholesale consultation was the potential costs associated with implementing sub-limits. In particular, stakeholders were particularly concerned about the potential for complexity – and hence additional costs – if sub-limits did not align with our existing approach to accounting separation.

Figure 10 Scope of network plus for water and sewerage



In line with stakeholders' comments, our preferred option is to build on the existing accounting separation information requirements when developing enhanced reporting required for implementing network plus.

By aligning the definition of network plus to the existing accounting separation business units, we will reduce significantly the regulatory burden associated with implementing network plus during 2015-20.

Also, taking a measured approach to implementing sub-limits will enable us to continue our work with companies to ensure that future reporting requirements are fit for purpose and align with the proposals envisaged in the Draft Water Bill.

So, our proposed boundaries of both the water and sewerage network plus remain in line with those in our wholesale consultation, as follows.

- Water network plus will include three business units – raw water distribution, water treatment, and treated water distribution.
- Sewerage network plus will include two business units – sewage collection and sewage treatment.

We invite any further views from stakeholders on this scope.

11.2.2 Implementing network plus

Setting binding wholesale price controls requires information about the costs and revenues of wholesale activities. Similarly, setting non-binding sub-limits for network plus requires information about both the revenues and costs associated with network plus activities.

As part of our work on accounting separation, companies have already begun to report separated cost information, split between the nine business units illustrated in figure 10 above, in their regulatory accounts.

To implement non-binding network plus sub-limits, we also need companies to implement separated revenue accounting to provide actual information to monitor against the indicative sub-limits. But companies do not currently identify or report separated revenue information.

Because revenues arise from charges, a view on the appropriate allocation of revenue between internal business units requires assumptions on the way in which external charges for the services provided by the business units concerned will be determined – including from regulation where relevant. So, our approach to regulated external access pricing during the next control period will inform companies' internal allocation of revenues for separated revenue accounting.

In turn, our future approach to regulated external access pricing depends, in part, on the timetable for implementing the reforms to charging and access pricing proposed in the Draft Water Bill. In particular, this timetable dictates the extent to which our approach to access pricing will need to reflect existing legislation – including the costs principle – or the revised framework of charging rules proposed in the Draft Water Bill.

In view of these dependencies, we propose to introduce both the particular separated revenue accounting requirements to support network plus and the non-binding network plus sub-limits during the 2015-20 period, when we expect to have a clear view of both the implementation of the Draft Water Bill and our future approach to access pricing.

But in any case we need to introduce non-binding network plus sub-limits in time for them to inform our regulatory approaches from 2020, including any new binding sub-limits. So, we consider that both separated revenue accounting and non-binding limits need to be introduced by 2017-18. Before then, we will continue to develop separated reporting of the costs concerned.

11.2.3 Incentives for providing network plus information

Section 11.3.4 sets out our preferred approach to incentives for providing network plus information.

11.3 Network management

The network management tool works by incentivising companies to provide information about their approach to managing their networks. We anticipate that revealing this information should, over time, increase the likelihood of companies developing interconnections, facilitating more water trading. In turn, this should result in the more sustainable and resilient networks that benefit both customers and the environment.

The purpose of the information that we will collect using this tool is:

- to inform best practice in relation to network management;
- to inform potential market entrants about the network management processes that they will encounter;
- to inform our decisions on whether it is appropriate to introduce incentives for efficient network management when we next set prices in 2019; and
- if we expect to introduce an incentive, to inform decisions on what we should incentivise, and the appropriate level of any incentives.

In our wholesale consultation, we set out four primary options, having provisionally ruled out two options for 2015-20.

Our four primary consultation options covered a range of possible approaches based on the:

- scope of network management – water only, or both water and wastewater;
- the nature of information required – reporting against consistent information requirements, or more flexible reporting;
- nature of rewards and penalties – financial or non-financial; and
- timing of rewards and penalties – as part of 2019 price review, or during the price control period 2015-20.

We have used responses to our wholesale consultation, alongside wider feedback from stakeholders, to take decisions on our preferred approach to network management incentives.

11.3.1 Scope of network management

Most companies operate water networks in which there is flexibility about how to move water over geographic areas to balance supply and demand efficiently, both in the short term, including choices over abstraction, storage and pumping, and even greater flexibility over the long term, including extension and configuration of networks.

Efficient short-term water network management should feed into decisions about long-term network investment – for example, identifying and alleviating identified constraints. Efficient short- and long-term water network management are also important for the development of effective water trading markets.

Existing anecdotal evidence suggests there is a significant disparity in the approaches that different companies take to managing their water networks. In turn, this suggests there may be scope for efficiency gains from more widespread adoption of best practice. But some of these differences may also reflect factors such as geography and the configuration of companies' networks.

This is why we proposed in our wholesale consultation to implement a network management information incentive for water.

But we also suggested we could also implement a network management incentive in the wastewater value chain to support the future development of the regulatory framework there, with the scope of this in line with our proposals for the network plus sub-limit – that is, focusing on a distinction between competitive sludge activities and other wastewater activities.

Within the wider wastewater value chain, companies' sewerage networks are considerably more fragmented than their water networks. In part, this reflects the impact of environmental discharge constraints on the size of treatment works, as well as the fact that sewage is more expensive – and difficult – to transport than water. Given the comparatively limited opportunities for optimising management of sewerage networks, we do not think it is appropriate to include sewerage networks within the scope of the network management incentive at this stage.

But sludge is typically transported by road, and there is significant flexibility – and scope for competition – for companies to take different approaches to sludge treatment and disposal. The OFT's market study also identified potential for significant efficiency gains from outsourcing sludge treatment, which companies were not currently exploiting. Better information about the approaches companies take to optimise their sludge treatment and transport could help inform market development and realise some of the efficiencies that the OFT identified.

As with network plus, almost half of respondents to our wholesale consultation thought that no specific incentive for reporting was needed. Most respondents that expressed a preference for scope suggested including both water and wastewater. Others expressed a preference for options including only water.

Given the scope for increased competition in both the water and the sludge part of the wastewater value chain, our preferred option is to implement a network management information incentive for both water and sludge activities in 2015-20.

11.3.2 Information needed for network management

The key issue we need to consider in relation to the information needed for network management is the extent to which we require companies to report consistent and specific information.

Respondents to our wholesale consultation had mixed views. Some supported consistent and specific reporting, while others wanted more flexibility for companies.

Before we next set prices in 2019, we want to be able to take decisions on whether – and, if so, how – we should incentivise efficient network management. So, we need to collect information, ahead of 2019, that enables us to:

- assess whether it is appropriate to introduce incentives for efficient network management;
- if so, identify the objectives, costs and (or) cost drivers we want to target – that is, what we should incentivise; and
- set baselines and incentives for those objectives and cost drivers.

Both the decision on whether to introduce incentives for efficient network management in 2019, and any incentives themselves, will need to be informed by consistent and specific reporting ahead of 2019.

But our current understanding of network management is limited, and we do not think it is feasible to move directly to consistent and specific reporting. So, our preferred option is to evolve reporting from a flexible, company-specific approach to specific, consistent reporting over the course of 2015-20.

If we decide, on the basis of early reporting, that we are likely to introduce an incentive for efficient network management from 2020, then we think there may be a case for testing it beforehand – but without any binding incentive element.

This would enable testing of objectives and reporting, ahead of any financial incentive for network management efficiency for 2020 and beyond. Any decisions on whether – and how – to use such a trial, non-binding incentive will need to be informed by the information we collect from companies earlier during 2015-20. We will keep this option open, and, if we decide to proceed, we will make a detailed proposal.

An illustration of how the reporting requirements could evolve for network management is set out in table 16.

We will provide more information about the information required alongside business plans when we consult on our approach to business plans in early 2013.

Table 16 Evolving information requirements for network management

Submission	Information and reporting	Objective	Requirements defined
In business plans for 2015-20	Open-ended questions about network management practices and models. Flexible responses.	Inform entrants and best practice. Enable us to understand existing practices.	In business plan requirements, summer 2013.
July 2015	Further questions building on the first round, potentially including targeted questions, company-specific questions and more information on costs and cost drivers. Specific responses.	To explore company characteristics that may justify different approaches to network management. Allow us to take decisions on the need to incentivise efficient network management for 2020 and beyond. Explore potential objectives and relevant cost drivers for any incentives.	Early 2015.
July 2016	Reporting of relevant costs and cost drivers for 2015-16. Companies report consistent cost data.	Companies establish systems for collecting and reporting data.	Autumn 2015.
July 2017	Reporting of costs and cost drivers for 2016-17, to inform incentive design. Companies report audited data.	Informs draft methodology for 2019 price review, including decision on any binding incentive for efficient network management. Informs decision on establishing any	Autumn 2016.

		trial non-binding targets or incentives for efficient network management. Informs baseline for any non-binding targets.	
July 2018	Reporting of costs and cost drivers for 2017-18. Reporting against non-binding targets/incentives, if we choose to set. Companies report audited data.	Data informs 2019 price review decisions, including on final calibration of any binding incentive for efficient network management.	Autumn 2017, including decision on whether to set non-binding targets or incentives for efficient network management.
July 2019	Reporting of costs and cost drivers for 2018-19. Reporting against non-binding targets/incentives, if we choose to set. Companies report audited data.	Data may inform decisions on final determinations.	Autumn 2018.

11.3.3 Incentives for providing network information – in network plus and network management

There are two key questions we need to consider in relation to incentives for providing information on network plus and network management.

- Should we use financial or non-financial incentives?
- When should any incentives be applied – at the 2019 price review, or during 2015-20?

Most respondents to our wholesale consultation supported applying incentives during 2015-20. But they were split on whether we should use financial or non-financial incentives. Several stakeholders questioned the need for financial incentives for reporting, as companies have obligations to provide us with information.

Our view is that there are two main arguments in favour of financial incentives to encourage network information reporting.

- Some of the information we will be seeking is unlikely to exist in a readily extractable form in companies' existing information systems.
- A key concern for us is the quality of information that companies provide. They will not have strong incentives to provide high-quality information in the absence of rewards and penalties.

The benefits that could eventually flow from future incentives for efficient network management are significant, and our view is that they may be sufficient to justify securing high-quality information in order to develop them.

On balance, we think there is a case for financial incentives for providing good network management information. But we need to balance potential increased costs for customers in the short term against the longer-term benefits of improvements in efficient network management.

Our preferred approach is to include an allowance for the specific additional efficient costs of new high-quality network information reporting in companies' wholesale controls, for network plus and network management), but with an opportunity to claw back these costs at the end of the period if reporting is not of a sufficient quality.

11.4 Consultation questions

Building for price reviews in 2019 and beyond

Q50 Do you agree with our preferred scope for network plus?

Q51 Do you agree with our preferred option to implementing network plus?

Q52 Do you agree with our preferred scope for network management?

Q53 Do you agree with our preferred approach to implementing network management?

Q54 Given our objectives for network management reporting over the period, what questions should be included in the first round of reporting within business plan requirements?

Q55 Do you agree with our preferred approach to financial incentives for network information reporting?

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 customers with a good quality and efficient service at a fair price.

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