



## **Companies' responses to Ofwat's October 2012 section 13 Notice**

Alongside the section 13 Notice published today, we have also published all of the responses that we received to our [October 2012](#) section 13 Notice, apart from two where the respondents wished to remain confidential.

The responses contained a number of issues that require further clarification or were based on misunderstandings of our consultation. This document provides our responses to those points.

### **1. Uncertainty**

A number of respondents considered that our proposals cause unnecessary uncertainty. We have been clear throughout the process that important safeguards are in place to protect against uncertain outcomes.

Our section 2 duties remain unchanged, including allowing efficient companies to be able to finance their functions. Crucially, these duties apply to the whole of a company's regulated business – even those elements that may be subject to a separate form of price control in the future. We could not set an alternative form of control that led to a position where we were unable to meet our duties.

Companies and investors have come to see the RPI+/-K form of control as providing certainty, and as an approach that is familiar and well understood. But this is premised on the knowledge that the determination of K is a matter of Ofwat policy. So, there is no reason why any other form of control that we set, following our policy, could not provide equal certainty. We will always consult on any changes to the way in which we regulate.

The mechanism for companies to appeal their price determinations to the Competition Commission remains unchanged. This provides certainty to companies and investors that where we make any price setting decisions that are considered contrary to our duties this can be challenged. Our interim and substantial effect

determination mechanisms also remain unchanged and are a tool for dealing with volatility between price reviews.

## **2. Water UK proposed modification**

A number of responses included or referred to an alternative draft licence modification that had been drafted on behalf of Water UK. This proposal retained references to the weighted average charges increase (WACI) and associated components (for example, the tariff basket) for wholesale controls.

Retaining the WACI pre-judges the outcome of our consultation on the methodology for the next price review. It also assumes that we would continue to use the WACI as the check on the overall RPI+/-K. Including such a detailed form of control for wholesale activities limits our ability to adapt the way in which we set wholesale revenue. We will always consult on our proposed approach and listen to and reflect on the responses that we receive.

The Water UK licence draft proposed indexing retail controls by RPI. No ordinary retail business, operating in a competitive market, gets an automatic pass through of RPI to its end customers. We are not convinced that water customers should be subject to automatic increases in the retail part of their bills. This proposal also pre-judges the outcome of our methodology consultation on this issue.

The Water UK licence draft sets out a more rigid definition of retail than what we proposed. Although we set out our proposals for which activities should sit within retail in our [‘Consultation on retail controls for the 2014 price review’](#), a rigid definition on the face of the licence may not allow the water and sewerage sectors to be as responsive to customers’ demands as they might wish to be. And again, it pre-judges the outcome of our methodology consultation on this issue.

## **3. Pre-empting Government policy**

A number of respondents suggested that our proposed licence modification sought to pre-empt the changes outlined in the Draft Water Bill. We have been very clear about the challenges that the sectors face and also provided clear signals about the steps that we need to take – in terms of the way in which we regulate – to meet them. We were clear that our proposed licence modifications provided sufficient flexibility to meet the policy objectives set out in the Water White Paper, the Draft Water Bill and Welsh Government policy, but they were not reliant on them and were not being proposed primarily to facilitate them.

As we explain in our [section 13 Notice](#), the primary purpose of our proposals is to provide sufficient flexibility in the price setting framework – and in particular our ability to set targeted incentives – such that the companies could meet the challenges of the future. As is recognised by all, these challenges are changing in scale and nature and becoming increasingly more complex. A rigid price setting framework as is currently set out in companies’ licences does not allow us to regulate in a sufficiently flexible way. The regulatory framework needs to change to incentivise the sectors more effectively so that they can respond efficiently, innovatively and sustainably to these challenges that exist (regardless of any legislative changes that might happen now or in the future).

#### **4. Lack of impact assessment**

A number of respondents criticised the absence of an impact assessment alongside our October 2012 section 13 Notice. It was neither appropriate nor possible to carry out an impact assessment for our proposals because, in themselves, they do not mean that price controls have to be or will be set differently from the way in which they are set now. Our proposals were intended to provide us with the option to set price controls in a less rigid way than that dictated by the existing licence.

Our proposed modifications will only introduce a change when they are used to set price controls differently from the way in which they are set now. Then it would be appropriate to carry out an impact assessment, because any proposed changes can be quantified and their impact assessed. The impact of any change would differ from price review to price review depending on how the price setting framework develops. In line with this, we have already stated that we will publish an impact assessment when we finalise our methodology for the 2014 price review. This is because we are proposing to set controls differently at this review. So, there will be an impact that can be measured.

#### **5. Competition Commission appeal on individual controls**

One respondent expressed concern that our proposals did not provide companies with the ability to challenge individual price controls or elements of price controls that form part of the same determination. This position is entirely consistent with that which exists now where price determinations have to be appealed as a whole package.

This is because determinations are made as a whole package and it is neither appropriate nor desirable to ‘unpick’ individual elements of that package. Ofwat has a continuing primary statutory duty to enable efficient companies to finance their functions. This duty applies to all our price setting responsibilities, including any proposals that are likely to affect companies’ revenues. The appeal process applies in a consistent way.

## **6. Changes at the 2014 price review to introduce competition**

One respondent referred to us making changes “at the next price review to facilitate more retail competition for industrial and commercial customers”. While our proposals would allow us to set separate and more responsive controls for retail activities, this is not solely to accommodate any further reduction in the threshold for the water supply licensing framework or its expansion to sewerage services. It is designed primarily to allow us to target incentives on different parts of companies’ businesses. But in line with good practice, we will ensure that our price controls are robust to proposed policy changes such as the Government’s proposal to introduce greater choice for non-household customers in England.

The primary purpose of our proposals is to allow our regulatory approach to respond to the challenges that the sectors face – which are changing in scale and nature and becoming increasingly more complex.