



## **Licence modification proposals – some clarifications**

### **Introduction**

On 26 October, we issued a consultation under section 13 of the Water Industry Act 1991 (WIA91) setting out our revised proposals for modifications to companies' licences. This consultation closes on 23 November.

In response to requests for additional information received from stakeholders, this document provides clarification on elements of our revised proposals to assist stakeholders in assessing them.

### **What is the compelling need for the changes?**

The challenges facing the sectors means there is a need for new, innovative ways to deliver sustainable water. Flexibility is needed in the licence since it is one of the key tools of regulation so that we, as regulator, can adapt to changing circumstances.

The flexibility would allow us to set segmental price controls and targeted incentives to achieve better outcomes, for example

- retail choice for business;
- better allocation of treated water resources; and
- different approaches to sludge treatment.

The focused incentives from separate retail controls and the potential for choice for business customers proposed in the Draft Water Bill have been well signalled and articulated. Incentives to improve the allocation and use of scarce water resources (including treatment where necessary) would mean the right signals for investment are made. The market for organic waste (including sludge) has been shown by the OFT to have significant barriers to entry that can be removed or ameliorated by appropriately focused price controls.

The legal basis for making changes to the licence is inefficient and costly for all parties, particularly in comparison to other regulators such as Ofgem. This is because two separate steps are needed at separate times (unlike in the energy sector where the two steps are undertaken simultaneously).

## **Safeguards and handling uncertainty**

We recognise that the water and sewerage sectors need to remain attractive to investors so that efficient long-term investment can be financed at reasonable cost. We outlined in our consultation the important regulatory safeguards that will be familiar to all stakeholders and will continue to apply. In particular:

- our statutory duties, particularly the duty to finance functions for the entire business as a whole (including a return on capital) continue;
- the ability to appeal any price control (and any revenue impacts of them);
- retaining RPI+/-K on the face of the licences for wholesale activities; and
- our commitment to no changes for the natural monopoly – hence much reducing the potential scope of any changes.

We set out below some further background on each of these.

### **Ofwat's statutory duties**

Ofwat has a duty under section 2 WIA91 to secure that efficient companies are able to carry out the proper financing of their functions, including providing a return on capital to achieve such efficient financing. This would apply to individual price controls but also to the overall appointed business.

Ofwat remains committed to the use of interim and substantial effect determinations to protect companies and investors from defined risks between reviews.

Wholesale controls at March 2015 will continue to be index linked to RPI for all material wholesale activities. The RCV will be allocated to the wholesale function and an RCV approach will continue to be used as the main mechanism for cost recovery. Efficiently incurred capital expenditure that is in the RCV at 31 March 2015 will be protected. In relation to other parts of the supply chain that become subject to a later specific price control Ofwat would expect to apply the principles set out below to determine how existing efficiently incurred capital expenditure that is in the RCV at that time would be protected.

## Thresholds

We have committed to a RPI+/-K form of control for wholesale activities at the 2014 price review.

We have also proposed a threshold that means that particular activities could only be moved out of the RPI+/-K wholesale control if they contributed less than 20% of revenue in any control period and cumulatively less than 40%.

Thresholds will apply at an industry level for water and sewerage services together.

The following table summarises the estimated revenue contributions across the industry value chain. This is based on accounting separation data provided by companies at industry level and on information that is in the public domain.

<b>The water and sewerage value chain by revenue</b>	
<b>Part of the value chain</b>	<b>% of total</b>
<b>Retail</b>	<b>11.0%</b>
<b>Wholesale activities</b>	
Resources	5.0%
Raw water distribution	2.0%
Water treatment	9.0%
Sewage treatment	16.0%
Sludge treatment	5.0%
Sludge distribution	1.0%
<b>Totals</b>	<b>38.0%</b>
<b>Natural monopoly</b>	
Treated water distribution	22.0%
Sewage collection	29.0%
<b>Totals</b>	<b>51.0%</b>

The monopoly water distribution and sewage collection and transport activities would always be part of the RPI+/-K wholesale control.

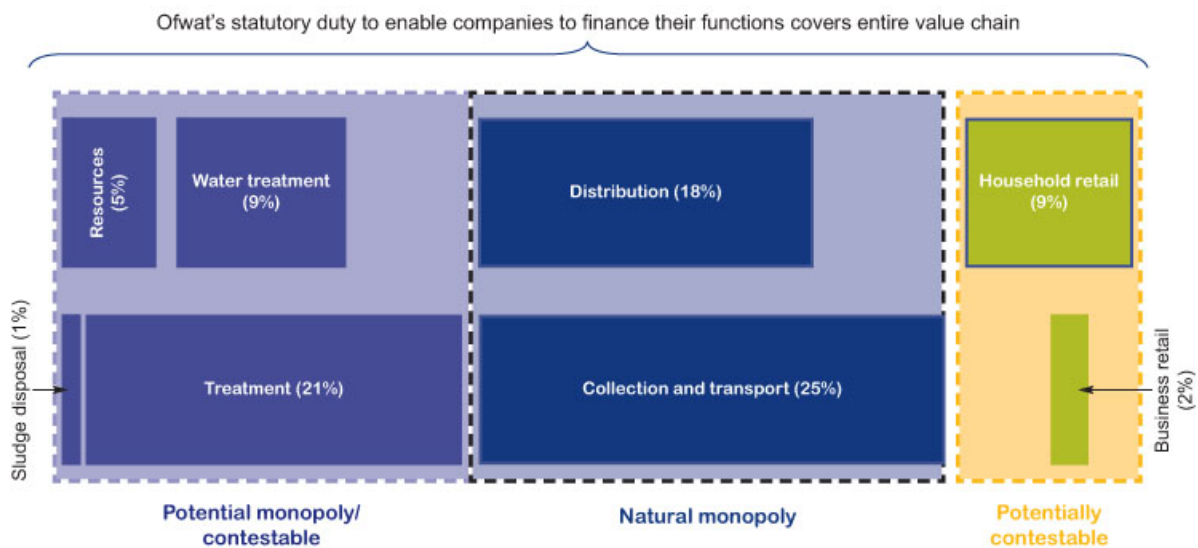
Segmented price controls may be appropriate in some of the other areas set out in the table where more targeted incentives to achieve better outcomes are needed over time.

We have already consulted and set out some early thinking in some of these areas. For example, water resources, raw water distribution and water treatment were discussed in ‘[Future price limits – preliminary model](#)’ (April 2011) and sludge treatment and disposal was the subject of the [OFT market study](#) on organic waste in September 2011.

For other areas such as sewage treatment, there has been no early thinking at this stage.

The proportions by revenue of the value chain are set out in figure 1 below which shows more clearly the relative contributions.

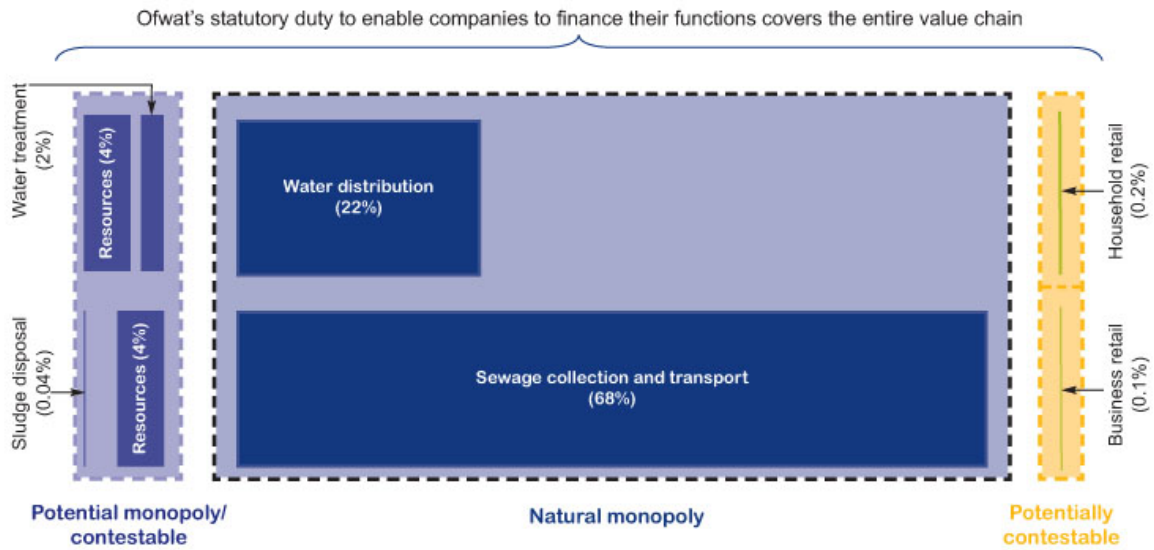
**Figure 1 The water and sewerage value chain by revenues**



Source: Ofwat, Based on % allocation of revenues to water and sewerage total assets. Note: Numbers do not add to 100% because of price review adjustments and mis-timing between costs incurred and revenue received.

The key revenue building blocks are opex, maintenance and return on capital. For example, retail has revenues of 11% and the key building block for it is opex with very little assets but this is not the case for the other elements. A much lower proportion of companies' assets (on a MEAV basis) would potentially be subject to new forms of price control. figure 2 below shows that a maximum of only some 10% of assets may be affected. While there is no direct relationship between the current cost value of companies' assets and the RCV, the former is cited to demonstrate that non-network activities are relatively 'asset light'.

**Figure 2 The water and sewerage value chain by asset values**



Source: Ofwat, Companies accounting data 2011/12. Based on the net book value of assets as % of water and sewerage total assets.

Consistent price controls have to be applied for water and sewerage companies (WaSCs) and water only companies (WoCs) to ensure a 'level playing field' and to give all customers the potential to benefit from efficiencies that these new controls could bring.

The diagrams above provide examples of non-network activities for which different forms of price control may be considered in future. The proportion of revenue attributable to non-network activities to the total revenue of a WoC will be broadly equivalent to that for a WaSC taking into account its additional revenue attributable to non-network sewage treatment and sludge disposal activities. Flexibility thresholds therefore have a similar overall effect on WoCs and WaSCs.

## Appeals

Companies will be able to appeal the nature, form, duration or level of any future price control. They would have to appeal the whole determination and could not appeal individual elements in isolation, as this would match our obligation to ensure that an efficient business as a whole was financeable.

Ofwat would normally expect to make changes to controls and the activities they cover at a periodic review. The determination made at such a review can be appealed and therefore there is a mechanism by which the impact of new controls and their effect at a periodic review are subject to appeal. If a new price control was introduced **between** price reviews, then this new price control could also be appealed.

Corrections between existing types of control could not be appealed as no new price control would have been set. If there is a revenue impact, a retrospective true-up at the end of the relevant price control period could be made to deal with this.

Any true-up adjustment would be made in the most appropriate way indicated by the specific circumstances and could be made to retail and/or wholesale controls. However, any such adjustment would form part of a determination and companies would have the option of appealing that determination if they disagreed materially either with the calculation of the adjustment or its impact on particular controls.

The process for changing the way we set price limits in the water sector requires two separate sequential steps – first the licence modification, then the consultation on and determination of the price control itself. There **must** be a separation between these two steps as we must make an appropriate licence modification in time to consult fully on the detailed methodology and final determination. This is unlike the energy sector where the two steps are undertaken simultaneously and the licence change and the determination are issued at the same time. This allows companies to appeal both the licence change and the determination (or either of them) based on their view of the impact which can be properly assessed since they have fuller information.

This type of process in water would be more efficient for both companies and Ofwat but would require a change in legislation to implement it.

## **Protecting efficiently incurred expenditure in the 2015 RCV**

In our consultation on our revised proposals for licence modifications, we reiterated our commitment to the protection of efficiently incurred capital expenditure that is included in the RCV at 31 March 2015. To achieve this, all of the RCV will be allocated to the wholesale function and efficiently incurred expenditure will be protected.

In setting price controls, we must continually assess whether the expenditure included within the RCV remains efficiently incurred and our approach in this respect will not change as a result of modifications to the licence. Where it is no longer the case that capital expenditure is efficiently incurred, we have the discretion to make any appropriate adjustments. This has always been our approach. For example, at the 2004 price review some companies invested more than was projected at the previous review and none of them submitted a strong enough case to demonstrate that this investment should be included in their RCV.

Ofwat's approach to the evaluation as to whether capital expenditure has been efficiently incurred will not change as a result of modification to the licence.

## Principles and criteria for new forms of control

Different price controls may be considered where we judge that it would incentivise performance in particular areas of wholesale activity. What forms these would take would depend on the activities involved and the incentives we were seeking. In considering new controls we would have regard to the following principles.

- If the activities were capital based then it is likely that these controls may take the form of RPI+/-K including, perhaps, its own RCV with a different 'K' factor to the wholesale control.
- If the control took an alternative form and was less asset intensive, we would need to set out clearly in advance how that capital would be remunerated in line with our duty to finance functions.
- If the activities had little or no assets, then we could decide that the assets could remain in the wholesale RCV (as we have proposed for the retail activity).
- We recognise that we would need to be clear about the way that we have allowed for the remuneration of the relevant assets in any new form of control if this formed part of the RCV at 31 March 2015. If a new control was set in a form other than RPI+/-K, we would need to set out how the return on these assets is consistent with an RPI linked return on the relevant assets.

## Next steps

The consultation closes on 23 November 2012. If companies have concerns with our proposals, we would welcome responses that set out in a constructive manner those concerns and propose how they might be addressed in a way that allows all parties to meet their key objectives. For example:

- this may be by way of further assurance as to how price controls may be set in the future;
- using a different basis for measuring the threshold;
- greater clarity on the treatment of the RCV; or
- greater clarity on how we prioritise areas which may need flexibility.

In our consultation, we set out an indicative timetable for implementing the modifications to the licence. We indicated that, if some companies are not able to accept our proposals and we have to refer the matter to the Competition Commission, we anticipate having clarity on the modifications by the summer of 2013.

We do not anticipate that this will have any impact on our timetable for setting price limits in November 2014 although this does involve us accepting a degree of risk of legal challenge. We could not make a price determination on the basis of an unchanged licence but can consult on the methodology for that determination on the assumption that our proposed modifications will be made.