December 2015

Trust in water

Water 2020: Regulatory framework for wholesale markets and the 2019 price review – summary

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Totex led to new approaches and helped deliver £3 billion savings

...and if we carry on regulating the same way, we will not drive the efficiencies we need

-£39	-£18	-£11
2000 to 2005	2005 to 2010	2010 to 2015

Value of efficiency savings (bill) (2012-13 prices)

When we set prices in 2019, we propose to keep what works well, while making changes to help the sector meet the long-term needs of customers, society, the environment and investors...

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...but stability in this sector is vital so certain changes will require a managed transition. That is why we are continuing to protect investment made (the RCV) as at the end of 2020

Executive summary

Customers rightly expect water and wastewater companies to provide high quality services and to listen carefully, and respond, to their needs, priorities and concerns. In meeting these expectations, the sector faces a wide range of challenges – not least those related to water scarcity and the environment. The combination of climate change and population growth means that these challenges are likely to increase over time, and must be met alongside the continuing challenge of affordability in the sector. Put simply, the sector needs to do more for less, and in particular, it must find ways of making the best use of the resource available to it, and discover new and better ways of delivering its services. Furthermore, a continuation of the status quo would similarly tend to result in customer bills being higher than they would otherwise be and, potentially, lower resilience. **Therefore, there is a pressing need to reform our regulatory approach** – albeit in a manner that is targeted at specific problems in a proportionate and coherent way.

Over the past year, we have engaged extensively with interested parties across the industry in order to help inform our thinking and gather evidence. Working with Water UK, **we established the 'market place of ideas'** where stakeholders could develop and contribute their own thinking, and separately have sought views from both current and potential market participants as part of our **July discussion document – 'Towards Water 2020'**.

Our analysis suggests that, **there is most scope to make a greater use of markets in relation to sludge and water resources to help us deliver more for less**. In relation to sludge, evidence suggests that there is scope for increased optimisation of activities across the companies – and, looking further ahead, greater participation from firms operating in wider waste markets. In relation to water resources, trading is below its optimal level, and taking steps to mitigate identified barriers to this could result in benefits of up to £1 billion for customers. Again, looking further ahead, there is also scope for third party participation, whereby wholesale providers of resource negotiate directly with water retailers as the retail non-household market develops in line with the Water Act 2014.

We also expect these reforms to help **reveal new and better information** that would help us to **regulate the sector more effectively** for customers, the environment and wider society.

To deliver the potential benefits of markets, we need to put in place a set of measures that we think will best facilitate them. But **we are trying to achieve different things in respect of water resources and sludge** and this means we are proposing **to take slightly different approaches to their future regulation**. The key elements of our proposals include the following.

- **Separate binding price controls for both sludge and water resources for PR19.** This will help better facilitate an effective market: revealing improved information that will help us set more targeted incentives; supporting company decision-making; and helping to foster a more commercial culture and focus within companies.

- **In relation to sludge, we are proposing the introduction of an information platform.** We want information to be available that will help others to offer services if they can do them cheaper or better than the existing companies. That information may contain, for example, data on things like capacity, treatment and transport costs or prices and site locations.

- **In relation to water resources, we are similarly proposing an information database** and a framework that would allow for the 'bidding in' of resource options by third parties on an ongoing and fair basis that provides a level playing field between participants.

- **Enabling third party access to networks** by developing rules that will apply to the prices that third party providers pay to use the water treatment and distribution networks of water companies (access prices) in England to allow new entry where supply from third parties is more efficient. For access to incumbents' networks for companies whose area is wholly or mainly in Wales, consistent with the Welsh Government's guidance, the access price will continue to be based on the cost principle.

Price control regulation will continue to apply to the wholesale parts of the value chain. Indeed, as for both sludge and water resources we cannot be certain about how far or how quickly markets could develop, **price regulation will remain an essential part of our approach, at least over the near term**.

We will also **enable direct procurement by appointees on behalf of customers** in relation to discrete, large-scale investments in service upgrades such as new water resources, which may be multi-sector, interconnections or major new treatment facilities.

We recognise the important role that the RCV has played and continues to play – especially as a mechanism for delivering regulatory predictability, acting as the primary means through which investors recover costs in future periods, enabling costs to be smoothed over time and financed more efficiently, benefitting customers. For this reason, we have previously set out a policy of providing protection to historical (efficiently incurred) investment up to 31 March 2015 as part of our wholesale controls. Under our proposals, **we will extend this protection so that water companies will always be able to recover the value of efficiently incurred investments included in the 31 March 2020 RCV, regardless of the impact of our reforms. This will ensure that no investments made prior to our reforms will be subject to any change in risk profile.** We see this additional RCV protection as being part of the integrated package we are proposing. In relation to investments made post-2020:

- for sludge, these will be subject to market risk, our future regulatory approach will pass on volume risk to companies. However, we consider stranded asset risk to be modest; and
- For water resources, our approach would mean that a market will apply for the incremental investment itself, at the point of procurement with no volume risk for additions to the water resource control.

By limiting the impact of a greater use of markets to new investment, we expect to **mitigate materially any potentially adverse impacts on financing costs in the sector**.

We are also proposing to change our approach to allowing for inflation in cost recovery. In particular, we will use CPI, rather than RPI, for indexing both the RCV and revenues (and therefore prices). To help companies manage this change, at the start of the next control period we will apply a transition mechanism that ensures that half of the RCV continues to be indexed by RPI. This will provide time for existing RPI linked debt to unwind and avoid undue risks to companies and customers in the transition to CPI.

Finally, a key part of our proposals is to **strengthen our approach to outcomes and customer engagement**. Here, one of the key themes of our approach is to help **drive a focus on customers over the longer-term** – which we will link to our risk-based review approach.

We welcome all responses to this consultation document, which we propose to follow with a decision document in May next year. We recognise that **changes to the companies' licences will be required to support our proposals** – and so intend to engage early with all relevant stakeholders as part of this process. We look forward to further constructive engagement as we continue this journey together.

1. Introduction

Customers rightly expect water and wastewater companies to provide high quality services and to listen carefully, and respond, to their needs, priorities, and concerns. In meeting these expectations, the sector faces a wide range of challenges – not least the challenge of water scarcity, caused by increasing demand and growing environmental pressures.

In July of this year, we published our discussion document, 'Towards Water 2020', which set out the possible ways in which these challenges could be met by all stakeholders collectively. In particular, it addressed the role that we, as the independent economic regulator in England and Wales, could play. We also consulted on how we take forward our duty to further the resilience objective, which we gained through the Water Act 2014.

We argued that, in a fast-moving world of increasing and more complex demands, we need to continue evolving the way we regulate, consistent with the journey we began at the last price review (PR14) and our enduring price control principles, which we have retained from PR14[1]. Key elements of this include:

- encouraging companies to genuinely understand, listen and respond to their customers;
- focusing on outcomes rather than processes;
- being proportionate and prioritising the right issues; and
- developing the right incentives to ensure that the benefits created by the industry are appropriately shared between companies, customers and the environment.

We also discussed the potential to make greater use of markets to help achieve this. Critically, we see the evolution of our regulatory approach as being an essential component of delivering our strategy in line with our statutory duties and, ultimately, achieving our vision for trust and confidence in these vital public services.

[1] 'Future Price Limits – statement of principles', Ofwat.

As we had hoped, our July discussion document and resilience consultation stimulated a high level of interest and debate. Since then, we have had productive and wide-ranging discussions about the ideas with customers, water companies, potential new third party providers, investors, governments and other interested parties. We have listened carefully to, and considered, the views and evidence put to us – and thank all participants for their engagement. The proposals we set out here build on that debate and the contributions made to it by all those involved.

Accordingly, today we are publishing, for consultation, our proposals for better use of markets and how we will regulate to both facilitate these markets while continuing to protect all customers in England and Wales. Our new regulatory model involves moving away from an approach heavily based on ex ante regulation, of 'one size fits all', that was highly administrative and regulator-focused, towards an approach that is more based on principles and frameworks, more ex post, proportionate and targeted - more pro-market, putting the customer at the heart of the sector. And in parallel, improves our approach to regulatory reporting, market intelligence and assurance so that we and others are better able to understand how the sector is performing, challenge it and hold it to account. At their heart, our proposals are about how we will implement our new regulatory model in practice and so move us closer towards achieving our vision of a sector that enjoys the trust and confidence of its customers and society.

This summary document provides an overview of what we are aiming to achieve and why this necessitates change, our preferred approach and specific proposals. A more detailed description of our proposals, and our underlying rationale and evidence, is set out in 'Water 2020: Regulatory framework for wholesale markets and the 2019 price review' (our main consultation). Our approach to resilience across our work programme, including our response to the recommendations of the independent task and finish group that has been looking at resilience, is provided in 'Towards resilience: how we will embed resilience in our work'. Following this consultation, we will set out our finalised proposals in a decision document, which we intend to publish in May 2016.

We welcome your views.

2. The benefits of our proposals

In summary, our proposals will **generate significant benefits** for all stakeholders.

- **For customers:** reduced pressure on bills and improved and more innovative services, as companies are encouraged to make better use of their existing assets and resources, manage demand and to seek out new and more efficient ways of delivering water and wastewater services. We will encourage companies to genuinely deepen their understanding of their different types of customers' needs and requirements and use this information to drive decision making at all levels of the business. We will also encourage companies to consider carefully:
  - how they could work in partnership with customers to develop solutions (for example, by reducing demand); and
  - whether there is more scope and desire for community-based solutions, where this is appropriate and efficient.

- **For the environment:** our proposals promote and enable better use of scarce resources within ecosystems and promote zero waste in the sector. The environment will also benefit indirectly as the efficiency gains resulting from our proposals create scope for environmental improvements to be delivered while maintaining affordability.

- **For companies and their investors:** our enduring price control principles provide a stable basis for regulation in the sector alongside a regulatory approach that continues to provide a fair return for risk. We have also carefully considered and allowed for an appropriate transition from current regulatory arrangements into our new framework. Our proposals will provide greater clarity of the different risks associated with different parts of the value chain. Our proportionate and targeted approach will enable management to focus on their businesses where we do not need to intervene and new opportunities will create the right incentives for companies to think innovatively about how they can generate value for both investors and customers.

As a result of our proposals, **all stakeholders will benefit from increased resilience** in the sector, as we create the scope for innovation in the delivery of resilience (of services and systems as well as corporate and financial resilience) and place greater incentives upon companies to respond flexibly to long-term and short-term challenges.

We will deliver these benefits by:

- **promoting a greater focus on customers and results,** ensuring that we focus on ensuring that companies deliver outcomes that matter to customers and society and continuing to incentivise companies to develop a deeper understanding of their different customers' needs and requirements, and using this information to drive decision making at all levels of the business;
- **retaining core elements of our regulatory approach that have worked well** by continuing to apply incentive based regulation that aligns the interests of investors and company management with customers and the environment – including:
  - incentivising companies to reveal efficient costs;
  - retaining a strong comparative efficiency challenge to companies' costs, allowing for general inflation in prices; and
  - regulating prices by allowing a return on the regulatory capital value;
- **making greater use of markets in relation to sludge and water resources** where there is potential to unlock substantial benefits for customers, companies, investors and the environment by:
  - encouraging a better use of resources across company boundaries and over the longer-term;
  - encouraging companies to find new, innovative ways of generating value; and
  - revealing information that supports better decision making and more targeted regulatory incentives;
- **promoting and enabling direct procurement on behalf of customers** in relation to discrete large scale investments in service upgrades (enhancements), new water resources which may be multi-sector, interconnections or major new treatment facilities;
- **promoting focus on and transparency of** market facing wholesale activities and ensuring a clear boundary between areas where markets will become more prevalent and those with persistent monopoly and so prevent undue cross-subsidy. These aims will be achieved by **introducing separate binding price controls in relation to sludge treatment, transport and disposal; and water resources**, increasing the total number of wholesale price controls from two to four;
- **enabling better information to be shared** with all service providers in relation to both sludge and water resources to further enable market development. This will enable companies to make informed 'make or buy' decisions, enable others who could offer services more efficiently to do so and enable us to better target incentives;
- **enabling third party access to networks,** developing rules that will apply to the prices that third party providers pay to be able to use the water treatment and distribution networks of water companies (access prices) in England;

- **protecting efficiently incurred costs in the RCV to 31 March 2020 to assist customers and provide certainty to companies and investors in the transition** to our new approach (building on our previous commitment to investment before 2015);
- **improving the legitimacy of regulation by migrating from the retail price index (RPI) to index both prices and regulatory returns by the consumer price index (CPI),** with transition mechanisms to assist customers, companies and their investors in making this change;
- **promoting a longer-term approach** by encouraging companies to focus beyond the five-yearly price control cycle, including by:
  - making the extent to which companies are putting their plans into a long-term context part of our risk-based review assessment;
  - seeking customers' views on long-term issues; and
  - asking customer challenge groups (CCGs) to report on the quality of customer engagement on longer-term issues to inform of our risk-based assessment of company business plans; and
- **smoothing the impact of our periodic reviews by introducing more 'in-period adjustments' to revenue** to take continual account of companies' performance during regulatory periods, and so avoid large adjustments to company revenues at the time of setting price controls.

Our proposals for new wholesale price controls, a move to CPI, and in-period adjustments, would all require amendments to current company licences. We therefore plan to discuss these potential changes directly with companies, so that there is a clear understanding of their potential implications ahead of our decision document in May 2016 and early discussion of how we will take this forward. We will continue to engage with companies and other stakeholders regarding any licence changes needed to implement our finalised proposals.

We will also continue to develop our approach to PR19 and propose to engage with stakeholders during 2016 on our approach to the following.

- **Outcomes:** including development of multi-period outcomes and where there is merit in taking a comparative approach.

- **Cost assessment:** building on the totex approach used in PR14. We will look at how we incentivise efficiency gains, particularly shifts in the industry frontier and the appropriate benchmark to use in setting the efficiency challenge such as historic or dynamic and upper quartile versus closer to the efficiency frontier. We will also look at use of disaggregated activity analysis to better understand efficient costs.

- **Risk and reward and setting cost of debt:** this work will consider evidence on company performance against the notional cost of debt, whether or not to index the cost of debt to changes in market rates over time for PR19 and the scope and approach to financial outperformance compared with other elements of the price control such as totex and ODIs. We will also look at the scope for improving our view on the forward looking cost of capital.

In November 2015, we consulted on our proposed approach to the PR16 review of non-household retail price controls, including the proposed timeline for the review. This will reset the non-household retail price control from April 2017. We will then need to consider our approach to regulation of non-household market beyond 2020, taking account of the development of the market.

As part of the UK Government's competition plan, we have been asked to review the benefits and costs of opening the retail household market to competition. We will report back to government in 2016, but note that the decision on whether or not to open the market is for the UK Government. We will take account of any decision by the government in developing our approach to setting controls for the household market in PR19.

3. What we are trying to achieve

In considering our new approach, we recognise that although we have an important role to play, we are just one party in the complex set of systems that generate water and wastewater services. Importantly, our vision of trust and confidence in water and wastewater services is a shared one that requires all parties (customers, companies, investors, governments, NGOs and other agencies) to work together in order to deliver better outcomes over the longer term. Therefore, our proposals start from a consideration of how we, as the independent economic regulator, can play our part in this broader context.

Accordingly, this consultation is about what our role should be, and how we can best deliver our strategy in line with our statutory duties. To develop our proposed new regulatory approach we weighed up our possible options against three criteria.

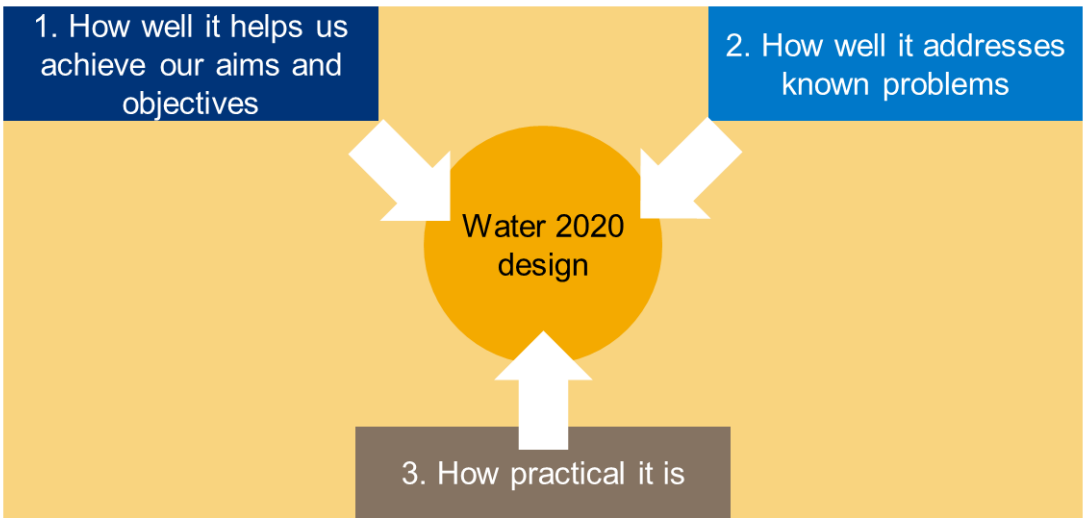
1. Helping us attain our aims and objectives – specifically, delivering against our **shared vision** of trust and confidence in water and waste services in line with our statutory duties – in a way that is consistent with the principles we established at PR14 and which now underpin our strategy, having served us well.

2. Ensuring that we are **addressing identified problems** so that our reforms are targeted at helping the sector meet the current and future challenges it faces.

3. Ensuring that our proposals are **practical and workable**.

Figure 1: Framework for determining our approach to regulator design

Assessing our options



3.1 Our aims and objectives

Our statutory duties, set out in legislation, are designed to make sure that the water sector works in the best interests of customers and society[2]. We exercise our relevant functions in the manner we consider is best calculated to:

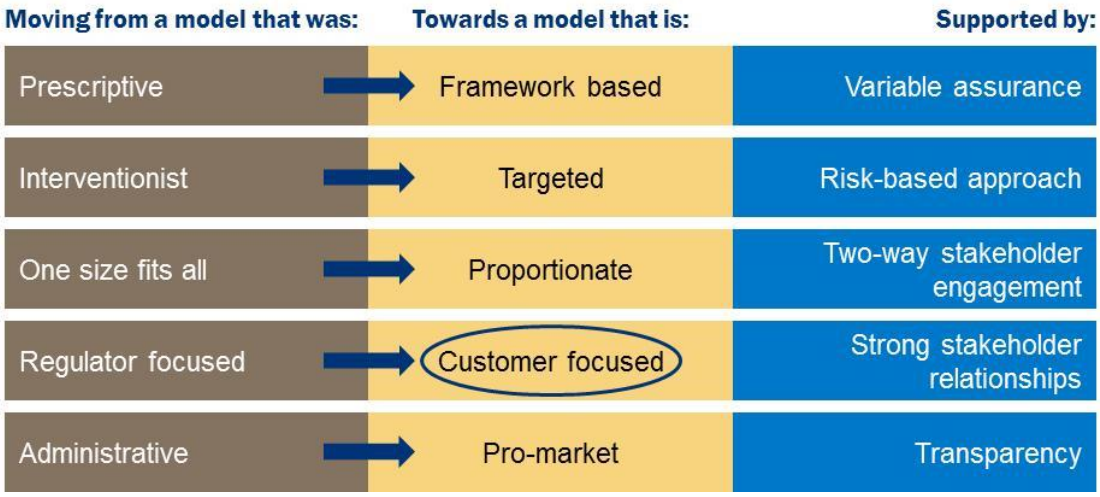
- further the consumer objective to protect the interests of consumers, wherever appropriate by promoting effective competition;
- secure that the companies and licensed water suppliers properly carry out their activities and functions;
- secure that the companies can finance the proper carrying out of their functions; and
- further the resilience objective to secure the long-term resilience of companies' systems and services to consumers. (Alongside this document, we have published 'Towards resilience', which sets out further information on the resilience objective and our approach to resilience in the way we deliver our strategy and wider work programme.)[3]

In January 2015, we set out our strategy, 'Trust in water'. It describes a shared vision for the water sector in England and Wales, whereby customers and wider society have trust and confidence in vital public water and wastewater services. Importantly, **our strategy is the means through which we will fulfil our duties as we look to the future**. We also carry out our functions in accordance with the statements of strategic priorities and objectives we receive from the UK and Welsh governments. Therefore, the goal of our proposed reforms is to move us towards a model that will help realise this vision – as illustrated below.

[2] The statutory framework for these duties is set out in full in the Water Industry Act 1991 (as amended) (WIA91) – see http://www.legislation.gov.uk.

[3] These duties are set out in section 2(2A) WIA91. There are further duties set out in WIA91. Section 2(3) sets out some further duties, which are subject to the duties in section 2(2A). One such further duty is to contribute to the achievement of sustainable development. The Welsh Government has announced an intention to elevate the status of this duty to a section 2(2A) duty in relation to its jurisdiction in Wales. When developing policy we are mindful that this change may occur, but we will make decisions in line with the statutory duties and powers that apply to us at the relevant time.

Figure 2: Journey towards a new regulatory model



We also want to ensure that any new approach we take is consistent with our **enduring price control principles**, as applied at PR14 and confirmed in our July discussion document. Of these principles, we understand the importance of ensuring our future approach continues to be transparent and predictable. This includes the need to provide clarity regarding the future treatment of the regulatory capital value (RCV), which is the historical basis on which we have set returns.

3.2 Addressing known problems

In addition to meeting our own aims, it is vital that our new approach addresses the current and future challenges facing the water sector. Put simply, in order to help build trust and confidence, we recognise that stakeholders must be able to understand how what we are proposing addresses issues that have been identified and evidenced. In summary, these problems and challenges include the following.

- **Environmental challenges**, most particularly, water scarcity and environmental quality. In relation to scarcity, we recognise that climate change, weather variability and population growth, will increase the extent of the problem in the future. Similarly, the uneven distribution of water resources and population across England and Wales mean that there is a regional dimension to this issue.

- **Developing and maintaining resilience of systems and services**, so that the sector can cope with, and recover from, disruption and anticipate trends and variability in order to maintain services for customers and protect the natural environment, now and in the future.

- **Customer bills and affordability:** our final determinations at the most recent price review (PR14) will result in water and wastewater bills being 5% lower on average in real terms in 2019-20, compared with 2014-15. However, affordability remains an issue for many customers. This was highlighted by our recent report on affordability and debt, which states that 11% of households in England spend more than 5% of their income on water, while this proportion is 15% for customers of companies whose area is wholly or mainly in Wales.

These challenges also present important opportunities. Some parts of the water and wastewater supply chain have benefitted from significant technological change. These changes have helped both involve customers more deeply in service delivery (through the development of apps and electronic interfaces with customers), but also helped address environmental challenges (as seen through the huge increase in the efficiency of transforming sludge into energy over recent years). Elsewhere, we have seen big changes in the capability and cost effectiveness of sensing equipment, so that service providers are better able to monitor what is going on across their networks and optimise more effectively.

Without greater optimisation of key activities and resources outside of traditional company boundaries, it is hard to see how these challenges and opportunities could be properly addressed over the long term. This is a challenge not only about doing things at lower cost, but about making the best overall use of resources and about finding new and different ways of doing things. Markets can inform, enable and incentivise such efficiencies. Therefore, while the refinements to our regulatory approach as part of PR14 provided clear benefits, **there is a compelling and clear case for further regulatory reform** to address the challenges facing the sector and deliver a new frontier of efficiencies.

3.3 Ensuring our approach is practical and workable

We recognise that it is essential that the approach we adopt is practical, workable and proportionate. We understand that the costs and benefits of any reforms will be shared across stakeholders and customers. Therefore, it is important that we take account of this as we develop and evaluate our options. We are doing this.

The UK and Welsh governments each set statements of strategic priorities and objectives for us. We carry out our functions in accordance with these statements.

Our proposals will lead to a framework that is flexible for all companies in England and Wales and will enable water companies to deliver services in partnership with customers that will meet their local needs. This will give flexibility for water companies wholly or mainly in Wales to deliver in line with the Welsh Government's policy and for other companies to take account of the UK Government policy where this is different. For instance, the recent Well-being of Future Generations (Wales) Act 2015 is an important piece of legislation in Wales. The local emphasis of this act and the likely direction of local emphasis for planning natural resources in Wales can be facilitated by our focus on customers and water companies having the flexibility to set out long-term outcomes that they will deliver which reflect their local circumstances.

Our proposals will help all water companies to move towards a number of the wellbeing goals. For instance, we expect our proposals for markets to lead to green growth by increasing innovation and resource efficiency. This will happen in a way that is consistent with healthy functioning ecosystems with the capacity to adapt to change (for example, climate change). We also expect it to contribute to a lower carbon society to help mitigate climate change in the first place. For sludge, this will be by increasing power generation and the effectiveness of fertiliser, which will reduce the need for farmers to use energy intensive manufactured fertiliser. For water, sharing water from resources that are already available is likely to use less carbon than if new sources were required, especially if otherwise companies would need to resort to desalination. Markets could also lead to new innovative solutions that could generate wealth, adding to the economy.

Furthermore, we are also conscious of the possibility of the implementation of the Silk Review recommendations on devolution, which could realign Welsh and UK Government jurisdictions relating to water and wastewater along national (rather than company) boundaries. Such a change would not alter what we are trying to achieve or the principles that we apply. However, in the event of such a change, it would be necessary for us to reconsider how we implement our proposals while maintaining the integrity of the timetable for the 2019 price review.

3.4 Key issues we need to consider

In assessing our options for future regulatory design against the above criteria, we have considered a number of important issues.

- **The characteristics of the supply of water and wastewater vary considerably across different elements of the value chain** and yet historically the industry has been regulated as an integrated monopoly. It would seem natural that the regulatory model should evolve over time to reflect these differing characteristics.

- **The importance of ensuring the resilience of water and wastewater services and the systems that provide them,** reflecting both our statutory duty relating to this, and the need to ensure that systems and services (including financial, corporate and ecosystems) are able to anticipate trends and withstand and recover from shocks.

- **The need to incentivise a longer-term approach** to enable and incentivise service providers in the sector to run their businesses with a long-term focus (rather than for example focusing on control periods or price reviews) and to ensure that the costs and benefits associated with supplying water and wastewater services are appropriately shared across generations.

- **The privatisation value of the industry was significantly below the replacement costs of its assets** which means that the prevailing prices paid by customers for services at different stages of the value chain are below levels that would reflect the cost of providing those services by a new third party provider today. While this means bills are generally lower than would otherwise be the case, it creates a number of challenges in relation to developing a greater use of markets in the sector.

- **The role of the RCV,** which is the basis on which we have set prices. The RCV has served as a helpful tool, which has benefitted both customers and companies. It has enabled companies to smooth the cost of large investment requirements over the years by enabling them to access private capital markets, and has enabled this access at relatively low cost by providing a regulatory commitment for the recovery of depreciation and financing costs. We therefore need to consider how the RCV will be treated under any changes, particularly in relation to the efficiently incurred cost of investments made prior to our reforms.

- The water sector is characterised by **complex co-ordination challenges**. Specifically, beyond the interactions between Ofwat and companies, there are many other stakeholders, including businesses, farmers, householders, developers, central government, local governments, risk management authorities, NGOs and different regulators, which exert an influence over the water environment. These various stakeholders collectively need to co-ordinate a complex mix of both decision-making, but also resource and process planning and interaction.

4. Summary of our proposals

In this chapter, we set out a summary of our key proposals regarding our future regulatory framework for wholesale markets and PR19, and how these map to the key questions we identified in our July discussion document. The full details of our proposals (including the supporting rationale and evidence – and views from wider stakeholders) are set out in our main consultation and its relevant supporting appendices.

4.1 The key questions we identified in July

In our July discussion document, we outlined six key questions regarding our future regulation of the sector, as summarised in the table below.

Key questions for our future regulation of the sector

KQ1 How do we regulate to encourage service providers to focus on their customers over the longer term, rather than focusing their effort around periodic price reviews?

KQ2 How do we build on the customer-focused approach to the 2014 price review (PR14) and promote and maintain genuine customer engagement that drives companies' businesses?

KQ3 How do we regulate to encourage service providers to discover new ways of delivering outcomes to customers, which reduce cost and improve service?

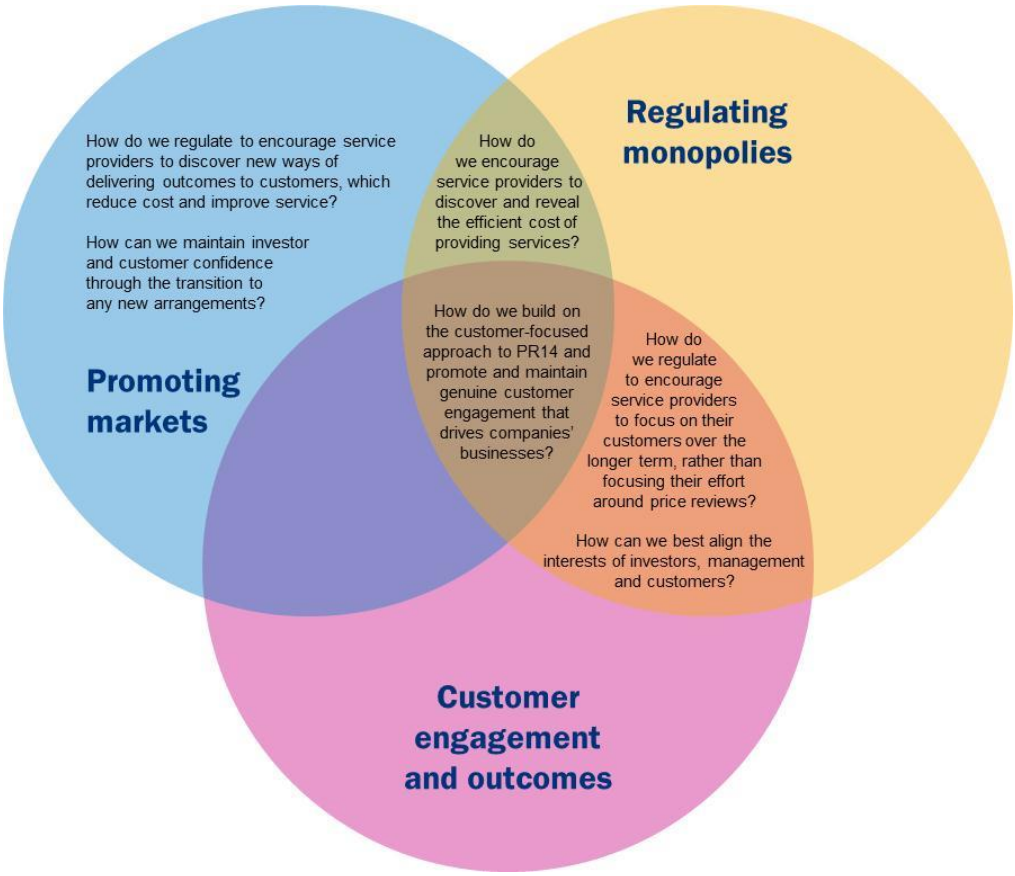
KQ4 How do we encourage service providers to discover and reveal the efficient cost of providing services?

KQ5 How can we best align the interests of investors, management and customers?

KQ6 How can we maintain investor and customer confidence through the transition to any new arrangements?

We further mapped the key questions to three policy areas, as illustrated in the following figure.

Figure 3: Mapping of high-level questions to policy areas



In the following, we summarise our key proposals under each of the three main policy areas shown above. For each proposal, we highlight how it relates to the key questions identified in our July discussion document.

4.2 How we will promote markets to deliver benefits

As we outlined in July, we see the promotion of markets as being a critical ingredient to meeting the challenges faced by the sector. In particular, without a broader approach to optimising how financial and environmental resources are used, it is hard to see how the water scarcity challenge can be met over the longer-term. Markets (which are simply places where buyers and sellers meet to exchange goods and services) can help deliver this broader perspective, because they reveal information that gives people choices, and enables transactions to take place that lead to resources being more efficiently utilised and allocated across companies, customers and the environment. In simple terms, this means that all key stakeholders benefit from a greater use of markets, if targeted appropriately. In determining our approach to this area, we had to address three key questions.

- In what areas do markets have the **most scope to deliver benefits?**
- What **issues or problems currently exist** that prevent markets from delivering these benefits?
- How can we **design our future regulatory framework** to address the identified problems?

4.2.1 Where do markets have the most scope to deliver benefits?

In this document and the supporting papers, we provide evidence suggesting that there is scope to make a greater use of markets:

- in relation to the treatment of sludge, its transport and disposal; and
- in the water resources elements of the value chain.

There is also scope to make more use of markets in relation to the direct procurement for customers of large-scale service improvements more widely.

Sewage sludge is a by-product of the sewage treatment process. But sludge is also a resource – it can be used as a fuel, or rather to produce biogas as a fuel, to generate renewable energy, and as a fertiliser replacement. In sludge, there is the potential for existing water and sewerage companies (WaSCs) to optimise their existing treatment, transport and disposal activities and make more efficient use of their assets, but also to compete directly with each other (in certain geographical areas). 'New entrants' to the sludge market could therefore include WaSCs operating outside their area as well as firms operating in other organic waste markets.

As the market provides companies with more choices as to who provides sludge treatment, transportation and disposal services, and greater opportunities to make more efficient use of their own assets, this, in turn, should reduce the pressure on customer bills. Moreover, there is also scope for existing firms to engage in wider waste treatment and disposal, and equally for firms operating in wider waste markets to similarly compete with WaSCs in relation to sludge treatment, transport and disposal. **The scope for interplay with wider waste markets could deliver even more material benefits, as innovative technologies are utilised to unlock new ways of generating value from waste.**

In water resources, the evidence in the water resources appendix shows that **there remain significant unrealised gains from water trading, which we estimate to be up to £1 billion** over the lifetime of assets. In general, water trading captures trading between water companies and trading between third party providers of water supplies and water companies. It can also be seen to include trading between customers and water companies on the demand side. Water trading levels have remained broadly flat, and low, over time in a way that cannot be explained by the features of the market, such as water transport costs. Looking further ahead, **there is scope for water resource providers to contract directly with water retailers in England in relation to non-household customers, as both the retail and wholesale markets develop**.

There is also scope for further competition from **water companies acting to procure services on behalf of customers,** for example, as demonstrated by the competitive procurement of the financing and construction of the Thames Tideway Tunnel. While there a number of special and one off factors associated with the Thames Tideway project such as the specific risks faced by the project and the associated government support package, the principle of using competitive procurement processes to gain best value for customers can be applied elsewhere in the sector. Related to this, Anglian Water has commissioned a paper on the potential for the multi sector financing of water supply assets. This includes a discussion of greater third party involvement (including partnering with companies) in order to finance new infrastructure investment in the industry.

Under our proposals we are setting our expectation that market-based procurement (including for financing, construction and where appropriate, operation) on a standalone basis should occur in relation to any discrete project with a value of more than £100 million. This will further help companies demonstrate that they are delivering best value services to customers. We believe that this approach will become more attractive and lower cost over time as it is more regularly applied. We consider that direct procurement is an important means for companies to demonstrate the efficiency and economy of their proposals in their business plans and will take into account companies' use of direct procurement as part of our risk-based review process for PR19. Going forward, we will seek to identify and address potential barriers to the wider application of direct procurement for customers, particularly those associated with the existing regulatory framework.

4.2.2 What currently prevents markets from delivering these benefits?

In order to understand whether regulatory reform is required (and if so, what form it should take) we need to be clear as to what the barriers are that prevent markets from developing at present. Full details of the issues we have identified, and the relevant supporting evidence, is provided in our main consultation. However, the main factors in relation to sludge and water resources, aside from physical constraints such as transport costs, are summarised in the table below.

Table 1: Key issues to address

Issue	Reason/implication	Whether we can address the factor or not (green = yes; amber = influence; red = no)
Sludge treatment, transport and disposal		
Environmental regulations.	Current regulations make co-digestion of sludge and wider organic waste difficult/ costly. Renewable subsidies are also targeted in ways that reduce the benefits of co-digestion.	No
Lack of information necessary to identify profitable trading opportunities.	Because there is limited visibility of costs, capacity and volumes, it is hard for WaSCs and third party providers to determine whether and where optimisation opportunities arise.	Yes
Cultural issues may result in WaSCs not considering outside options.	The existing regulatory approach is focused on cost minimisation and sludge is only a small part of a much larger wastewater control. The implication is that opportunities to maximise value from sludge are not effectively incentivised at present.	Influence
Water resources		
Insufficient information to properly consider third party options.	While the existing water resource management planning process incorporates the evaluation of third party options, there are limitations to this.	Yes
Cultural issues could mean water companies do not consider outside options.	There is a general focus by companies on 'within area' solutions, linked to concerns relating to meeting security of supply obligations. Trading incentives are modest relative to the size of wholesale water control.	Influence

Issue	Reason/implication	Whether we can address the factor or not (green = yes; amber = influence; red = no)
Tension between average cost of existing resource and higher cost of new resource.	It is likely to be difficult for third party providers to beat the average cost of existing resources, even where their resources are lower cost than incumbent's new resources. Need to understand the price of transport and treatment.	Yes

4.2.3 Our proposals for sludge treatment, transport and disposal

The table below summarises our key proposals in relation to sludge (which by definition apply only to WaSCs). The table also summarises the key rationale for our proposals and highlights how they relate to the key questions raised in our July discussion document.

Table 2: Sludge market proposals

Proposal	Rationale	Key questions from July addressed
Separate binding price control for sludge treatment, transport and disposal.	Will reveal information to help us set more targeted incentives. Will better facilitate choices between different suppliers, which will also help reveal efficient costs, but will also incentivise improved service and innovation, offering firms the potential to generate additional value.	KQ3, KQ4
Make data available on transport costs, capacity, and sludge quality, at an individual site level.	Will help WaSCs and third party providers identify opportunities for trades, which will lower costs, but also help unlock new value opportunities. Given the absence of market price information, we propose to collect cost information as a substitute for price. We recognise there are risks associated with publishing detailed cost information and so we will consider developing alternatives, such as collating 'price to beat' information.	KQ3, KQ4

Proposal	Rationale	Key questions from July addressed
A centralised information platform to disseminate the data.	In addition to the above, centralising information should reduce the burden on market participants having to seek out data. In addition, centralised data is likely to improve comparability and so better reveal efficient costs.	KQ3, KQ4
Develop guidelines that set out the basis on which incumbents should evaluate bids from rival firms to undertake sludge treatment, transport and disposal activities.	As WaSCs will be monopoly 'sellers' of untreated sludge in many cases, we want to mitigate potential discriminatory behaviour, but in a proportionate way.	KQ3, KQ4
Allocate a proportion of the RCV to sludge. This will be done on a 'focused' basis, so that the value allocated to sludge is equal to the modern replacement value of assets to provide sludge services.	Allocation of RCV necessary to support application of a separate binding price control. Rationale for using a 'focused' approach is that we want to ensure a level playing field between WaSCs and other providers.	KQ4
Extend our protection of efficiently incurred costs in the RCV to 31 March 2020.	Consistent with our commitment to allow recovery of efficiently incurred costs under the current regulatory regime and mitigate any potential adverse impact on industry financing costs (and therefore customer bills).	KQ6

4.2.4 Our proposals for water resources

The table below summarises our key proposals in relation to water resources (which apply to both WaSCs and WoCs). It also contains the rationale for the proposals and how they relate to the key questions raised in our July discussion document.

Table 3: Water resources market proposals

Proposal	Rationale	Key questions from July addressed
Separate binding price control for water resources.	Will reveal information to help us set more targeted incentives. Will better facilitate competition, which will also help reveal efficient costs.	KQ3

Proposal	Rationale	Key questions from July addressed
Market information database containing data on: • water sources and quality; • environmental and security of supply impacts; and • costs/benefits of potential sources.	Will help water companies and third parties more transparently identify opportunities for alternative resource options.	KQ3, KQ4
Platform to allow the ongoing assessment of bids from third party providers (linked to above information database).	The ongoing assessment of bids should helpfully complement existing water resource management plans.	KQ3, KQ4
Access prices set to allow the recovery of average network costs (based on our network plus price control) and a compensation payment or rebate to offset the difference between the incumbent's average incremental cost of new resource and the average cost.	Third party providers of water resources will need to access the water treatment and distribution networks of companies in order to provide water to retailers. The compensation payment will ensure a level playing field between incumbent appointees and third party providers to provide new resources. This is consistent with our focus on water resources focusing on new resources. In effect, the access price allows for the higher cost of new resources and ensures that customers' interests are best served by selection of the most efficient option.	KQ3, KQ4
Allocate a proportion of the RCV to water resources. This will be done on an 'unfocused' basis, so that the proportion of RCV allocated is equal to the proportion of companies' assets associated with water resources as proportion of total assets.	Allocation of the RCV is necessary to support the application of a separate binding price control. The rationale for using an 'unfocused' approach is that the market is focused on new resources and this reflects the impact of the discount at privatisation and alternative methods would result in very little or no capital values in the remaining monopoly parts of companies.	KQ4
Consider extending water trading incentives.	Because we have identified material benefits of increased trading and want to ensure the incentives are appropriate to deliver some of the gains back to customers.	KQ5
Extend our protection of efficiently incurred costs in the RCV to 31 March 2020.	Consistent with our commitment to allow recovery of efficiently incurred costs under the current regulatory regime and mitigate any potential adverse impact on industry financing costs (and therefore customer bills).	KQ6

4.2.5 Managing the transition to our new approach

A key feature of our approach to markets is our proposal to **extend our protection of the efficiently incurred costs in the Regulatory Capital Value (RCV) to 31 March 2020** (we previously stated that we would protect the RCV as at March 2015). This protection means that, going forwards, companies will be able to recover the full costs of investment included in the RCV. We consider this to be an important element of our package, which will help customers, companies and investors, better manage any transition. Importantly, by continuing to protect efficiently incurred costs of investment made prior to any of our reforms **we will mitigate any adverse impact on financing costs, and therefore, on customer bills**.

4.3 How will we apply effective regulation?

We recognise that, while there is scope for markets to develop in a number of areas, some parts of the water sector are persistent monopolies and so there will be a continued need to apply price regulation across the value chain. We will need to do this in ways that both protect customers and support the development of markets where we think this is appropriate. **There are a number of features of our prevailing approach to regulation that we propose to retain.** These include:

- increased focus on customer engagement and outcomes (discussed further in the subsequent section of this paper);
- the continuation of a risk-based review approach to the assessment of business plans;
- the continuation of a totex approach to cost assessment; and
- a balanced package of risk and reward, which aligns the interests of company management and investors with those of customers.

4.3.1 Form of controls

In relation to the form of price controls for PR19, we are proposing two additional wholesale controls, taking the total number of binding, separate wholesale controls from two to four, which are:

- sludge treatment, transport and disposal;
- wastewater network plus;
- water resources; and
- water network plus.

Across all of these, **we will again retain a number of features from our current forms of control**. These include continuing to:

- allow for general inflation in prices (although we are proposing to transition our measure of inflation from RPI to CPI over time, as set out below); and
- allow companies to earn a return (based on a weighted average cost of capital) on their RCV.

The following table summarises our proposed forms of control across the four binding separate wholesale price controls proposed. Further details of these, and the relevant supporting evidence, is set out in our main consultation.

Table 4: Form of price control proposals

Wholesale area	Form of control	Method of setting return	Rationale	Key questions from July addressed
Sludge treatment, transport and disposal	Price cap to put volume risk on appointee and enable regulated firm to retain significant share of the benefit from revenue earned from providing to other appointees and outside the sector.	Return on RCV, migrating to market based pricing.	As we anticipate there being scope for third party provision, it is appropriate for firms to face risks associated with market share gains and losses, and so a pure total revenue control is not appropriate. For PR19, we envisage any control being set on a return on RCV basis, but as and when market prices emerge, we would anticipate being able to migrate away from this.	KQ4
Wastewater network plus	Total revenue	Return on RCV	No change proposed to scope for markets in PR19 and therefore continue to maintain approach to price controls.	KQ6
Water resources	Total revenue	Return on RCV	We expect the market to focus on the provision of new resources, and so provision of existing resources requires continued regulation to protect customers.	KQ4, KQ6
Water network plus	Total revenue	Return on RCV	No change proposed to scope for markets in PR19 and therefore continue to maintain approach to price controls.	KQ6

4.3.2 Our approach to indexation for inflation in wholesale price controls

Historically, allowing for general inflation in regulated prices has been a key feature of our approach (and indeed, has been a feature of regulation more widely for the last three decades). Regulated businesses are not well placed to manage general inflation risk and therefore it does not make sense to allocate that risk to them, as doing so would increase financing costs, ultimately borne by customers.

To date, the inflation measure we have used in setting price limits has been the retail price index (RPI). However, since 2003, the Government has used the consumer price index (CPI) as the basis for inflation targeting, and since March 2013 RPI has no longer been an official government statistic[4]. Furthermore, in January 2015 an independent report by Paul Johnson recommended that: "Government and regulators should work towards ending the use of the RPI as soon as practicable," reflecting serious concerns regarding the robustness of RPI. In its place, the report suggested moving to CPI or CPIH (which includes housing costs). The UK Statistics Authority (UKSA) is currently considering the most appropriate measure of inflation and will publish its conclusions in the first half of 2016.

The Johnson review recommendation was based on a number of deficiencies with RPI, these include:

- RPI is an upwardly biased measure of inflation due to the way that changes in price movements are calculated;
- RPI is not calculated according to international standards and national statistical institutes around the world reject the approach used in the calculation of RPI to estimate price changes;
- the RPI calculation methodology has basic statistical flaws;
- issues with the weights of data sources, population coverage and treatment of some goods make the RPI less suitable as a measure of overall inflation; and
- the RPI methodology will not be updated like CPI to reflect changes in how price information is collected and compared and therefore there is scope for sudden changes in the difference or wedge between RPI and CPI.

There are a number of benefits from moving to CPI as:

[4] As RPI is no longer a national statistic – RPI statistics are no longer provided alongside other measures of inflation and the lesser status of the RPI measure is made clear. It should also be noted that the methods used to calculate are frozen and RPI is only updated for routine changes. RPI is likely to get less accurate over time. A UK Statistics Authority report provides further information.

- it would safeguard the legitimacy of indexation in price controls by using a common measure of inflation and reduce the risk that indexation leads to perceptions of poor value from water bills;
- it is the main measure of inflation and so is more readily understood by customers;
- it is less volatile than RPI, meaning smoother bills for customers; and
- it does not have the significant methodological problems of RPI and so is a more accurate (and lower) measure of inflation for both customers and companies.

CPI is also increasingly being used by regulators and is used to index prices for some controls by the Civil Aviation Authority (CAA), the Water Industry Commission for Scotland (WICS) and by Ofcom[5]. Ofgem is currently consulting on the potential use of CPI.

Indexation is applied to both prices and the RCV in setting price controls, with indexation of the RCV impacting on prices over time. We consider that there is a strong case to move to CPI indexation for both the overall price control and for a proportion of the RCV. If only the price control is indexed to CPI, and the RCV remains indexed to RPI, then there remains a link between RPI and any differences between RPI and CPI would need to be corrected. This would mean that prices would go up by RPI over the long term, and customers would still be subject to longer term bill volatility.

In light of the above, we propose to change our measure of inflation from RPI to CPI (or possibly CPIH depending on the UKSA review) at the next price control (PR19). However, **we will put in place transition measures to support both customers and companies in making this change** because, without any such measures:

1. there could be an impact on the profile of cost recovery over time, resulting in significant one-off increases in customer bills in the near to medium term, and falling bills in future periods; and
2. any change to CPI could result in companies incurring costs associated with 'hedging' for the difference between RPI and CPI (because the industry has a substantial amount of debt that is index-linked on an RPI basis).

[5] CPI is used by CAA to set the price control for en route air traffic services and Ofcom to set wholesale broadband access, mobile call termination and fixed access markets. In addition, Ofcom is intending to apply a CPI approach to the setting of annual licence fees (ALFs) in relation to 900 and 1800 MHz spectrum used to provide 2G and 3G services, including voice calls, and some for 4G mobile services.

Accordingly, **we are proposing to phase in the introduction of CPI indexation, by continuing to apply RPI to 50% of the RCV and CPI to the remainder**. Correspondingly, we will set returns by applying an RPI based rate of return to the RPI proportion of the RCV and a CPI based rate of return to the remaining (CPI) proportion of the RCV. Our application of CPI to the RCV and allowed returns will be symmetrical, **ensuring that nominal returns to companies are revenue neutral over time**.

In terms of setting the proportion of the RCV that will continue to be linked to RPI, we have taken account of both:

- the proportion of index linked debt we assumed (for the notionally geared company) when we set the cost of capital for PR14; and
- the existing levels of RPI linked debt in the industry.

In addition, we propose to **allow companies to smooth the impact of a move to CPI on customer bills over time**. Companies should engage with their customers on the impact of the move to CPI as they develop their business plans and should consider whether (in addition to our proposed phasing) any further mitigation of short-term bill impacts is required.

Table 5: Approach to inflation in price controls

Proposal	Rationale	Key questions from July addressed
We will change our inflation measure from RPI to CPI.	The ONS and independent reviews have concluded that the RPI is flawed, statistically inadequate, upwardly biased and not produced to international standards and so RPI is no longer an official national statistic. CPI is the main inflation measure used in the UK and is more readily understood by customers. It is also less volatile than RPI leading to smoother customer bills. Consequently, we consider that it is no longer tenable to use RPI to index price controls and propose that we should move towards CPI based controls.	KQ1, KQ5
We will phase in the introduction of CPI.	We need to enable companies to mitigate short run bill impacts and also allow existing RPI linked debt to unwind in the sector.	KQ6

4.4 Putting customers at the heart of decision making

PR14 was successful in achieving a step change in customer engagement as companies produced business plans that better reflected their customers' needs and requirements. The customer challenge groups (CCGs) were crucial in achieving this. That said, we think companies can do more to genuinely understand their different customers' needs and requirements and put customers at the heart of decision making.

This will involve a deeper understanding of the needs and requirements of different types of customers, including the more vulnerable and hard to reach. It will involve engaging customers on longer-term issues, including the resilience of the companies' systems and services. It will also involve careful consideration of the tools and techniques used to inform and engage customers. We said in July that we wanted companies to move away from over-reliance on stated preference willingness to pay (WTP) techniques and consider how alternative approaches (such as revealed preference choice experiments) could be used to develop a richer understanding of customers' views. We also believe companies should consider how they could make more use of information they receive from customers in their day-to-day interactions with them (such as complaints, queries and tweets for example). Where companies do use stated preference WTP techniques, careful consideration will be required to ensure such techniques deliver robust results.

We want to see more evidence of companies putting customers at the heart of the way they run their businesses and make decisions – at all levels of the business. We also encourage companies to consider how they could work in partnership with their customers to design and deliver solutions (for example by managing demand) and consider the scope for more community-based approaches, where this is appropriate and efficient.

We propose to consider the quality of a company's customer engagement as well as its performance in the current regulatory period, including the way it has engaged with its customers on this performance, in our assessment at the PR19 risk-based review.

Building on the success of PR14, we propose that the CCGs should continue to provide challenge and assurance on the:

- quality of a companies' customer engagement; and
- degree to which this is reflected in their plans at the 2019 price review.

We do not consider that CCGs should act as a substitute for a company engaging with its actual customers or substitute its views for those of customers. However, we will expect the CCG to draw on the results of a company's customer engagement and challenge the company so that its plan reflects its engagement.

We propose to build on our experience with PR14 by providing greater clarity on the scope of the CCG's role and the timetable of deliverables. We also propose to provide more clarity on the issues we would like addressed by the CCG reports, for example, how effectively a company has engaged with its customers on longer-term issues. It is of paramount importance that CCGs remain independent and have access to information that allows them to genuinely challenge the companies. At PR14 the groups were mainly reliant on the companies for information and analysis. To improve this balance at PR19 we propose to facilitate regular workshops with the CCG Chairs to share information, best practice and challenge. We will also be looking for assurance from the companies on the measures they have taken to preserve the independence of the CCGs. Having access to good-quality and appropriate comparative information is also important so we are committing to a consultation next November on the role that comparative information can play at PR19. This consultation will also address the balance of comparative and bespoke outcomes at PR19. To facilitate good quality conversations with customers we also intend to publish our indicative views on allowed returns earlier in the price setting process.

Finally, in relation to outcome delivery incentives, we want to see these reflecting the importance of good operational performance to customers and, where appropriate, spanning multiple price control periods to provide a long term focus for companies and customers.

Table 6: Customer engagement and outcomes

Proposal	Rationale	Key questions from July addressed
Customer engagement		
Encourage companies to build further on the success at PR14 to develop a genuine understanding of different types of customers' needs and requirements.	We know that needs and preferences vary by customer type, but also that the best way of engaging customers can also vary.	KQ2
Encourage companies to engage with customers on longer-term issues, including resilience and seek assurance from CCGs that this is done well.	To help incentivise companies to deliver for customers beyond short-term regulatory review cycles and to improve the resilience of the sector.	KQ1, KQ2

Proposal	Rationale	Key questions from July addressed
Encourage companies to use alternative methods to understand their customers' needs and requirements such as: • revealed preference techniques (for example choice experiments); and • better use of information received from customers on a day-to-day basis (for example, queries, complaints and tweets). Where companies do use more traditional stated preference WTP methods, to ensure they are being used appropriately.	At the last price control, stated preference survey results found large differences in customer preferences across companies. Several stakeholders raised concerns about whether the variations were genuine reflections of customer preferences or due to survey design differences.	KQ2
Encourage companies to consider carefully how they can work in partnership with customers to design and deliver solutions (for example, demand management).	Working in partnership with customers to design and deliver solutions will align company and customer interests and help to deliver innovative and cost effective solutions.	KQ2
We propose that CCGs focus on challenging and assuring: • the quality of a company's customer engagement; and • the degree to which this is reflected in their plans. We plan to build on experience from PR14 by providing more clarity on the scope of issues we expect CCGs to address and the timetable of deliverables.	CCGs proved to be highly effective in PR14 by challenging companies and assuring their customer engagement.	KQ2
We propose to facilitate more collaboration between CCG Chairs by hosting regular workshops with the Chairs to share information, practice and challenge. We also aspire to publish our indicative views on allowed returns earlier in the price setting process	To provide more information to key stakeholders that should improve the quality of companies' plans, the customer engagement on them and the challenge provided by CCGs.	KQ2, KQ6
We take account of companies' past performance and the quality of their customer engagement in our risk-based review in PR19.	How companies perform and how they engage with their customers are relevant to our assessment of their business plans for PR19.	KQ6
Outcomes		
We propose a licence modification to allow all companies to have in-period outcome delivery incentives.	To further incentivise service delivery by companies by linking rewards and penalties to performance more closely in time.	KQ1

Proposal	Rationale	Key questions from July addressed
We will separately consult, in November 2016, on the balance of common and bespoke outcomes and the role that comparative information could play at PR19.	Outcome incentives that are comparable across companies have some advantages, because customers can assess them on a like-for-like basis, but bespoke outcomes also have benefits because they allow companies to innovate to reflect their customers' preferences. We wish to consider this further.	KQ6

4.5 Focus on the longer term

The water sector is a long-term business. Decisions made today can have impacts well beyond a five-year price control. So, we want to ensure that the way in which we regulate, in line with our duties, encourages companies to take ownership of their long-term future and manage risks, rather than focus unduly on the five-year price control cycle.

We do not believe that the lengthening of controls is appropriate at this time, given our proposals for wholesale market development and uncertainty regarding the future evolution of these markets. However, we want companies to focus beyond the five yearly price control cycle.

We are proposing a number of measures to help further drive a longer-term focus on planning and service provision within the industry. Key elements of our proposals (which are listed separately in the above tables) that we should highlight include:

- evolving our risk-based review of company business plans, so that it places more emphasis on the assessment of the longer-term context to those plans;
- setting an expectation that companies should seek to engage further with customers on longer-term issues; and
- that CCGs will report on the extent to which companies have engaged with customers on longer term issues.

In addition to these proposals, in our main consultation we are also seeking views as to whether we should mandate longer-term outcome incentives. Finally, at this time we are not intending to change the timing of price controls.

4.6 In-period adjustment to price controls

As stated above, we do not believe that the lengthening of controls is appropriate at this time. We consider that it is desirable that, where company performance during a price control period will result in adjustments to their allowed revenue, this adjustment should be made during the period, rather than left to true-up at the end of the period. This avoids the potential for accruing large impacts on future customer bills from performance during the period, reduces company focus on the five yearly price control cycle, and provides more visibility of company performance to management and investors. We are consulting on a range of in-period adjustments, including outcome delivery incentives[6]; and cost out- or under-performance. We acknowledge that some incentives may crystallise later in, or at the end of, the period and it will still remain appropriate to have an end of the period adjustment, albeit a smaller one.

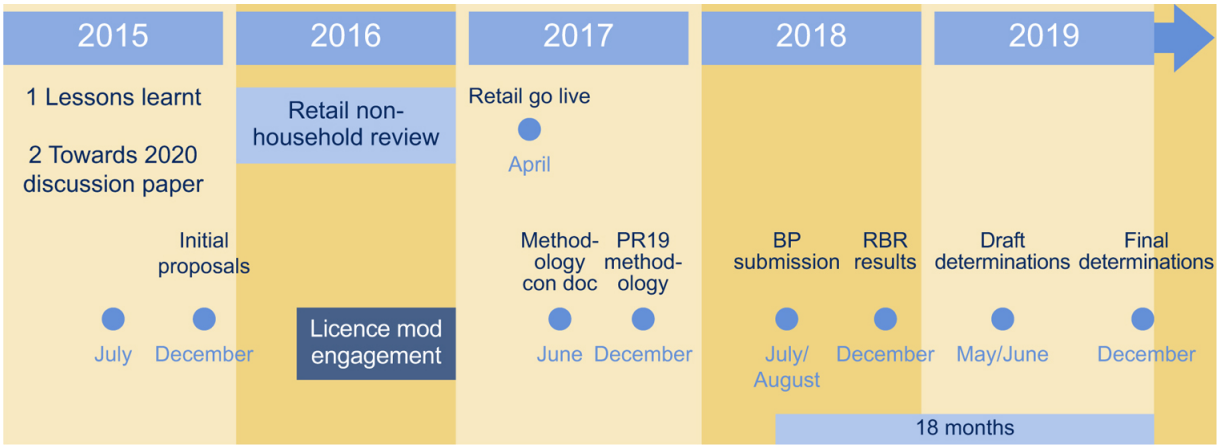
4.7 Next steps and timeline for Water 2020

We recognise that this consultation document does not address all the issues that we need to in order to set prices in 2019 or indeed to implement the wholesale reforms in the 2014 Water Act. This consultation is focused on those areas of policy that we need to resolve quickly in order to allow them to be implemented effectively in time for the 2019 price control methodology statement, including any necessary licence reform. We propose to consult during 2016 on the outstanding policy issues, including, for example, further details on our proposed market and price control design for sludge and water resources, risk and reward, outcomes and outcome delivery incentives, customer engagement, any changes to the regulation of retail services and other aspects of network regulation. This will be through further consultations during 2016, alongside our decision document, which is planned for May 2016.

Our timeline for Water 2020 is summarised in the figure below.

[6] At PR14, three companies opted for licence adjustments to enable in-period adjustments to their price control to reflect outcome delivery incentive rewards and penalties.

Figure 4: Proposed timescales for the Water 2020 programme



5. Consultation questions

The proposals summarised here are for consultation, and we welcome all views from interested parties. Questions that relate to the details of our proposals are set out in main consultation. Here, therefore, we set out some higher-level questions, primarily intended for those parties who wish to offer views on the overall strategic dimensions of our proposals. Parties are, of course, welcome to provide responses to both these and our more detailed questions if they so wish.

Strategic level questions

SQ1 Do you agree with our proposals for making a greater use of markets in relation to sludge and water resources?

SQ2 Do you agree with our proposals in relation to the future form of regulation for the sector?

SQ3 Do you agree with our proposals in relation to customer engagement and outcomes?

SQ4 Do you agree with our proposal to extend protection of the RCV to 2020?

You can respond to this consultation by **10 February 2016**.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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