

Setting price controls in 2014

A briefing note for investors

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Delivering sustainable water

Customers of water and sewerage and water only companies in England and Wales deserve excellent service at a fair price. And we know that the role investors play in the water and sewerage sectors is vital to the delivery of that objective.

We are consulting on our proposed price limits methodology framework, which sets out how we will set price controls for the water companies for each of the five years from 2015 to 2020.

This briefing note sets out what our proposals mean for you. We want your input in helping us to ensure that our regulatory framework evolves in a way that helps the sectors meet the challenges of the future, while building on the considerable success of the past.

Overview

The Water White Paper, 'Water for Life', describes a vision for future water management in which:

- the water and sewerage sectors are resilient;
- water companies are more efficient and customer focused; and
- water is properly valued.

A key feature of our proposals is, for the first time, to set separate price controls for:

- retail water and sewerage services to household customers;
- retail water and sewerage services to non-household (business) customers;
- wholesale water services; and
- wholesale sewerage services.

By setting these distinct controls, we can encourage companies to focus on what their customers want, while driving efficiency – both in the way they operate and in their investment decisions. We think that this will reward innovation and sustainable solutions to managing this valuable and precious resource, while maintaining the attractiveness of the water and sewerage sectors to you as investors.

It notes that we need to encourage innovation and dynamism while ensuring the sectors remain a low-risk and attractive choice for investors. The Draft Water Bill develops the framework to achieve this vision.

Our proposed methodology framework supports both of these in:

- ensuring **growth and investment**;
- driving a focus on **delivering for customers and creating greater accountability** and opportunity for water companies; and
- ensuring **sustainable water supplies** for the future.

1. Regulating for growth and investment

More than £108 billion has been invested over the past 24 years in delivering improved services and infrastructure. Water companies continue to spend about £4 billion each year on improving services for customers and enhancing and maintaining the environment. But the solutions of the past are not necessarily the right solutions for the future. New, emerging challenges require water companies to be more innovative – and deliver more efficient and sustainable solutions for the long term.

We know debt and equity investors value a stable, transparent and predictable regulatory framework. We are committed to making sure that you have confidence that efficient investment will continue to earn returns proportionate to the risks of that investment.

What we intend to do and why

As new challenges emerge within the economy – from population growth to new industries and uses for water that change the demand for it – our framework will provide the sectors with greater flexibility to respond.

We want to make sure that water companies continue to be able to raise the finance they need at a low cost, keeping customers' bills down. At the same time, we need to make sure that the finance raised is invested in the right, long-term, sustainable solutions. This, along with the UK Government's reforms of the sectors, will deliver the legitimacy they need with their customers, to ensure sustainable and stable returns over the long term.

To ensure continued access to low-cost financing, we will protect existing investment and incentivise new investment. The wholesale part of the sectors represents 90% of the companies' business. We will continue to set wholesale price controls using tried and tested tools – including using the familiar concept of the regulatory capital value (RCV) and linkage to RPI, while it remains the most appropriate index. We will use the RPI+/-K framework, where K is a yearly

adjustment factor we set in our price determinations. The stability of our approach will provide the certainty that investors value.

And to make sure that the finance raised is invested in the right solutions, we will use targeted incentives – including ones to facilitate efficient water trading. These will encourage water companies to improve efficiency and customer service, while boosting innovation and keeping costs down. They will also have greater freedom and accountability and will be able to take greater ownership of the risks they are best placed to manage. Companies performing well will attract investment, while those that perform less well will be incentivised to improve.

2. Shifting the focus to customers and creating greater accountability

There is significant pressure on all customers in these tough economic times. Household income has fallen, in real terms, by about 5% since 2010, while bad debt in the sectors adds £15 onto every customer's bill each year. Meanwhile, businesses are struggling to meet costs, and their ability to control the cost of managing their water and sewerage service is severely restricted. A [Policy Exchange report in July 2011](#) highlighted one business that would be able to save between £80,000 and £200,000 by receiving just one water and sewerage bill, instead of its usual 4,000 bills from a number of different water companies.

What we intend to do and why

We want water companies and their Boards to focus on the long-term outcomes their customers value instead of on short-term outputs set by the regulator. We want water company Boards to take greater accountability and develop business plans that meet customers' needs – and be rewarded when they succeed.

It is essential that water companies have the confidence of their customers – after all, it is they who pay the bills that underpin the safe, secure revenue stream that guarantees returns to investors. So we are incentivising and rewarding companies and Boards that focus more on their customers. We have required each of them to set up a customer challenge group (CCG) to hold them to account for their engagement with customers. Those that do well will benefit from a lighter touch scrutiny of their business plans.

And we will set two binding retail controls in 2014 – one for household customers and one for non-household customers. To bring the sectors in line with others, retail controls for household customers will not be indexed to RPI. Instead, water companies will be encouraged to improve their retail businesses by focusing on the average cost to serve. This will help to keep bills manageable for customers. For non-household customers, we will set a default tariff – a maximum price for a minimum level of service.

When the Draft Water Bill becomes law, all non-household customers in England will be allowed to choose their water and sewerage supplier. This will give them access to a wider choice of value-added services such as improved water efficiency and account management. This, in turn, will enable them to better control the internal costs of managing their water and sewerage supplier. We will support this process but also provide protection until the market is more mature.

3. Ensuring sustainable water for the future

Water is arguably one of our most precious resources and is often undervalued. And managing it sustainably is becoming ever more challenging in the face of changing weather patterns. The year 2012 was the second wettest since records began in the UK. And [four of the top five wettest years have occurred since 2000](#) – part of a global trend towards more extreme rainfall events. The impact of this is devastating – during 2012 almost 8,000 properties in England and Wales were flooded, keeping families out of their homes for an average of nine months.

In stark contrast, in April 2012, several companies were preparing to find extra water supplies and had imposed hosepipe bans, restricting the volume of water their customers could use. These drought conditions were caused by exceptionally low groundwater levels in many areas of England because [the previous 18 months](#)

[were the driest for more than 100 years.](#)

At the same time, our population is growing, where people are choosing to live is affecting water demand and new water intensive industries are emerging – like ‘fracking’ (exploiting shale gas).

We need to make sure water is available where and when we need it most. According to the Environment Agency, more than half of the UK’s rivers are over-abstracted, while others have plentiful supplies. But at the moment, less than 5% of the water in the UK is traded between companies across regions.

The challenges we face here in the UK reflect what is happening globally, which means water is rising up the agenda worldwide. Indeed, some energy commentators have suggested that water is the new oil¹.

What we intend to do and why

We want to allow water companies greater freedom to innovate and find more sustainable solutions to meet demand while increasing resilience. To do this, they need to base their decisions on the true economic, environmental and social value of water. Our framework will help reveal this value and allow them to make better informed decisions on what and where to invest to meet supply and demand pressures.

We will incentivise innovation by removing regulatory barriers,

which will lead to more sustainable approaches. We will:

- equalise incentives for different types of expenditure, by rolling together operating expenditure (opex) and capital expenditure (capex) in a total expenditure (totex) approach;
- incentivise efficient water trading across company boundaries; and
- create the abstraction incentive mechanism (AIM) to reward companies that source water from where it does not damage the environment – and to penalise them if they take it from where it does.

Water companies that deliver the right solutions for the long term will gain the confidence of their customers and policy makers. This which will lead to the predictable and sustainable environment that investors tell us they value.

Conclusion

As outlined in the Water White Paper, it is essential that the water and sewerage sectors are resilient, efficient and customer focused – and that water is valued as a precious and finite resource. Our framework will enable water companies to make sustainable choices on how they use investors’ money based on a better understanding of the true economic, social and environmental value of water. It will reward innovation and efficiency, and maintain the attractiveness of the sectors for investors by protecting existing investment while encouraging new investment.

¹ Forbes magazine, 3 May 2012

More information

'Water retail services competition in England and Wales. Still Hobson's choice?' Policy Exchange, July 2011

'Involving customers in price setting – Ofwat's customer engagement policy statement', Ofwat, August 2011

'Future price limits – statement of principles', Ofwat, May 2012

'Consultation on retail price controls for the 2014 price review', Ofwat, July 2012

'Consultation on wholesale incentives for the 2014 price review', Ofwat, August 2012

'Review of the 2010-2012 drought and prospects for water resources in 2013', Environment Agency, December 2012

'Met Office: 2012 was UK's second wettest year on record', BBC News, January 2013

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water and sewerage sectors in England and Wales provide consumers with a good quality and efficient service at a fair price.

Water today, water tomorrow



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