

Setting price controls for 2015-20 – final methodology and expectations for companies' business plans

A briefing note for investors

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Maintaining stability and transparency

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 sector is vital to the delivery of that objective.

In 2014-15, we will decide the price and service package (the 'price controls') that each of the monopoly water and sewerage and water only companies in England and Wales must deliver in each of the five years between 2015 and 2020.

In 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (our 'methodology statement') we set out in detail how we will reach our decisions. We also set out our expectations for the business plans that each company will send to us by 2 December 2013 – and that we will use to set their price controls.

We have developed our approach for setting price controls over the

past three years. This included talking with and listening to, among others:

- customers and their representatives;
- the water companies;
- debt and equity investors, analysts and rating agencies;
- the UK and Welsh Governments; and
- environmental and quality regulators.

This briefing note summarises our methodology statement and what it means for investors. We also set out next steps in the price review process.

Overview

Our final methodology sets a modern and updated framework for setting prices that supports:

- economic growth;
- efficiency; and
- sustainability.

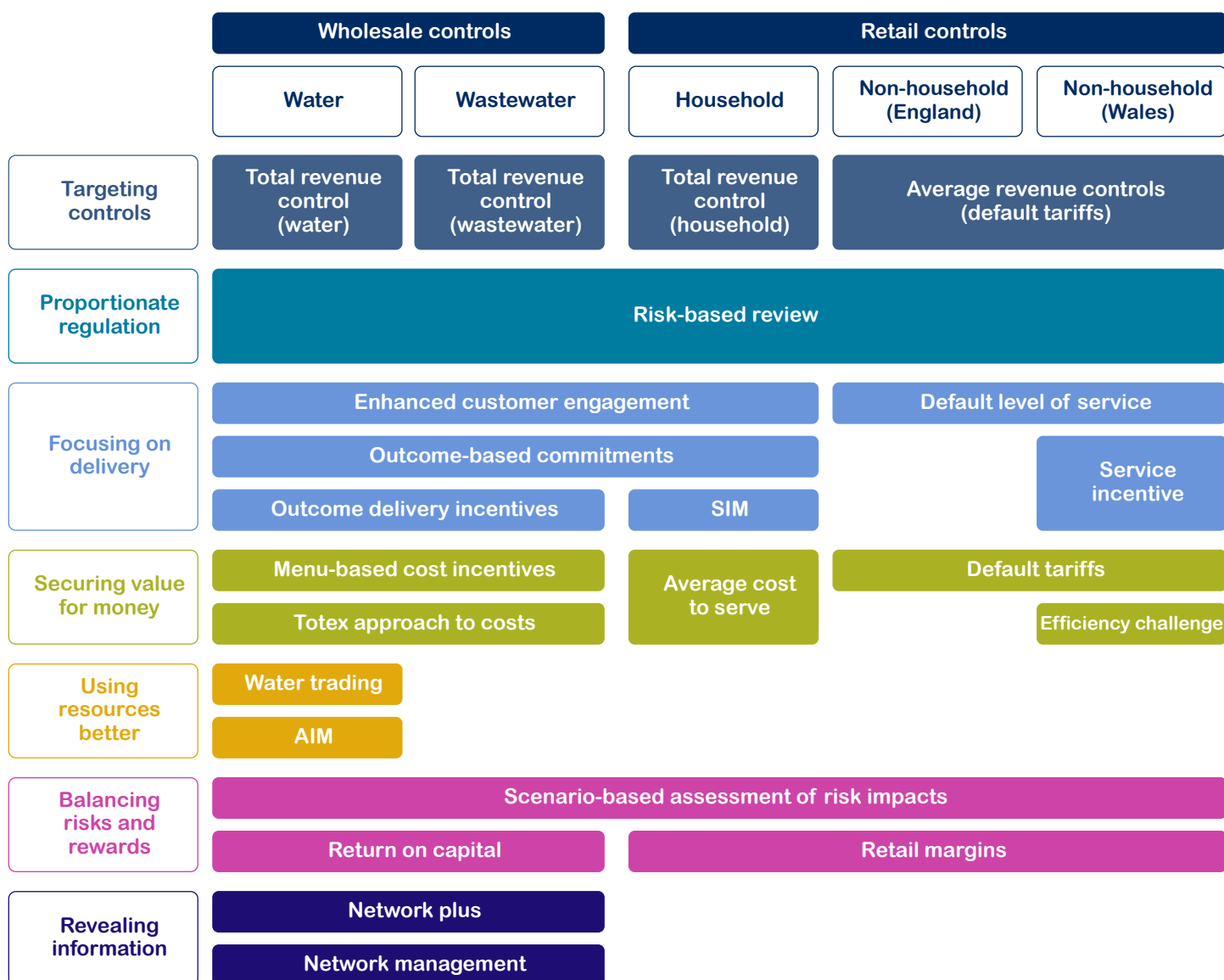
Our aim is that the water sector will remain attractive for investment – while adjusting our regulatory framework to enable it to meet the challenges of the

future and build on the considerable success of the past. So, we are:

- encouraging the companies to produce high-quality business plans, and have given them and their Boards greater ownership of those plans;
- maintaining many of the features that investors tell us they value, such as the regulatory capital value (RCV), Retail Price Index (RPI) indexation in the wholesale price controls and the weighted average cost of capital (WACC);
- focusing on targeted controls and strong incentives that will allow better performing companies to create greater rewards for investors and poorer performing companies to be held to account; and
- creating more scope and freedom for companies to innovate and decide how they deliver solutions for customers both now and in the future.

Below we summarise each of the main elements in our methodology and what they mean for investors.

Our final methodology – a summary



Targeting controls

The different parts of each company's business (the 'value chain') have different characteristics. Setting separate price controls for different parts of the value chain allows us to use stronger targeted incentives in order to drive dynamic, allocative and productive efficiencies in companies. So we will:

- set two wholesale controls – one for water and one for wastewater;
- set two retail controls – one for household customers and one for non-household customers in England;
- set a modified retail control for non-household customers in Wales; and
- use a single definition of retail activities applied from the start of 2015-20.

This change will mean the companies and investors will have greater transparency of the costs, risks and rewards associated with each of these businesses. We have provided clear incentives for companies to improve, but allowed a glide path – particularly in household retail controls – to enable those that perform less well to catch up.

Stronger targeted controls and incentives will mean that the better performing companies will be able to earn greater rewards. But the poorer performing companies could be more exposed and should be held accountable to shareholders.

Investors have told us of the importance of the RCV and RPI indexation. So we have allocated all of the companies' historic RCV to their wholesale controls, which will take the conventional RPI±K form.

Proportionate regulation

We want the companies' Boards to take full responsibility and accountability for planning and managing their business. So we will not set detailed requirements on what we expect each company to provide in its plan – other than specific information we need to set price controls.

Instead, we will use a series of tests to review the quality of each company's plan (a 'risk-based review'). We will give the companies one of three ratings – 'enhanced', 'standard' and 'resubmission'. Companies with the best ('enhanced') plans will be rewarded by less scrutiny, more choice of financial rewards and earlier decisions.

Focusing on delivery

We want the companies to focus on delivering the services their customers want.

- For each of the price-controlled parts of its business, the

companies will agree with their customers a series of long-term objectives that they will deliver ('outcomes').

- They can set the rewards and penalties they should receive for over or under-delivering these outcomes ('outcome delivery incentives'). We also require the companies to set an outcome – and associated incentives – on reducing leakage.
- Reports prepared by customer challenge groups (CCGs) – independent groups of customer representatives and quality regulators – will tell us how well each company has engaged with its customers. We will use these reports as part of our risk-based review.

This approach will:

- allow the companies to have more freedom to innovate and decide how they deliver outcomes – which means there is more scope for well-performing management to outperform and create enhanced returns for investors;
- mean that the companies that perform poorly can be held to account by their investors; and
- deliver outcomes that customers want and that allow the companies to better target investment programmes (financed by investors), which will reduce the risk of inefficient investment.

Securing value for money

Efficient and effective water companies are good for the

economy. Investment can help support economic growth and – when targeted in the right way – can reduce the future risk to customers of paying higher prices or having more frequent restrictions on the water they use. So for each company's wholesale price controls we will:

- use a total expenditure ('totex') approach for assessing its costs, which should help remove a possible bias towards capital-intensive – and potentially more expensive – solutions for delivering services;
- give each company a choice about its level of risk and reward to encourage them to give accurate forecasts of their costs ('menu regulation'); and
- allow each company to propose the proportion of its expenditure to be recovered from current and future customers, so that it is fair to both groups.

For retail price controls we will:

- use each company's actual costs to determine the average cost to serve household customers, to encourage those companies with higher costs to reduce them – and those with lower costs to do even better; and
- use each company's proposed tariff structures to determine the default tariffs they should provide to non-household customers in England.

These are powerful incentives that will allow the better performing companies to retain a higher proportion of outperformance and earn enhanced returns for investors.

Using resources better

We want to encourage the companies to manage water supplies more sustainably, while improving efficiency. Trading water can help reveal the true value of this precious resource, which will help the companies to make better decisions on where to invest and how to balance supply and demand for water. So we will:

- introduce financial incentives for water trading, covering all new exports and imports; and
- introduce a non-financial incentive (the 'abstraction incentive mechanism') to encourage the companies to source water from where it does not damage the environment. We will use this incentive to rank the companies and compare them on their performance in reducing damaging water abstractions – with a view to strengthening it in future. Each company can also propose its own financial incentives in this area as part of its outcome delivery incentives.

The financial incentives for water trading are stronger than at previous price reviews and encourage both exporters and importers. This could mean greater rewards for those companies that can innovate in improving management of this vital resource.

Balancing risks and rewards

We want to make sure that efficient companies receive appropriate remuneration for the risks that they bear in delivering

services. This is so that potential investors have the confidence to lend them the finance they need for long-term investment. We will:

- use tried and tested methods that investors have told us they value and understand such as the RCV indexed by RPI, a RPI±K form of control for wholesale and a single WACC;
- use retail margin to remunerate the companies for retail risks;
- maintain protections such as interim determinations, which allow the companies to seek additional funding from customers before the next price review in the event of significant specific cost or revenue shocks that are outside of management control; and
- use scenario modelling to assess quantitative risk impacts to inform the overall level of risk in companies' plans.

Our approach allows the companies greater flexibility in managing the risks they bear. For example, it allows them to:

- choose the split between pay-as-you-go and capitalised expenditure in totex; or
- determine the appropriate run-off rate for the RCV.

Revealing information

We want investors to be confident that our regulatory framework will evolve where necessary on the basis of sound evidence and in consultation with all stakeholders. So we will:

- gradually implement two non-binding network plus sub-limits

during 2015-20, one for water and one for wastewater, building on accounting separation to introduce both separated revenue accounting and non-binding sub-limits by 2017-18; and

- introduce network management reporting for water networks and sludge gradually over 2015-20, allowing the companies to focus on the 2014 price review.

Delivering the right overall package

Investors tell us that the overall price control and service package is of key importance. So we will:

- assess each company's proposals as an overall package using familiar tests of financeability at the whole company level; and
- ensure that efficient companies are able to finance their functions in accordance with our statutory duties.

We intend to introduce a financial structure monitoring regime following the price review to assess:

- the sector's financial resilience; and
- the risks to customers posed by the companies' financial structures.

This is so we can identify whether (and when) it might be appropriate for us to intervene to protect customers.

Next steps

The publication of our methodology statement marks the end of the consultation on our policy and approach to setting price controls for 2015-20. We are now moving into the delivery phase of the price review – where the companies will submit their business plans, and we will assess their proposals and set price controls.

The next major milestone for the price review is the submission of companies' business plans by 2 December 2013. The companies' independent CCGs will also submit their reports by this date.

We will publish more information about the price review timetable in the autumn.

Further information

We look forward to continued productive engagement with all of our stakeholders, including those in the investment community, as we move forward into the price setting process. We will continue with our twice yearly City briefing events as part of our strategy of engagement targeted at investors.

If you want more information or have questions about the price review, please contact corporate.finance@ofwat.gsi.gov.uk.

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.

More information

[‘Setting price controls for 2015-20 – final methodology and expectations for companies’ business plans’](#), July 2013

[‘Setting price controls for 2015-20 – business planning expectations: a consultation’](#), March 2013

[‘Setting price controls for 2015-20 – framework and approach: a consultation’](#), January 2013

[‘Future price limits – statement of principles’](#), May 2012

You can find more information about price setting and the 2014 price review on our website at www.ofwat.gov.uk/pricereview.



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