

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

A summary briefing note for stakeholders





Delivering better outcomes for customers today and tomorrow

Customers of water and sewerage companies deserve excellent service at a fair price. But most customers cannot choose their supplier. Instead, they receive their services from one or more monopoly supplier. So it is our role to protect their interests by regulating these monopoly companies.

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.

We have now published '[Setting price controls for 2015-20 – final methodology and expectations for companies' business plans](#)' (our 'final methodology statement'), which sets out how we will set those price controls. This also includes:

- our expectations for the information each water company should include in its business plan, setting out its proposals for the next five years; and
- how we will review and challenge those plans.

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 and investors;
- the UK and Welsh Governments; and
- environmental and quality regulators.

This briefing note summarises our final methodology and what it means for customers and other stakeholders. We also set out the next steps in the price review process.

Overview

We want customers to be at the heart of water companies' business strategies. This is in line with the thinking of the UK and Welsh Governments and is also a key part of our long-term plan for a sustainable water sector. Our final methodology sets a modern and updated framework for setting prices that supports economic growth, efficiency and sustainability. This includes:

- [empowering customers today by giving them a stronger voice](#) in how companies deliver services and how much customers pay for them;
- [protecting the needs of future customers](#) by ensuring companies plan how they will deliver [secure and sustainable supplies over the long term](#);

- encouraging companies to produce [high-quality plans](#) based on their legal obligations and effective customer engagement – and giving them [greater ownership](#) for delivery of those plans;
- [challenging companies to keep costs low and deliver improved value](#) to customers and the environment;
- [protecting the environment](#) by encouraging companies to [use scarce resources carefully](#) and consider [more sustainable solutions for delivering services](#);
- maintaining the [stability and transparency](#) that investors value and which will encourage them to continue to [finance long-term investment](#); and
- [revealing new information](#) from companies to improve how we set price controls in future and continue to [protect customers' interests](#).

Overall, our methodology gives companies the flexibility and the tools to respond to the challenges from their customers, environmental stakeholders and policy makers.

Next, we summarise each of the main parts of our methodology and what our overall methodology will mean for different stakeholders.

Targeting controls

We want to encourage companies to do the right things for customers and the environment across their business. So we will set four price controls for each water and sewerage company – one each for retail water and sewerage services to household and non-household (business) customers, one for wholesale water services and one for wholesale sewerage services. We will only set two price controls for water only companies.

Targeting price controls will allow us to set better rewards and penalties ('incentives') for different parts of the companies to encourage them to improve the services they offer to customers and the environment – and the price they do it for.

For example, retail price controls will encourage companies in England to prepare for when all non-household customers can choose their supplier. Subject to legislation, this is expected to happen in 2017.

Proportionate regulation

We want companies 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.

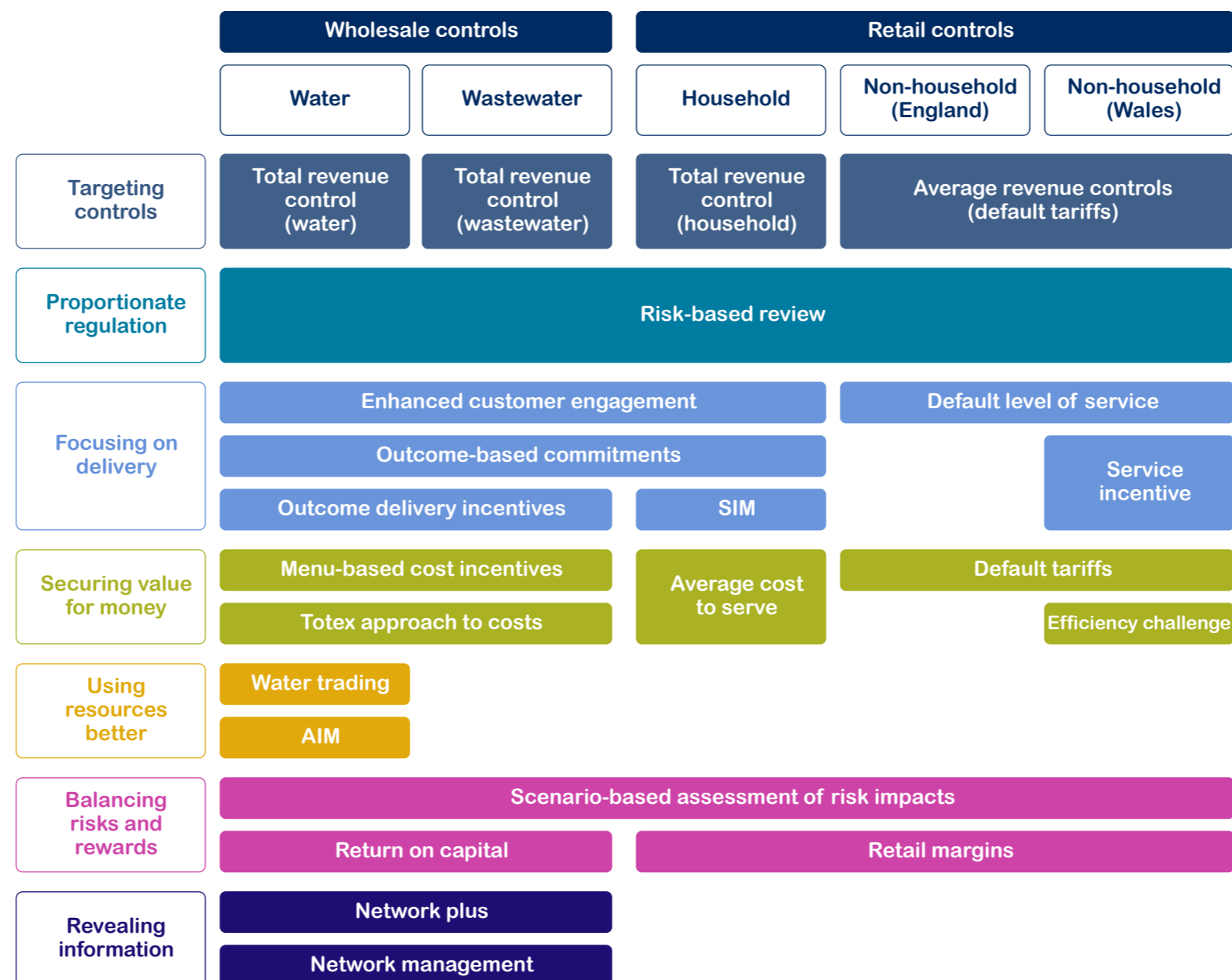
Instead, we will use a series of tests to review the quality of each company's plan. This is so that we focus on those areas and those companies where the biggest risks are for customers and the environment (a 'risk-based review'). We will give companies one of three ratings – 'enhanced', 'standard' 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 companies to focus on delivering the services their customers want. So we have adopted a customer-led and company-owned approach that focuses them on delivering the things that customers value.

- For each of the price-controlled parts of its business each company will agree with its customers a series of long-term objectives that it will deliver ('outcomes') and the rewards and penalties it should receive for over- or under-delivering these outcomes ('outcome delivery incentives'). We also require companies to set an outcome – and associated incentives – on leakage reduction.
- 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.
- We will set consistent national service incentives to encourage companies to deliver better customer service to households – and non-households in Wales. We will protect non-household customers in England by regulating companies using default tariffs – setting a minimum level of service that must be delivered and a maximum price that can be charged.

Our final methodology – a summary



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 companies' costs, which should help remove a possible bias companies have 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;
- use each company's proposed tariff structures to determine the default tariffs they should provide to non-household customers in England, to reduce negative impacts on customers from setting national tariffs; and
- include an efficiency challenge for companies in Wales – based on comparison with equivalent English companies – to encourage them to deliver better value services to non-household customers in Wales.

Using resources better

We want to encourage 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 companies to make better decisions on where to invest and how to balance supply and demand for water. So we will:

- introduce a financial incentive to encourage companies to trade water with each other where this is the most efficient option; and
- introduce a non-financial incentive (the 'abstraction incentive mechanism') to encourage companies to source water ('abstract it') 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. Individual companies can also propose their own financial rewards and penalties in this area as part of their outcome delivery incentives.

Balancing risks and rewards

We want to make sure that efficient companies receive appropriate remuneration from 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 also want to be sure that customers are not exposed to inappropriate or unexpected risks from the financial structures that companies adopt. So we will:

- set an allowance on top of companies' retail costs to reflect the risks to them from providing retail services (a 'retail margin');
- continue to use the regulatory capital value (RCV) – the value of each company's regulated business – and a single notional weighted average cost of capital (WACC) – the financial return we assume companies will need to attract finance – to remunerate companies for risks to them from providing wholesale services; and
- introduce a framework to review and assess risks to customers posed by companies' financial structures.

Revealing information

We want to continue to improve the way we set price controls in future so that continue to protect customers' interest. In order to do this we need to reveal improved information about the activities that companies carry out in certain areas. So during 2015-20, we will:

- encourage companies to reveal information about their water and sewerage network and treatment activities by gradually introducing price controls for them in these areas; and
- introduce reporting for companies on managing their water and sewerage networks and sewage sludge.

Delivering the right overall package

We want to make sure the overall price controls we set deliver the best possible outcome for current and future customers. So before we set companies' price controls we will:

- look at affordability and financing to make sure the different elements of our price controls do not – when combined – have a significant negative impact on customers or companies; and
- adjust each company's price controls to reflect their performance during 2010-15.

What our proposals mean for stakeholders

Customers

A stronger voice in the price review process. Companies must develop outcomes – and associated incentives – that are supported by their customers.

We will test companies' plans to check how well they have listened to their customers – and how affordable they are for customers.

Retail controls will prepare companies to provide improved choice to non-household customers when markets open.

Companies

Each company will have greater ownership and accountability for its plan.

Each company will have more freedom to develop how it delivers services.

Greater opportunities for innovation to be rewarded.

Companies with enhanced plans will be rewarded with less scrutiny, more choice and quicker decisions.

Next steps

We will now use our methodology to set companies' price controls. The key next step in the price review process is for each company to send us its business plan by 2 December 2013. The CCGs will also submit their reports by this date.

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

We look forward to continued productive engagement with, and involvement of, all our stakeholders throughout the price setting process.

The environment

Companies will focus on long-term outcomes – including statutory obligations – so they can find more sustainable ways to deliver services.

Companies no longer have a bias toward capital- and resource-intensive solutions.

Companies will be encouraged to trade water to use precious resources more carefully

Companies will be encouraged to source water from areas that do not damage the natural environment.

Investors

A stable, transparent and predictable regulatory framework.

We will continue to set wholesale price controls using tried and tested tools – including using the familiar concept of the regulatory capital value (RCV).

More opportunities for companies to innovate and outperform our assumptions.

Each company's directors are accountable for the quality of its plan – and the opportunity to earn rewards by submitting an enhanced plan.

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 customers with a good quality and efficient service at a fair price.

More information

For the full details of our methodology and business planning expectations read '[Setting price controls for 2015-20 – final methodology and expectations for companies' business plans](#)'.

You can also find more information about price setting on our website at www.ofwat.gov.uk/pricereview.



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