

Consultation under section 13 of the Water Industry Act 1991 on proposed modifications to the licence conditions

About this document

This document invites comments on the proposed modifications of the conditions of the appointment ('licence') of each of the 17 largest water companies¹ in England and Wales (listed in table 3).

The modifications will enable the implementation of key policy decisions published in Water 2020: Our regulatory approach for water and wastewater services in England and Wales. This set out how we intended to change the way we regulate to enable the sector to address the future challenges it faces and to inform, enable and encourage greater efficiency within the sector, helping to maintain the trust and confidence of customers. This will allow us to implement our new regulatory approach and to apply it to companies in England and Wales. The detail of the proposed modifications set out in this document were developed through close collaboration with companies. The proposed modifications will benefit customers in both England and Wales. We believe that the changes we are making as part of Water 2020 (and which these modifications enable) are in line with the UK Government's Water for Life White Paper and the well-being goals in the Well-being of Future Generations (Wales) Act 2015. Consequently, we are proposing the modifications for both companies whose areas are wholly or mainly in England and companies whose areas are wholly or mainly in Wales.

Under section 13 of the Water Industry Act 1991 ('WIA91'), the Water Services Regulation Authority ('Ofwat') may modify the conditions of a water company's licence if the company consents to the modifications.

Before making modifications under section 13 of the WIA91, Ofwat must give notice in accordance with that section. This document (including attached appendix) is a Notice under section 13.

¹ For the purpose of this document, a reference to a water company or company means a company holding an appointment as a water and/or sewerage undertaker under the Water Industry Act 1991.

Responding to this consultation

We invite stakeholders to consent to the proposed modifications by no later than Wednesday 7 December. Each relevant water company should also indicate its acceptance or otherwise of the proposed modification by this date. You can email your responses to water2020@ofwat.gsi.gov.uk or post them to:

Licence changes consultation
Water 2020
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA.

If you wish to discuss any aspect of this document, please direct your enquiry to Stephen St Pier on 0121 644 7801 or by email to water2020@ofwat.gsi.gov.uk.

We will publish responses to this document on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

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1. Structure of this document

This document invites comments on the proposed licence modifications related to the way we intend to set price controls for the water and wastewater sectors in England and Wales that will apply from 1 April 2020 and to establish market information databases for water resources and bioresources.

The document is structured as follows:

- This first section provides the background to the proposed modifications. It sets out how the key regulatory policies that require licence changes were developed, and how the drafting of the licence modifications has been progressed.
- Sections 3 to 6 describe the proposed modifications, their effect and why they are needed. In summary, we are proposing licence modifications in relation to:
 - indexation of price controls by CPI or CPIH (instead of RPI);
 - new separate Water Resources, Network Plus Water, Bioresources and Network Plus Wastewater price controls;
 - market information databases in relation to water resources and bioresources; and
 - in-period adjustments to price controls to reflect performance against performance commitments (in-period outcome delivery incentives).
- Section 7, briefly sets out the impact of our proposals with reference to the detailed assessment in our May document [Water 2020: Our regulatory approach for water and wastewater services in England and Wales](#).
- Section 8 sets out the Next Steps, following publication of this Notice.
- The appendix sets out the proposed modifications to Conditions A, B and K and the proposed new condition M1. Its purpose is to help to show the effect of the proposed modifications. It does not necessarily include the exact wording that will apply for each water company because the conditions of each company's licence are individual and may vary, or because technical errors or inconsistencies, may need to be corrected without changing the substance and intended effect.

2. Background

2.1 Our May document and the need for licence changes

In May, we published [Water 2020: Our regulatory approach for water and wastewater services in England and Wales](#) (the 'May document') that set out policy decisions related to how we intended to set price controls for the water and wastewater sectors from 1 April 2020.

We want to ensure that customers and wider society have trust and confidence that their water and wastewater services are of a high quality, are provided in an environmentally sustainable way and are resilient and affordable. After the 2014 price review process ('PR14'), we had explained that we wanted to build on the changes we made at that time to deliver a better approach to setting price controls at the 2019 price review process ('PR19'). We needed to take an approach which better allowed companies to respond to and meet the challenges faced by the sector and find ways of driving companies to become more efficient, helping to maintain affordable bills for customers. We have worked closely with stakeholders to understand their views on how we could improve our approach (see table 1 below).

Table 1: Summary of the work underpinning the May document

Steps we took	Why we did it
Reflections on 2014 price review	After the final determination in December 2014, we spoke to a variety of stakeholders to understand how we could build on the changes introduced to how we set price controls at the 2014 price review
Understanding the challenges and how we might help the sector meet them	In July 2015, we published a series of discussion papers that considered the challenges facing the water and wastewater sector in England and Wales, and how Ofwat could help it to address these challenges. This was accompanied by substantive engagement, including the collaborative 'market place of ideas' with companies putting forward their own proposals.
Consultation on regulatory framework including approach to setting price controls	In December 2015, we set out for consultation our proposals for long-term changes to our regulatory approach for wholesale markets and PR19. This set out why the changes were needed and how our proposals would help deliver better services to customers that remained affordable. We included our initial assessment of the costs and benefits of these changes and engaged with stakeholders on key elements of our proposals. We also indicated where the proposals, if firmed up, might require changes to company licences.
Making our decisions on our approach to setting price controls and wholesale markets	In May 2016, having reflected on the views and contributions of stakeholders, we published our decisions on our regulatory approach to setting price controls. We included a refined impact assessment and confirmed those policy decisions which would require a licence change to enable them.

Steps we took	Why we did it
Working with companies to deliver licence changes	Since July 2016, we have had a series of discussions with companies who indicated their support in principle for the package of policy decisions that required licence changes and a desire to work with us to deliver the detail of those modifications.

The policy decisions in our May document reflect this process of co-development with stakeholders including companies. It set out the main elements of our new regulatory approach for wholesale markets and PR19 and beyond, building on the successes of PR14. The changes will also help to secure a resilient future for water, for the benefit of customers, the environment and wider society by:

- strengthening the approach to customer engagement and outcomes to enable and encourage companies' focus on delivering the outcomes that matter to current and future customers.
- taking steps to inform, enable and encourage the development of new markets in bioresources, water resources and through direct procurement for customers where there is potential to unlock substantial benefits for customers, companies, the environment and investors, helping to meet future challenges, ensuring that water and wastewater services are resilient, efficient and taking a long-term approach.
- seeking credible and legitimate indexation of customer bills and other regulatory tools, such as the regulatory capital value, to maintain trust and confidence in the sector.

To enable some of these policy decisions, we need to amend the licences of those companies subject to full price controls (see section 2.3). Specifically, we need to modify them to implement the policy decisions set out in Table 2 below.

Table 2: Summary of policy decisions requiring licence modifications

Policy	Why a change is required	The benefits of the change
Index revenues by the Consumer Prices Index (CPI) or Consumer Prices Index including owner-occupiers' housing costs (CPIH) instead of the Retail Prices Index (RPI).	Condition B currently requires price controls for wholesale activities to be indexed by RPI	Increased legitimacy for price controls as indexation of price controls to a less volatile index (CPI or CPIH) means less uncertainty for stakeholders and for customer bills.
Set separate controls for Water Resources and Bioresources (also known as sludge) and water and wastewater network plus controls.	Condition B currently only allows separate controls to be set for retail activities and all water and/or wastewater wholesale activities. A separate Water Resources and Bioresources control requires a modification to the current wholesale controls.	This will inform, enable and encourage an effective market by revealing improved information that will help us to set better targeted incentives; supporting company decision-making; mitigating cross-subsidy concerns; and helping to foster a more commercial culture and focus within companies in relation to these activities.
Allow in-period adjustments to price control revenue for outcome delivery incentive (ODI) rewards and penalties.	Currently only three companies' revenues can be adjusted between price reviews to reflect ODI rewards and penalties	Enabling strengthening of company incentives by linking their rewards and penalties more closely in time to the performance that generated them.
Establish market information databases in relation to Water Resources and Bioresources activities.	The licence does not include a specific provision for this.	To inform, enable and encourage the development of two new markets - Water Resources and Bioresources -where there is potential to unlock substantial benefits to customers, companies, investors and the environment.

In considering the proposed licence modifications, it is important to also take into account relevant wider policy decisions, detail of approach and commitments. These provide companies and stakeholders with greater certainty about our methodology for setting price controls at PR19 and the process we intend to follow. We refer to these in this document where relevant.

2.2 Developing the licence modifications

In our May document, we invited companies to indicate support in principle for the proposed licence modifications. Fourteen of the seventeen companies did indicate their in principle support by the close-off date. Of the remaining three, two indicated

support but did not wish to participate in the development of the modifications and one was not able to put the matter to its board in time to enter the process.

Since July we have worked with those 14 companies who indicated support in principle to develop the detail of the required licence modifications. Through a series of five workshops companies have been able to comment on our proposed approach and helped shape the intent and detailed drafting of the modifications.

In particular, we shared full drafts of our proposed modifications with all companies ahead of the publication of this document. The proposed modifications reflect where appropriate the feedback received from companies. We welcome the constructive approach taken by companies in this process.

Following the engagement process with the fourteen companies, we also shared full drafts with those companies not involved in the engagement process. We wanted to provide an opportunity to them to better understand the proposals and identify any key issues of concern ahead of publication of this document and reflect these where appropriate.

We are now seeking each company's consent for the purpose of section 13 of the WIA91 to the licence modifications proposed in this document (and summarised in Table 2).

2.3 Who the proposed licence modifications will apply to

Table 3 lists the companies that, subject to agreement, the licence modifications will apply to. We are only proposing licence modifications for the 17 largest water companies for whom we set separate price controls for retail and wholesale activities at PR14. Some of the proposals relate to wastewater services and are only therefore relevant to companies that provide these services.

Currently, the smallest water companies either have a relative price control (limiting their prices by reference to the prices of other water companies) or a simplified price control (one overall revenue control). We do not propose to make any changes to their licences at this time. We will consider whether any licence modifications are needed for the smallest water companies as we develop and confirm our methodology for PR19.

Table 3: List of the companies we propose the modifications will apply to.

Who?	What will apply to them (subject to agreement)?
<p>Water and sewerage undertakers: Anglian Water Services Limited Dŵr Cymru Cyfyngedig (Welsh Water) Northumbrian Water Limited Severn Trent Water Limited Southern Water Services Limited South West Water Limited Thames Water Utilities Limited United Utilities Water Limited Wessex Water Services Limited Yorkshire Water Services Limited</p>	<p>All elements of licence modifications will apply:</p> <ul style="list-style-type: none"> • indexing controls by CPI or CPIH • separate network plus, water resources and bioresources controls • information remedy for water resources and bioresources • in period adjustments for ODIs
<p>Water only undertakers: Affinity Water Limited Bristol Water plc Dee Valley Water plc Portsmouth Water Limited South East Water Limited South Staffordshire Water plc Sutton and East Surrey Water Plc</p>	<p>All these elements of licence modifications will apply:</p> <ul style="list-style-type: none"> • indexing controls by CPI or CPIH • separate network plus and water resources controls • information remedy for water resources • in period adjustments for ODIs

3. Indexation of price controls by CPI or CPIH

3.1 What are the changes we are proposing?

Currently, licences set RPI as the inflation measure by which wholesale price controls are indexed on an annual basis. The proposed modification will change the indexation of wholesale controls to either CPI or CPIH, rather than RPI, from 1 April 2020. It will allow us to decide, by no later than 31 January 2018, whether the index used for controls in relation to wholesale activities is either CPI or CPIH. We will confirm the final decision as to whether to use CPI or CPIH in the methodology for PR19.

It will change all references to indexation in Condition B (Charges) and all references in Condition K (Ring Fencing and Disposal of Land) to either CPI or CPIH from 1 April 2020.

It does not change the basis for indexing existing price controls, which run until 31 March 2020 and will continue to be indexed by reference to RPI. It also does not change the basis for indexation in Condition C (Infrastructure Charges) and Condition N (Licence Fees) (we will address this separately see section 3.4.1 for further details).

3.2 Why do we need to make the changes we are proposing?

Our May document, and the associated [Annex on 'Securing the Legitimacy of Future Price Controls'](#), sets out the detailed rationale for our decisions.

Indexation of wholesale price controls will continue to be an important mechanism for allocating risk over the long term. As costs associated with the movement in general inflation are passed on to customers (we expose companies to the changes in the movement of their own costs net of general inflation), it is important the inflation measure we use is credible and statistically robust in the eyes of customers and their representatives. This will help maintain trust and confidence in the regulatory regime.

RPI was chosen as the indexation mechanism at privatisation, as it was the primary measure of inflation at the time. However, RPI is increasingly falling out of use. Since March 2013, RPI is no longer classified as an official government statistic. Its robustness has been called into question and its use by government and regulators is diminishing. CPI is used as the inflation target by the Bank of England. The media refers to CPI when reporting inflation movements and CPI is increasingly used as the

inflation measure in the pensions sector. Although CPIH is not currently an official statistic, in March 2016, the National Statistician wrote to the Chair of the UK Statistics Authority (UKSA)² and stated that he was “inclined to consider that CPIH should become the ONS preferred measure of consumer inflation and the focal point of ONS commentary in due course”.

The proposed licence modification on indexation enables our longer-term vision is to make sure the measure we use for the indexation of price controls is widely agreed to be legitimate in the eyes of all stakeholders, including customers. It forms part of this important transition increasing customer trust and confidence in the water bills they pay.

3.3 Relevant policy commitments from the May document

We have consistently acknowledged that moving to CPI or CPIH is a significant change. We have engaged with stakeholders over the last 18 months to understand their concerns and have carefully considered what steps we could reasonably take to reduce uncertainty and the potential impact on customers and investors.

In line with our vision of trust and confidence in water and wastewater services, we recognise that continued investor confidence is key as the sector will continue to require significant investment to deliver resilient services. We see a managed transition – which provides clarity on the direction of travel – as key to maintaining the confidence of investors, by providing time to adjust to allow the unwinding of embedded RPI-based debt over time and to ensure customer impacts can be managed.

As set out in the May document, we have made a number of policy decisions to secure the legitimacy of future price controls as follows (p.56 of the May document):

- We will seek to change revenue indexation to the Consumer Prices Index (CPI or CPIH) from the start of the 2019 price review (PR19) price control and to amend the licence conditions accordingly.
- We will change regulatory capital value (RCV) indexation to CPI (or CPIH). 50% of the RCV will be indexed to the Retail Prices Index (RPI) at 1 April 2020. The

² The UK Statistics Authority is the Statistics Board established by the Statistics and Registration Services Act 2007.

rest of the RCV, including all new RCV will be linked to CPI/H and so the proportion of RCV that is indexed to CPI/H will increase through 2020-25.

- We will confirm the final decision as to whether to use CPI or CPIH in the methodology for PR19. This will allow us to take account of developments in the use of CPI and CPIH including the advice of the Office for National Statistics (ONS) to the UK Statistics Authority (UKSA) on the status of CPIH as an official statistic.
- We will state a single nominal cost of capital – stated separately as real CPI or CPIH based and real RPI-based costs of capital – for the purposes of setting price limits.
- We will reconcile for the difference between the RPI and CPI/H forecast for setting price limits and the actual out-turn for RPI-linked cost of capital that applies to the RPI-linked part of the RCV. Together with a nominal cost of capital this will mean the change to indexation will be net present value (NPV)-neutral for a notionally efficient company.
- We have set out the principles³ we will apply when considering the transition of the indexation of the RCV beyond 2025 to make our intentions clear and predictable.
- We confirm that to the extent we use similar cost assessment models to PR14 at PR19, we will deflate the base cost data using the same measure of inflation we will apply for revenues.

3.4 Detail of the proposed licence modification

The proposed wording for this modification is set out in the appendix. We set out the key aspects of the modification below.

3.4.1 Replacing RPI with the ‘Relevant Index’

The proposed licence modification introduces the term ‘Relevant Index’ in place of a specific indexation metric. We consider this is the most effective way of maintaining the use of RPI where relevant until 1 April 2020, and moving to CPI or CPIH from 1 April 2020 onwards, including for the price controls that we will set at the 2019 price review.

³ See page 84 of the May document

The Relevant Index will be defined in Condition A (Interpretation and Construction) as:

- RPI for the period before 1 April 2020; and
- either (i) CPI or (ii) CPIH, to be determined by Ofwat no later than 31 January 2018, for the period from 1 April 2020.

The use of RPI for the existing price controls that run until 1 April 2020 will be maintained by the consequential changes to Part VIII of Condition B (see section 4.4.4 below). These will make clear that the provisions of Condition B that have effect before the modification will continue to have effect in relation to the price controls set for a period ending before 1 April 2020.

There are a number of references to RPI in the licences. Not all relate directly to setting price controls. We are fully committed to moving all across to CPI or CPIH.

The proposed modification addresses the references to RPI in the following conditions:

- Condition B: Charges; and
- Condition K: Ring Fencing and Disposals of Land.

The proposed modification does not address the following conditions:

- Condition C: Infrastructure Charges; and
- Condition N: Licence Fees.

For these parts of the licence, it is simpler and more efficient to make changes through other, ongoing workstreams. Changes to Condition C will be addressed as part of our work on charges for new connection services⁴. Changes to Condition N are being addressed through our work on licence simplification. The existing definition of RPI will remain in Condition A (Interpretation and construction) for transitional purposes.

⁴ Please see, for example, the [Update on implementation date for new connections charging rules](#) we published in October 2016.

Again, we are fully committed to making these changes. This approach simply allows other parts of the licence to be modified in an orderly manner as part of different workstreams.

3.4.2 Allowing Ofwat to determine, by a specified date, whether indexation of wholesale revenues will be to CPI or CPIH

The proposed modification allows Ofwat to determine whether the index should be CPI or CPIH without the need for any further licence modification. Once the decision has been made on whether CPI or CPIH will be used, this will be final. Any subsequent change in index would require another licence modification.

As set out in our May document, we will make the decision on whether to use CPI or CPIH from 1 April 2020 in the methodology for PR19. This will allow us to take full account of relevant factors at that time, including on any potential re-designation of CPIH as a national statistic. This decision is integral to the ability to set a price control, and is one we will have to make.

The proposed modification sets 31 January 2018 as the latest date by which we will make this decision. In doing so we provide the strongest commitment and certainty on the timing of this decision, for companies' business planning purposes.

3.4.3 Interaction of Condition A and wholesale charges

Condition A of the existing licences includes a provision to ensure that, if the RPI for November is not published by 31 December of the relevant year, Ofwat can no later than the following 7 January determine what index will apply instead after consultation with water companies. This safeguard is retained in the proposed modification in relation to the Relevant Index.

We are aware of an interaction between this part of Condition A and the wholesale charges rules [currently being developed](#). Our draft wholesale charging rules would require water companies to publish final wholesale charges no later than 11 weeks before the start of the charging period. Working back from the start of April this means that these charges could be required by the middle of January, if charges are determined for a year beginning at 1 April.

As such, in the event that the relevant inflation index was not published by 31 December and we had to determine what inflation index can be used instead, companies could have as little as 1 week to update their wholesale charges. We acknowledge that such a timeline would be challenging for companies.

Because the likelihood of this occurring is extremely low (there is no precedent), we consider that the most appropriate way of dealing with that eventuality, if it occurred, would be to relax the publication deadline in the wholesale charging rules (and any other relevant rules) to give companies enough time to finalise their relevant charges. We consider this to be preferable to bringing the 7 January date forward, given the already challenging timescales for us and companies.

The safeguard in the proposed modification does not explicitly refer to changes in the November index, the basis for indexation of price controls. This is because there are references to inflation indices elsewhere in licence conditions which do not explicitly relate to changes in the November value of the index. For example, interim determinations are made with reference to changes in the September value of the index.

4. Separate Water Resources, Network Plus Water, Bioresources and Network Plus Wastewater controls

4.1 What are the changes we are proposing?

Currently, licences only allow Ofwat to set separate controls for Retail Activities and wholesale water and, where relevant, wastewater activities (“wholesale activities” are defined as “all activities undertaken as part of the Appointed Business apart from Retail Activities”).

The proposed modification allows us to set separate binding controls for Water Resources and Network Plus Water activities for periods starting on or after 1 April 2020. For wastewater companies, it will also allow Ofwat to set separate binding controls for Bioresources (also known as sludge) and Network Plus Wastewater activities for periods starting on or after 1 April 2020.

The Network Plus controls will be restricted to the same form as the existing controls for wholesale activities, that is inflation plus or minus K controls that limit the change in the charges to be levied and/or revenue allowed to the regulated business in each charging year in respect of the activities concerned.

To support the additional separate binding controls, the proposed modification also sets out:

- how the activities covered by each control are defined and the extent to which this can be changed;
- the form of the controls and the extent to which Ofwat can determine this when it sets the controls; and
- the duration and the indexation of the controls.

The proposed modification is less prescriptive about the form of the Water Resources and Bioresources controls compared to the Water and Wastewater Network Plus controls (see section 4.2 and 4.4.2).

It also proposes some specific consequential changes. In particular it includes a modification to make clear that a reference to the Competition and Markets Authority (CMA) must comprise all of a company’s controls determined at the same time, not individual control/s.

The licence modification does not propose any changes in relation to price controls for Retail Activities, with one exception where we propose updating the reference in the current definition of “Retail Activities” in Condition B to version 4.04 of the Regulatory Accounting Guidelines (RAGs) to the most recent 4.06 version. This will

ensure that the same version of the RAGs is referred to for the purposes of all the separate controls and is not intended to change the definition of Retail Activities.

4.2 Why do we need to make the changes we are proposing?

In our May document we said we would introduce separate binding price controls for Bioresource treatment, transportation and recycling/disposal and Water Resources for PR19.

Separate controls help facilitate the setting of better targeted regulatory incentives and increase the focus (both within companies and the regulator) on specific services and activities that companies undertake. Over time this helps to identify and deliver further efficiency gains, which benefit customers, investors and the environment. It helps companies to better understand the costs of providing services and identify their investment needs, supporting a more resilient service.

Separate controls also help to inform, enable and encourage an effective market by revealing improved information that will support company decision-making; mitigate cross-subsidy concerns; and help foster a more commercial culture within companies in relation to relevant activities.⁵

Because our proposals will encourage and enable companies to make the best use of Water Resources and Bioresources, they will promote sustainable development, directly supporting the Welsh Government's well-being goals of a prosperous and resilient Wales.

For Water Resources, we want to encourage companies to innovate and make the best use of Water Resources. In part this is about finding ways to encourage markets to develop to provide companies with the ability and incentive to look beyond the assets and systems they own to options for water trading with other companies, including non-water companies, and to other options available from third parties such as water efficiency schemes or reclaimed water provision. Overall, we expect water resource markets will help bring benefits for customers, investors and the environment.

We proposed that the new Water Resources price control should apply to the 17 largest water companies in England and Wales, even though companies whose areas are wholly or mainly in Wales will not be subject to the bilateral market reforms introduced by the Water Act 2014.

⁵ Water 2020 May document Executive summary p.6

Introducing separate Water Resources controls will benefit customers of companies whose areas are wholly or mainly in Wales, as separate controls will allow us to more effectively regulate by providing greater transparency, setting better targeted incentives and facilitating greater efficiency. We will be able to ensure that data can be compared across all companies, and to allow us to protect the interests of customers in Wales using a comparative benchmarking approach to regulation. A separate price control will also facilitate the costing and the sharing of benefits for customers where Welsh water companies' resources are used to export water to other water companies.

For Bioresources, there are opportunities to broaden the range of those involved in Bioresources services, to optimise transport, treatment, recycling and disposal outside traditional company boundaries – through Bioresource trading or third party provision, for example. The opportunities are not only about doing things at lower cost, but also about making the best use of resources, improving resilience and finding new ways of doing things. Markets can inform, enable and incentivise efficiencies and innovation for the benefit of customers and the environment.

A separate Bioresources control helps to clearly delineate the costs and revenues associated with bioresource activities and is key to preventing cross-subsidisation between wastewater and bioresource activities in Wales and in England. The May document noted that we had considered whether a non-binding sub-cap would give the same management focus and clarity of costs, but considered a binding price control to be a better option for facilitating a transparent market where third parties can be confident of a level playing field with no cross-subsidy between the monopoly water company activities and bioresource services. It will also focus incentives on incumbent companies to encourage them to explore commercial opportunities.⁶

In the May document we explained that we did not want the licence to specify the detailed forms of the Water Resources and Bioresources controls. We explained that we want the licence to allow us to work with stakeholders to develop and refine the more detailed aspects of the controls (for example, the formula for the within-period adjustment mechanism) as we develop our price review methodology, and this would be confirmed in the final determination.

We also explained that we wanted the licence to limit what would and would not be included in the Water Resources and Bioresources controls, while allowing us to

⁶ Water 2020 May document section 4.5.3 p.106

decide the precise boundary of each price review to protect companies and customers from the risks of hardcoding an inappropriate boundary between Water Resources and Network Plus controls, or between Bioresources and Network Plus controls, in the licence and make it easier to address any practical issues or ambiguities that arise with the definition of the boundary.

4.3 Relevant policy commitments from the May document

The modification means the licence will be less prescriptive about the form of the Water Resources and Bioresources controls than about the form of Network Plus controls or current wholesale controls. But, there is still significant certainty for companies. The licence will continue to commit to five year controls and indexation of all wholesale controls. The form of the Network Plus controls retains the form currently set out in the licence for wholesale activities.

In addition, the May document provided early clarity on the direction of policy for the Water Resources and Bioresources controls. For Water Resources, the May document said the control will:

- last five years, in line with the Network Plus price control.
- be a total revenue control with an explicit within-period adjustment mechanism that depends on the scale of bilateral market entry.
- provide regulatory capital value (RCV) protection for efficient expenditure up to 31 March 2020.
- require RCV allocation using an unfocused approach, but each company will propose its own allocation to the water resources control to Ofwat for review to ensure outcomes are in the customer interest.

For Bioresources, in the May document we said we will

- set the Bioresources price control at a company level rather than site level.
- set a five-year price control at PR19.
- set an average revenue control to regulate bioresources, which will reflect the volume of bioresource produced by water and sewerage companies (WaSCs).
- keep the bioresources system operator functions within the incumbent companies.
- not introduce bioresources trading incentives at PR19.
- use a focused approach to allocate the regulatory capital value (RCV) to the separate Bioresources control.
- not create a regulatory mechanism for guaranteeing the Bioresources RCV during the 2020-25 control period.

4.4 Detail of the proposed licence modification

The proposed wording for this modification is set out in the appendix. We set out the key aspects of the modification below.

The changes we are proposing in relation to Bioresources and Network Plus Wastewater Activities are only relevant to water companies that are sewerage undertakers.

4.4.1 Defining each control

The proposed licence modification (in the same way as for Retail Activities) allows Ofwat, as part of each price review process, to designate Water Resources Activities and Bioresources Activities for the following price control period. These designations will be treated as part of Ofwat's final determination for the purposes of any reference to the CMA.

In order to provide certainty and transparency about the activities which may be designated to each control in the licence, the proposed modification sets out an 'envelope' of activities that (together with ancillary activities) Ofwat may designate as "Water Resources Activities" and "Bioresources Activities". It also sets out a list of certain activities which could not be designated and that will therefore never be covered by the Water Resources or Bioresources controls (subject to any further licence modification).

The proposed licence modification would therefore provide companies with clarity about the upper and lower limit of activities that could be included in the Water Resources and Bioresources controls.

The list of activities in the proposed modification that could be designated as Water Resources or Bioresources Activities reflects our intention, set out in the May document, to protect companies and customers from the risks of hardcoding an inappropriate boundary between Water Resources/ Bioresources and Network Plus controls. An inappropriate boundary would mean that the benefits from separate controls in these areas would not be fully realised, as company decisions may be sub-optimal simply due to boundary definitions.

In particular, the focus of the Water Resources control will be abstraction licences and raw water abstractions. But we have included the possibility of designating raw water transport or storage activities as our work on the regulatory accounts has shown that the boundary between these activities has not always been clear or

consistently applied. For example after the RAGs consultation in August we added a ‘15 day storage’ rule to RAG 4.06⁷ to ensure raw water reservoirs that serve a water resources function are captured under water resources. This change was introduced as a result of consultation with companies at the Ofwat water resources working group⁸. While we do not anticipate further changes to the boundary, we have included raw water activities in the list to be transparent and to reduce the risk of inadvertently having set the boundary in the wrong place.

The lists of activities are set out in the definitions of “Water Resources Activities” and “Bioresources Activities” that would be inserted into paragraph 2 of Condition B. The terms used in the lists of activities that can and cannot be designated will have the meanings assigned to them in RAG 4.06 and are therefore fixed by reference to that version of that guideline. Future changes to the RAGs would not change either the activities already designated for the purpose of a price control or the activities that could be designated for the purposes of a future price control.

For “Water Resources Activities”:

- “abstraction licences”, “raw water abstractions”, “raw water transport” and “raw water storage” and ancillary activities are the list of the activities of a water undertaker that could potentially be designated by Ofwat to be covered by the Water Resources control.
- “water treatment” and “treated water distribution” are the list of activities which cannot be designated by Ofwat and which are definitely excluded from the scope of the Water Resources control.

For “Bioresources Activities”:

- “sludge transport”, “sludge treatment” “sludge disposal” and “Network+ - Sludge liquor treatment” and ancillary activities are the list of the activities of a sewerage undertaker that could be designated by Ofwat to be covered by the Bioresources control.

⁷ http://www.ofwat.gov.uk/wp-content/uploads/2016/08/prs_web20161031regrep406.pdf

⁸ See <http://www.ofwat.gov.uk/regulated-companies/improving-regulation/future-price-setting-for-2020/water-2020-working-groups/>. The working group was set up to support our development of the water resource proposals within the May document. The working group includes a range of stakeholders including companies who we will make the modifications for, as well as other stakeholders such as Government, potential market participants and NGOs.

- “sewage collection”, “sewage treatment” and “sewage disposal” are the list of activities which cannot be designated by Ofwat and which are definitely excluded from the scope of the Bioresources control.

Other definitions will also be inserted into paragraph 2 of Condition B to make clear that:

- “Network Plus Water activities will be those activities carried out by a company as a water undertaker other than Water Resources activities and Retail activities.
- Network Plus Wastewater activities will be those activities carried out by a company as a sewerage undertaker other than Bioresources activities and Retail activities.

4.4.2 The form of the separate binding controls

The proposed modification provides for a different level of prescription for the Water and Wastewater Network Plus controls compared to the Water Resources and Bioresources controls.

For both separate **Water Resources** and **Bioresources controls**, it allows Ofwat to determine:

- the appropriate nature, form and level of the price controls (subject to the constraints set out below); and
- how the Appointee shall demonstrate compliance with the price controls at the Final determination.

The proposed licence modification for each of the Water Resources and Bioresources controls:

- only allows Ofwat to set one single control;
- fixes the duration of the controls at five years; and
- explicitly includes a requirement for an annual adjustment to reflect any percentage change in the Relevant Index.

For each of the **Network Plus Water** and **Network Plus Waste water price controls** the proposed licence modification sets the duration of the controls at five years and would allow Ofwat to set:

- a single control in the same form of price control as the existing price control(s) for Wholesale Activities, that is a form of inflation plus or minus K that limits the

- change in the charges to be levied and/or revenue allowed to the regulated business in each charging year in respect of the activities concerned; and
- how the appointee shall demonstrate compliance with the price controls at the Final determination.

In the May document, we said that all wholesale revenue would be inflated by CPI or CPIH. This remains the case.

But we also said we did not want to specify the detailed form of the Water Resources and Bioresources controls as we would work with stakeholders to develop and refine the more detailed aspects of the controls.

This is because we need to be able to understand and take account of the interactions between the Water Resources and Bioresources controls and Network Plus controls and the impact of market development. For example, the formula for in-period adjustments to reflect bilateral market entry for water resources will be developed as part of the price review methodology and set in final determinations. For Bioresources, further work is required to identify the appropriate measure of volume for the average revenue control. Our proposed form of control text will ensure that the licence does not constrain the most appropriate policy approach. We want to avoid constraining what companies or Ofwat can reasonably do, to the detriment of customers.

As a consequence, the drafting for the indexation of Water Resources and Bioresources controls differs from the drafting for the indexation of Network Plus controls. This is intended to ensure that the form of the Water Resources and Bioresources controls, while including an annual adjustment to reflect any percentage change in the Relevant Index, is not unduly constrained from reflecting other relevant factors. The commitment to inflation indexation remains the same across all four wholesale controls, but the licence text recognises the required different practical implementation issues.

4.4.3 Referring our determination of price controls to the Competition and Markets Authority

Each company's licence ensures that the company can ask Ofwat to refer its Final Determination of price controls to the CMA. Given that the modification increases the number of controls to be set, and in response to queries, it will make clear that any such reference must comprise all a company's controls determined at the same time (including retail controls), not an individual price control/s.

4.4.4 Other consequential changes

The changes we propose to make require us to make a small number of associated changes to other parts of the licence to support the key changes described above.

The proposed modification updates Part VIII of Condition B to:

- ensure that the current price controls (including the RPI indexation for wholesale price controls) continue to have effect until the new price controls are determined and come into effect on 1 April 2020.
- provide for the 2019-20 price controls to “roll-over” (until new price controls are determined) in the unlikely event that Ofwat fails to set price controls by 31 December 2019.

This provision is equivalent in form and content to that included in licences prior to PR14 to provide for the possibility of Ofwat not setting price controls for 2015-20 by 31 December 2014.

The interim determination provisions in Part IV of Condition B include a small number of references to RPI that will be replaced by references to the Relevant Index and relate to:

- calculating the ‘current value’ and ‘outturn prices’ of costs, savings and receipts that form part of an interim determination application; and
- adjusting the appropriate discount rate (to exclude any allowance for changes in inflation).

The interim determination provisions were amended in 2013 alongside the amendments to introduce separate controls for retail and wholesale activities. This ensured Ofwat could adjust separate price controls to give effect to an interim determination and allow the company to recover the allowable amount. As these provisions already allow for the adjustment of separate price controls, the proposed modification does not include any further substantive changes to these provisions.

5. Information remedies

5.1 What are the changes we are proposing?

The proposed licence modification introduces a new requirement for water companies to provide and share specified information with Ofwat and/or third parties in relation to the Water Resources and Bioresources activities to support the development and operation of markets. It will also require water companies to permit the reasonable re-use of such information by third parties.

The proposed modification will allow Ofwat to specify the information to be published or made available and the persons or classes of persons to whom it should be made available. We propose to set out our specifications in guidelines that will only be issued, or revised, after consultation with the companies concerned. Companies will also be able to ask for our guidelines to be referred to the CMA if they do not think they are reasonable and appropriate.

The proposed modification sets out the limits on the information that Ofwat can require companies to provide and share.

5.2 Why do we need to make the changes we are proposing?

We explained in section 4.2 the benefits of taking a different approach to the way we regulate in relation to Water Resources and Bioresources. We said that our proposals in these areas will encourage and enable companies to make the best use of Water Resources and Bioresources, promoting a resilient future for the sector, for the benefit of customers, the environment and wider society.

In our May document, we explained that to help deliver the most benefit to customers, we needed to do more than setting separate controls alone. We explained the important role that revealing information within Water Resources and Bioresources has in helping to improve the value of the services provided and encouraging service providers to think about new ways of delivering the services.

For Water Resources, we have identified that market participants interested in identifying new opportunities for trading faced 'search costs' as well as information barriers compared to incumbent water companies. Transparency and easy accessibility of data is important for our proposed reforms to work effectively and while some level of transparency and accessibility is provided by the Water Resource Management Plan (WRMP) decision-making process, we cannot rely on this alone. Therefore there is a need for the licence modification.

Increased information would enable and encourage potential market participants to identify and put forward opportunities to supply water resources or provide demand management or leakage services. To facilitate this process we are focusing on providing greater visibility and accessibility of existing information, including key assumptions and economic data that underpin the preferred options presented in WRMPs. The proposed modification is intended to facilitate this process.

For Water Resources the May document explained that “the information would be limited to that which would be reasonable to support the development and operation of a market in water resources and demand management/leakage services”⁹. We said that companies could publish data on their own websites and that we would require incumbent companies to allow reasonable commercial and non-commercial use of the published information.

For Bioresources, at present there is no readily available supply-side information on where bioresources are produced, their quantity or quality. Evidence from water companies and potential entrants to bioresource markets suggests that better information would help markets develop. This would enable potential market participants, including water companies, to identify opportunities to supply services in the treatment, transportation and disposal of bioresources.

We explained in the May document that for bioresource markets to develop, all participants, both incumbent providers and new entrants, need to have confidence that the information on which they base decisions is robust and consistent. Some companies have indicated that they are willing to participate and provide information without the need for a licence change. However, a specific licence change is necessary so that companies are required to provide information to support markets and to ensure the data is reliable and trustworthy, so that third parties can rely on it. The information would be limited to that which would be reasonable to support development of the bioresource market.¹⁰

The benefits of providing information to help identify opportunities are relevant for companies whose areas are wholly or mainly in Wales as they may have cross-border trading opportunities with a number of companies wholly or mainly in England which should lead to more efficient operations and lower costs to customers. There

⁹ Water 2020 May document section 5.4.3, page 141

¹⁰ Water 2020 May document section 4.4.3 page 100

are also Welsh Other Organic Waste (OOW) facilities that may be able to offer Bioresources treatment services to companies wholly or mainly in Wales.

Our proposed approach is to require standardised and defined information that will ensure trading opportunities can be identified and that information is comparable and reliable for use by market participants. The proposed modification is intended to facilitate this process.

The May document set out our broad expectations for the likely coverage of information. It explained that in terms of the data content for a bioresources information platform, our consultation and analysis suggest that identifying market opportunities will, as a first step, require standard information on the demand-side for bioresources services. It explained that, to reduce reporting and minimise costs, the information provided in relation to the bioresources produced at Wastewater Treatment Works (WwTWs), would include:

- location of the WwTW site;
- volume of bioresources produced;
- the dry solids concentration of the bioresources;
- storage constraints (how often collection is required);
- information on the quality of bioresources (for smaller sites, a proxy such as treatment process could be used); and
- any particular points that market participants may need to know, such as restrictions on the size of tanker that can access the site, or unusual constituents of the bioresources.¹¹

We will consider whether cost or price information would help to facilitate market development in future, consistent with the approach set out in our May decision document.

5.3 Detail of the proposed licence modification

The proposed wording for this modification is set out in the appendix. We set out the key aspects of the modification below.

¹¹ Water 2020 May document section 4.4.3, page 100

The changes we are proposing in relation to Bioresources are only relevant to companies that are sewerage undertakers.

5.3.1 Purpose and scope

The proposed modification gives Ofwat the power to require a water company to provide specified information about the regulated business to Ofwat or third parties (or a class of third parties) specified by Ofwat or to publish information for the purpose of:

- supporting the development and operation of a market in the provision, management and development of Water Resources, Demand Management or Leakage Services, where we envisage the information will be drawn predominantly from data provided through the WRMP process. This is consistent with the proposed scope set out in the May document.
- supporting the development and operation of a market in Bioresources services.

In both cases, the information required might be wider than information about the activities designated under Condition B for the purposes of Water Resources and Bioresources price controls. This is because some relevant information might relate to activities covered by the Network Plus price controls – for example, information on Demand Management and Leakage Services will relate to activities within a Network Plus Water control and information on where bioresources are produced will relate to activities within a Network Plus Wastewater control.

The proposed modification defines “Demand Management” as activities connected with the promotion of the efficient use of water and reduction of demand for water. “Leakage Services” are defined as activities connected with the discovery and repair of unplanned or unintended leaks of water from pipes (which will reduce demand for water). The proposed modification also provides that Appointees shall permit the reasonable re-use of information by a recipient.

5.3.2 Determining the information required

The detail of the information that water companies will be required to provide or publish will be set out in supporting guidelines (referred to as ‘Directions’ in the proposed modification). This approach is broadly equivalent to the RAGs, which are issued under with Condition F (Accounts and accounting information) of water companies’ licences.

The proposed modification includes provisions which limit the information Ofwat can require to be made available, after consultation with the companies concerned, to information which is reasonable and appropriate for the purpose (described above and set out in paragraph 3 of the proposed new Condition M1). Similar to the process for RAGs, each affected company will also have the ability to require Ofwat to refer to the CMA, within one month of the issue of new guidelines, the question whether the guidelines are reasonable and appropriate for the purpose.

A further safeguard for companies is that Ofwat is only allowed to set information requirements that we reasonably consider would not be contrary to the interests of national security or seriously and prejudicially affect the interests of any person (see paragraph 4(c) of the proposed Condition M1). The proposed modification is not intended to set a process for how Ofwat would consider any company specific issues in this respect. Companies will have the opportunity to raise any company specific issues when (as required by the proposed modification) we consult them on draft information requirements or changes to existing information requirements.

This information disclosure provision is standalone and does not appropriately sit within Condition B. We therefore propose to insert a new Condition M1 (Information Remedies) after Condition M (Provision of Information to the Water Services Regulation Authority).

6. In-period adjustments for performance against outcome delivery incentives

6.1 What are the changes we are proposing?

This proposed licence modification will allow any of companies' price controls to change between price reviews to reflect outcome delivery incentive (ODI) rewards and penalties which reflect companies' performance against specific performance commitments (PCs) made at a price review.

Without the licence modification companies (with the exception of the three that already have in-period ODIs) would be subject to a reconciliation of all their ODI rewards and penalties at the following price review.

Currently three companies' licences allow for in-period ODIs – the three companies are Anglian Water, Severn Trent Water and South West Water. The proposed licence modification is based on, but will replace, the existing provisions for in-period ODIs in Condition B of the licences of these three companies. However, the changes will not affect the current in-period ODIs in the 2015-20 period and the first relevant price review for the new licence modification on in-period ODIs will be PR19.

6.2 Why do we need to make the changes we are proposing?

Companies set their outcomes, PCs and ODIs following extensive engagement with their customers and local stakeholders and challenge from their customer challenge groups (CCGs). This allows companies' outcomes to reflect local priorities which can vary between areas, for example, allowing companies in Wales to reflect Welsh priorities for water where relevant, including the duty to maintain and enhance biodiversity introduced by the Environment (Wales) Act 2016. Or allowing companies to reflect regional differences in their service commitments, for example, by making commitments about clean beaches in coastal areas that depend on tourism.

The proposed licence modification will support our focus on strengthening the approach to customer engagement and outcomes. We explained in the May document that allowing in-period ODIs, links the rewards and penalties more closely in time to the performance that generated them. Currently, with the exception of three companies, all ODI rewards and penalties incurred in a control period are reconciled at the following price review. So for example, rewards and penalties for performance in 2020-2021 would be reconciled at the 2024 price review and affect prices from 2025 onwards. In-period ODIs can provide a more immediate, and hence

a more visible and stronger, incentive to companies to improve their performance, which in turn should lead to better performance and greater benefits to customers and the environment. In-period ODIs could increase investor confidence in the incentive framework, given the more immediate application of any rewards or penalties due. They could also improve the legitimacy of the sector in the eyes of customers if they can readily see the financial impact on the company of its performance.

While linking incentives more closely in time to performance could potentially lead to bill changes year on year (which customers tend not to prefer), this can be managed by companies. The proposed licence modification allow companies to propose that the application of in-period ODIs to be spread over several years to allow smoother changes in bills to manage any concern on bill changes, but still capturing benefits of bringing forward incentive payments closer to the performance that generated them.

6.3 Wider framework that in period ODIs operate within

The proposed licence modification is intended to provide the framework for operating in-period ODI adjustments. The modification does not set out a detailed process for the determination of in-period ODIs by Ofwat. The reconciliation process for in-period ODIs in the 2020-25 period will be included in the PR19 methodology.

The operation of the ODI regime is a policy decision within our price review methodology, on which we consult, and does not form part of the licence modification. Nevertheless, we consider it helpful to describe in broad terms how we expect to implement the process as it is important context for the proposed modification.

All outcomes, associated performance commitments and ODIs will be set at a price review. We do not intend for all ODIs to be recovered in period. There can be reasons why ODIs are better reconciled at a price review rather than in-period. An example might be an ODI involving a large investment programme where it might be better to judge how successful a company had been at the end of the period rather than during it and to reflect this in the incentives.

We expect companies to consider the benefits of using in-period or end-of-period ODIs and engage with their customers about their proposed approach as part of the preparation of their business plans. By enabling in-period ODIs for all companies, this conversation can start to take place now with stakeholders, including Customer Challenge Groups (CCGs), with clarity and certainty about how the process for in-period ODIs will work.

At the price review we would confirm which ODIs will be in-period. Our decisions on which PCs have in-period ODIs will reflect our price review methodology. Our intention is that the decision on in-period ODIs will reflect:

- companies' business plan proposals, which should be based on engagement with customers and other stakeholders about the merits, and use, of in-period ODIs;
- any interventions we make at a price review in relation to in-period ODIs in order to protect customers' interests, for example by applying an in-period ODI for a particular PC if a company had ignored its customers' preference for an in-period ODI without good reason; and
- any common (compulsory) PCs with in-period ODIs that we might set out in our price review methodology, following consultation.

The licence modification is not intended to allow us to reset the ODIs agreed at a price review. Rather, the purpose is to assess whether or not a company has incurred a reward or penalty for delivery of a PC. We expect to look at performance in relation to each individual in-period ODI and that the determination would relate to the net position on all in-period rewards and penalties for each price control. We would typically expect to make a determination even if the net position was neutral (or close to neutral) on in-period ODIs for a particular price control as we would want to verify the assurance around how the company had reached that net neutral position (which might be the sum of some significant penalties and rewards).

In relation to any bill smoothing of the reward or penalty our intention is that companies would put forward proposals and when making a determination we would review the reasoning, assurance and customer support for a company's proposals.

We will clarify the factors we will take into account when deciding to initiate an in-period ODI determination in the PR19 methodology. For this year's in-period ODI determinations for Anglian Water, Severn Trent Water and South West Water we used information from companies' Annual Performance Reports (APRs) to cross-check the calculations in the companies' applications for in-period ODIs. We could use APR information to inform a decision on whether to initiate an in-period ODI determination. Our methodology for in-period ODIs at PR19 will inform whether any changes are needed to the APRs to provide more information on in-period ODI rewards and penalties and the net position.

6.4 Detail of the proposed licence modification

The proposed wording for this modification is set out in the appendix. We set out the key aspects of the modification below.

6.4.1 Notification that ODIs will operate in period

The proposed modification provides that Ofwat must notify companies of the specific PCs to which in-period ODIs apply by 31 December in the price review year (the year before the new price controls start). The in-period ODIs could relate to any of the price controls we set (including price controls for residential retail activities).

Once notified, we will not be able to change which PCs have in-period ODIs attached to them. Where the price controls Ofwat has determined at a price review are referred to the CMA, the CMA will be able to make changes to the PCs which have in-period ODIs attached to them that were notified by Ofwat.

6.4.2 Timing of in period ODI determinations

The proposed modification provides that, where necessary, we will (no later than 15 November in any year) determine whether there should be a change to the level of, or the amount of revenue allowed by, the relevant price control(s) and, if so, what that change should be.

A company can ask Ofwat (no later than 15 August in any year) to make a determination or Ofwat can make a determination on its own initiative. Our power to make adjustments to price controls would allow us to make a change to reflect performance in more than one year if, for example, a PC was based on average performance across two or more years or if (for whatever reason) we had not made a determination in the previous year.

6.4.3 In-period ODI determination

We intend for the application of in-period ODI rewards and penalties to be predictable based on the outcomes, PCs and ODIs specified in the final determination at the previous price review.

The licence modification provides for Ofwat to determine the appropriate changes to price controls so that the interests of customers can be protected by, for example, ensuring that a company has provided sufficient assurance about its performance and how it has calculated the rewards or penalties it believes are due.

Our power to make adjustments to price controls would allow us to smooth the bill impacts of the in-period ODI rewards and penalties. This will give companies the ability to propose approaches to bill smoothing that respond to customers' views. It would also allow Ofwat to review the company's proposed approach and allow us to intervene to protect customers' interests in relation to bill smoothing, where companies have provided insufficient evidence they are acting in customers' interests.

In relation to the penultimate year of price control periods (year four of a five year price control), we think it would be more appropriate for any changes to price controls to reflect year four performance to be made as part of the price review rather than be made through an in-period ODI determination. This avoids the potential duplication of work that might result from making an in-period ODI determination a few weeks away from a price review determination. The proposed modification does not explicitly exclude this, but we consider it unlikely that a company would wish to apply for an in-period ODI determination for the penultimate year of a price control period.

In relation to the last year of price control periods (year five of a five year price control), the proposed modification is intended to allow us to make adjustments in the following price control period to reflect year five performance. This is because actual year five ('blind year') performance will not be known when we set price controls at a price review for the following five year period. It would undermine the incentive effects of in-period ODIs if blind year performance could not be reflected in changes to price controls until the following price review.

Companies will be required to provide us with the information that we need to make a determination.

In making a determination on the amount of the reward or penalty we will consider a company's performance in the relevant period against the specific PCs with in-period ODIs. This is intended to reflect that the performance which needs to be taken into account may differ, depending on the nature of the PC. We expect that it will normally be the previous charging year that is being reconciled, but it could be more than one year where a PC is based on an average across more than one year. An example is leakage related ODIs, which can be based on a three-year performance average.

For bill smoothing purposes the proposed modification will allow us to consider a company's actual and projected performance in the current year and one or more future years up to, but not including the years covered by the next price control period. To be clear, this is intended to allow any calculated net adjustment to be recovered across more than one year in a way that helps to smooth potential bill

impacts only. That is, it is intended to allow flexibility of the timing of recovering a net adjustment not flexibility to change the amount of the net adjustment based on anticipated future performance.

Our determination process will be reasonable and proportionate to the nature of the in-period ODI applications made.

7. What is the impact of our proposals?

As part of our May document we included a detailed assessment of what the impact of our decisions might be in terms of potential financial benefits and costs and intangible benefits (such as facilitating new and innovative approaches to meet new and existing challenges).

We considered what the impact of our decisions would be for companies operating wholly or mainly in Wales and companies operating wholly or mainly in England separately. The licence changes set out in this consultation are intended to enable the policy decisions set out in the May document.

As a consequence, we consider the likely impact of the licence changes is consistent with our assessment of the likely impact of the policies set out in the May decision document (which has not changed).

Full details of the impact assessment can be found in the May document and appendices.

8. Next steps

We invite stakeholders to comment on the proposed modifications by no later than Wednesday 7 December. Each relevant water company should also indicate its acceptance or otherwise of the proposed modification by this date. You can email your responses to water2020@ofwat.gsi.gov.uk or post them to:

Licence changes consultation
Water 2020
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA.

Subject to agreement, we expect the proposed modifications to companies' licences to come into effect from 1 April 2017.

Appendix: Proposed modifications

This appendix sets out an example of the proposed modifications to Conditions A, B and K and the proposed new condition M1. The purpose of this appendix is to help to show the effect of the proposed modifications. It does not necessarily include the exact wording that will apply for each water company because the conditions of each company's licence are individual and may vary or because technical errors or inconsistencies may need to be corrected without changing the substance and intended effect.

In particular, this example relates to the licence of a water and sewerage company (WaSC)¹² and some of the wording (including the separate price controls for Bioresources Activities and Network Plus Wastewater Activities) will not be relevant to a water only company (WoC)¹³. Other variations also exist between licences. For example, although we are proposing to insert a new Part IIIA (Performance Measure Adjustments) into Condition B, three water companies' licences already have a Part IIIA (Performance Measure Adjustments) in Condition B that would be replaced by our proposed modification.

We will also update any out of date references to persons or legislation in the relevant conditions where these have changed. For example, any references to the Competition Commission will become references to the Competition and Markets Authority (to whom the relevant functions of the Competition Commission transferred in 2014). Any such updates will not change the substance or effect of a licence condition.

Condition A: Interpretation and Construction

After the definition of "Charging Year" ADD:

"the Consumer Prices Index" means the all items Consumer Prices Index published by the Statistics Board;

¹² A water and sewerage company is a company that holds appointments as both a water undertaker and a sewerage undertaker under the Water Industry Act 1991

¹³ A water only company is a company that only holds an appointment as a water undertaker under the Water Industry Act 1991.

"the Consumer Prices Index (H)" means the all items Consumer Prices Index including owner occupiers' housing costs published by the Statistics Board;

After the definition of "Related Company" ADD:

"the Relevant Index" means –

- (a) for any period before 1 April 2020, the Retail Prices Index,
- (b) for any period including, or after, 1 April 2020, either –
 - (i) the Consumer Prices Index, or
 - (ii) the Consumer Prices Index (H)

as the Water Services Regulation Authority shall determine to be appropriate in all the circumstances no later than 31 January 2018;

- (c) in any year where the Statistics Board has not published the index to be applied by 31 December, such index for such month as the Water Services Regulation Authority may not later than 7 January next following determine to be appropriate in all the circumstances after such consultation with the Appointee as is reasonably practicable;

After the definition of "Sewerage Infrastructure Charge" (in WaSC licences) or "the Review Notice Date" (in WoC licences) ADD:

"Statistics Board" has the same meaning as in the Statistics and Registration Service Act 2007;

Condition B: Charges

Part I (Explanatory Provisions) is amended as follows-

In paragraph 2 (Defined terms which apply for the purposes of all Parts of this Condition):

ADD the following definitions in the appropriate place:

"Bioresources Activities" means -

- (a) such activities carried out by the Appointee in performance of its functions as a sewerage undertaker in connection with sludge transport, sludge treatment, sludge disposal and Network+ – Sludge liquor treatment, and such ancillary activities, as may be

so designated from time to time (which designation, for the avoidance of doubt, shall be reversible) by the Water Services Regulation Authority;

EXCEPT THAT:

- (b) Bioresources Activities shall not include sewage collection, sewage treatment and sewage disposal;

"Network Plus Activities" means Network Plus Water Activities and Network Plus Wastewater Activities;

"Network Plus Water Activities" means all activities carried out by the Appointee in performance of its functions as a water undertaker other than Water Resources Activities and Retail Activities;

"Network Plus Wastewater Activities" means all activities carried out by the Appointee in performance of its functions as a sewerage undertaker other than Bioresources Activities and Retail Activities;

"Water Resources Activities" means -

- (a) such activities carried out by the Appointee in performance of its functions as a water undertaker in connection with abstraction licences, raw water abstraction, raw water transport and raw water storage, and such ancillary activities, as may be so designated from time to time (which designation, for the avoidance of doubt, shall be reversible) by the Water Services Regulation Authority;

EXCEPT THAT:

- (b) Water Resources Activities shall not include water treatment and treated water distribution;

REPLACE the existing definition of "Price Control" with:

"Price Control" means a control set by the Water Services Regulation Authority, pursuant to a Periodic Review or Interim Determination, or deemed to be so set by virtue of sub-paragraph 16.2, in respect of the charges to be levied by and/or revenue allowed to an Appointed Business or any part thereof (having regard to its costs) and such matters ancillary to the said control, by way of a determination pursuant to this condition. The appropriate nature and form of each control for Water Resources Activities, Bioresources Activities and Retail Activities will depend on the circumstances of each case.

In the definition of "Retail Activities", delete the words "or by such person or persons as may be nominated by the Water Services Regulation Authority to do so" and replace the words "Regulatory Accounting Guideline 4.04" with "Regulatory Accounting Guideline (RAG) 4.06".

In the definition of “Standard Charges”, replace “Wholesale Charges” with “Water Resources Activities, Bioresources Activities and Network Plus Activities”.

DELETE the definition of “Wholesale Charges”.

After paragraph 2 ADD:

3. Interpretation

Where the context so requires, terms used in the definitions in this Part of Bioresources Activities and Water Resources Activities shall have the meanings assigned to them in the Water Services Regulation Authority’s Regulatory Accounting Guideline (RAG) 4.06.

[Please note: In relation to Condition B paragraph numbers higher than 3 it is necessary to deduct 1 to find the equivalent paragraph number for Condition B in a WoC licence. So, for example, sub-paragraph 8.4 of Condition B in a WoC licence is the equivalent of sub-paragraph 9.4 of Condition B in a WaSC licence.]

Part III (Periodic Reviews) is amended as follows-

REPLACE sub-paragraph 9.4 with-

- 9.4 (1) In respect of the Appointed Business's Water Resources Activities, Bioresources Activities, Network Plus Water Activities and Network Plus Wastewater Activities except for those activities for which there are Excluded Charges, the Water Services Regulation Authority shall determine separate Price Controls in accordance with this sub-paragraph (having regard to all the circumstances which are relevant in the light of the principles which apply by virtue of Part I of the Water Industry Act 1991 in relation to the Water Services Regulation Authority's determinations including, without limitation, any change in circumstance which has occurred since the last Periodic Review or which is to occur).
- (2) In relation to Network Plus Activities, the Water Services Regulation Authority shall determine:
- (a) one single Price Control in respect of the Appointed Business’s Network Plus Water Activities and one single Price Control in respect of the Appointed Business’s Network Plus Wastewater Activities, each such Price Control consisting of, in each Charging Year:
 - (i) the percentage change (expressed, in the case of an increase, as a positive number, in the case of a decrease, as a negative number, and in the case of no change, as zero) in the Relevant Index between

that published for the month of November in the Prior Year and that published for the immediately preceding November; and

- (ii) a number, "**K**" which may be a positive number or a negative number or zero

which shall together be expressed as a percentage, and which shall limit the change in the charges to be levied and/or revenue allowed to the Appointed Business in each Charging Year in respect of the activities concerned; and

- (b) how the Appointee shall, in respect of each Network Plus Control applicable to it, demonstrate the compliance referred to in sub-paragraph 9.1)

- (3) In relation to Water Resources Activities, the Water Services Regulation Authority shall determine:

- (a) what is the appropriate nature, form and level of the Price Control in respect of Water Resources Activities;
- (b) how the Appointee shall demonstrate the compliance referred to in sub-paragraph 9.1 in respect of Water Resources Activities,

and in making any such determination will include an annual adjustment to reflect any percentage change in the Relevant Index between that published for the month of November in the Prior Year and that published for the immediately preceding November.

- (4) In relation to Bioresources Activities, the Water Services Regulation Authority shall determine:

- (a) what is the appropriate nature, form and level of the Price Control in respect of Bioresources Activities;
- (b) how the Appointee shall demonstrate the compliance referred to in sub-paragraph 9.1 in respect of Bioresources Activities,

and in making any such determination will include an annual adjustment to reflect any percentage change in the Relevant Index between that published for the month of November in the Prior Year and that published for the immediately preceding November.

REPLACE sub-paragraph 9.6 with-

9.6 Each Price Control determined under sub-paragraph 9.4 pursuant to a Periodic Review shall be set:

- (1) for the five consecutive Charging Years starting on 1 April 2020; and
- (2) thereafter for each period of five consecutive Charging Years starting on the fifth anniversary of the first day of the period in respect of which the immediately preceding Periodic Review was carried out.

In sub-paragraph 9.7 – in the introductory words replace “1 April 2015” with “1 April 2020” and in (2) replace "Wholesale Activities" with "Water Resource Activities, Bioresources Activities or Network Plus Activities".

In sub-paragraph 9.8 – replace the term "Retail Prices Index" with the term "Relevant Index" wherever it appears.

REPLACE sub-paragraph 9.9 with the following-

- 9.9 The Water Services Regulation Authority may, at its discretion, from time to time (whether pursuant to a Periodic Review in connection with a determination pursuant to sub-paragraph 9.3 or sub-paragraph 9.4, or at other times) designate any activity carried out as part of the Appointed Business as falling within:
- (i) Retail Activities (subject to the definition of “Retail Activities” in paragraph 2);
 - (ii) Water Resources Activities (subject to the definition of “Water Resources Activities” in paragraph 2);
 - (iii) Bioresources Activities (subject to the definition of “Bioresources Activities” in paragraph 2);
 - (iv) Network Plus Water Activities (subject to the definition of “Network Plus Water Activities” in paragraph 2); or
 - (v) Network Plus Wastewater Activities (subject to the definition of “Network Plus Wastewater Activities” in paragraph 2).

In paragraph 10 – amend heading to read "Non Retail Charges Publication" and in sub-paragraph 10.1 replace "Wholesale Activities" by "Water Resources Activities, Bioresources Activities and Network Plus Activities".

INSERT after Part III:

Part IIIA Performance Measure Adjustments

- 12(1) This Part III A applies where the Water Services Regulation Authority has notified the Appointee by 31 December in the Charging Year before the Review Charging Year that a Price Control determined under sub-paragraph 9.3 in respect of the Appointee's Retail Activities or sub-paragraph 9.4 in respect of the Appointee's Water Resources Activities, Bioresources Activities or Network Plus Activities may be adjusted to reflect the Appointee's performance in relation to a specific Performance Commitment.
- (2) The Appointee may by notice to the Water Services Regulation Authority refer for a determination under this Part the question set out in sub-paragraph 12(5) or the Water Services Regulation Authority may make a determination under this Part of the question set out in sub-paragraph 12(5) on its own initiative.
- (3) Any such reference by the Appointee must be made no later than 15 August in the year before the first Charging Year for which any adjustment to a Price Control is sought.
- (4) Any such determination by the Water Services Regulation Authority must be made no later than 15 November in the year before the first Charging Year for which any adjustment to a Price Control would take effect.
- (5) Under this Part the Water Services Regulation Authority may determine the question of whether there should be a change to the revenue allowed under, or, as the case may be, the level of, any Price Control determined under sub-paragraph 9.3 in respect of the Appointee's Retail Activities or sub-paragraph 9.4 in respect of its Water Resources Activities, Bioresources Activities or Network Plus Activities for the following and any subsequent Charging Year and, if so, the amount of such change.
- (6) The Appointee shall furnish to the Water Services Regulation Authority such Information as the Water Services Regulation Authority may reasonably require for the purpose of making a determination pursuant to this Part.
- (7) In making a determination pursuant to this Part, the Water Services Regulation Authority shall:
 - (a) consider the Appointee's performance in relation to each relevant Performance Commitment in the period for which performance is being assessed and, in deciding for which Charging Year or Charging Years an adjustment to a Price Control should be made, shall consider both that and the

Appointee's expected performance in the current year or one or more future years up to, but not including, the next Review Charging Year; and

- (b) take account of the adjustments to the relevant Price Control which the Water Services Regulation Authority notified to the Appointee under sub-paragraph 12(1) above in relation to each relevant Performance Commitment in question.
- (8) In this Part "**Performance Commitment**" means a target or other measure of the performance of the Appointee in relation to the carrying out of the Regulated Activities that the Water Services Regulation Authority has notified to the Appointee by 31 December in the Charging Year before the Review Charging Year or which is set by the Competition and Markets Authority following a determination under paragraph 16.
- (9) In this Condition references to a "**Price Control**" include a Price Control that has been changed in accordance with a determination made under this Part.
- (10) Where a notification of a Performance Commitment is made for the purposes of sub-paragraph 12(1), that notification shall be treated for the purposes of sub-paragraph 16.1 (regarding references to the Competition and Markets Authority) as part of the relevant determination made under sub-paragraph 9.3 or sub-paragraph 9.4.

Part IV (Interim Determinations) is amended as follows-

REPLACE references to "Retail Prices Index" with the term "Relevant Index" wherever it appears (see, in particular, sub-paragraphs 13.4(2), 13.4(3) and 14.2(8)(a)(vii)).

Part V (References to the Competition and Markets Authority) is amended as follows-

ADD sub-paragraph 16.3:

- 16.3 Where after 1 April 2019 the Appointee requests the Water Services Regulation Authority to make a reference to the Competition and Markets Authority in respect of any determination under sub-paragraph 9.3 concerning Retail Activities, or under sub-paragraph 9.4 concerning Water Resources Activities, Bioresources Activities or Network Plus Activities, such reference must comprise all such determinations made

under sub-paragraphs 9.3 or 9.4 at the same time relating to the Appointee.

REPLACE Part VIII as follows-

Part VIII. Price Controls in effect before 1 April 2020

- 20.1 The provisions of Condition B of this instrument in the form that had effect immediately prior to [date modifications come into effect to be inserted] shall continue to have effect in respect of the Price Controls set for a period ending before 1 April 2020 and in respect of the making of any Interim Determinations to set any such Price Controls.
- 20.2 In the event that the Water Services Regulation Authority is, in respect of the Appointed Business, unable to determine Price Controls, for the period or periods starting on 1 April 2020, under sub-paragraph 9.3 and sub-paragraph 9.4 of this Condition B by 31 December 2019, the provisions of Condition B in the form that had effect immediately prior to [date modifications come into effect to be inserted] shall continue to have effect in respect of the Price Controls until such time as a determination under sub-paragraph 9.3 and sub-paragraph 9.4 of the current Condition B is made and takes effect.

Condition K: “Ring Fencing” and Disposals of Land

In paragraph 2.1, replace the references to "Retail Prices Index" with the term "Relevant Index" in the definitions of "Materiality Amount" and "the Transfer Threshold".

Condition M1: Information Remedies

1 For the purposes of this Condition:

“**Bioresources**” means – activities connected with the transport, treatment and disposal of sludge produced by sewage disposal works.

“Demand Management” means activities connected with the promotion of the efficient use of water and the reduction of demand for water.

“Direction” includes any material revision thereof.

“Leakage Services” means activities connected with the discovery and repair of unplanned or unintended leaks of water from pipes.

- 2 Subject to paragraphs 3 to 6 below, the Water Services Regulation Authority may make a Direction to the Appointee –
- (a) to provide specified Information about the Appointed Business –
 - (i) to the Water Services Regulation Authority;
 - (ii) to such person or class of persons as the Water Services Regulation Authority may specify in the Direction; or
 - (b) to publish specified Information about the Appointed Business,
- and the Appointee shall permit reasonable re-use of such Information by any recipient.
- 3 The purpose for which any Direction under paragraph 2 may be given shall be to support the development and operation of a market in one or more of the provision, management and development of water resources, Demand Management, Leakage Services, or, as the case may be, Bioresources, through the promotion of effective competition or monitoring the progress or development of such markets.
- 4 Any Direction under paragraph 2 may only be given where the Water Services Regulation Authority –
- (a) considers it to be reasonable and appropriate for the purpose referred to in paragraph 3 above;
 - (b) has consulted with the Appointee; and
 - (c) reasonably considers that the Direction would not –
 - (i) be contrary to the interests of national security; or
 - (ii) seriously and prejudicially affect the interests of any person.
- 5 The Appointee may within one month of the date of any such Direction require the Water Services Regulation Authority to refer to the Competition and Markets Authority for determination by it the question whether the Direction is reasonable and appropriate for the purpose referred to in paragraph 3.
- 6 Where the Appointee requires the Water Services Regulation Authority to make a reference to the Competition and Markets Authority under paragraph

5 the Direction which is the subject of that reference shall not apply to the Appointee unless and until the Competition and Markets Authority determines that it shall apply.

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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