

Modification of the Conditions of Appointment of 17 largest water companies

Following the notice of the proposal published on [9 November 2016](#) (issued under section 13 of the Water Industry Act 1991), this notice confirms that Ofwat has now modified the conditions of the appointments ('licences') of the 17 largest water companies to enable some of the policy decisions set out in [Water 2020: Our regulatory approach for water and wastewater services in England and Wales \(the 'water 2020 decision document'\)](#) to be implemented for the 2019 price review ('PR19').

The modifications have been made for 10 companies holding appointments as both water and sewerage undertakers:

- Anglian Water Services Limited, Dŵr Cymru Cyfyngedig, 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 and Yorkshire Water Services Limited.

The modifications have also been made for 7 companies that only hold appointments as water undertakers:

- Affinity Water Limited, Bristol Water plc, Dee Valley Water plc, Portsmouth Water Limited, South East Water Limited, South Staffordshire Water plc and Sutton and East Surrey Water plc.

In this document, these companies are collectively referred to as 'water companies'. Ofwat has made the modifications with the agreement of the water companies concerned.

The modifications will come into effect on 15 April 2017 (although they include transitional provisions in relation to current price controls). The text of the modifications to the conditions of appointment for each of the 17 affected water companies can be viewed on our website.

The background and the reasons for the modification are set out below.

Modifications made and the reasons for them

The purpose of the modifications are to enable some of the policy decisions set out in [Water 2020: Our regulatory approach for water and wastewater services in England and Wales](#) (the 'water 2020 decision document') to be implemented. The water 2020 decision document set out the main elements of our new regulatory approach for wholesale markets and PR19 and beyond. The changes will also help to secure a resilient future for water, for the benefit of customers, the environment and wider society. Specifically, we needed to modify the water companies' conditions of appointment to implement specific policy decisions in the following ways:

Changes to Condition B (Charges) to allow separate controls to be set at a price review for Water Resources Activities and Bioresources (also known as sludge) Activities and Water and Wastewater Network Plus Activities

The licence modification allows separate price controls for the above activities to be set. It sets out the activities that can, and cannot, be included in a particular price control.

For both separate **Water Resources Activities** and **Bioresources Activities** 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 water company shall demonstrate compliance with the price controls;
- only allows Ofwat to set one single control for each;
- 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 inflation index (see below).

For each of the **Network Plus Water Activities** and **Network Plus Wastewater Activities** price controls the modification sets the duration of the controls at five years and allows 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 each water company shall demonstrate compliance with the price controls.

Each water company's licence says that the company can ask Ofwat to refer the final determination of its price controls to the Competition and Markets Authority ('CMA'). The modification makes clear that any such reference must comprise all of the water company's price controls determined at the same time (including controls for retail activities).

A small number of associated changes to other parts of the licence to support the key changes described above have also been made. Part VIII of Condition B has been updated 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.

We have made these changes because we want to introduce separate binding price controls for Bioresources treatment, transportation and recycling/disposal and for Water Resources at PR19.

Separate controls help facilitate the setting of better targeted regulatory incentives and increase the focus (both within water companies and the regulator) on specific services and activities that water companies undertake. Over time this helps to identify and deliver further efficiency gains, which benefit customers, investors and the environment. It helps water 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 water companies in relation to relevant activities.

For Water Resources, we want to encourage water companies to innovate and make the best use of Water Resources. 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 Bioresources trading or third party provision, for example.

Changes to ensure that CPI or CPIH are used from 2020 (instead of RPI) in Condition B and Condition K

The licence modification introduces the term ‘Relevant Index’ in place of the specific indexation metric RPI. We consider this is the most effective way of maintaining the use of RPI where relevant until 1 April 2020, and moving to Consumer Prices Index (CPI) or Consumer Prices Index including owner-occupiers' housing costs (CPIH) from 1 April 2020 onwards, including for the price controls that we will set at the 2019 price review. It allows for Ofwat to make a decision on whether to use the CPI or CPIH index by no later than 31 January 2018.

We have made these changes to ensure that the measure used for the indexation of price controls is widely agreed to be legitimate in the eyes of all stakeholders, including customers. 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 (water companies are exposed 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.

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. Although CPIH is not currently an official statistic, in March 2016, the National Statistician wrote to the Chair of the UK Statistics Authority (UKSA)¹ 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”.

Changes to Condition B to allow future in-period adjustments to price control revenue for outcome delivery incentive (ODI) rewards and penalties for the 17 water companies

At price reviews, water companies set outcomes, Performance Commitments (PCs) and Outcome Delivery Incentives (ODIs) associated with PCs following extensive engagement with their customers and local stakeholders and challenge from their customer challenge groups (CCGs). Currently, the ODI rewards and penalties, which reflect water companies’ performance against specific PCs are only taken into account at the following price review for all but three water companies.

The licence modification allows any of the 17 water companies’ price controls to change between price reviews (in-period) to reflect the ODI rewards and penalties that water companies’ performance against PCs incurs. It sets out the framework that any adjustment to price controls must follow.

We have made these changes so that, from April 2020, we can allow price controls for all the 17 water companies to be adjusted between price reviews to reflect ODI rewards and penalties. This will provide a more immediate, and hence a more visible and stronger, incentive to water companies to improve their performance, which in turn should lead to better performance and greater benefits to customers (increasing legitimacy) and the environment. In-period ODIs could also increase investor confidence in the incentive framework, given the more immediate application of any rewards or penalties due.

Changes to enable market information databases in relation to water resources and Bioresources

The modification introduces condition M1 (Information Remedies). It 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. This power can be used for the purpose of

¹ The UK Statistics Authority is the Statistics Board established by the Statistics and Registration Services Act 2007.

supporting the development and operation of a market in the provision, management and development of a market on one or more of the provision, management and development of water resources, Demand Management or Leakage Services or, as the case may be, Bioresources.

The modification allows detail of the information that water companies will be required to provide or publish to be set out in supporting guidelines (referred to as 'Directions'). It limits the information Ofwat can require to be made available to information which is reasonable and appropriate for the purpose (described above and set out in paragraph 3 of Condition M1). Ofwat must consult water companies on the supporting guidelines and each affected company will be able to require Ofwat to refer to the CMA, within one month of the issue of new guidelines, the question whether the guidelines issued to that company are reasonable and appropriate for the purpose.

Ofwat is only allowed to set information requirements that it reasonably considers would not be contrary to the interests of national security or would not seriously and prejudicially affect the interests of any person (see paragraph 4(c) of the proposed Condition M1).

We have made these changes because we want to encourage and enable water 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.

To do this, as well as setting separate controls for Water Resources Activities and Bioresources Activities, we want to reveal information within to help improve the value of the services provided and encourage 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. 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 bioresources markets suggests that better information would help markets develop.