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Trust in water

# **Delivering Water 2020: consultation on PR19 methodology**

## **Appendix 11: Assessment of the duration of retail controls**

**Appendix to chapter 8:  
Targeted controls,  
markets and innovation:  
retail controls**

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## 1. Summary

This appendix sets out our consideration of the duration of residential and business retail price controls in England and Wales.

## 2. Background

In the 2014 price review (PR14), we set a five-year price control for residential retail activities of monopoly water companies in England and Wales. For business retail activities in England and Wales, we set a two-year control to allow us to reset prices before business retail market opening in England, on 1 April 2017. For customers of Welsh water companies, business retail competition has not been extended beyond water supplies to customers using at least 50 megalitres a year.

In the 2016 price review, we reviewed the price control arrangements and set a new three-year control for business retail activities of monopoly water companies in England and Wales.

Apart from the business retail controls in PR14, water and wastewater sector, price controls have been set for five-year cycles. This reflects the longer term approach that is important for infrastructure businesses and the time required to realise efficiency gains within price control period. The disadvantage of longer term control is that provide less flexibility to adjust to changing circumstances over time and expose incumbents and customers to risks that controls are no longer appropriate as new information becomes available. For retail controls, our price determination powers allow us to set price controls for up to five years, however, controls can be set for a shorter period.

Given the opening of the business retail market in England and the changing regulatory environment, we have considered the duration of any price controls that should apply. In particular, we considered whether a shorter price control period than five years is more appropriate as this would allow us to respond more flexibly to a changing environment.

Due to the different circumstances that affect these markets, we have separately analysed the impact of different lengths of control on non-competitive and competitive retail activities in England and Wales.

### 3. Duration of retail price controls

#### **Non-competitive retail activities - residential retail in England and Wales and business retail in Wales**

Residential retail activities of water companies in England and Wales are not subject to competition.

For Welsh water companies - wastewater business retail customers and water business customers using up to 50 megalitres a year are also not subject to competition. This reflects the policy position of the Welsh Government.

We have assessed the impact of a three-year and five-year price control for these non-competitive retail activities.

Following the opening of the English business retail market on 1 April 2017, a shorter duration price control would provide greater opportunity to take into account the emerging evidence from business retail market in setting residential retail price controls in England and Wales and business retail controls in Wales. In the 2019 price review (PR19) we will only have access to early evidence on the introduction of competition in the business retail market in England by the time we make our final determinations, with company business plans prepared around one year after market opening. PR19 is therefore likely to only capture limited information from the operation of business retail market. A shorter, three-year price control would enable a more comprehensive reflection of evidence from the first five years of competition and so would allow the benefits to be passed onto customers well in advance of a five year control.

Set against this is greater security and potentially stronger incentives from a longer control period. A five-year period also coincides with the rest of our price controls and therefore provides a good opportunity for a holistic review of our regulatory approach to the sector.

On balance, while both options have merits, we consider **a three-year price control** for non-competitive retail activities could have advantages given the additional flexibility that it provides. We provide a detailed assessment below.

**Table 1 Assessment of the duration of non-competitive retail controls**

	<b>Option 1 five-year (Current approach)</b>	<b>Option 2 three-year</b>
Achieving our objectives	<p>Enhanced efficiency incentives as companies retain outperformance for longer</p> <p>Promotes long term resilience by providing companies with longer term security to invest</p> <p>✓✓</p>	<p>While a shorter price control reduces company incentives for efficiency as gains are clawed back quicker, it could allow more stretching efficiency targets to be set as emerging market information could be used earlier.</p> <p>✓✓✓</p>
How our objectives are achieved	<p>A longer control period is more predictable and increases the incentives for efficiency and innovation</p> <p>✓</p>	<p>This option allows us to transcribe the learning from the English business retail market sooner to other customers.</p> <p>✓✓</p>
Practicality	<p>Practical as there is already a well-established process for undertaking a price review and consistent with five-year control period used for other controls</p> <p>✓✓✓</p>	<p>Practical as already well-established process for undertaking a price review. However, shorter review period could increase regulatory burden and costs.</p> <p>✓✓</p>

## **Competitive business retail activities – non exited English companies and water customers of Welsh companies using at least 50 megalitres a year**

The English business retail market opened to competition on the 1 April 2017. The market is still in its infancy. We do not yet have robust information on the operation of the market. We are therefore still considering whether to continue to set price controls for monopoly water companies who still operate in the competitive market. That is English water companies who have not exited the business retail market, i.e. not transferred activities to a separate retail licensee, or Welsh water companies who are not able to exit the business retail market. Further detail is provided in the PR19 methodology consultation document.

If we decide to maintain price controls on these companies, we will then need to decide the duration of these controls. We have considered the same options as for customers of the non-competitive segments, i.e. either five-year or three-year control.

While a five-year price control would provide greater certainty for companies, **a three-year price control** would have advantages in that it would:

- provide an opportunity to refine controls to reflect emerging evidence from the market;
- allow the same length of the price control as for the other retail price controls; and
- allow price controls to be removed sooner if controls are no longer be required.

We provide a detailed assessment below.

**Table 2 Assessment of the duration of competitive retail controls**

	<b>Option 1 five-year</b>	<b>Option 2 three-year</b>
Achieving our objectives	<p>Enhanced efficiency incentives as companies retain outperformance for longer                      Promotes long term resilience by providing companies with longer term security to invest</p> <p>✓✓</p>	<p>Allows us to account for the potential changes in how the market develops and whether price controlled companies exit the business retail market.</p> <p>✓✓✓</p>
How our objectives are achieved	<p>A longer control period is more predictable and increases the incentives for efficiency and innovation</p> <p>✓</p>	<p>Pro market and proportionate as it would allow us to remove controls if appropriate                      Flexible and responsive to changes in the market</p> <p>✓✓✓</p>
Practicality	<p>Practical as there is already a well-established process for undertaking a price review and consistent with 5 year control period used for other controls.                      Reduced practicality from applying a longer price control to a competitive market</p> <p>✓</p>	<p>Practical as already well-established process for undertaking a price review.                      Consistent with the approach used for non-competitive retail activities                      However a shorter review period could increase regulatory burden and costs</p> <p>✓✓</p>