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Trust in water

**Delivering Water 2020: Our
final methodology for the
2019 price review
Appendix 10: Assessment of
the duration of retail
controls and measures for
the appropriate
management of voids and
gap sites**

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

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1. Summary

Applicability to England and Wales

Our final methodology for the duration of retail price controls and measures for the appropriate management of voids and gap sites **applies to both** companies whose areas are wholly or mainly in England and companies whose areas are wholly or mainly in Wales.



This appendix sets out our final considerations on:

- the appropriate duration of residential and business retail price controls in England and Wales; and
- measures for the appropriate management of voids and gap sites.

These are significant issues where we have changed our position from our draft methodology proposals.

This methodology has been determined following full consideration of the views expressed by respondents to our draft methodology proposals, published in our PR19 draft methodology.

This appendix supplements the information set out on the retail price control in chapter 8 (targeted controls, markets and innovation: retail controls) of our methodology for the 2019 price review.

2. Duration of retail price controls

In the 2014 price review (PR14), we set five-year price controls for the residential retail activities of water companies in England and Wales. For business retail activities in England and Wales, we set two-year controls. This was to allow us to reset controls before the opening of the English business retail market on 1 April 2017¹.

In the 2016 price review (PR16), we reviewed the price control arrangements and set new three-year price controls for the business retail activities of water companies in England and Wales.

Apart from the business retail controls in PR14 and PR16 in the 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 a price control period. For retail activities, our price determination powers allow us to set price controls for up to five years. However, controls can also be set for a shorter period.

The residential retail activities of water companies in England and Wales are not subject to competition. Therefore, we will continue to set price controls. This also applies to Welsh water companies, wastewater business retail customers and water business customers using up to 50 megalitres a year. As they are also not subject to competition (reflecting the policy position of the Welsh Government) we will continue to set price controls.

The English business retail market opened to competition on 1 April 2017. However, as the market is still in its infancy, we have also decided to continue to set price controls for:

¹ For customers of English water companies, business retail competition has been extended to all business premises. For customers of Welsh water companies, it has not been extended beyond water supplies to business customers using at least 50 megalitres a year.

- English water companies who operate in the competitive business retail market, but have not “exited” that market (that is, had not transferred business retail activities to a separate legally separate retail licensee); and
- Welsh water companies who are not able to exit the business retail market.

Further detail is provided in the PR19 final methodology.

In our draft methodology proposals, we expressed a preference for a three-year duration for retail controls. This was because only limited evidence from competition in the business market will be available for PR19. Cost data from businesses could reveal the true costs of retail activities. If the costs of contestable business activities were revealed to be lower, for example, we could take these into account for residential retail activities (and business retail activities by non-exited English companies and Welsh companies). Setting new price controls from 2023, for example, would allow us to take this into account.

Some stakeholders, however, expressed concerns about our proposed duration, and indicated a preference for a five-year control. In light of this feedback, we have considered:

- a five-year duration;
- a three-year duration; and
- an option to allow a five-year control with a reopener (if appropriate under predefined conditions).

2.1 Stakeholders’ views

Respondents to our draft methodology proposals expressed mixed views on our proposed three-year duration of retail price controls. Some queried whether the benefits of a shorter retail control outweighed its costs. Other respondents suggested that a five-year control with a reopener should be considered, if we wanted to retain the option of a shorter control.

A number of concerns were raised, including the following.

- A subsequent control would impose a disproportionate regulatory burden.
- Shorter controls weaken companies’ incentives and ability to invest, make savings and/or improve service levels for customers.
- There would be too much uncertainty over the two years after a three-year control to be able to provide assurance of financeability.

See section 7 of appendix 15 (responses to our draft methodology) for full details of the views expressed by respondents.

2.2 Our assessment

Having taken into account the respondents' concerns, we have assessed the pros and cons of a five-year price control (Option 1), a three-year price control (Option 2) and a five-year control with a reopener (Option 3) on all three types of price controls – that is covering the provision of services to:

- English and Welsh residential;
- Welsh business (including businesses consuming more than 50 megalitres of water a year); and
- English businesses when the company has not yet exited the competitive market.

A three-year price control offers some benefits compared to a five-year control. Following the opening of the English business retail market on 1 April 2017, a three-year control could make it easier to take into account the emerging evidence from the business retail market in England when setting price controls for all three services mentioned above.

Similarly, a five-year control with a reopener would also allow us to take emerging evidence from the business retail market into account and provide us with extra flexibility as to when to reopen the price control.

However, both a three-year duration and a five-year duration with a reopener carry additional costs. A three-year duration would be more burdensome on companies and Ofwat than a five-year duration. A five-year duration with a reopener not only carries similar costs to a three-year duration option (if indeed reopened), but it would also require a licence change, which would need agreement from each company. In addition, the circumstances for triggering a reopener would need to be clearly defined to give certainty on when controls could be reopened. Any decision about whether or not to reopen has the potential to be challenged, as has its outcome. These features make a five-year duration with a reopener particularly costly.

We have concluded that the advantages of a shorter control would not outweigh its costs. We have therefore decided in favour of a **five-year price control** for retail activities, given that it would minimise the regulatory burden and strengthen incentives.

We provide a detailed assessment below.

Table 1 Assessment of the duration for residential controls in England and Wales, business controls in Wales and business controls in England for non-exited companies

	Option 1 five-year (chosen approach)	Option 2 three-year	Option 3 five-year with reopener
Achieving our objectives	Enhanced efficiency incentives as companies retain outperformance for longer. ✓	Allows more stretching efficiency targets to be set, because new cost information from a competitive business retail market could be used earlier. ✓✓	As under Option 2, but potentially with more flexibility and benefits of a longer term default option in terms of incentive to outperform. ✓✓
How our objectives are achieved	A longer control period is more predictable, increasing incentives and minimising risk around financeability. This meets better regulation principles. ✓✓✓	Pro-market as it would allow us to remove controls for contestable activities at an earlier time, if appropriate. ✓✓✓	Pro-market as Option 2. Offers more flexibility but would be complex to set up and determine the need for a re-opener. More flexibility once in place, but burdensome to set up and trigger a re-opener. Pro-market as for option 2. ✓✓
Practicality	Practical, because there is already a well-established process for undertaking a price review and a five-year duration is consistent with the five-year control period used for other controls. ✓✓	There is already a tested process for undertaking a price review. However, a shorter review period would increase regulatory burden and costs compared to the chosen approach. ✓	Raises further issues in addition to those under Option 2: 1) there would be uncertainty about timing, making it difficult for companies to plan ahead; and 2) the implementation of such an approach would be complex and more burdensome than the chosen approach. ✓

3. Measures to encourage appropriate management of voids and gap sites

Voids are properties classed by water companies as being vacant. However, some voids are actually occupied, so they may be erroneously billed, that is, either too little or nothing at all. A gap site² is a property where water and/or wastewater services are being consumed, but the property is not on a water company's system and is therefore not billed.

We regulate water companies to ensure that they recover the right amount of revenue. The consequence of a water company not billing gap sites or voids appropriately is that other customers are charged more, as a water company will use this reduced customer base to recover its allowed **wholesale** revenue. Therefore, minimising gap sites and voids is important for affordability and fairness of charges.

Retail water businesses have a financial incentive to bill voids and gap sites, because otherwise they lose out on revenue allowed through our **retail** control. Wholesale businesses are also incentivised to ensure that bills are issued for sites incorrectly classified as voids and gap sites, as a way to manage estimated leakage³; they also face a reputational incentive to minimise average bills⁴.

However, there are currently also disincentives to taking action.

- It costs money to do so.
- It could harm a water company's service incentive mechanism (SIM) score, if it led to more complaints.
- It could increase water companies' bad debt charge, if the newly identified customers are particularly likely to default.

² Such sites are sometimes referred to as 'missing properties' in the residential market. We use the term 'gap site' to cover both the residential and business markets.

³ Estimated leakage accounts for estimated water entering water companies' networks and estimated consumption into the system. Therefore, gap sites and occupied voids can increase estimated leakage, because they are not included in estimated consumption while the water entering the system is unaffected.

⁴ Water companies' average bills can be found at discoverwater.co.uk/

3.1 Our assessment

We have considered different ways to encourage water companies to manage voids and gap sites appropriately, because:

- companies may not currently have sufficiently strong incentives in this area;
- [recent research](#) suggests the level of residential voids is often overstated (leading to other customers covering the revenue shortfall), because of poor quality customer data and the different approaches to void management adopted by the water companies; and
- some stakeholders (two business retailers in response to our draft methodology proposals and more recently, a company specialising in customer data) have said there are insufficient incentives to charge gap sites and/or voids, so they support an explicit financial incentive to encourage this.

As a result, we want to make sure water companies have the right incentives. We are concerned that without further action, this would not be achieved.

We have considered three options.

- **Option 1: No additional measures.** This option is the position we took in our draft methodology proposals. It includes some measures that may indirectly address our concerns by challenging companies to improve affordability and replacing SIM with the Customer Measure of Experience (C-MeX).
- **Option 2: Targeted intervention.** This option would involve us specifically covering voids and gap sites as part of our initial assessment of business plans; and requiring water companies to come forward with bespoke performance commitments to manage their voids and gap sites (or justify why they have not). This would strengthen the incentives for water companies to act to reduce gap sites and voids.
- **Option 3: Prescriptive approach.** This option would involve us setting a common performance commitment for voids and gap sites. As with Option 2, this would strengthen the incentives for water companies to act.

We did not propose any additional measures in our draft methodology proposals. However, given the recent research, stakeholders' views and our subsequent consideration of the issues discussed above, we have decided that stronger and more targeted incentives are required, because this would lead to fairer bills and improved affordability for existing customers. Table 2 provides a detailed assessment of these options.

Table 2 Assessment of the measures to address voids and gap sites in England and Wales

	Option 1: No additional measures	Option 2: Targeted intervention (chosen approach)	Option 3: Prescriptive approach
Achieving our objectives	<p>Our move to C-MeX will help to reduce the disincentive to take action, because the number of customer complaints and unwanted phone contacts that a company receives will no longer form a direct part of the financial incentive of C-MeX.</p> <p>Companies may better consider their voids and gap sites to some degree as part of their approach to improving affordability, which we are encouraging through our Initial Assessment of Plans.</p> <p>✓✓</p>	<p>This Option improves on Option 1 as it requires companies to design a bespoke performance commitment and set stretching targets and associated incentives to improve outcomes, where appropriate.</p> <p>✓✓✓</p>	<p>This Option improves on Option 1 by requiring companies to include a specific comparable performance commitment.</p> <p>✓✓✓</p>
How our objectives are achieved	<p>This approach gives companies maximum ownership and reduces regulatory burden by not introducing any additional measures. However, it may not be sufficient to change the incentives on companies to address voids and gap sites.</p> <p>✓</p>	<p>This approach is proportionate, targeted and gives companies ownership. It focusses on the specific issues and provides companies with the flexibility and tools to address them.</p> <p>✓✓✓</p>	<p>This Option has the benefit of creating a standardised approach, which could facilitate comparison and challenge of companies' approaches, it would not be proportionate or targeted, as a one-size-fits-all approach may not be appropriate.</p> <p>✓</p>

	Option 1: No additional measures	Option 2: Targeted intervention (chosen approach)	Option 3: Prescriptive approach
Practicality	<p>This approach is practical as it introduces no additional measures.</p> <p>✓✓✓</p>	<p>This approach is consistent with our approach to setting performance commitments. It also enables companies to justify not setting a performance commitment.</p> <p>✓✓</p>	<p>This Option would provide companies with clarity. However, there would be practical challenges as we would need to design a performance commitment to apply to all water companies. It is likely that the information about gaps and voids is not reliable or easy to obtain. Different water companies also face different circumstances which makes consistency difficult</p> <p>✓</p>